

**STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION**

THE PEOPLES GAS LIGHT AND COKE COMPANY)
Proposed general increase in) Docket No. 09-0167
Rates for Gas Service)

**CUB'S INITIAL BRIEF ON THE ISSUE OF
PEOPLES GAS LIGHT AND COKE COMPANY'S
PROPOSED RIDER ICR**

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Pursuant to Section 200.800 of the Rules of Practice of the Illinois Commerce Commission (“Commission” or “ICC”), 83 Ill. Admin. Code 200.800, and the briefing schedule set by the Administrative Law Judges (“ALJs”), the CITIZENS UTILITY BOARD (“CUB”), by its attorney, submits its Initial Brief on the issue of Peoples Gas Light & Coke Company’s (“Peoples,” “PGL” or the “Company”) proposed Rider ICR in this proceeding. For the reasons described in detail below, CUB opposes adoption of either Rider ICR or any of its alternatives.

I. INTRODUCTION

CUB submits this brief separately from its Joint Initial Brief with the City of Chicago (“City”) to address CUB’s opposition to the Company’s proposed rate-tracking mechanism entitled “Infrastructure Cost Recovery” rider or “Rider ICR.” This brief corresponds to the parties’ common outline Section VIII. Proposed New Rider ICR (PGL).

Peoples Gas proposed to use Rider ICR to implement its Accelerated Infrastructure Replacement Program to accelerate the replacement of its gas mains and services infrastructure and achieve modernization of its aging cast iron (“CI”) and ductile iron (“DI”) (together,

“CI/DI”) mains, as well as its antiquated low-pressure system. PGL Ex. SDM-1.0 at 2, LL. 28-30. Although Peoples currently has a CI/DI main replacement program in place and the current system is operating safely, the accelerated program would be a “prudent risk management decision.” PGL Ex. SDM-2.0 at 2, L. 41. Rider ICR includes all new, forecasted infrastructure investment in the following accounts: distribution mains, measuring and regulating station equipment, general; measuring and regulating station equipment, City Gate check stations; services; and a percentage of forecasted investments in meters, including meter installations, and house regulators. PGL Ex. VG-1.1 at 89 of 120. The rider would affect all residential, small commercial/small business, large volume demand and compressed natural gas service customers by imposing a surcharge on these customers’ bills. PGL Ex. VG-1.1 at 89 of 120.

If adopted, Rider ICR would recover the return on capital, depreciation expense, and incremental operation and maintenance (“O&M”) expenses associated with investments in its distribution infrastructure. The proposed tariff defines incremental O&M expenses as being those “arising from the cost of program management and additional labor,” but not including “any costs recovered in base rates in the Company’s most recent rate case.” AG/CUB Ex. 3.0 at 2, LL. 35-37. The Company proposes to include a cap on ICR revenues of 5% of annual ICR base rate revenues, (PGL Ex. VG-1.0 at 36, LL. 786), and an offset of \$6,000 per mile of main replaced to reflect estimated O&M expense savings (PGL Ex. VG-1.1 at 91 of 120). However, the rider would *not* reflect merely incremental investments in the eligible accounts over and above a baseline of typical annual investment amounts. Instead, it assesses surcharges for *all* new investments in these accounts. Tr. 58; 161-162. Although the proposed rider also includes a limit on the amount Peoples can collect annually – a “cap” of 5% of ICR base rate revenues

(PGL Ex. VG-1.14 at 3 of 12) – the total dollar amount that can be collected under Rider ICR will increase as base rates increase, each time Peoples files a new rate case.

CUB will not specifically address the operational need for such an accelerated program, except to note the flaws in the Company’s cost-benefit analysis. However, because the Company has not demonstrated that rider recovery is necessary to recover the costs of the program, and violates the legal prescriptions against rider recovery, the proposed rider should be rejected.

CUB and the Attorney General (collectively, “CUB-AG”) co-sponsored the testimony of Mr. Scott Rubin, who concluded that automatic rate adjustment mechanisms like Rider ICR violate the matching principle and destroy the underlying relationship between utility rates and levels of cost and investment. AG/CUB Ex. 3.0 at 6, LL. 101-103. Mr. Rubin articulated the regulatory construct that rate adjustment like Rider ICR should be used, if at all, only for significant expenses that are volatile and largely outside the utility’s control. *Id.* at 6, LL. 104-105. Further, CUB return on equity witness, Mr. Christopher Thomas, testified that Rider ICR reduces the variability in the Companies’ future cash flow and their risk of non-recovery of the associated costs, and thus reduces the Company’s overall risk of doing business. CUB-City Ex. 2.0 at 49, LL. 1236-38.

Staff of the Illinois Commerce Commission (“Staff”) also made clear its position that Rider ICR should be rejected. Staff witness Hathhorn nonetheless recommended several modifications to the tariff in the event the Commission approved the rider, in order to cure some of its more significant infirmities. Staff Ex. 1.0 at 36-43. Company witness Grace adopted many of Ms. Hathhorn’s proposed modifications in rebuttal testimony. NS-PGL Ex. VG-2.0 Rev. at 50-53. These modifications do not, however, cure the fatal legal and regulatory policy defects that necessitate denial of the Rider.

Rider ICR violates the prohibition against retroactive and single issue ratemaking, and violates the Public Utilities Act (“PUA”) requirement that all rates and other charges be just and reasonable and used and useful. Further, the Company failed to present compelling evidence to demonstrate that a rider is needed to recover costs associated with infrastructure replacement. For these reasons and those stated below, CUB joins Staff and the Illinois Attorney General in recommending that the Commission reject Rider ICR, whether as originally proposed or as modified pursuant to the Company’s adoption of Staff’s recommendations.

II. ARGUMENT

A. RIDER ICR FAILS TO SATISFY LEGAL AND REGULATORY CRITERIA JUSTIFYING SPECIAL RATE TREATMENT

1. Legal Criteria

The PUA requires that all utility rates and charges must be just and reasonable. 220 ILCS 5/9-101. Additionally, any significant addition to existing facilities or plant can only be included in a utility’s rate base if the Commission determines that it is both prudent and used and useful in providing utility service to the utilities’ customers. 220 ILCS 5/9-212. Rider ICR allows infrastructure costs to be added to rate base before the Commission makes the determination that the plant is prudent, used and useful. Thus, Rider ICR violates these provisions of the PUA by requiring customers to pay for infrastructure that has not been demonstrated to be used and useful or just and reasonable. Section 9-201(c) of the PUA further dictates that “the burden of proof to establish the justness and reasonableness of the proposed rates or other charges, classifications, contracts, practices, rules or regulations, in whole and in part, shall be upon the utility.” 220 ILCS 5/9-201(c). The PUA provides for very limited exceptions to the prohibition against single-issue ratemaking. CUB submits that Peoples Gas has

failed to meet its burden to justify exceptional rate treatment for the costs proposed to be collected in Rider ICR.

Illinois courts have upheld strict limitations to the use of rider mechanisms like Rider ICR to protect against single-issue and retroactive ratemaking, and to defend the fundamental principle that rates should be based on a comprehensive test year. The Illinois Supreme Court has circumscribed specific guidelines for Commission approval of riders that limit the use of these extraordinary ratemaking mechanisms to recovery of “unexpected, volatile or fluctuating expenses” that by their nature do not lend themselves to representative sampling in a single test year. *Citizens Utility Bd. v. Ill. Commerce Comm’n*, 166 Ill. 2d 111, 138-139, 651 N.E.2d 1089 (1995) (rider appropriate for recovery of “uncertain and variable” expenses associated with coal-tar cleanup remediation required by federal statute); *see also A. Finkl & Sons Co. v. Ill. Commerce Comm’n*, 250 Ill. App. 3d 317, 327, 620 N.E.2d 1141 (1st Dist. 1993) (“Riders are useful in alleviating the burden imposed upon a utility in meeting *unexpected, volatile or fluctuating* expenses.”) (emphasis in original); *City of Chicago v. Ill. Commerce Comm’n (City of Chicago II)*, 264 Ill. App. 3d 403, 405, 636 N.E.2d 704 (1st Dist. 1993) (rider appropriate “for recovery of costs that are uncertain in duration, timing or amount”); *City of Chicago v. Ill. Commerce Comm’n (City of Chicago I)*, 13 Ill. 2d 607, 150 N.E.2d 776 (1958) (accepting rider to accommodate fluctuating wholesale rates for natural gas).

Illinois courts have permitted riders to recover costs or fees required by statute or ordinance to all ratepayers or a subset of customers. *See Citizens Util. Bd.*, 166 Ill.2d at 138-139; *City of Chicago v. Illinois Commerce Comm’n*, 281 Ill. App. 3d 617, 627 (1st. Dist. 1996) (*City of Chicago III*) (rider recovery of franchise fees to be charged to residents of municipalities assessing the fees did not constitute single-issue ratemaking). *See City of Chicago II*, 264 Ill.

App. 3d at 410 (“Rider 28 allows Edison to look to those who cause costs to pay for them.”) Additionally, the PUA authorizes surcharges for fuel, environmental remediation, and water and sewage infrastructure costs. *See, e.g.*, 220 ILCS 5/9-220(a), 220 ILCS 5/9-220.1, 220 ILCS 5/9-220.2. Notably, the PUA does not contain a similar infrastructure rider provision for electric or gas utilities. More recently, the Legislature authorized rider recovery of energy efficiency program expenses, (220 ILCS 5/8-103(e), 220 ILCS 5/8-104(e)), and incremental bad debt, (220 ILCS 5/19-145).

2. Regulatory Criteria

Mr. Rubin testified that, according to well-established ratemaking principles followed throughout the nation and in Illinois, “utility rates are set based on a synchronized examination of all aspects of the utility’s cost of service and sources of revenue, as well as other considerations such as the quality of service and efficiency of management.” AG/CUB Ex. 3.0 at 5, LL. 85-87. One treatise on utility regulation discusses this synchronization, or the matching principle, as follows:

If the utility proposes a change, particularly a major change, in the test year rate base, it is required also to consider the related changes in other costs or in revenue. Additional investments may result in efficiencies that reduce operating costs or quality improvements that will increase sales. Unless the utility shows that it has taken such matters into account, its revenue requirement is likely to be out of balance or overstated.¹

For example, under normal circumstances, when a utility replaces an aging piece of equipment, it might increase rate base and depreciation expense, but it also could reduce maintenance expenses or produce other cost savings (such as reducing losses). *Id.* at 5, LL. 96-98. Rider ICR isolates costs of infrastructure without proper consideration of savings. Peoples’s proposal to include

¹ Leonard Saul Goodman, *The Process of Ratemaking* (1998), vol. II, p. 735.

savings of \$6,000 per mile of main replaced is a projection produced by Mr. Marano, (Tr. at 846), and does not represent a complete balanced analysis, synchronizing all aspects of the utility's cost of service, as required in a traditional test year rate proceeding.

Furthermore, the Commission has previously considered and rejected similar proposed infrastructure riders in the recent past. In fact, Peoples Gas proposed a nearly identical Rider ICR in its last rate case, ICC Docket No. 07-0242. There, the Commission rejected Peoples request, concluding the following:

In the case of Rider ICR, the Utilities' proposal is insufficient for the Commission to approve it. It might have been easier to approve the rider had the Utilities included, or the Staff or the Intervenors' elicited, such information as: a detailed description and cost analysis of the proposed system modernization; an identification and evaluation of the range of technology options considered and analysis and justification of the proposed technology approach; a detailed identification and description of the functionalities of the new system, related both to system operation as well as on the customer side of the meter, as well as an identification and justification of functionalities foregone; analysis of the benefits of the system modernization, both to system operation as well as to customers; these benefits should include reductions in system costs as well as an analysis of the range and benefits of potential new products and services for customers made possible by the system modernization; an analysis of regulatory mechanisms to allow companies to both recover their costs of system modernization as well as to flow reduced system costs back to customers; and an identification and analysis of legal or regulatory barriers to the implementation of system modernization proposals. Since we reject Rider

ICC Docket No. 07-0242, Order at 162. Importantly, the Commission did not state that if these conditions were met it would approve an infrastructure rider – only that it “might have been easier to approve” a rider if these provisions were included in the request.

In the most recent Nicor Gas² rate case, the Commission similarly rejected a proposal for a cast iron main replacement program – what Nicor termed Rider QIP (Qualifying Infrastructure Program). The Commission concluded that Nicor has “provided us with no reason to impose the additional cost of ‘better keeping pace’ upon ratepayers, many of whom are, as Nicor has acknowledged, facing difficult financial times.” ICC Docket No. 08-0363, Final Order (Mar. 25, 2009) at 1709. Mr. Rubin likewise concluded that Peoples has not shown it is necessary – not to mention fair to customers – to have a capital-cost recovery rider begin with the first dollar of investment as opposed to setting a base level of investment that would be treated under traditional regulatory concepts (as Nicor had proposed).” AG/CUB Ex. 3.0 at 8, LL. 161-164.

Rider ICR does not address or respond to issues of volatility or uncertainty or costs beyond the control of management. In fact, the Company does not argue costs under Rider ICR are unexpected or volatile, nor could it, since these costs are well within the control of management. Instead, costs of financing basic infrastructure investment are the most central investment a gas utility can make, considering it is the means by which the utility is able to perform its obligation to deliver natural gas to its customers. In fact, Peoples has an existing CI/DI main replacement program for years, and has been able to undertake this investment - and maintain and “prudently operate” its gas distribution system (PGL Ex. SDM-1.0 at 9, LL. 176-177) - without a special rider until now. Nor does Rider ICR fit within any of the statutory or judicially-recognized exceptions allowing rider recovery of specific costs. In sum, Peoples Gas’s proposed Rider ICR is deficient as a matter of law and fails to satisfy regulatory requirements for rider treatment and should therefore be rejected.

² Northern Illinois Gas Company d/b/a Nicor Gas Company.

B. THE COMPANY HAS NOT SUBSTANTIATED A NEED FOR EXTRAORDINARY RATE TREATMENT

AG/CUB witness Scott Rubin, as well as Staff witnesses Sheena Kight-Garlich and Peter Lazare, all agreed the Company failed to prove that Rider ICR is needed or appropriate. Staff witness Kight-Garlich, for example, noted that the Company identified two other methods that allow “prompt and fair rate recovery” - traditional rate case filings with a future test year or a deferral mechanism - both of which the Company rejected in favor of Rider ICR. ICC Staff Ex. 8.0 at 22. Ms. Kight-Garlich testified that the Company provided no analysis to support its need for Rider ICR to raise sufficient capital to provide adequate, efficient, reliable and safe utility service at a reasonable cost. *Id.* Staff witness Lazare was particularly critical of Mr. Schott’s assertion that Rider ICR would somehow “keep the capital costs associated with the infrastructure improvement reasonable.” PGL Ex. JS-1.0 at 14. Mr. Lazare noted that Mr. Schott provided no specific evidence concerning what the capital costs for the program would be with and without Rider ICR. ICC Ex. 9.0 at 4. The Company’s responses to various Staff and AG data requests confirmed this fact. For example, the Company created no financial models to estimate the effects on the company’s financial position, with or without Rider ICR, if it adopted an infrastructure replacement program that ended in 2030, as recommended by PGL witness Salvatore Marano. ICC Staff Ex. 8.0, Attachment B, at 2,-3 and 7.

Peoples failed to show that the existence or absence of Rider ICR would affect its cost of capital, impact its capability to finance necessary improvements, or jeopardize its ability to provide safe and reliable service to its customers. AG/CUB Ex. 3.0 at 4-5. In fact, Mr. Schott made clear that proposed Rider ICR is desired because of the “greater level of certainty of recovery on and of the investment in cast iron main, even more critical to keep the capital costs associated with the infrastructure improvement reasonable.” PGL Ex. JFS-1.0 at 14, LL. 288-89.

Peoples Gas could accelerate its program, as desired, without the use of extraordinary rate treatment while maintaining the balanced test year review process. Instead, the Company holds the proverbial gun to the Commission's head by stating that approval Rider ICR, among other factors, would dictate whether Peoples Gas would proceed with the accelerated program. Tr. at 67. Yet, at the same time, the Company refuses to commit to the accelerated program, even if Rider ICR is approved by the Commission:

- Q.** But approval of the rider, in and of itself, would not necessarily dictate the pace or, in fact, whether or not the acceleration would occur; is that correct?
- A.** That's correct.

Tr. at 61 (Schott). Thus, if awarded Rider ICR by this Commission, Peoples Gas could refuse to implement the accelerated program, yet nonetheless begin to collect revenue for all incremental costs associated with new infrastructure investment – even if not related to the accelerated main replacement program.

C. RIDER ICR DECREASES UTILITY RISK, PROVIDES FOR EXCESSIVE RETURNS FOR THE COMPANY, AND UNREASONABLY INCREASES CUSTOMER COSTS

Mr. Rubin concludes that the net effect on the revenue requirement associated with the capitalized O&M costs is that customer would be required to pay an additional \$128.8 million in rates over the 19-year period of the proposed accelerated replacement program. AG/CUB Ex. 6.0 at 2-3, LL. 40-42. Mr. Rubin presented unrebutted comparison of the total revenue requirement effect of Mr. Marano's preferred 2030 date and the 2059 date that exists under the current accelerated main replacement plan. AG/CUB Exhibit 6.05 shows the revenue requirements associated with Peoples' current main replacement program: the total capital-related revenue requirement (that is, pre-tax return and depreciation) associated with continuing this program through the year 2059 (the end year of the existing acceleration program) is \$8.87 billion. *Id.* at 5-6. On Exhibit 6.06, Mr. Rubin shows that the comparable figure for Mr.

Marano's recommended 2030 end-date accelerated program, including the capitalized O&M that would be collected under Rider ICR is \$11.94 billion. *Id.* at 6. Thus, contrary to the assertions in Mr. Marano's testimony that customers would experience a net benefit from the accelerated investment program, (PGL Ex. SDM-1.0 at 54, LL. 994-95), when a proper revenue requirement analysis is performed that compares the costs customers actually would pay *and the revenue the Company actually would receive*, the Company's accelerated program is significantly *more* expensive to customers – by more than \$3 billion – than is the continuation of Peoples' existing replacement program.

The rate of return credit proposed by the Company would not protect customers from paying excessive rates. First, the 5% cap built into the rider would increase the allowed dollars under Rider ICR each time rate base grows – i.e. when the utility files a rate case. Second, Mr. Rubin noted that with the magnitude of the accelerated program highlighted in Mr. Marano's testimony, the “cap” would be reached somewhere between every year and every two years for the entire length of the program. Thus, in order for the Company to continue spending money and earning a return on it, as envisioned in the Rider ICR tariff and Mr. Marano's suggested time frame, Mr. Rubin determined that Peoples would need to file rate cases every year or two to reset the base revenue amount built into the 5% cap. *Tr.* at 993. Third, the rate of return credit reduces the authorized rate of return to account for infrastructure investment only when the company is earning more than its authorized rate of return. The credit does not affect excess revenues due to weather or exceptional cost control. Thus, the Company could still earn returns in excess of its authorized rate of return. NS/PG Ex. JFS-3.0 at 5-6, LL. 106-116.

Mr. Rubin's analysis demonstrates that customers of Peoples Gas will pay significantly more under the accelerated program. Mr. Rubin's own comparison of the Company's annual

estimate of cost savings under a 2030 acceleration with the revenue requirement for the capitalized O&M costs shows that the total O&M expense savings during this period, as projected by Peoples, is approximately \$99.6 million. AG/CUB Ex. 6.01 In contrast the revenue requirement associated with the capitalized O&M costs is approximately \$228.4 million. *Id.* The net effect is that customers would be required to pay an additional \$128.8 million in rates - at a minimum - over the 19-year period of the proposed accelerated replacement program. Mr. Rubin noted, too, that capitalized O&M is just one component of investment that Peoples proposes to recover through Rider ICR. AG/CUB Ex. 6.0 at 3, LL. 41-42.

Mr. Schott confirmed that even with Rider ICR, the Company's overall revenue requirement will increase under Mr. Marano's recommended completion date. Tr. at 66-67. Mr. Schott testified, too, that the adoption of Rider ICR will not protect customers from future rate increase requests:

The Company – Integrys' position with regard to its regulated utilities, including Peoples Gas and North Shore Gas, is we to expect earn our authorized return. And to the extent revenues are insufficient for us to earn that authorized return, we will file rate cases as needed.

Tr. at 63. The significant increase in revenue requirements triggered by a 2030 acceleration date, along with the Companies' position that "we expect to earn our authorized return," and will file rate cases as needed, argue strongly against approving extraordinary rate recovery.

III. CONCLUSION

Peoples Gas' proposed Rider ICR is unacceptable and should be rejected by the Commission for the following reasons: it fails to satisfy legal and regulatory criteria to justify extraordinary rate treatment outside the traditional, balanced test year analysis; Peoples Gas has

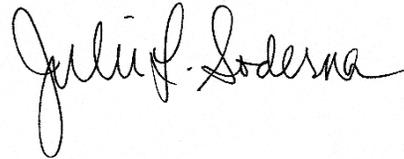
failed to demonstrate a need for the extraordinary treatment in lieu of filing traditional rate cases; and Rider ICR decreases utility risk, provides for excessive returns for the Company, and unreasonably increases customer costs.

WHEREFORE, for the reasons stated herein, CUB respectfully requests that the Commission reject the Company's proposed Rider ICR in all its proposed forms.

Respectfully submitted,

CITIZENS UTILITY BOARD

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