**STATE OF ILLINOIS**
**ILLINOIS COMMERCE COMMISSION**

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| **North Shore Gas Company** | : | |
| | : | **Docket No. 09-0166** |
| **Proposed General Increase in Rates for Gas Service** | : | |
| | : | **(cons.)** |
| **The Peoples Gas Light and Coke Company** | : | |
| | : | **Docket No. 09-0167** |
| **Proposed General Increase in Rates for Gas Service** | : | |

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**INITIAL BRIEF OF THE**
**STAFF OF THE ILLINOIS COMMERCE COMMISSION**


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September 29, 2009

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Staff of the Illinois Commerce Commission ("Staff"), by and through its counsel, pursuant to Section 200.800 of the Rules of Practice (83 Ill. Adm. Code 200.800) of the Illinois Commerce Commission's ("Commission"), respectfully submits its Initial Brief in the above-captioned matter.

# I. INTRODUCTION

## A. Overview/Summary

North Shore Gas Company ("North Shore") and the Peoples Gas Light and Coke Company ("Peoples Gas") (individually, the "Company" and collectively the "Companies") filed new tariff sheets on February 25, 2009 in which the Companies proposed general increase in their natural gas rates. On March 25, 2009 the Companies' tariff sheets were suspended by the Commission and on July 8, 2009 the

Commission entered a Re-suspension Order extending the suspension to and including January 24, 2010. In due course, the Administrative Law Judges ("ALJs") assigned to this proceeding established a schedule for the submission of pre-filed testimony, hearings and briefs. (Notice of Administrative Law Judges' Ruling, April 27, 2009)

In response to the Company's filing, the following parties filed Petitions to Intervene, which were granted: The People of the State of Illinois *ex rel.* Lisa Madigan, Attorney General of the State of Illinois (the "AG"), Citizens Utility Board ("CUB"), the City of Chicago ("City") (collectively, "AG/CUB/City," Government and Consumer Interveners" or "GCI"); Illinois Industrial Energy Consumers ("IIEC"); Dominion Retail, Inc., Interstate Gas Supply of Illinois, Inc. and Nicor Advanced Energy, L.L.C., (collectively, the "Retail Gas Suppliers" or "RGS"); and Constellation NewEnergy-Gas Division ("CNE-Gas").

The following witnesses submitted testimony on behalf of the Staff of the Illinois Commerce Commission ("Staff"): Dianna Hathhorn (ICC Staff Exhibit ("Ex.) 1.0; ICC Staff Ex. 15.0), Bonita A. Pearce (ICC Staff Ex. 2.0; ICC Staff Ex. 16.0), Mike Ostrander (ICC Staff Ex. 3.0; ICC Staff Ex. 17); Mary Everson (ICC Staff Ex. 4.0; ICC Staff Ex. 18.0), Richard Bridal (ICC Staff Ex. 5.0; ICC Staff Ex. 19.0); Larry Wilcox (ICC Staff Ex. 6.0; ICC Staff Exhibit 20.0); Michael McNally (ICC Staff Ex. 7.0R; ICC Staff Ex. 21.0); Sheena Kight-Garlisch (ICC Staff Ex. 8.0; ICC Staff Ex. 22.0); Peter Lazare (ICC Staff Ex. 9.0); Cheri L. Harden (ICC Staff Ex. 10.0; ICC Staff Ex. 24.0); Christopher Boggs (ICC Staff Ex. 11.0; ICC Staff Ex. 25.0); David Sackett (ICC Staff Ex. 12.0R; ICC Staff Ex. 26.0); Brett Seagle (ICC Staff Ex. 13.0; ICC Staff Ex. 27.0); Harold Stoller (ICC Staff

Ex. 14.0; ICC Staff Ex. 28.0); Darin Burk (ICC Staff Ex. 23.0); and David Rearden (ICC Staff Exhibit 29.0).

During the course of the proceeding, Staff proposed various adjustments and changes to the Companies' February 25, 2009 request. The Companies accepted certain of Staff's modifications and Staff withdrew others. A summary of Staff's final recommendations to the Commission in this proceeding for Peoples Gas and North Shore are attached hereto, respectively, as Appendix A and Appendix B. Also, attached as part of Appendix A and Appendix B are Staff's revised Revenue Requirements. For the reasons stated below, Staff's proposed adjustments should be adopted by the Commission.

### B. Nature of Operations

#### 1. North Shore

#### 2. Peoples Gas

## II. TEST YEAR (Uncontested)

## III. REVENUE REQUIREMENT

### A. North Shore

### B. Peoples Gas

## IV. RATE BASE

### A. Overview/Summary/Totals

#### 1. North Shore

Staff recommends the Commission adopt a rate base of $177,867,000 as reflected on page 4 of Appendix B to Staff's Initial Brief.

#### 2. Peoples Gas

Staff recommends the Commission adopt a rate base of $1,170,346,000 as reflected on page 4 of Appendix A to Staff's Initial Brief.

### B. Uncontested Issues (All Subjects Relate to NS and PGL Unless Otherwise Noted)

#### 1. Natural Gas Prices for Purposes of Cushion Gas (PGL), Gas in Storage, and Cash Working Capital

Natural gas prices directly affect the cost of Cushion Gas, Gas in Storage and Cash Working Capital. ICC Staff Ex. 29.0, p. 3. Gas prices affect rate base through the Last In First Out ("LIFO") price. The LIFO price is the total average cost of gas, including transportation and storage. Id., p. 2.

The Companies calculated their costs using a future test year, therefore, natural gas prices need to be forecasted in order to calculate these costs. Id., p. 3. The forecasts used were the New York Mercantile Exchange ("NYMEX") futures prices adjusted for the different locations at which the Companies buy gas and for any hedging. Id., p. 3. NYMEX prices are updated every trading day; accordingly there are many forecasts to choose from. Id., p. 3-4.

Prices were periodically updated in order to find the most recent, and presumably more accurate, set of prices for the test year. Id., pp. 4-5 and Attachments 3-NS and 3-PGL. Peoples Gas and North Shore filed their cases using June 2008 prices, but updated those prices using February 2009 prices in a response to a Staff data request. Id., p. 4. The February 2009 prices were substantially lower than the June 2008 prices, (Id., p. 5) and Staff used them to formulate adjusted costs in direct testimony. In the Companies' rebuttal testimony, they developed costs based upon prices in June 2009. NS-PGL Ex. JH-2.0, pp. 5-7. By the time Staff was scheduled to file its rebuttal testimony at the end of August, futures prices had fallen below the June 2009 levels. ICC Staff Ex. 29.0, p. 5. Staff's position was that, since the February 2009 prices were closer to current levels than the June 2009 prices, costs were better represented by February 2009 prices. Id., p. 6. In surrebuttal, the Companies' updated prices again, this time to August 2009 prices. NS-PGL Ex. JH-3.0 at 4-6. Staff does not contest these prices. Tr., pp. 914-915, August 27, 2009. The final adjustments reflecting the uncontested prices for Peoples Gas are reflected in Appendix A, page 3 column (k), page 6, columns (f) and (g), and page 7 column (k). The final adjustment for North Shore is reflected in Appendix B, page 5 column (e).

### 2. Plant

#### a. Original Cost Determinations as to Plant Balances as of 12/31/07

Staff witness Bridal recommends the Commission approve $2,524,981,000 and $398,956,000 as the original cost of plant in service for Peoples Gas and North Shore , respectively, as of December 31, 2007. These balances consist of the balance from each Company's Schedule B-5 (Companies' Section 285.2030 Schedule B-5, p. 1 of 2, Line 14, Column F) reduced by Staff's proposed adjustment for capitalized incentive compensation costs the Commission disallowed in each Company's prior rate case. ICC Staff Exhibit 15.0, Schedules 15.7 P and 15.7 N, p. 5, line 4. For Peoples Gas, the $2,524,981,000 balance equals $2,525,147,000 (Peoples Gas Section 285.2030 Schedule B-5) minus $166.000. ICC Staff Exhibit 15.0, Schedule 15.7 P. For North Shore, the $398,956,000 equals $398,983,000 (North Shore Section 285.2030, Schedule B-5) minus $27,000. ICC Staff Exhibit 15.0, Schedule 15.7N. Staff and the Companies agree that the Commission should make original cost findings regarding the Companies' plant as of December 31, 2007. NS-PGL Ex. JH-2.0, pp. 17-18. Given Staff witness Bridal's recommendation regarding the original cost determination (ICC Staff Ex. 5.0, p. 9), Staff recommends the Commission's order state as follows:

It is further ordered that the $2,524,981,000 original cost of plant for Peoples Gas at December 31, 2007, as reflected on the Company's Schedule B-5, Page 1 of 2, Line 14, Column F; and the $ $398,956,000 original cost of plant for North Shore at December 31, 2007, as reflected on the Company's Schedule B-5, Page 1 of 2, Line 12, Column F, are unconditionally approved as the original costs of plant.

### b. Capitalized Union Wages

Staff witness Hathhorn proposed adjustments to reduce each of the Companies' rate base and operating expenses to correct their error in calculating the test year union wages at the non-union rate. ICC Staff Ex. 1.0, Schedules 1.9 P and N, Union Wages Adjustment. The Companies accepted Staff's adjustments. NS-PGL Ex. JH-2.0, p. 4.

### c. Capitalized Civic, Political, and Related Activities

### d. Net Dismantling

The Commission should accept the revised pro forma adjustment to Net Dismantling the Companies proposed in rebuttal (NS-PGL Ex. SM-2.0, p. 6, l. 129-134) which Staff does not contest. ICC Staff Ex. 18.0, p. 3, lines 54-58.

Staff witness Mary H. Everson proposed an adjustment to the Companies' pro forma adjustment for Net Dismantling related to her proposed adjustment to forecasted plant additions. ICC Staff Ex. 4.0, p. 9, lines 200-206. The Companies did not contest that an adjustment was appropriate. However, the Companies disagreed with the calculation and provided a revised adjustment to Net Dismantling based on its revised level of forecasted plant additions in the rebuttal testimony of Sharon Moy. NS-PGL Ex. SM-2.0, p. 6, lines 129-134. Ms. Everson did not contest this revision to the Net Dismantling pro forma adjustment proposed by Peoples Gas and North Shore in rebuttal. ICC Staff Ex. 18.0, p. 3, lines 54-58.

### e. Gathering System Pigging Project (PGL)

Staff witness Seagle initially recommended the removal of all of Peoples Gas' requested costs associated with the Gathering System Pigging Project at the Manlove Storage field based on the Company's failure to provide sufficient documentation to allow Staff to determine if the project was prudent and used and useful. ICC Staff Ex. 13.0, pp. 7-8 and ICC Staff Ex. 27.0, pp. 7-10.

In response to Staff's concerns, Peoples Gas provided additional support for this project. NS-PGL Ex. TLP-3.0 pp. 2-3, TLP-3.1, and TLP-3.2. The information provided by the Company alleviated Staff's concerns regarding the Gathering System Pigging project and Staff no longer disputes the Company's request to include the costs associated with this project in its requested rates. Tr., pp. 910-911, August 27, 2009.

**f. Cushion Gas – Recoverable (PGL)**

Staff witness Seagle expressed a concern that Peoples Gas relied on overstated gas prices for its forecasted recoverable cushion gas injections for 2009 and 2010. ICC Staff Ex. 13.0, pp. 3-5. Mr. Seagle recommended that the Company provide an update of its additional recoverable cushion gas injection valuation, using the most recent gas pricing information available. *Id.*, p. 6. The Company agreed with Staff's request and provided a revised calculation for its recoverable cushion gas injections for 2009 and 2010 using the most up-to-date pricing available for the price of natural gas. NS-PGL CMG-3.0, pp. 3, 5-6. Staff accepted Peoples Gas' revised calculation for the value associated with its recoverable cushion gas injections in 2009 and 2010. Tr., p. 915, August 27, 2009. The final adjustment reflecting the uncontested prices for Peoples Gas is reflected in Appendix A, page 6 column (f).

**g. Cushion Gas – Non-recoverable (PGL)**

Staff witness Seagle expressed a concern that Peoples Gas relied on overstated gas prices for its forecasted non-recoverable cushion gas injections for 2009 and 2010. ICC Staff Ex. 13.0, pp. 3-5. Mr. Seagle recommended that the Company provide an update of its additional non-recoverable cushion gas injection valuation, using the most recent gas pricing information available. *Id.* p. 6. Cushion gas, a/k/a base gas, is the volume of gas required in a storage reservoir to provide adequate pressure to cycle the working gas in and out of the reservoir. Cushion gas is usually broken down into recoverable cushion gas and non-recoverable cushion gas. Recoverable cushion gas is the gas that the company expects to be able to recover from the field when it is retired. The non-recoverable cushion gas is the gas that the company does not expect to recover from the field when the field is retired. *Id*., pp. 4-5. The Company agreed with Staff's request and provided a revised calculation for its non-recoverable cushion gas injections for 2009 and 2010 using the most up-to-date pricing available for the price of natural gas. NS-PGL CMG-3.0, pp. 3, 5-6. During cross examination, Staff witness Dr. Rearden who was Staff' expert witness on the price of natural gas accepted Peoples Gas' revised price for natural gas to be used in the calculation for the value associated with its non-recoverable cushion gas injections in 2009 and 2010. Tr., p. 915, August 27, 2009. As such, Staff now accepts the Company's revised calculation for the value associated with its non-recoverable cushion gas injections in 2009 and 2010. The final adjustments reflecting the uncontested prices for Peoples Gas are reflected in Appendix A, page 3, column (k), and page 6, column (g).

**h. Capitalized Savings Plan Costs**

**i. Gathering System Replacement Project Phase 1**

Staff witness Seagle recommended the removal of all of Peoples Gas' requested costs associated with the Gathering System Replacement project at the Manlove Storage field. Mr. Seagle noted the Company was unable to demonstrate the project will be prudently incurred and used and useful. ICC Staff Ex. 13.0, pp. 7-8.

Peoples Gas provided additional information regarding phase 1 of this project in its rebuttal testimony. This additional information alleviated Staff's concerns about Phase 1 of the Gathering System Replacement project. Staff no longer disputes

Peoples Gas request to include the costs associated with Phase 1 of the Gathering System Replacement project in its proposed rates. ICC Staff Ex. 27.0, p. 11.

### 3. Accumulated Reserve for Depreciation and Amortization

#### a. Inventory Reclassification

Staff witness Hathhorn proposed adjustments to reflect in operating expenses and rate base the impact of the inventory reclassifications made as a result of the Schlumberger Data & Consulting Services study ("DCS study"). ICC Staff Ex. 1.0, Schedules 1.11 P and N, Inventory Reclassification Adjustment. The reclassification adjustments resulting from the DCS study were not included in the Companies' test year Schedules B-1 and C-1. The Companies accepted Staff's adjustments. NS-PGL Ex. JH-2.0, p. 4.

### 4. Materials and Supplies Correction

### 5. Gas in Storage

GCI witness David Effron raised a concern that the forecasted price of gas in the test year impacted the Companies' gas in storage inventories. Mr. Effron recommended that the Companies update their test year gas in storage inventories to reflect updated gas prices as well as the volume of gas the Companies relied upon in its calculation. GCI Ex. 1.0, p. 10. Staff witness Seagle agreed with Mr. Effron's concern regarding the gas pricing, but did not agree with the volumes that Mr. Effron relied upon in his calculation. ICC Staff Ex. 27.0, pp. 13-14.

In response to the concerns raised by Mr. Effron and Staff, the Companies provided a revised gas in storage calculation that used updated gas prices and corrected for an error they had made in their volume calculation. NS-PGL Ex. JH-3.0, pp. 5-6. Staff accepted the Companies revised calculation for their valuation of the gas in storage inventories. Tr., p. 915, August 27, 2009. The final adjustment reflecting the uncontested prices and the error correction for Peoples Gas is reflected in Appendix A, page 7, column (l). The final adjustment for North Shore is reflected in Appendix B, page 5, column (e).

### 6. Methodology to Account for Amortization of Remaining Pre-Merger Unamortized costs

In the Companies' prior rate case, Docket No. 07-0241/0242 (Cons.), the Companies were allowed by the Commission to begin recovering costs to achieve ("CTA") their merger which was approved in Docket No. 06-0540. Staff witness Pearce proposed an adjustment to reconcile total recoveries collected through existing rates and those that will be recovered as a result of the instant proceeding with actual CTAs incurred to date and projected through the remainder of 2009. This adjustment is necessary because the Companies have already begun recovering a portion of the merger CTAs. In the prior rate case, the Commission recognized that some CTA costs would not actually have been incurred yet. Since then, additional costs have been incurred and, according to the Companies' projections for the 2010 test year, all CTA will be incurred by the end of 2009. Accordingly, the instant proceeding is the appropriate time to reconcile recoveries of CTA with actual CTA incurred.

Ultimately, Staff and the Companies reached agreement as to the amount of this adjustment, which reflects actual CTA incurred by the Companies through July 31, 2009 and the estimated CTA to be incurred during the remainder of 2009. NS-PGL Ex. SM-3.0 REV, p. 6. The final adjustments that reflect this agreement were presented at the hearing as NS-PGL Cross Ex. Pearce 25.

### C. Plant (All Subjects Relate to NS and PGL Unless Otherwise Noted)

#### 1. Forecasted Plant Additions

The Commission should accept the revised level of forecasted plant additions the Companies proposed in rebuttal (NS-PGL JH-2.3N and JH-2.3P) which Staff does not contest. ICC Staff Ex. 18.0, pp. 2-3, l. 34-49.

Staff witness Mary H. Everson proposed reductions to Peoples Gas' and North Shore's revenue requirements since the Companies had made several statements that called into question the level of forecasted plant additions. Companies' witness James Schott discussed the effort Peoples Gas and North Shore had taken to reduce current and future costs and stated that the revenue requirement would be changed based on decisions made at a later time. NS-PGL Ex. JFS-1.0, p. 4, lines 81-86. The Companies' Section 285.7025, Assumptions Used in the Forecast, stated that the Companies would likely reduce their 2009-2010 capital expenditures in response to the current economic slowdown. North Shore Section 285.7025, Schedule G-5, page 6 of 6; Peoples Gas Section 285.7025, Schedule G-5, page 6 of 7. Further, in response to data requests, Peoples Gas and North Shore quantified the level of reductions to their 2009-2010 forecasted levels of plant additions they were considering. ICC Staff Ex. 4.0, pp.5-7, line 83-138. Ms. Everson testified that the Companies' responses to various data requests collectively gave the impression that only under a seemingly perfect set of circumstances as described in Peoples Gas' and North Shore's data request responses, would the 2009 and 2010 forecasted level of plant additions be achieved. Ms. Everson concluded that the Companies had not demonstrated a commitment to proceeding with the forecasted levels of plant additions and that an adjustment was appropriate. ICC Staff Ex. 4.0, p. 9, line 184-192.

In his rebuttal testimony, John Hengtgen testified that the Companies agreed that the level of forecasted plant additions should be reduced, but that the Company did not agree with certain related adjustments. NS-PGL Ex. JH-2.0, p. 4, line 83-92. Peoples Gas and North Shore witness Hengtgen provided a revised level of forecasted plant additions in rebuttal. NS-PGL JH-2.3N and JH-2.3P.

After reviewing the Companies' responses to data requests related to the revised level of forecasted plant additions, Ms. Everson testified in rebuttal that she had no objection to the Companies' revised levels of forecasted plant additions. ICC Staff Ex. 18.0, pp. 2-3, lines 34-49.

**2. Gathering System Phase 2 Project (PGL)**

Staff disputes Peoples Gas' request to include Phase 2 of its Gathering System project into its requested rates. Specifically, Staff testified that Peoples Gas failed to provide sufficient information to demonstrate that Phase 2 of the project would be prudently incurred and used and useful. Next, Staff noted that Peoples Gas failed to demonstrate that it is pursing this project prior to the end of the 2010 test year. Finally, Staff noted that Peoples Gas' reduction of the test year cost estimates associated with the project supports Staff's concerns that the project is speculative. Therefore, Staff recommended the removal of Peoples Gas' requested costs associated with Phase 2 from its requested rates.

Peoples Gas proposed Gathering System Replacement project is a two-phase project. Phase 1 involves an engineering study to assess the existing system and the development of an optimized replacement plan. PGL Ex. TLP-1.0, p. 8. Staff does not dispute Peoples Gas' request to include the cost of Phase 1 of the project in its rates. ICC Staff Ex. 27.0, p. 11.

Phase 2 of the project involves either the complete or partial replacement of the gathering system at Peoples Gas' Manlove storage field. Peoples Gas also explained that it is only after Phase 1 of the project is completed will it prepare a cost benefit analysis and business case for the project and then seek approval for any expenditures from the Board of Directors. Peoples Gas also indicated under either option (partial or complete replacement), the test year costs would be the same and that the project may take up to 10 years to complete. PGL Ex. TLP-1.0, pp. 9-10.

Staff witness Seagle expressed three concerns regarding the inclusion of the costs associated with Phase 2 of the Gathering System project in Peoples Gas' proposed rates. First, Mr. Seagle was concerned that Peoples Gas was unable to provide sufficient information to demonstrate that the project to replace a portion of the gathering system at the Manlove storage field will be prudently incurred and used and useful. Second, Peoples Gas failed to demonstrate that it is pursing this project prior to the end of the 2010 test year. Finally, Peoples Gas' reduction of the cost associated with the project in the test year demonstrated the speculative nature of the Company's request. As a result, Mr. Seagle recommended the removal of all of the costs associated with Phase 2 of the project from the Company's proposed rates. ICC Staff Ex. 13.0, pp. 7-8, 12.

Regarding Staff's first concern Mr. Seagle noted that Peoples Gas must meet the requirements of Section 9-211 of the Public Utilities Act ("Act") to include the cost of

Phase 2 of its Manlove gathering system project into its proposed rates. ICC Staff Ex. 13.0, p. 8. Specifically, this section of the Act states as follows:

> The Commission, in any determination of rates or charges, shall include in a utility's rate base only the value of such investment which is both prudently incurred and used and useful in providing service to public utilities customers.

220 ILCS 5/9-211.]

He further noted that the Act provides a definition of used and useful in Section 9-212 of the Act (*Id*.) which states:

> A generation or production facility is used and useful only if, and only to the extent that, it is necessary to meet customer demand or economically beneficial in meeting such demand.

220 ILCS 5/9-212.

Finally, Mr. Seagle pointed out that in prior cases the Commission has provided guidance regarding the requirements for prudence. *Id*., p. 9. Namely, in Docket No. 88-0142, the Commission defined prudence as follows:

> Prudence is that standard of care which a reasonable person would be expected to exercise under the same circumstances encountered by utility management at the time decisions had to be made. In determining whether a judgment was prudently made, only those facts available at the time judgment was exercised can be considered. Hindsight review is impermissible.

ICC Docket No. 88-0142, Order February 5, 1992, pp. 25-26.

In other words, Peoples Gas must demonstrate the project is necessary or economically beneficial to customers as well as the prudence of its decision-making associated with the project. However, the Company itself admits that the cost benefit analysis and business case that it expects to demonstrate that the project will be prudent and used and useful will not be developed until 2009. Peoples Gas Ex. TLP-

1.0, p. 10. While Peoples Gas admits these documents are required for it to demonstrate to its Board of Directors that expenditures should be made on the project, Peoples Gas failed to provide these documents for the record in this proceeding for the Commission to review and make a decision on the prudence and used and usefulness of the project.

Peoples Gas was unable to provide such documentation because it must wait on the result of its Phase 1 engineering study to determine the scope and need for Phase 2 of the project. Phase 1 of the project was only recently initiated, July 2009 with a project kick-off meeting with the selected engineering firm the week of July 13, 2009, and Peoples Gas projects a completion date of November 2009. NS-PGL TLP-2.0, p. 5.

Mr. Seagle indicated that documentation, such as a cost benefit analysis or business case is necessary in order for it to determine if a project is prudent and used and useful. ICC Staff Ex. 13.0, p. 11. Without such information, Peoples Gas cannot demonstrate how it reached a decision, demonstrate a benefit, or show a need for the project.

Peoples Gas claimed that it needs to proceed with the project due to a concern for $CO_2$-related and microbial-influenced corrosion in the gathering system. The Company also indicated the existing gathering system at the Manlove storage field was not designed to accommodate pipeline pigs for either routine cleaning or internal inspection. Finally, the Company noted that a program for replacement should begin before the gathering system reaches the end of its useful life. PGL Ex. TLP-2.0, p. 9.While Staff does not disagree, the existing system cannot accommodate pipeline pigs, Peoples Gas failed to demonstrate the gathering system corrosion has reached a point that the gathering system at Manlove needs replacement or that the gathering system has reached the end of its useful life. Instead, Staff witness Seagle noted the only support that Peoples Gas provided for its claims was a slide show presentation where it made unsubstantiated claims of increased safety and reliability associated with the project. In short, Peoples Gas did not provide to the record any documentation regarding how the replacement project was needed or will benefit its ratepayers. ICC Staff Ex. 13.0, p. 11.

Peoples Gas also failed to provide any documentation that demonstrates the prudence of its decision to replace the Manlove storage field gathering system. In fact, People Gas lacks the basic information that supports its conclusion that it needs to replace the gathering system. This same lack of information also makes it impossible for the Company to demonstrate the used and usefulness of this proposed project. As such, Staff concluded that Peoples Gas failed to demonstrate the prudence and used and usefulness of Phase 2 of its proposed Gathering System Replacement project.

Regarding Staff's second concern that Peoples Gas failed to demonstrate that it is pursing this project prior to the end of the 2010 test year, Mr. Seagle noted that the absence of a completed engineering study (Phase 1 of project) and the absence of a cost benefit analysis or business case for the project demonstrates that the Company cannot produce a definitive timeline for the project. Mr. Seagle noted that the recent issuance of the engineering study RFP (Phase 1) indicated Peoples Gas was still at the starting point in determining what, if anything, needs replaced at the Manlove storage field. ICC Staff Ex. 13.0, pp. 11-12.

Peoples Gas has provided a proposed timeline for Phase 2 of the project that indicates it intends to start work on the gathering system in early 2010. However, the Company admits that the determination of the length of time needed for the completion of the project and the approximate start date of the project requires the completion of the engineering study (Phase 1). NS-PGL Ex. TLP-2.0, p. 6. The Company also admitted that until the completion of the engineering study, Phase 1, there will be some uncertainty involved in pursuing this addition, but Peoples Gas is confident that enough of the gathering system needs replacement that it begin making its projected investments to replace at least a portion of the gathering system in 2010. *Id.*, pp. 4-5.

Peoples Gas also admits until the completion of engineering study (Phase 1), it does not know the full scope of the project, which includes if the project is needed in 2010 or not, and it cannot conduct a cost benefit analysis or business case for the project. Due to the potential monetary investment needed for the proposed project, Peoples Gas requires all of this information to seek approval for any expenditure from the Board of Directors. However, Peoples Gas has not completed any of the required studies nor has Peoples Gas received Board approval for any expenditure associated with Phase 2 of the project. In short, Peoples Gas has provided nothing but its good intentions to support that it will incur any costs or pursue Phase 2 of this project in the 2010 test year.

Regarding Staff's final concern that Peoples Gas reduction of costs associated with Phase 2 of the Gathering System Replacement project supported a conclusion that the project is speculative in nature, Staff notes that given the lack of supporting documentation regarding the scope and timing of the project, any cost projections are pure conjecture and do not support Peoples Gas' request to include the Phase 2 costs within its requested rates.

Peoples Gas originally requested $10.8 million associated with both Phase 1 and 2 of the gathering system replacement project. ICC Staff Ex. 13.0, p. 8. Then, Peoples Gas reduced its requested amount to $1.5 million for Phase 1 and $5.7 million for Phase 2. ICC Staff Ex. 27.0, p. 10. Staff concluded that Peoples Gas needed this cost revision because Peoples Gas' initial project cost projection was, at best, a rough estimate for the cost of the project during the test year.

However, a closer review of Peoples Gas situation indicates its cost estimate is speculative in nature. As noted above, Peoples Gas lack of detailed information regarding Phase 2 of its proposed project, such as the Phase 1 engineering study, a cost benefit analysis, or a business case, means it does not know the scope, timing, or limitations associated with the project. In fact, Peoples Gas can only speculate regarding the scope, timing, and limitations associated with the project.

Further, Peoples Gas assumption that it will acquire Board of Director approval for Phase 2 of the project in either late 2009 or early 2010 (NS-PGL TLP-2.0, p. 7) is pure conjecture. Even under the assumption that the engineering study (Phase 1) indicates a portion of the gathering system at Manlove needs replaced and Peoples Gas can develop a cost benefit analysis and business case to support the replacement, Peoples Gas' Board of Directors could still elect to defer the project to a later period.

In short, Peoples Gas cannot project a reasonable estimate for the overall cost or extent of the project, nor can it guarantee its Board of Directors will provide immediate approval of the project assuming some replacement of the gathering system is necessary.  Given the unknown nature of the project and its costs, Staff cannot support including any estimated costs associated with this project in the test year. ICC Staff Ex. 13.0, p. 12.

Staff recommends the Commission remove all the costs associated with Phase 2 of the Gas Gathering System project from Peoples Gas' requested rates.  Staff's recommendation is based on Peoples Gas failure to provide sufficient information to demonstrate that Phase 2 of the project would be prudently incurred and used and useful.  Next, Staff noted that Peoples Gas failed to demonstrate that it is pursing this project prior to the end of the 2010 test year.  Finally, Staff noted that Peoples Gas' continued reduction of the test year cost estimates and the nature of its estimates supports Staff's concerns that the project is speculative.  Therefore, Staff recommends the removal of Peoples Gas' requested costs associated with Phase 2 of this project from its requested rates.

#### 3. Capitalized Incentive Compensation

Please refer to Section V.C.1 of Staff's Initial Brief.

#### 4. Capitalized Non-Union Base Wages

Please refer to Section V.C.2 of Staff's Initial Brief.

### D. Reserve for Accumulated Depreciation and Amortization (Uncontested Except for Derivative Adjustments from Contested Adjustments)

The Commission should accept the adjustments to Accumulated Depreciation and Amortization the Companies' proposed in rebuttal related to the revised level of forecasted plant additions (NS-PGL JH-2.0, p. 4, l. 87; NS-PGL SM-2.0, p. 9, lines 202-208) which Staff does not contest.  ICC Staff Ex. 18.0, pp. 2-3, lines 34-49.

Staff witness Mary H. Everson proposed an adjustment for Accumulated Depreciation related to Staff's proposed adjustments to forecasted plant additions. ICC Staff Ex. 4.0, p. 9, lines 193-198. Except to propose revised levels of Accumulated Depreciation related to the Companies' proposed revised levels of forecasted plant additions, the Companies did not contest this adjustment. NS-PGL JH-2.0, p. 4, line 87; NS-PGL SM-2.0, p. 9, line 202-208.

### E. Cash Working Capital

#### 1. Pass-Through Taxes

As explained by Staff witness Mike Ostrander, "Cash Working Capital ("CWC") is the amount of funds required from investors to finance the day-to-day operations of the Companies. A company's CWC requirement may be positive or negative, depending on whether it receives cash from ratepayers for delivery of utility service, on average, slower or faster than it pays expenses. One way to determine the level of CWC to be included in rate base is a lead-lag study that analyzes test year cash transactions and invoices. "In general, lag times are associated with the collection of revenues for delivery of utility service owed to the Companies (that is, the collection of cash from ratepayers for the provision of service lags behind the Companies' cash outlays for the provision of service), and lead times are associated generally with the payments for goods and services received by the Companies (for example, vendors allow the Companies to pay later for goods and services provided currently)." ICC Staff Ex. 3.0, pp. 3-4. With respect to pass-through taxes, because Investors receive the benefit of the Companies having pass-through taxes as cash on hand to finance the day-to-day operations until the cash is remitted to the appropriate taxing authority they must be accounted for in the cash working capital calculation. *Id*., pp. 7-8. Therefore, the Commission should adopt revenue lag days of zero for pass-through taxes and reject the Companies' argument that revenue lag days of 40.84 for North Shore and 50.22 for Peoples Gas be included in the CWC revenue requirement.

Staff proposes to reduce the amount of CWC added to rate base for pass-through taxes because pass-through taxes represent funds provided by ratepayers rather than investors. Staff proposes to do this by applying revenue lag days of zero to pass-through taxes in the CWC calculation because 1) in the context of a rate case, pass-through taxes are not operating revenue, and therefore cannot have a revenue lag; and 2) ratepayers provide pass-through taxes for the Company to hold and later remit to taxing bodies. Through the CWC requirement, investors rightly receive a return on their financing of operating expenses which produce operating revenue, if there is a lag in operating revenue covering operating expenses. However, with respect to pass-through taxes, investors have not invested funds to finance operations. If a revenue lag for pass-through taxes is included in the CWC requirement and added to rate base, investors will earn a return on ratepayer supplied funds. Staff Ex. 3.0, pp. 3-8; Staff Ex. 17.0, pp. 4-10. The Commission should not allow the Company to increase its rate base for revenue lag on funds for pass-through taxes because funds for pass-through taxes are provided by ratepayers.

Staff and the Companies agree that pass-through taxes are not recorded as revenue or expense on the income statement but the collection and payment of these amounts causes a timing difference in the Companies' cash flow. Staff Ex. 3.0, p. 6. The Companies, through the surrebuttal testimony of witness John Hengtgen, argue that the use of revenue lag days would reflect the proper timing difference between receipt of pass through taxes and payment to taxing authorities, *i.e.*, pass-through taxes are paid to taxing authorities approximately as cash is received from its customers. NS-PGL Ex. JH-3.0, p. 9. However, Staff maintains that the evidence indicates that the Companies do have access to the funds provided from the pass through taxes until the funds are remitted to the taxing authorities.

The Companies acknowledge that the Commission accepted the use of a lag of zero days in the most recent Northern Illinois Gas Company ("Nicor") rate case, Docket No. 08-0363. However, the Companies say that their process for paying pass-through taxes is different than the process used by Nicor in Docket No. 08-0363. The Companies describe Nicor's process for pass through taxes as amounts are billed, received and held for a period of time, and then remitted at a later date to taxing authorities. The Companies pass-through payment process is based on an agreement with the City of Chicago, which allows the Companies to pay the Municipal Utility Tax and the Chicago Use Tax on the basis of estimated cash receipts. The Companies describe their process for pass through taxes as amounts that are billed and paid to taxing authorities approximately as received. NS-PGL Ex. JH-3.0, pp. 9-10.

The Companies assertion that pass through taxes are paid to taxing authorities approximately when received from ratepayers is contradicted by the facts in evidence. In response to Staff Data Requests JMO 14.04 through JMO 14.09 (Staff Ex. 17.0, pp. 7-8), the Companies describe the process and timing of collection and payment of the various pass-through taxes as follows:

1. The taxes are included in the customer's monthly bill.

2. The Companies collect the taxes.
3. Taxes are paid on or before the due dates.
4. The payments are based on estimated amounts.
5. The payments are made regardless of whether or not the Companies collect from the customers.

Mr. Hengtgen's testimony under cross examination and ICC Staff Cross Hengtgen Ex. No. 21 (WPG-8, page 45 of 48) provide further support for Staff's position that the Companies do in fact utilize a process for collection and payment of pass through taxes similar to Nicor in that amounts are billed, collected, and held for a period of time, and then remitted at a later date to taxing authorities. Mr. Hengtgen described how the pass through tax liability to the City of Chicago for August 2009 is based on the estimated gross receipts net of a provision of uncollectible accounts that are deemed collected during August 2009 and subsequently paid by one check on September 30th. Tr., pp. 667-672. The Companies are liable to remit the proper amount due on a timely basis whether the payment of pass-through taxes is based on actual cash receipts or estimates or any other methodology. *In re Northern Illinois Gas Co.*, ICC Docket No. 08-0363, p. 12 (Order, Mar. 25, 2009). The source of funds for such tax payments is ultimately the collection of the ratepayers' bills as confirmed by Mr. Hengtgen. Tr., pp. 668-669.

The Companies' use of lead days for pass through taxes confirms that pass through taxes deemed collected from ratepayers (during August 2009) are held until remitted to a taxing authority at a later due date (September 30$^{th}$). The length of time that the Companies have pass-through taxes available for their use has been calculated in the Companies' lead/lag study. *See* ICC Staff Cross Hengtgen Ex. 21. The Commission should not allow the Company to increase its rate base for revenue lag on funds for pass-through taxes because the Companies do indeed receive pass-through taxes from ratepayers, hold those funds, and later remit those funds to the taxing authorities.

#### 2. All Other (Uncontested)

### F. Accumulated Deferred Income Taxes (Uncontested Except for Derivative Adjustments from Contested Adjustments)

The Commission should accept the adjustments to Accumulated Deferred Income Taxes the Companies' proposed in rebuttal related to the revised level of forecasted plant additions (NS-PGL JH-2.0, p. 4, line 87; NS-PGL SM-2.0, p. 9, lines 202-208) which Staff does not contest. ICC Staff Ex. 18.0, pp. 2-3, lines 34-49.

Staff witness Mary H. Everson proposed an adjustment for Accumulated Deferred Income Taxes Depreciation related to Staff's proposed adjustments to forecasted plant additions. ICC Staff Ex. 4.0, p. 9, lines 193-198. Company witness John Hengtgen did not agree with the calculation of Accumulated Deferred Income Taxes related to Staff's proposed adjustments to forecasted plant additions and provided revised calculations of Accumulated Deferred Income Taxes based on his revised level of forecasted plant additions. NS-PGL Ex. JH-2.0, p. 9-10, line 200-210. Ms. Everson revised her calculation of Accumulated Deferred Income Taxes related to the revised level of forecasted plant additions in rebuttal testimony to agree with the Companies' methodology. ICC Staff Ex. 18.0, pp. 2-3, lines 34-49.

### G. Reserve for Injuries and Damages

The Companies accepted Staff witness Mike Ostrander's proposed adjustments to injuries and damages expense contingent upon what they allege are consistent adjustments with respect to the injuries and damages reserves in rate base. NS-PGL Ex. SM-3.0, p. 4. Staff disagrees that corresponding adjustments should be made to the injuries and damages reserves in rate base.

The Companies believe that there is a direct correlation between the amount of injuries and damages expense and the amount of the injuries and damages reserve amount which would warrant that any adjustment made to expense should also be made to the reserve. The Companies direct correlation argument is based on the bookkeeping entries that are made when an expense is accrued or adjusted and when a claim payment is made. NS-PGL Ex. JH-3.0, p. 12. Staff agrees in theory that the Companies are making the proper bookkeeping entries to record the economic transactions associated with injuries and damages. However, for purposes of determining a revenue requirement, Staff does not agree that there is a direct correlation between the injuries and damages reserve and the expense amounts. Nor is there a need for a rate base adjustment due to the test year normalized operating expense adjustments proposed by Mr. Ostrander. While the 2010 expense accrual component of the injuries and damages reserve represents the Companies' cumulative estimate of what payments will be made in the future for incurred injuries and damages claims as of December 31, 2010, the normalized level of injuries and damages operating expense is based on actual historical claim payments. ICC Staff Ex. 3.0, p. 12. As such, Mr. Ostrander's proposed adjustments to reflect a normal level of annual operating expense or period cost are based on historical payments and have no direct corresponding impact on the estimate of the test year balance sheet liability or reserve for future payments. Thus, it would be inappropriate to adjust the Companies' injuries and damages reserve in rate base due to a rate making adjustment to normalize the injuries and damages operating expense in the revenue requirement.

### H. Pension Asset (PGL) / Liability (NS) and OPEB Liabilities

The Companies included in their respective rate bases a total amount identified as "Retirement Benefits, Net". For Peoples Gas, the retirement benefits combine the pension asset with the Other Post Employment Benefits ("OPEB") liability to derive the net amount of total retirement benefits the Company has added to its rate base. For North Shore, the retirement benefits combine the pension liability with the OPEB liability to derive the total liability for retirement benefits by which North Shore has reduced its rate base.

Staff witness Pearce proposed an adjustment of $143,240,000 (before accumulated deferred income taxes) to remove Peoples Gas' pension asset from rate base because it was created with funds supplied by ratepayers, not shareholders. Accordingly, Staff's position is that shareholders should not be allowed to earn a return on an asset that was created with normal operating revenues collected from utility ratepayers. ICC Staff Ex. 2.0, lines 53 – 66.

GCI witness Effron also proposed an adjustment to remove from utility rate base the pension asset of $143,240,000 for Peoples Gas and the pension liability of $3,022,000 for North Shore, along with the related impact of accumulated deferred income taxes. According to Mr. Effron's direct testimony (AG/CUB/City Exhibit 1.0, lines 252 – 266), he proposed these adjustments to be consistent with his understanding of the Commission's findings in the prior rate case for North Shore and Peoples Gas. Docket Nos. 07-0241/-0242 (Cons.).

Companies' witness John Hentgen sponsored rebuttal testimony in which the Companies increased the amount of Peoples Gas' pension asset to $155,496,000 and reduced the amount of the North Shore pension liability to $2,728,000. He also reiterated the Companies' position that although the Commission did not agree to include the pension asset in Peoples Gas' rate base in the prior rate case, the Companies have appealed that decision and the issue remains on appeal. NS-PGL Ex. JH-2.0, lines 145 – 151. Companies' witness Alan Felsenthal argued against removal of the Peoples Gas pension asset based on his assertion that the pension asset represents shareholder supplied funds. He further asserted that it is inconsistent to remove the pension asset from Peoples Gas' rate base but not the pension liability from North Shore along with the OPEB liabilities for both Peoples Gas and North Shore. NS-PGL Ex. AF-1.0, lines 24 – 33.

The Commission has addressed ratemaking treatment of pension assets and OPEB liabilities in many dockets. As Mr. Hengtgen admitted, this issue came before the Commission in the Companies' prior rate case, Docket Nos. 07-0241/-0242 (Cons.). In their initial filing for that case, the Companies excluded all pension and OPEB related assets and liabilities from rate base. However, the Companies later sought to include the Peoples Gas pension asset and the North Shore pension liability in rate base in response to adjustments proposed by Staff and Intervenors that reduced rate base for OPEB liabilities. The Commission found that neither the pension asset nor contributions to the pension plan should be reflected in the utility's rate base. The

Commission also found that the treatment of the pension asset should not determine the treatment of the OPEB liability. Accordingly, the Commission supported Staff and Intervenor adjustments to reflect OPEB liabilities as a rate base reduction. ICC Docket No. 07-0241/-0242 (Cons.), Order February 5, 2008, at 36.

The Commission has addressed the pension asset issue in several cases involving other Illinois utilities, as well. For example, in Docket No. 08-0363, the Commission rejected Northern Illinois Gas Company's ("Nicor Gas") request to include its pension asset in rate base. The Commission has consistently rejected Nicor Gas' request to include its pension asset in rate base in prior cases as well, including Docket Nos. 04-0779 and 95-0219. The Commission found, in both cases, that the pension asset was created by ratepayer-supplied funds, not by shareholder-supplied funds, and concluded that ratepayers should not be denied the benefits associated with the previous overpayment for pension expense which they funded. Accordingly, the Commission concluded that the pension asset should be eliminated from rate base.

Finally, although Companies' witness Felsenthal asserted that the Commission's Order on Rehearing in Docket No. 05-0597 (Commonwealth Edison Company) allowed an $803 million pension contribution in rate base (NS-PGL Ex. AF-1.0, pp. 25 – 26), the Commission is well aware of what it allowed for Commonwealth Edison Company ("ComEd") and it did not allow ComEd to reflect any amount of the pension asset or contribution in its rate base. Rather, the Commission allowed ComEd to earn a debt return on the amount of the contribution, to be recovered through operating expense, after the Company demonstrated that the contribution was directly financed through long-term debt issuance. The fact pattern of Docket No. 05-0597 is unique to ComEd and the facts and circumstances of Docket No. 05-0597 do not resemble the facts of the instant proceeding in any way. However, it is significant to note that the Commission's order in Docket No. 05-0597 was recently upheld on appeal. By upholding the Commission's decision on appeal, the Court did not disturb the Commission's decision to <u>not allow a single part</u> of ComEd's pension asset or contribution into utility rate base, (*Commonwealth Edison Co. v. Ill. Commerce Comm'n*, ___Ill. App. 3d___, 2009 Ill. App. LEXIS 913 (2d Dist. Sept. 17, 2009)) which is exactly what the Companies want the Commission to do in this case. Accordingly, no part of a pension asset should be allowed into the Companies rate base.

The Commission has also addressed the treatment of OPEB liability in the previously discussed Nicor rate proceeding, Docket No. 04-0779 and in the Ameren Companies' request for an increase in delivery service tariffs ("DST"), Docket Nos. 06-0070, 06-0071, and 06-0072, (Cons.) (AmerenCILCO, AmerenCIPS, AmerenIP) Order dated November 21, 2006 at page 27. In these cases, the Commission found that the OPEB liability should be treated as a reduction of utility rate base.

For ratemaking purposes, a rate base reduction of the accrued liability associated with OPEB is appropriate to the extent that the test year obligation is unfunded or partially funded. The accrued liability represents the aggregate OPEB costs recognized in the income statement which has not been paid to a third party. Ratepayers have supplied funds for future obligations; therefore, a source of cost free capital has been provided to the utility which should be recognized in the revenue requirement as a reduction from rate base.

At issue in the instant proceeding is the treatment of the Peoples Gas pension asset and the North Shore pension liability. Companies' witness Mr. Felsenthal characterized the essence of the disagreement over the proper treatment of Peoples Gas' pension asset for ratemaking purposes as follows:

> I address both Ms. Pearce's and Mr. Effron's exclusion of Peoples Gas' prepaid pension asset from the rate base on the **incorrect notion** that the prepaid pension asset represents ratepayer supplied funds.

NS-PGL Ex. AF-1.0, lines 24 – 26 (emphasis added**).**

Essentially, Mr. Felsenthal believes the pension asset was created with shareholder funds and therefore, represents an asset on which shareholders should earn a return. In contrast, Staff contends the pension asset was created with contributions using monies supplied by ratepayers through the collection of utility rates. Although the determination of a net pension asset or liability at any given point in time will be impacted by multiple factors, including returns on invested assets and actuarial assumptions, ratepayers ultimately, through the collection of utility rates, have borne and will continue to bear the cost of the pension plans. Since the pension asset was funded by normal operations, rather than provided by shareholders, shareholders should not earn a return on it. The pension expense is and has been reflected in utility rates. The pension expense is determined by accounting rules based on actuarial calculations that recognize an amount of pension cost for that period. Contributions to the pension plan represent payments of that obligation with monies provided through the collection of utility revenues from ratepayers. ICC Staff Exhibit 16.0, lines 64 – 97.

Companies' witness Felsenthal asserted that "[a]s with any capital expenditure, the source of the contribution is investors, as ratepayers pay for the cost of service consisting of annual operating costs and return (rate base times rate of return)." NS-

PGL Ex. AF-1.0, lines 232 – 234. Staff disagrees with this characterization. The net pension asset is not the result of a "capital expenditure" by shareholders. Instead, it is the net difference between the fair value of the pension fund and the projected pension obligation, as measured at a specific point in time. The pension fund value is based on the investments included in the pension fund and the pension obligation is based on estimates, determined by actuarial analysis using various assumptions and methods. Accordingly, the net pension asset is a function of comparing two components—the value of the pension fund and the projected pension obligation. If either the value of the pension fund or the amount of the pension obligation changes, the net difference (for Peoples Gas, a net pension asset) will also change. This difference is basically a timing difference that results from several factors, including differences between the amount of pension expense reflected in rates and the amount of cash contributed to the plan, actuarial assumptions, market performance that impacts the underlying investments, and factors that impact the obligation, like curtailments. ICC Staff Ex. 16.0, pp. 5 – 6, lines 104 – 119.

Companies' witness Felsenthal agrees that pension expense for ratemaking and financial reporting purposes (which is reflected in the test year revenue requirement) will usually differ from funding requirements (i.e., cash contributed to the pension plan) since the two amounts are determined according to different sets of rules.

> The funding rules as set forth under ERISA *(Employee Retirement Income Security Act of 1974)* and the IRC *(Internal Revenue Code)* are different than the methodology used to determine pension expense under FAS 87 *(Statement of Financial Accounting Standard)*. Over time, the cumulative employer contributions made to the plan and the cumulative accounting costs under FAS 87 should be equal. But in the shorter term there will be differences." (NS-PGL Ex. AF-1.0, lines 129 – 133) [Information in italics added]. ICC Staff Exhibit 16.0, lines 99 – 132.

Accordingly, the Companies and Staff agree that timing differences impact the resulting net pension asset. However, the Companies' witness further asserted that:

> To the extent that cumulative contributions to the pension plan exceed the cumulative accounting costs based on FAS 87, there is a balance sheet entry equal to the excess. This is the prepaid pension asset, representing the employer's contributions which have not yet been reflected as pension cost in the accounting records or on the financial statements. NS-PGL Ex. AF-1.0, lines 133 – 137.

While that statement is not necessarily untrue, it provides a simple but incomplete analysis because it fails to address the main factor that has contributed to the net pension asset in the instant Peoples Gas proceeding; specifically, a regulatory asset created by the application of accounting rules. Moreover, there is no evidence in the instant proceeding to support the contention that cumulative cash contributions in excess of the pension expense alone, account for the Peoples Gas' pension asset. ICC Staff Ex. 16.0, lines 134 – 152.

Companies' witness Felsenthal described at length the origin of Peoples' Gas pension asset, as the difference between the fair value of assets set aside to pay for projected benefit obligations and the projected benefit obligation. He further explained there are two typical transactions that result in a pension asset, one being that the entity makes pension contributions in excess of pension cost, and the other resulting when annual pension cost according to FAS 87 is a negative, not a positive expense. NS-PGL Ex. AF-1.0, lines 168 – 178. However, Mr. Felsenthal did not specifically indicate which of these two transactions created the Peoples' Gas pension asset in the instant proceeding. He stated:

> In all cases, the prepaid pension asset and the related regulatory asset represents the cumulative difference between what has been contributed to the pension plan and what has been expensed under the pension accounting rules. NS-PGL Ex. AF-1.0, lines 195 – 197.

Based on this rationale, the reader might infer that as of December 31, 2010, cumulative pension contributions from Peoples Gas will exceed cumulative pension expense reflected in utility rates by $155,496,000 (NS-PGL Ex. JH-2.0, Ex. JH-2.7P, line 15, column (I)), the amount of net pension asset Peoples Gas seeks to reflect in the test year rate base. This is simply not credible. As stated previously, there is no evidence in the record of this proceeding to support the contention that Peoples Gas' shareholders have made contributions to the pension plan in an amount $155,496,000 greater than the amounts collected from ratepayers through utility rates (or in any other amount). Moreover, based on the Company's response to Staff Data Request BAP-12.03, during the most recent five-year period from 2004 to the present, including the Company's projection for the balance of 2009, total cash contributions by Peoples Gas to the pension plan total $37,743,228 and pension expense recorded by Peoples Gas totals $56,137,260. ICC Staff Exhibit 16.0, Attachment A. This evidence demonstrates that just within the last five years, pension expense, which is recovered in rates, has exceeded pension contributions by $18,394,032. ICC Staff Ex. 16.0, lines 189 – 225.

In the aforementioned quote, Mr. Felsenthal refers to the prepaid pension asset *and the related regulatory asset.* Referring to the rebuttal testimony of Mr. John Hengtgen, NS-PGL Ex. JH-2.7 P, reflects the Company's updated pension and Other Post Employment Benefits ("OPEB") liability amounts. NS-PGL Ex. JH-2.0, lines 352 – 356. As this exhibit shows, the net pension asset consists of the Net Pension Funded

Status, a liability of $70,859,000 (NS-PGL Ex. JH-2.7 P, line 9, column (I)) and the Net Pension Regulatory Asset of $226,355,000 (NS-PGL Ex. JH-2.7 P, line 14, column (I)), which sum to the Total Pension net asset of $155,496,000 (NS-PGL Ex. JH-2.7 P, line 15, column (I)) that Peoples Gas seeks to reflect in rate base. As is clear from the descriptions used by the Company, the funded portion of the pension is a liability. Accordingly, the net pension asset that the Company seeks to recover in rate base is largely a function of accounting rules according to FAS 158, not a result of excess contributions. It is also worth noting that the description "regulatory asset" is used to denote timing differences that will eventually be collected from ratepayers. If ratepayers were not eventually going to bear this cost, it could not by definition be classified as a regulatory asset. ICC Staff Ex. 16.0, lines 234 – 253.

FAS 87 refers to Statement of Financial Accounting Standards No. 87 entitled *Employers' Accounting for Pensions* and FAS 158 refers to Statement of Financial Accounting Standards No. 158 entitled *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans.* Basically, FAS 87 covers the employers' accounting for pension plans. FAS 158 amends FAS 87 with regard to financial statement disclosure and generally requires companies to reflect the funded status of the pension plan on the balance sheet instead of disclosing the funded status in footnotes attached to the financial statements, as previously allowed. (The funded status of the pension plan basically is the difference between the fair value of pension plan assets and the projected benefit obligation.) FAS 158 (issued in September 2006) affects employers' balance sheets by requiring the entity to recognize the overfunded or underfunded status of the pension plan as an asset or liability and to recognize changes in the funded status as other comprehensive income. FAS 158 does not alter the way annual pension cost is calculated. ICC Staff Ex. 16.0, lines 256 – 271.

The Companies obtained an actuarial update and revised the 2010 test year pension expense and related regulatory asset in the rebuttal phase of this proceeding. Based on the rebuttal testimony of Companies' witness Ms. Christine M. Phillips, the actuarial update increased the Peoples Gas 2010 test year pension expense by $6,268,000. NS-PGL Ex. CMP-1.0, lines 104 – 106. The impact on the forecasted average balances for the 2010 test year rate base is as follows:

> For the 2010 test year, the initial filing reflected an average prepaid pension of $16,416,000 with a related regulatory asset of $124,715,000; reflecting a net pension asset of $141,131,000. The updated forecasted average balances for the 2010 test year are an accrued pension liability of $70,859,000 with a related regulatory asset of $223,373,000; reflecting a net pension asset of $152,514,000, a net increase of $11,383,000. NS-PGL Ex. CMP-1.0, lines 144 – 149.

The impact of the actuarial update on the test year filing proves two things: (1) since pension expense increased, ratepayers are the ones who bear the cost of the pension plan and provide the revenues that fund the Company's contributions; and (2) the $98,658,000 increase in the pension regulatory asset, ($223,373,000 – $124,715,000) is the result of a timing difference created through application of the accounting rules, not excess cash contributions from shareholders. ICC Staff Ex. 16.0, lines 273 – 296.

In summary, although Mr. Felsenthal and Staff agree on many aspects of this issue, the fundamental disagreement concerns the source of the funds that gave rise to the net pension asset. For all the reasons stated above, Staff maintains that the net pension asset was created with ratepayer funds; accordingly, the net pension asset should be removed from the test year rate base so that shareholders do not earn a return on this asset.

Because ratepayers bear the cost of the pension plans in utility rates, it is improper to reflect pension contributions or pension assets in rate base. Such treatment would allow shareholders to earn a return on ratepayer-supplied funds. Similarly, it is proper to reduce rate base by the amount of pension liability. The North Shore pension liability represents the amount of expense that has been recovered in rates and not yet contributed to the pension plan by the Company. Therefore, it represents a cost-free source of capital to the Company and must be a reduction of rate base.

# V. OPERATING EXPENSES

## A. Overview/Summary/Totals

### 1. North Shore

Staff recommends the Commission adopt Staff's proposed operating expenses of $57,780,000, resulting in a revenue requirement of $77,412,000 as reflected on page 1 of Appendix B to Staff's Initial Brief.

### 2. Peoples Gas

Staff recommends the Commission adopt Staff's proposed operating expenses of $386,315,000, resulting in a revenue requirement of $514,190,000 as reflected on page 1 of Appendix A to Staff's Initial Brief.

### B. Uncontested Issues

#### 1. Natural Gas Prices for Purposes of Company Use Gas, Uncollectibles Expense, and North Shore Franchise Gas

Natural gas prices affect the Companies' costs of operating expenses, in particular, costs of uncollectibles, company use gas and North Shore franchise gas. ICC Staff Ex. 29.0, p. 3.

The Companies' calculated their costs using a future test year, therefore, natural gas prices need to be forecasted in order to calculate these costs. The forecasts used were the NYMEX futures prices adjusted for where the gas is purchased and for any volumes that are hedged. (Id., p. 3) NYMEX prices are updated every trading day; accordingly there are many forecasts to choose from. Id., p. 3-4.

Prices were periodically updated in order to find the most recent, and presumably better, set of prices for the test year. Id., pp. 4-5 and Attachments 3-NS and 3-PGL. Peoples Gas and North Shore filed their cases using June 2008 prices, but updated those prices using February 2009 prices in a response to a Staff data request. Id., p. 4. The February 2009 prices were substantially lower than the June 2008 prices. Id., p. 5. Staff used them to formulate adjusted costs in direct testimony. In the Companies' rebuttal testimony, they developed costs based upon prices in June 2009. NS-PGL Ex. CMG-2.0, pp. 6, 8. By the time Staff was scheduled to file its rebuttal testimony at the end of August, futures prices had fallen below the June 2009 levels. ICC Staff Ex. 29.0 at 5. Staff's position was that, since the February 2009 prices were closer to current levels than the June 2009 prices, costs were better represented by February 2009 prices. Id., p. 6. In surrebuttal, the Companies updated prices again, this time to August 2009 prices. NS-PGL Ex. CMG-3.0, p. 4-6. Staff does not contest these prices.

Tr., pp. 914-915, August 27, 2009. The final adjustment reflecting the uncontested prices for Peoples Gas is reflected in Appendix A, page 3 column (m). The final adjustments for North Shore are reflected in Appendix B, page 2 column (h), page 3 columns (l) and (m).

### 2. Union Wages (Falls in Multiple Categories of O&M)

Staff witness Hathhorn proposed adjustments to reduce each of the Companies' rate base and operating expenses to correct their error in calculating the test year union wages at the non-union rate. ICC Staff Ex. 1.0, Schedules 1.9 P and N, Union Wages Adjustment. The Companies accepted Staff's adjustments. NS-PGL Ex. JH-2.0, p. 4.

### 3. Company Use Gas (Falls in Multiple Categories of O&M)

GCI witness Effron testified that the forecasted price of gas in the test year impacted the Companies' company-use gas expense request. Mr. Effron recommended that the Companies update their company-use gas expense with more recent gas prices. GCI Ex. 1.0, p. 23. Staff also recommended that the Companies update the gas price used to calculate their company-use gas expense. ICC Staff Ex. 27.0, pp. 15-16.

In response to the concerns raised by Mr. Effron and Staff, the Companies calculated a revised company-use gas expense based upon updated gas prices. NS-PGL Gas Ex. CMG-3.0, p. 3. During cross examination, Staff witness Dr. Rearden who was Staff' expert witness on the price of natural gas accepted the Companies' revised price for natural gas to be used in the calculation of company –use gas expense. Tr., p. 915, August 27, 2009. As such, Staff now accepts the Company's revised calculation for company-use gas. The final adjustment reflecting the uncontested prices for

Peoples Gas is reflected in Appendix A, page 3, column (o). The final adjustment reflecting the uncontested prices for North Shore is reflected in Appendix B, page 3, column (l).

### 4. IBS Charges (Falls in Multiple Categories of O&M)

Staff and AG/CUB/City proposed adjustments to operating expenses to reflect the Companies' planned reductions in spending at Integrys Business Support, which the Companies provided in revised responses to Staff Data Request DLH-4.06. ICC Staff Ex. 1.0, Schedules 1.10 P and N, Reduction in IBS Charges Adjustment; AG/CUB/City Ex. 1.0. The Companies accepted the total dollar amount of the adjustments of $7,493,000 for Peoples Gas and $360,000 for North Shore, but revised them to reflect proper account allocations. NS-PGL Ex. SM-2.0, p. 4, footnote 2.

### 5. Distribution

#### a. Gasoline and Fuel

Staff witness Seagle testified that the pricing the Companies used to value its gasoline and diesel ("transportation") fuels in the test year was overstated and recommended the Companies use an updated transportation fuel price. ICC Staff Ex. 13.0, pp. 14-16. The Companies agreed to update their requested transportation fuel expense by using more up-to-date transportation fuel pricing information. NS-PGL Gas Ex. CMG-2.0, p. 7. Staff agreed with the Companies' updated position and no longer disputes the Companies requested transportation fuel expense. ICC Staff Ex. 27.0, pp. 2-3.

### 6. Customer Accounts

#### a. Uncollectibles Expense Except for AG-CUB Sales Revenues Adjustment-Related

Staff and the Companies agree upon the adjustments to Uncollectibles Expenses as presented in the surrebuttal testimony of Christine M. Gregor. NS-PGL Ex. CMG-3.0, NS-PGL Ex. CMG-3.1N; and NS-PGL Ex. CMG-3.1P. In his direct testimony, Staff witness Bridal examined the Companies' Uncollectible Expenses, and determined the uncollectibles percentages used by the Companies in their Schedules C-16 and in their data request responses are reasonable. The bases for Mr. Bridal's conclusions were that the uncollectibles percentages used by the Companies are comparable to the Companies' net write-offs as a percentage of revenues for the last four historical years, and they are identical to the percentages granted to the Companies in their previous rate case in ICC Docket Nos. 07-0241/07-0242 (Cons.). ICC Staff Exhibit 5.0, pp 7-8. However, Mr. Bridal did propose adjustments to reduce the Companies' Uncollectibles Expense to amounts based on the Companies' March 2009 reforecast revenues. ICC Staff Exhibit 5.0, pp. 6-8 and Schedules 5.2 P and N.

In her rebuttal testimony, Company witness Ms. Gregor proposed reducing Uncollectibles Expense to amounts based on the June 5, 2009 NYMEX gas price (NS-PGL Ex. CMG-2.0, lines 119 – 122), rather than the amounts presented in the Companies' March 2009 reforecast. The issue of the appropriate gas price for purposes of Mr. Bridal's calculation as well as certain other Staff witnesses' calculations was addressed by Staff witness Dr. Rearden In his rebuttal testimony, Dr. Rearden stated the February 2009 NYMEX gas prices (which are the basis of the Companies' March 2009 reforecast) are more representative of current and future prices than the

June 2009 prices used by Ms. Gregor in her rebuttal testimony (ICC Staff Exhibit 29.0, p. 6), and Mr. Bridal again proposed reducing the Companies' Uncollectibles Expense to amounts based on the Companies' March 2009 reforecast revenues. ICC Staff Exhibit 19.0, pp. 3-4 and Schedules 19.1 P and N. In surrebuttal, Ms. Gregor explained that while the NYMEX price is a major factor in the determination of natural gas costs, there are other factors which also must be taken into consideration. These factors include the hedges the Utilities have in place and the non-commodity costs. The hedges in place for 2010 are at a higher price than the current NYMEX prices and, as a result, the total gas costs are higher and therefore the "LIFO prices" are at higher rates than in February 2009. Ms. Gregor again proposed adjusting the Companies' Uncollectible Expenses, this time to amounts based on the July 2, 2009 NYMEX price which was used in the Companies' August Gas Charge Filing, their most recent Gas Charge filing. NS-PGL Ex. CMG-3.0, pp. 2-5.

During cross-examination, Dr. Rearden stated the price of natural gas used in the Companies' surrebuttal to calculate uncollectibles expenses is acceptable to him. As such, Staff now accepts the adjustments to Uncollectibles Expenses as presented in the surrebuttal testimony of Companies' witness Gregor. NS-PGL Ex. CMG-3.0, and NS-PGL Ex. CMG-3.1N and NS-PGL Ex. CMG-3.1P. For Peoples Gas, this is reflected in Appendix A, page 3 column (m). For North Shore, the final adjustment is reflected in Appendix B, page 2 column (h).

### 7. Administrative & General

#### a. Account 921

#### b. Interest on Budget Payment Plans

Staff witness Ostrander proposed adjustments to decrease the amount of test year interest expense on the Companies' budget payment plan balances. Mr. Ostrander's adjustments utilize the interest rate to be paid on all customer deposits as ordered in Docket No. 08-0679, the most recent ordered interest rate, which is lower than the interest rate used by the Companies in the calculation of the interest expense accrual for the 2010 test year revenue requirement. The Commission accepted the use of the most recent ordered interest rate with a future test year in Docket No. 08-0363. ICC Staff Ex. 3.0, pp. 13-14 and Sch. 3.4 N and P. The Companies accepted Staff's adjustment. NS-PGL Ex. SM-2.0, p. 5.

#### c. Interest on Customer Deposits

Staff witness Ostrander proposed adjustments to decrease the amount of test year interest expense on the Companies' customer deposits. Mr. Ostrander's adjustments utilize the interest rate to be paid on all customer deposits as ordered in Docket No. 08-0679, the most recent ordered interest rate, which is lower than the interest rate used by the Companies in the calculation of the interest expense accrual for the 2010 test year revenue requirement. The Commission accepted the use of the most recent ordered interest rate with a future test year in Docket No. 08-0363. ICC Staff Ex. 3.0, pp. 14-16 and Sch. 3.5 N and P. The Companies accepted Staff's adjustment. NS-PGL Ex. SM-2.0, p. 5.

#### d. Lobbying

#### e. Social and Service Club Dues

#### f. Civic, Political, and Related

#### g. Non-union Base Wages Adjustment in DLH-4.06 (PGL)

Peoples Gas accepted an $86,000 reduction in non-union merit increases noted in footnote (e) of ICC Staff Ex. 1.0, Schedule 1.8 P. NS-PGL Ex. SM-2.0, p. 4. The $86,000 is deducted from Staff's contested adjustment in ICC Staff Ex. 15.0, Schedule 15.8 P.

#### h. Liberty Audit Outside Contractor Fees (PGL)

Peoples Gas accepted Staff witness Hathhorn's adjustment to disallow $540,000 in test year fees for Liberty Consulting Group and Huron Consulting Group related to the Liberty Audit follow up work. ICC Staff Ex. 1.0, Schedule 1.13P and NS-PGL Ex. SM-2.0, p. 4.

#### i. Rate Case Expenses

Staff witness Ostrander proposed no adjustments to the Companies rate case expenses. Section 9-229 of the PUA (220 ILCS 5/9-229) became law during this docketed proceeding and requires the Commission to expressly address rate case expense in its final order. Based on the public version of the Companies' Response to Staff Data Request JMO 18.01 (ICC Staff Ex. 17.0, Attachments O and P), Mr. Ostrander recommended that the Commission expressly address in its order that the proposed amounts to be expended by the Companies for rate case expense in this proceeding are just and reasonable. ICC Staff Ex. 17.0, pp. 13-15. The Companies agree with Staff's recommendation. NS-PGL Ex. SM-2.0, p. 4.

### j. Franchise Gas Requirements (NS)

GCI witness Effron testified that the forecasted price of gas in the test year impacted North Shore's requested franchise gas expense in the test year. Mr. Effron recommended that North Shore update its requested test year franchise gas costs. AG-CUB-City Ex. 1.0, p. 26. Staff also requested that North Shore update its request with more recent gas prices. ICC Staff Ex. 27.0, pp. 15-16.

Based on the concerns raised by Staff and Mr. Effron, North Shore agreed to update its requested franchise gas expense based on updated gas prices. NS-PGL Gas Ex. CMG-3.0, p. 3. During cross examination, Staff witness Dr. Rearden who was Staff' expert witness on the price of natural gas accepted the Companies' revised price for natural gas to be used in the calculation of franchise gas expense. Tr., p. 915, August 27, 2009. As such, Staff now accepts the Company's revised calculation for franchise gas expense. The final adjustment reflecting the uncontested prices for North Shore is reflected in Appendix B, page 3, column (m).

### k. Regulatory Asset – Welfare

### l. Regulatory Asset – Pension

The Companies each reflected two ratemaking adjustments to recognize amortization of the remaining pre-merger unamortized gains and losses from North Shore and Peoples Gas' pension and other post retirement benefit plans. Schedules C-2.9 and C-2.10 of North Shore Ex. SM-1.1 and Peoples Gas Ex. SM-1.1, respectively. Companies' witness Ms. Christine Gregor explained the rationale for the change in accounting treatment being proposed by the Companies as a refinement of the method to account for the amortization of the remaining pre-merger unamortized costs related to actuarial gains and losses, prior service costs, and transition costs as of the date the Companies adopted SFAS 158, December 31, 2006. Instead of including them in the amortization in accordance with SFAS Nos. 87 and 106, the Companies proposed to separately identify the remaining pre-merger net regulatory assets for pension and other welfare benefit plans and amortize those costs using a straight-line amortization based on the average remaining service lives of the underlying benefit plans. According to Ms. Gregor, this treatment eliminates the need for the actuary to prepare a separate accounting valuation. North Shore Ex. CMG-1.0, lines 389 - 420 and Peoples Gas Ex. CMG-1.0, lines 418 – 449.

Both Companies' ratemaking adjustments are attached to the direct testimony of Companies' witness Ms. Sharon Moy. North Shore Ex. SM-1.1 and Peoples Gas Ex. SM-1.1, Schedules C-2.9 and C-2.10. In her rebuttal testimony, Ms. Moy updated her adjustments related to amortization of the regulatory assets for pension and welfare costs. Her updates reflected a change based on the most recent actuarial valuation provided to the Companies, as well as a "correction" to reflect these adjustments entirely as expense, with no portion being capitalized. NS-PGL Ex. SM-2.0, lines 220 – 252.

In his rebuttal testimony, GCI witness Effron proposed an adjustment to capitalize a portion of the amortization of the regulatory assets for welfare costs reflected by the Companies in their rebuttal testimony. AG/CUB Exhibit 4.0, lines 179 – 187.

In surrebuttal testimony Ms. Moy corrected the adjustments to properly capitalize a portion of the amortization of regulatory asset for pension and welfare costs. NS-PGL Ex. SM-3.0 Rev., lines 136 – 143.

Accordingly, it appears this issue is no longer contested.

**m. Employee Benefits Update**

Companies' witness Christine Phillips described the impact of an updated actuarial valuation on employee benefits in rebuttal testimony. NS-PGL Ex. CMP-1.0. As Ms. Phillips explained, the updated calculations were provided to the Companies by their actuaries in June 2009 and as such, were not available when the Companies made their initial rate case filings in February 2009. Accordingly, the updated actuarial valuations represent the most recent actuarial studies and should properly be reflected in the test year. No witness challenged the Companies' use of the updated actuarial valuations.

**n. Merger Costs and Savings**

See explanation at IV. B. 6.

**8. Depreciation**

The Commission should accept the adjustments to Depreciation Expense the Companies' proposed in rebuttal related the revised level of forecasted plant additions (NS-PGL JH-2.0, p. 4, line 87; NS-PGL SM-2.0, p. 9, lines 202-208) which Staff does not contest. ICC Staff Ex. 18.0, pp. 2-3, lines 34-49.

Staff witness Mary H. Everson proposed an adjustment for Depreciation Expense related to Staff's proposed adjustments to forecasted plant additions. ICC Staff Ex. 4.0, p. 9, lines 193-198. Except to propose revised levels of Accumulated Depreciation related to the Companies' proposed revised levels of forecasted plant additions, the Companies did not contest this adjustment. NS-PGL SM-2.0, p. 9, lines 202-208.

##### a. Inventory Reclassification

##### b. IBS Mainframe

#### 9. Taxes Other Than Income Taxes

##### a. Real Estate Taxes

In his direct testimony, Staff witness Bridal proposed adjustments to the Companies' Real Estate Taxes using the 2009 – 2013 Consumer Price Index inflation percentage of 2.2% as an escalation factor to 2008 actual real estate taxes (ICC Staff Ex. 5.0, Schedules 5.1 N and P) rather than on the Companies' assumed "increase in the effective tax rate of 5.0%" for the forecasted periods 2008, 2009, and 2010 (Companies' Section 285.7065, Schedules G-12, Line 1, Column F). In their rebuttal testimony, the Companies, in order to narrow issues, accepted Mr. Bridal's adjustments. NS-PGL Ex. SM-2.0, p. 5.

#### 10. Revenues

##### a. Accounting Charge Revenues

### C. Contested Issues

#### 1. Incentive Compensation (Falls in Multiple Categories of O&M)

The Commission should accept Staff witness Hathhorn's proposed adjustments to reduce each Company's rate base and operating expenses for incentive compensation expenses. ICC Staff Exhibit 15.0, Schedules 15.7 P and N, Incentive Compensation Adjustment. The adjustment is comprised of four subparts, and is the same as reflected on Schedule 1.7 P and N, pages 2 through 5, summarized on page 1 of Schedule 1.7 P and N, except for a correction of the calculation of accumulated deferred income taxes. The four subparts of this adjustment are:

A) Disallowance of Executive Incentive plan costs related to shareholder-oriented goals, performance goals unlikely to be achieved, Company affiliate-performance goals, and performance goals tied to financial goals;

B) Disallowance of Non-Executive Incentive plan costs related to shareholder-oriented goals, performance goals unlikely to be achieved, Company affiliate-performance goals, and performance goals tied to financial goals;

C) Disallowance of the Companies' stock plan costs related to shareholder-oriented goals; and

D) Disallowance of capitalized incentive compensation previously disallowed by the Commission.

Each of these subparts, will be discussed below.

Before beginning this discussion, however, Staff notes that the Illinois Appellate Court issued a decision on September 17, 2009, in which it upheld this Commission's decision to exclude incentive compensation from Commonwealth Edison Company's base rates. *Commonwealth Edison Co. v. Ill. Commerce Comm'n*, ___Ill. App. 3d___, 2009 Ill. App. LEXIS 913 (2d Dist. Sept. 17, 2009). This decision makes clear that the long line of Commission cases conditioning recovery of incentive compensation costs based upon consideration of whether those costs benefit ratepayers is proper. As noted by the court, "both *Citizens Utility Board* [*v. Illinois Commerce Comm'n, 166 Ill. 2d 111, 121 (1995)*] and the Act expressly make room for considerations beyond simply whether an expenditure is reasonable and prudent." *Id*. at 10. After reviewing relevant case law, the court concluded "there is ample precedent making a benefit to ratepayers a condition upon which the recovery of salary-related expense depends." *Id*. at 12. The court also confirmed that the utility has the burden of demonstrating a sufficient nexus between plan measures and a benefit to ratepayers. *Id*. at 13. Thus, any argument by the Companies that it is legally improper for the Commission to consider benefits to ratepayers with respect to incentive compensation costs is without merit and contrary to Illinois law.

**a. Disallowance of Certain Executive Incentive Plan Costs**

Staff addresses in this section its proposed disallowance of Executive Incentive plan costs related to shareholder-oriented goals, performance goals unlikely to be achieved, Company affiliate-performance goals, and performance goals tied to financial goals. ICC Staff Ex. 15.0, Schedules 15.7 P and N, p. 2.

Staff recommends disallowances of approximately 88% and 87% respectively of the Executive Incentive plan costs [$722,000 of $816,000 (Peoples Gas) and $140,000 of $161,000 (North Shore)] the Companies propose to recover in the revenue requirement since those costs were not shown to benefit ratepayers. ICC Staff Ex. 1.0, pp. 9-10, lines 184-204. Specifically, and as discussed in more detail below, Staff proposed the following disallowances:

- Shareholder oriented goals – Disallow 70% of the costs of the Executive Incentive Plan because 70% of the payout is based upon the achievement of the specified financial measures of the following entities: 1) Integrys Energy Group, Inc.'s ("IEG") consolidated net income, 2) Peoples Gas' or North Shore's net income, 3) Integrys' combined regulated subsidiaries[1] net income, and 4) Integrys Energy Services' net income; ICC Staff Exhibit 15.0, Attachment A.;

[1] The combined regulated subsidiaries are: Minnesota Energy Resources ("MER"), Michigan Gas Utilities ("MGU"), North Shore ("NSG"), Peoples Gas ("PGL"), Upper Peninsula Power Company ("UPPCO") and Wisconsin Public Service Company ("WPSC"). ICC Staff Exhibit 15.0, Attachment A.

- Unlikely achievement of performance – Disallow 20% (Peoples Gas) and 10% (North Shore) of the remaining Executive Incentive plan expense for performance goals unlikely to be achieved;

- Company affiliate-performance goals – Disallow 17% (Peoples Gas) and 24% (North Shore) of the remaining Executive Incentive plan expense as an estimate for the performance goals that are based upon achievements of Peoples Gas' and North Shore's affiliates; and

- Performance goals tied to financial goals – Disallow 50% of the remaining Executive Incentive plan expense performance goals which are tied to IEG's net income.

#### i. Shareholder-oriented goals

Referring to Schedules 15.7 P and N, page 2, line 4, Staff disallowed 70% of the administrative and general expense costs of the Executive Incentive plan that is based upon the achievement of stated financial measures of the above-stated entities [$571,000 (Peoples Gas) and $113,000 (North Shore)]. The Companies acknowledge that "…the ICC has previously approved measures that are specifically related to cost control or to cost reduction, although it has not approved the net income measure." NS-PGL Ex. JCH-1.0, p. 4, lines 76-78. However, the Companies contend that to the extent net income is a "hybrid of revenue and cost, the costs associated with the Utilities' Executive Incentive Plan should be allowed even under the logic of the Commission's standards." *Id*. The Companies are correct that the Commission has <u>repeatedly</u> denied cost recovery of incentive compensation costs based upon achievement solely of a net income level, as discussed below -- a goal determined to benefit shareholders primarily over ratepayers. Net income is a result of revenues minus costs. The Companies have made no showing that any specific cost reduction goals exist, that any such goals are related to Peoples Gas' or North Shore's operations, or that any such cost reductions are reflected in the test year expense. Rather, the test year net income goals are determined on an Integrys Energy Group consolidated basis and include the results of both regulated and unregulated Peoples Gas' and North Shore's affiliates. ICC Staff Ex. 15.0, pp. 13-14, lines 312-329.

Further, similar to the Illinois-American Water Company ("IAWC") case discussed below, much of the financial measures in the Executive Incentive plan relate to the operations of Peoples Gas' and North Shore's affiliates rather than those of the utilities. The Companies cannot demonstrate benefits to Illinois ratepayers for goals based upon total enterprise results encompassing regulated operations in Minnesota, Michigan, and Wisconsin, as well as non-regulated operations throughout Integrys Energy Group, Inc. ICC Staff Ex. 1.0, p. 12, lines 255-260.

The Companies oppose Staff's adjustment for the Executive Incentive Plan costs because, according to them, it "fulfills a legitimate purpose, and is not excessive…and, as a result, is prudent." NS-PGL Ex. JCH-1.0, p. 3, lines 62-63, 66. Staff disagrees with the Companies' criteria for rate recovery of incentive compensation expense. ICC Staff Ex. 15.0, p. 11, lines 273-274. Staff's adjustment is not based on the amount of the Executive Incentive Plan, but rather on the failure to meet criteria previously found necessary by the Commission, as discussed further below. Further, an expense may not be allowable in rates even if it is not, in and of itself, "excessive." Lobbying expenses are an example of this scenario, since they are barred from rate recovery no matter the amount. *Id.*, lines 302-307. Even if the levels of incentive compensation included in the revenue requirement were not considered to be excessive, the costs of incentive compensation should not be included in the revenue requirement if the utility fails to demonstrate that the costs are prudent, reasonable and provide tangible benefits to Illinois ratepayers.

As discussed in the Companies' most recent rate case, Docket Nos. 07-0241/07-0242 (Cons.), the Commission concluded that incentive compensation costs are recoverable in rates only if the utility demonstrates tangible benefits to ratepayers:

> The record shows that there are many instances where the Commission has approved incentive compensation as there are cases where such an expense has been denied. The main and guiding criterion is that the expense be prudent, reasonable and ***operating in a way to benefit the utility's customers.***

*In re North Shore Gas Co. and The Peoples Gas Light and Coke Company*, ICC Docket Nos. 07-0241/07-0242 (Cons.), p. 66 (Order, Feb. 5, 2008) (emphasis added). Specifically, the Commission denied cost recovery of the Short-Term Incentive Compensation, Affiliate Charges, and Restricted Stock & Performance Shares plans because the Companies failed to demonstrate the required cost savings or other direct ratepayer benefit. The Commission did allow partial cost recovery of the Team Incentive Award and Individual Performance Bonus plans. ICC Staff Exhibit 1.0, p. 18, lines 377-393.

In Northern Illinois Gas Company's ("Nicor") 2004 rate case, Docket No. 04-0779, the Commission discussed several prior orders in its conclusion that incentive compensation costs are recoverable in rates only if the utility demonstrates tangible benefits to ratepayers:

> ***Costs related to incentive compensation are recoverable in rates only if the utility demonstrates tangible benefits to ratepayers.*** (See, e.g., 03-0403 at 15 ("[T]o recover incentive compensation, ***the plan must confer upon ratepayers specific dollar savings or other tangible benefits.*** Furthermore, the degree of benefit that accrues directly to ratepayers, rather than to other stakeholders, is a significant factor in determining whether incentive compensation should be recovered in

> rates."); 01-0696 at 10 (requiring evidence of "specific dollar savings or any other tangible benefit for the ratepayers"); 01-0432 (Mar. 28, 2002) at 42-43 (***"the Commission has generally disallowed such expenses except where the utility has demonstrated that its incentive compensation plan has reduced expenses and created greater efficiencies in operations.*** … [I]f a utility is seeking to recover such projected expenses from ratepayers, ***the utility should demonstrate that its plan can reasonably be expected to provide net benefits to ratepayers.")*** The utility bears the burden to establish that such tangible benefits accrue to ratepayers, in order to prove that the recovery of incentive compensation costs is just and reasonable. (See 220 ILCS 9-201(c).)

*In re Northern Illinois Gas Co*., ICC Docket No. 04-0779, p. 44 (Order, Sept. 20, 2005) (emphasis added); *see also* ICC Staff Exhibit 1.0, page 19, lines 398-425.

In Illinois American Water Company's ("IAWC") 2007 general rate case, the Commission Conclusion begins with a summary of the Commission's policy on incentive compensation:

> ***The Commission has consistently disallowed recovery of payouts that are tied to overall company financial goals.*** As is apparent from previous rate orders, the Commission has generally disallowed such expenses except where the utility has demonstrated that its incentive compensation plan has reduced expenses and created greater efficiencies in operations which provide net benefits to ratepayers. In this case, no such showing has been made by IAWC.

*In re Illinois American Water Co.*, ICC Docket No. 07-0507, p. 25 (Order, July 30, 2008) (emphasis added). The Commission denied rate recovery of 100% of IAWC's annual incentive plan costs including performance goals since they were dependent on IAWC's corporate parent obtaining its financial earnings goals. ICC Staff Ex. 1.0, p. 20, lines 427-443.

The Commission has remained consistent in its denial of incentive compensation expense for costs associated with achievement of financial goals. In Docket No. 07-

0566 concerning Commonwealth Edison Company ("ComEd"), the Commission disallowed 100% of ComEd's Annual Incentive Plan ("AIP") net income goals.

> Regarding ComEd's AIP's Net Income Metric, the Commission agrees with Staff's proposed adjustment disallowing 100% of AIP costs related to the financial net income goal which primarily benefits shareholders. ComEd's net income goals are financially based and primarily result in shareholder benefits. ***The Commission has repeatedly held that the cost of financial goals should not be paid by ratepayers.***

*In re Commonwealth Edison Co.*, ICC Docket No. 07-0566, p. 61 (Order, Sept. 10, 2008) (emphasis added). As noted earlier, the Commission's ruling was recently upheld on appeal. *Commonwealth Edison Co. v. Ill. Commerce Comm'n*, ___Ill. App. 3d___, 2009 Ill. App. LEXIS 913 (2d Dist. Sept. 17, 2009). In the more recent Nicor general rate case, Docket No. 08-0363, Nicor agreed to remove the costs of all its financially based plans except one, the Incentive Compensation Units ("ICU") plan. The Commission concluded that it, too, was tied to financial goals and denied cost recovery of the ICU expense:

> Although the ICU Plan was created and administered in accordance with Commission policies, the Commission finds that the evidence does not demonstrate that the costs related to the Company's ICU Plan are just and reasonable. The plan is no longer in effect and payout under the Plan is tied to financial goals. ***Recent Commission orders have set forth the requirements that incentive compensation plans demonstrate tangible benefits to ratepayers, and that incentive compensation not be based on shareholder goals.***

*In re Northern Illinois Gas Co.*, ICC Docket No. 08-0363, p. 28 (Order, March 25, 2009) (emphasis added). The Commission further elaborated on its policy to deny recovery of costs for goals based on achievement of financial metrics in its Ameren order, Docket Nos. 07-0585 et al. (Cons.):

> If during the period that the rates approved herein are in effect, however, the incentive compensation plans are revised such that financial goals of Ameren become the payment trigger for a greater portion of the plans, the

> Commission will not look favorably on incentive compensation expenses in AIU's next rate cases. ***The Commission is allowing AIU to recover 50% of its incentive compensation expenses with the understanding that at least 50% of the payments made thereunder will be based on performance or goals other than Ameren's financial goals.***

*In re Central Illinois Light Co., et al*, ICC Docket Nos. 07-0585, 07-0586, 07-0587, 07-0588, 07-0589, 07-0590 (Cons.), p. 108 (Order, Sept. 24, 2008) (emphasis added).

Older Commission orders reflect similar conclusions. In Docket No. 93-0183 concerning Illinois Power Company, the Commission concluded that, since financial goals benefit shareholders, ratepayers should not have to bear the costs of incentive compensation plans tied to financial goals:

> Two of the goals, earnings per share and reduced O & M expenses are goals that benefit shareholders. ***If the shareholders are the ones to benefit, they should be the ones who foot the bill.***

*In re Illinois Power Co.*, ICC Docket No. 93-0183, p. 52 (Order, April 6, 1994) (emphasis added). And, in Docket No. 99-0534 concerning MidAmerican Energy Company, the Commission reached a similar conclusion regarding ratepayer benefit from incentive compensation based on financial goals:

> The Commission is not convinced that the ratepayers are protected in the event that the targeted return on capital investment is not achieved. Ratepayers would still fund the projected levels of incentive compensation even if that level is not achieved.

*In re MidAmerican Energy Co.*, ICC Docket No. 99-0534, p. 9 (Order, July 11, 2000).

#### ii. Performance goals unlikely to be achieved

Historical results demonstrate that the Companies are unlikely to achieve their performance goals. Referring to Schedules 15.7 P and N, page 2, line 7, Staff disallows 20% (Peoples Gas) and 10% (North Shore) of the remaining administrative and general expense for the Executive Incentive plan costs for performance goals unlikely to be achieved under the Executive Incentive plan [$49,000 (Peoples Gas) and $5,000 (North Shore)]. For Peoples Gas only, 10% of incentive compensation based upon achievement of performance goals relates to a goal based upon reduction in system leaks. The goal is based on the ratio of outside gas leaks cleared as compared to the number of outside gas leaks received. ICC Staff Ex. 15.0, Attachment A. However, in 2008, the actual reduction in system leaks result for Peoples Gas was below target. ICC Staff Ex. 15.0, Attachment D. This historical performance calls into question the accuracy of the test year forecasted amount being based upon achievement of target level measures that have not been achieved in the past. ICC Staff Ex. 1.0, pp. 10-11, lines 216-226.

Further, another 10% of each Company's incentive compensation is based upon achievement of performance goals for employee safety goals based on the Occupational Safety and Health Administration ("OSHA") recordable incident rates. However, in 2007 and 2008, the actual performance of both Companies related to its employee safety goals was below target. ICC Staff Exhibit 15.0, Attachment D. This historical performance calls into question the accuracy of the test year forecasted amount being based upon achievement of OSHA recordable incident rates that have not been achieved in the past. ICC Staff Ex. 1.0, p. 11, line 227-236.

The Companies present a discussion of the Executive Incentive Plan's non-financial measures and conclude that, "in summary, these measures have a direct impact to customers." NS-PGL Ex. JCH-1.0, pp. 5-6, lines 92-116. However, to consider a plan's costs for rate recovery, the plan along with the Company's historical plan achievements, discussed above, must be considered. ICC Staff Ex. 15.0, p. 14, lines 335-346. The Companies further argue that their performance goals based upon the achievement of Peoples Gas' and North Shore's affiliates represent a "team-based Company philosophy" wherein the Companies share best-practices which benefits Illinois customers. The Companies further state that "all subsidiaries share in staff support and should share in the support expense." NS-PGL Ex. JCH-1.0, p. 6. However, following this logic would lead to the unreasonable requirement that the Commission analyze in this record the Companies' affiliates' performance goal results in Minnesota, Michigan, and Wisconsin. The Companies must be able to demonstrate in this proceeding's record the benefits of incentive compensation expense to Illinois ratepayers. The Companies are free to design their plans using a team-based philosophy, but are not exempt from the rate recovery criteria established by the Commission over a number of consistent orders, discussed below. ICC Staff Ex. 15.0, pp. 15-16, lines 354-361.

The Companies discuss their compensation philosophy and conclude that "[a]ttracting and retaining a sufficient, qualified and motivated work force benefits the Utilities' customers by making sure there are enough employees to perform needed work, by maintaining and improving the productivity and quality of work, and by reducing the expenses associated with recruiting and training new employees." NS-PGL Ex. JCH-1.0, pp. 7-8, quoting lines 161-164. However, the test year costs are not directly based upon these goals. As discussed above, the goals that trigger the test year incentive compensation costs are not based upon this statement, but rather the specific goals and measures identified in ICC Staff Ex. 15.0, Attachments A, B, and C.

Staff's adjustments are consistent with the Commission's policy to disallow incentive compensation plan costs when the plans do not provide a ratepayer benefit. In Docket No. 01-0432 the Commission concluded that Illinois Power Company should not be allowed to recover from ratepayers the expenses associated with its incentive compensation plan because the Company did not demonstrate that the plan provides net benefits to ratepayers. *In re Illinois Power Co.*, ICC Docket No. 01-0432, p. 42 (Order, March 28, 2002). The Commission's policy to disallow incentive compensation plan costs when the plans do not provide a ratepayer benefit is further demonstrated by its order in Docket No. 00-0802:

> First, as Staff has argued, the Commission has generally disallowed such expenses except where the utility has demonstrated that its incentive compensation plan has reduced expenses and created greater efficiencies in operations. For example, in its Order in the CILCO proceeding in Dockets 99-0199/99-0131 (Cons.), the Commission disallowed such expenses, and in doing so stated on pages 37-38, ***"The Commission remains convinced that such expenses are not recoverable in the absence of any evidence that the . . . Plan benefits ratepayers."*** In the limited number of cases in which such expenses were allowed, those companies had historical patterns of paying incentive compensation and were able to demonstrate that the incentive compensation payments provided benefits to ratepayers. Generally speaking, the Commission believes that if a utility is seeking to recover such projected expenses from ratepayers, the utility should demonstrate that its plan can reasonably be expected to provide net benefits to ratepayers. In the instant case, while Ameren has provided test year amounts for the expenses purportedly associated with its incentive compensation plan, as discussed below, it has not demonstrated that its plan has provided or will provide net benefits to ratepayers. ….
>
> …Accordingly, while the Commission believes that incentive compensation plans have the potential to provide benefits in terms of improving performance and reducing costs, and that the recovery of expenses associated with incentive compensation plans may be appropriate in some circumstances, the Commission concludes, for the reasons set forth above, that Ameren should not be allowed to recover from ratepayers the expenses associated with its current incentive compensation plan as requested in this docket.

*In re Central Ill. Public Service Co.*, ICC Docket No. 00-0802, pp. 18-19 (Order, Dec. 11, 2001) (emphasis added. Also, in its Order dated November 21, 2006, in Docket Nos. 06-0070/06-0071/06-0072 (Cons.), Ameren DST proceeding, the Commission stated as follows in denying the recovery of incentive compensation expenses:

> For the Commission to include ***any*** portion of incentive compensation costs in approved operating expenses, ***Ameren must demonstrate that the plan confers upon ratepayers specific dollar savings or other tangible benefits.*** As Staff notes, the Commission has generally disallowed recovery of incentive compensation costs except where the utility has demonstrated that its ICP has reduced expenses and created greater efficiencies in operations, as was done in Dockets No. 05-0597, 03-0403, 97-0351 and 95-0219. Consistent with those decisions, ***we are disallowing funding measures that primarily depend on meeting financial goals.*** In this case all three funding measures rely on earnings per share ("EPS") targets and therefore all operational goals are dependent upon meeting the EPS target first.

*In re Central Illinois Light Co., et al.*, Docket Nos. 06-0070, 06-0071, 06-0072 (Cons.), p. 72 (Order, Nov. 21, 2006) (emphasis added).

**iii. Company affiliate-performance goals**

Referring to Schedules 15.7 P and N page 2, line 8, Staff disallows 17% (Peoples Gas) and 24% (North Shore) of the remaining administrative and general expenses of the Executive Incentive plan costs as an estimate for the performance goals that are based upon achievements of Peoples Gas and North Shore's affiliates [$8,000 (Peoples Gas) and $1,000 (North Shore)]. The 17% (Peoples Gas) and 24% (North Shore) disallowances represent the ratio of the Companies' IBS/Corp SSO (shared services) and IBS Gas Services groups' incentive compensation expense for the Executive Incentive plan to the total Executive Incentive plan cost. ICC Staff Ex. 1.0, p. 13, lines 273-278.

The test year incentive compensation expense for all plans assumes the "target" level of performance is achieved, with the target based on the approved 2008 incentive compensation plans. ICC Staff Ex. 1.0, p. 12, lines 242-245. The Executive Incentive plan states that "[t]here will be no payouts for financial measure results unless Integrys Energy Group, Inc. Consolidated Net Income threshold outcome level is reached." ICC Staff Ex. 1.0, Attachment A. However, in 2008, the IEG net income actual result was below target. ICC Staff Ex. 1.0, Attachment D. This historical performance calls into question the accuracy of the test year forecasted incentive compensation amount being based upon achievement of target level IEG net income that has not been achieved in the past.

Further, the performance goals included in the Executive Incentive plan also include goals based upon results of Peoples Gas' and North Shore's affiliates. The IBS/Corp SSO (shared services) and IBS Gas Services groups, both of which allocate expenses to the test year, measure achievement of performance goals based on MER, MGU, UPPCO, and WPSC results in addition to Peoples Gas' and North Shore's results. Therefore, these groups could generate incentive compensation expense because performance goals are met in Wisconsin, Minnesota, and Michigan but not necessarily for achievements by Peoples Gas or North Shore. ICC Staff Exhibit 1.0, p. 13, lines 262-271. Staff's adjustments are consistent with the Commission's policy to disallow incentive compensation plan costs when the plans do not provide a tangible benefit to Illinois ratepayers.

#### iv. Performance goals tied to financial goals

Referring to Schedules 15.7 P and N, page 2, line 9, Staff disallows 50% of the of the remaining administrative and general expenses for the Executive Incentive plan costs associated with performance goals that are tied to IEG net income [$94,000 (Peoples Gas) and $21,000 (North Shore)]. In 2009, the plan changed so that if the consolidated net income threshold performance level of IEG is not reached, any earned non-financial measure payouts will be reduced by 50%. ICC Staff Ex. 1.0, pp. 13-14, lines 280-286 and ICC Staff Ex. 15.0, Attachment E. This calls into question the accuracy of the test year forecast that the performance goals will be paid out at the 100% target level since the payouts will be based upon IEG's consolidated net income targets, which have not been achieved in the past. ICC Staff Ex. 15.0, Attachment D. Staff's adjustment is consistent with the IAWC order discussed above.

### b. Disallowance of Certain Non-Executive Incentive Plan Costs

This section addressed Staff's proposed disallowance of Non-Executive Incentive plan costs related to shareholder-oriented goals, performance goals unlikely to be achieved, Company affiliate-performance goals, and performance goals tied to financial goals. ICC Staff Ex. 15.0, Schedules 15.7 P and N, p. 3.

The structure of the Non-Executive Incentive plan mirrors the Executive Incentive plan. ICC Staff Ex. 15.0, Attachments B and C. The only differences are the weighting of the financial goals versus performance or non-financial goals, and the estimated proportionate share of performance goals costs based upon the Companies' affiliates' goals. First, the financial weighting is 50/50 for the Non-Executive Incentive plan, rather than 70/30 for the Executive Incentive plan. ICC. Staff Ex. 1.0, pp. 14-15, lines 303-306.

Second, the estimated disallowance for Company affiliate goals based upon the ratio of the Companies' IBS/Corp SSO (shared services) and IBS Gas Services groups' incentive compensation expense for the Non-Executive Incentive plan to the total Non-Executive Incentive plan cost are 74% and 59% for Peoples Gas and North Shore, respectively. *See* Schedule 1.7 P and N, page 3, note (f). Therefore, Staff's adjustments for the Non-Executive Incentive plan are based upon the same facts and arguments as for the Executive Incentive plan discussed above. The result of Staff's analysis disallows approximately 98% (Peoples Gas) and 92% (North Shore) of the operating expense and rate base Non-Executive Incentive plan costs [$4,218,000 of $4,280,000 (Peoples Gas expense); $509,000 of $517,000 (Peoples Gas rate base) and $989,000 of $1,071,000 (North Shore expense) and $97,000 of $105,000 (North Shore rate base)] the Companies propose to recover in the revenue requirement but have not shown to benefit ratepayers.

**c. Disallowance of the Companies' stock plan costs related to shareholder-oriented goals**

Referring to Schedules 15.7 P and N page 4, Staff disallows the Companies' stock plan costs related to shareholder-oriented goals because the goals are based on financial measures that primarily benefit shareholders and not ratepayers. The three stock plans are awarded based on the following financial outcomes:

1. The Integrys Restricted Stock Unit Award plan is valued solely using the stock price of Integrys Energy Group, Inc.
2. The Integrys Performance Stock Right Agreement plan is valued using a model comparing Integrys Energy Group, Inc.'s stock price, shareholder returns, total stock return volatility and dividend yield with a peer group.

3. The Integrys NonQualified Stock Option Agreement plan is valued using a model comparing Integrys Energy Group, Inc.'s stock return volatility and dividend yield.

ICC Staff Ex. 1.0, pp. 15-16, lines 325-337. The result of Staff's analysis is disallowance of 100% or $3,067,000 (Peoples Gas) and $609,000 (North Shore) of the stock plan costs that the Companies propose to recover in the revenue requirement but have not shown to benefit ratepayers. Id., lines 339-342.

The Companies oppose this sub-part of Staff's adjustment to remove the incentive compensation costs of its stock-based plans since the "stock plans are designed to attract and retain a qualified and motivated workforce." NS-PGL Ex. JCH-1.0, p. 9. However, there is no debate that the stock plans are based solely on financial goals that primarily benefit shareholders. ICC Staff Ex.. 1.0, pp. 15-16, lines 322-342 and Staff Ex. 15.0, Attachment F. The Companies were denied cost recovery of their restricted stock and performance shares plan costs in their last rate cases since they failed to demonstrate cost savings or other direct ratepayer benefit. ICC Staff Ex. 1.0, p. 18, lines 388-391.. The Commission stated the following:

> We agree with Staff that three of the five plans (STIC, Affiliate Charges, Restricted Stock & Performance Shares) fail to demonstrate the cost savings or other direct ratepayer benefit that we require.

*In re North Shore Gas Company and The Peoples Gas Light and Coke Company*, ICC Docket Nos. 07-0241/07-0242 (Cons.), p. 66 (Order, Feb. 5, 2008). The current record similarly lacks a demonstration of cost savings or other direct ratepayer benefit.

### d. Disallowance of capitalized incentive compensation previously disallowed by the Commission

Referring to Schedules 15.7 P and N, page 5, Staff disallows capitalized incentive compensation previously disallowed by the Commission. In the Companies' last rate case, Docket Nos. 07-0241/07-0242 (Cons.), the Commission disallowed a portion of the Companies' capitalized incentive compensation. *In re North Shore Gas Company and The Peoples Gas Light and Coke Company*, ICC Docket No. 07-0241/07-0242 (Cons.), pp. 66-67 (Order, Feb. 5, 2008) The Companies did not make any entries, though, to remove the disallowed amount from rate base. ICC Staff Ex. 1.0, p. 17, lines 356-360. Therefore, the previously disallowed capitalized incentive compensation is included in the test year rate base and should be disallowed in accordance with the Commission's prior order. The Companies agree that they did not make entries to remove disallowed capitalized incentive compensation from rate base denied by the Commission in Docket Nos. 07-0241/0242 (Cons.), but maintain that these amounts should be included in rate base in this proceeding since its appeal remains pending. NS-PGL Ex. JH-2.0, p. 16. However, rulings of the Commission remain valid unless and until they are reversed or set aside by a reviewing court. 220 ILCS 5/10-204. Accordingly, the rates set in this case should not include amounts that the Commission has already disallowed from rate base.

Just over a year ago, the Commission adopted an adjustment similar to what Staff proposes in this case in another rate case. In ComEd's 2007 rate case, Docket No. 07-0566, Staff proposed to decrease rate base and operating expenses to disallow incentive compensation costs capitalized but disallowed in Docket No. 05-0597. *In re Commonwealth Edison Co.*, Docket No. 07-0566, p. 12 (Order, Sept. 10, 2008).

ComEd did not contest Staff's adjustment subject to its appeal of the Commission's prior order. ICC Staff Ex. 1.0, pp. 17-18, lines 367-372. Staff has no objection to the Companies similarly preserving their right to pursue their appeal the earlier ruling, but Staff's adjustment must be made unless and until the Commission's earlier ruling is reversed.

#### e. AG/CUB/City Incentive Compensation Adjustment

AG/CUB/City witness Effron also proposed an adjustment to remove these costs from the Companies' test year filing. However, his adjustment does not include all test year incentive compensation costs, since it does not include costs identified by the Companies later in their responses to discovery. ICC Staff Ex. 15.0, p. 18, lines 416-421. The Companies did not dispute the calculation of Staff's adjustment. Also, AG/CUB/City advocate a disallowance of 50% of incentive compensation paid directly to the employees of the Companies, and 100% disallowance of incentive compensation allocated from affiliates. AG/CUB/City Ex. 1.0, p. 21. Staff is unaware of the Commission strictly using these criteria -- direct payments versus allocations -- as the basis for calculation of an incentive compensation disallowance. Therefore, Staff recommends the Commission adopt Staff's adjustment rather than the AG/CUB/City's adjustment.

### 2. Non-union Base Wages (Agreed in Part) (Falls in Multiple Categories of O&M)

The Commission should accept Staff witness Hathhorn's proposed adjustments to reduce each Company's rate base and operating expenses to reflect test year non-union base wages at a more reasonable amount in light of the current economic environment. ICC Staff Ex. 15.0, Schedules 15.8 P and N, Non-Union Wages

Adjustment. The adjustments are the same as reflected on Schedule 1.8 P and N, pages 1 and 2, except for a correction of the calculation of accumulated deferred income taxes. Staff's adjustment is calculated using the 2009-2013 Consumer Price Index ("CPI") inflation rate of 2.2% as forecasted by the *Survey of Professional Forecasters* ("*Survey*"). ICC Staff Ex. 1.0, p. 26, footnote 3.

Staff used the Survey rate to escalate the Companies' 2008 actual non-union base wages to determine test year non-union base wages. This compares to the Companies' forecast increase of 4.2% in both calendar years 2009 and 2010. Id., p. 27, lines 629-630. The Companies state that their projected annual increases were forecasted using market data provided by the World at Work 2008-2009 Salary Budget Survey and with input from Towers Perrin consultants. NS-PGL Ex. JCH-1.0, p. 9-10. The 2009 market data was received by the Companies during the spring/summer 2008. ICC Staff Ex. 1.0, p. 27, lines 630-645. The test year percentage of 4.2% also appears overstated in comparison to the years 2006 through 2008 inclusive, wherein the percentage increase in non-union base wages was 3.0%, 3.5%, and 3.8%, respectively. ICC Staff Ex. 1.0, p. 27, lines 651-653.

An update to the salary survey upon which the Companies rely for their wages forecast shows the unreasonableness of their decision to rely upon pre-economic downturn data. A July 8, 2009 press release from World at Work discussed the WorldatWork 36th Annual Salary Budget Survey which collected survey data in April 2009. The press release states that corporate salary budget increases have dropped to historic lows, and that at 2.2%, the 2009 increase is the smallest in the survey's history and 1.7 percentage points below the 3.9% that had been projected in the previous year's report.  Finally, the press release stated that the projected budget increase for salaries for 2010 is 2.8%. ICC Staff Ex. 15.0, p. 21, lines 459-466. Thus, the very source upon which the Companies rely to support their case supports Staff's proposal rather than it supports the Companies' proposal.

The Companies discuss in direct testimony their consideration of the challenging economic times. Peoples Gas Ex. JFS-1.0 Rev. p. 4, line 67 et seq. and North Shore Ex. JFS-1.0 Rev. p. 3, line 53 et seq.  The Companies further state the forecasted increase amounts are prudent and reasonable, and necessary to remain competitive in the industry. NS-PGL Ex. JCH-1.0, p. 11.  The Companies would have rates set upon increases based on a salary study conducted prior to the current economic downturn. The Companies' response to the recent changes in the economy regarding its wage increases does not demonstrate reasonableness for rate setting.  The Companies state they cancelled the 2008 annual merit increase but replaced it with a "general wage delayed" increase covering a 14-month time period. NS-PGL Ex. JCH-1.0, p. 10.  The Companies have not demonstrated why a two month salary increase delay based upon pre-economic downturn data is reasonable for ratepayers to pay during this economic downturn.

The Commission has adopted adjustments to test year wages using an inflation factor in the past.  In Docket No. 91-0193, the Commission adopted a Staff adjustment to Central Illinois Public Service Company's proposed wage increases using the former Wharton Econometric Forecasting Associates ("WEFA") Economic Outlook. *In re Central Illinois Public Service Company*, ICC Docket No. 91-0193, p. 70 (Order, Mar. 18, 1992).  A similar adjustment was adopted by the Commission for ComEd. *In re*

*Commonwealth Edison Co.*, ICC Docket No. 90-0169, p. 38 (Order, Mar. 8, 1991). The Commission also adopted a Staff adjustment based upon an updated WEFA index in Peoples Gas' Docket No. 90-0007. *In re The Peoples Gas Light and Coke Co.*, ICC Docket No. 90-0007, p. 19, (Order, Nov. 9, 1990). The issue in the three previous cases was contested; the Commission also adopted an uncontested adjustment based upon the WEFA inflation indicator for IAWC. *In re Illinois American Water Co.*, ICC Docket No. 92-0116, p. 14 Order, Feb. 9, 1993).

### 3. Headcounts (Falls in Multiple Categories of O&M)

AG/CUB/City witness Mr. Effron proposed adjustments to reduce test year headcount from 1,139 to 1,080 for Peoples Gas and from 170 to 167 employees for North Shore. AG/CUB/City Exhibits 1.0, 1.1, 1.2, Schedules C-2.1. In regard to the adjustment to headcount for Peoples Gas, Staff witness Hathhorn testified that she agreed with the position of Peoples Gas that its increased forecast headcount is designed to address specific Liberty Audit recommendations. NS-PGL Ex. ED-2.0, pp. 6-7 and ICC Staff Exhibit 15.0, p. 32, lines 702-707. In regard to the adjustment of headcount for North Shore, Staff is not aware of any response from the Company other than simply not reflecting the adjustment in its rebuttal schedules; therefore, Staff has no opinion on whether it should be adopted. Id., lines 707-711.

### 4. Distribution Expenses

#### a. Liberty Audit-Related Expenses (PGL)

The Commission should accept Staff witness Hathhorn's proposed adjustment to disallow $4,961,000 in test year operating expenses prohibited from rate recovery by the Commission's order in Docket No. 06-0311 entered pursuant to a Stipulation and

Memorandum of Understanding ("MOU") among the parties to that docket. *See Illinois Commerce Comm'n v. The Peoples Gas Light & Coke Co.*, Ill. C.C. Docket No. 06-0311 (Order, Dec. 20, 2006) ("*06-0311 Order*"); ICC Staff Ex. 15.0, Schedule 15.12 P.

As explained in more detail below, the *06-0311 Order:*

(I) found that Peoples Gas failed to comply with certain federal and state pipeline safety regulations;

(ii) required Peoples Gas to pay for a consultant, to be retained by and perform under the direction and control of the Commission, to conduct a comprehensive investigation of Peoples Gas' compliance with the Commission's pipeline safety regulations;

(iii) required Peoples Gas to develop a program to address the recommendations identified by the Commission's consultant;

(iv) required Peoples Gas to bring itself into compliance with the Commission's pipeline safety regulations;

(v) prohibited Peoples Gas from seeking recovery in any future rate or reconciliation proceeding "of costs or expenses solely attributable to [its] not performing corrosion inspections in a timely manner, as specified in [Findings and Ordering] paragraph 4 …, or any incremental costs caused solely by violation of the Illinois Gas Pipeline Safety Act or its implementing regulations ("the Act") discovered by the Commission's consultant …, and which are over and above the prudent and reasonable costs necessary to comply with the Act";

(vi) required Peoples Gas to "operate an internal tracking mechanism to account for any such incremental costs"; and

(vii) prohibited Peoples Gas from recovering "any fees paid to the consultants retained by Peoples Gas or by the … Commission … in connection with or as a result of ICC Docket 06-0311."

*06-0311 Order*, pp. 7-8. The Liberty Consulting Group was retained as the Commission's consultant and investigated and reported on Peoples Gas' pipeline safety program, providing 66 recommendations ("Liberty Audit"). ICC Staff Ex. 23.0, Attachment A.

Ms. Hathhorn's proposed adjustment is for all costs that come within the above-described cost recovery prohibitions set forth in the *06-0311 Order*, including (i) costs attributable to the acts or omissions resulting in the Commission's finding that Peoples Gas failed to comply with corrosion inspection and related pipeline safety regulations, (ii) incremental costs caused solely by violation of the Pipeline Safety Act or its implementing regulations discovered by the Commission's consultant (Liberty Consulting) and which are over and above the prudent and reasonable costs necessary to comply with the Act, and (iii) costs for fees paid to consultants retained by Peoples Gas or by the Commission in connection with or as a result of ICC Docket 06-0311. All of the costs proposed for disallowance are collectively referred to in this brief and the outline as Liberty Audit-Related Expenses.

**i. The 06-0311 Order Cost Recovery Prohibition**

The Commission commenced Docket 06-0311 "to determine whether … Peoples Gas … failed to: 1) comply with the cathodic protection inspection requirements of 49 CFR § 192.465(a); 2) test corrosion control segments on an annual and/or ten-year testing schedule as required by Commission rules; 3) take prompt remedial action to correct any deficiencies indicated by the monitoring as required by 49 CFR § 192.465(d); and 4) comply with the requirement of 49 CFR § 192.13(c) by failing to follow its Corrosion Control Policy, Operation and Maintenance Plan." *06-0311 Order*, p. 1. Pursuant to the Stipulation and record evidence, the Commission in Docket 06-0311 found that Peoples Gas had indeed failed to comply with various pipeline safety regulations in Findings and Ordering Paragraph (4):

> (4) as acknowledged by Peoples Gas in the Stipulation, and as supported by the evidence, Peoples Gas was **not in compliance with applicable federal and state pipeline safety regulations** -- *viz*., 49 CFR §192.13(c) and 49 CFR §192.465(a) and (d), adopted by the Commission at 83 Ill. Admin. Code 590 pursuant to Section 3 of the Illinois Gas Pipeline Safety Act (220 ILCS 20/3) --

> respecting cathodic protection inspection and remediation and the requirement to maintain and follow procedures and programs, **by being late in conducting corrosion testing on certain service pipes and main segments that were due for inspection before and during 2003 and 2004, and by failing to perform corrective action during 2004 and 2005 at test points on certain service pipes and main segments found to be out of compliance during in 2003 and 2004**;

*06-0311 Order*, p. 7 (emphasis added).

In addition to imposing a penalty for the above-described violations (*Id*. at 7), the Commission imposed rate recovery limitations and cost tracking requirements on Peoples Gas in Findings and Ordering Paragraph (11):

> (11) pursuant to its agreement in the Stipulation, Peoples Gas shall not seek recovery, in any future rate or reconciliation proceeding before the Commission, of costs or expenses solely attributable to Peoples Gas' not performing corrosion inspections in a timely manner, as specified in paragraph 4 above, or any incremental costs caused solely by violation of the Illinois Gas Pipeline Safety Act or its implementing regulations ("the Act") discovered by the Commission's consultant retained pursuant to the Memorandum of Understanding, and which are over and above the prudent and reasonable costs necessary to comply with the Act. Peoples Gas shall operate an internal tracking mechanism to account for any such incremental costs. Peoples Gas shall respond to reasonable inquires by Commission Staff or intervenors concerning the information gathered by this tracking mechanism. Also, Peoples Gas should not recover any fees paid to the consultants retained by Peoples Gas or by the Illinois Commerce Commission (collectively, "the Consultants") in connection with or as a result of ICC Docket 06-0311;

*06-0311 Order*, page 8. While there is not a general discussion of these recovery limitations in the *06-0311 Order*, the Commission's intent is clear and reasonable: ratepayers should not pay for any cost increase that results from the Company's failure to comply with applicable pipeline safety regulations.

The failure to comply with applicable pipeline safety regulations clearly constitutes an imprudent act or omission by Company management. The Commission properly found that additional or incremental costs resulting from the compliance violations identified in the *06-0311 Order,* as well as other compliance violations discovered by the Commission's consultant, should not be recovered from ratepayers. This ruling is legally sound, since the Commission must examine why a particular cost is incurred to determine whether it is a prudently incurred cost. In other words, as explained below, the Commission may find a cost that would otherwise be prudent and reasonable to be an imprudently incurred cost if the reasons that necessitated the purchase or expenditure are imprudent management decisions, acts or omissions. The Commission's decision to bar recovery of additional costs incurred as a result of Peoples Gas' failure to comply with applicable pipeline safety regulations is proper since the failure to comply is not prudent and the costs caused by those imprudent acts or omissions cannot constitute prudently incurred costs. The fact that those costs are necessary to come into compliance with applicable pipeline safety regulations (and would otherwise be considered prudent when viewed from that perspective) does not excuse the Company from the consequences of its imprudent acts or omissions; namely, the non-recovery of additional costs incurred as a result of its imprudent acts or omissions.

In *Business & Professional People for Public Interest v. Illinois Commerce Comm'n*, 171 Ill. App. 3d 948 (1st Dist. 1988) ("*BPI*") Commonwealth Edison Company ("ComEd") appealed a Commission's determination in a uniform fuel adjustment clause reconciliation proceeding that over $70 million of costs should be refunded to customers because they were not prudently incurred. *Id*. at 955-956. ComEd argued that the Commission erred in making its prudence determination by looking at plant productivity (i.e., the failure of the LaSalle 1 nuclear power plant to operate at forecasted capacity) to determine the prudence of purchased fuel and power (i.e., fuel and power needed to generate or obtain electricity to replace power not generated due to the reduced productivity of LaSalle 1). *Id*. at 956-958. The court upheld the Commission's decision and explained that ComEd's view on the narrow scope of a prudence review was contrary to the requirement for just and reasonable rates:

> If, in a fuel reconciliation proceeding, the Commission could not examine the reasons that necessitated a fuel purchase, the prudence standard would have no effect on ensuring a just and reasonable rate as required by sections 36 and 41 of the Act; a utility could generate electricity in any manner it chose, efficiently or inefficiently, and the Commission would be limited to determining merely whether the utility paid a prudent price for the fuel.

(*Id*. at 958) Thus, while the costs of reasonably priced fuel needed to generate electricity for a utility's customers would generally be considered prudently incurred costs, such costs are not prudently incurred if an imprudent management act or omission caused or contributed to the need for such fuel. Thus, the court held "that the Commission was within its statutory authority when it applied the prudence standard to the reasons for the purchases, and not only to the actual purchase transactions." *Id*. at 959.

The Commission applied this same logic to exclude from Central Illinois Light Company's ("CILCO") rate base additional costs incurred to replace cast iron mains on an expedited basis because the need for expedited replacement resulted from CILCO's imprudent failure to adequately maintain its Springfield cast iron distribution system. *In re Central Illinois Light Company*, ICC Docket No. 94-0040, 1994 Ill. PUC LEXIS 577, 12-42; 158 P.U.R.4th 1 (Order, Dec. 12, 1994). Specifically, the Commission found that CILCO had acted imprudently with respect to its management of gas leaks:

> The Commission concludes that the weight of the evidence leads to the inexorable conclusion that CILCO, for an unspecified period of time prior to the discovery of gas in Springfield manholes by Commission personnel in the spring of 1992, had been engaged in a systematic course of conduct intended to underreport the number and severity of gas leaks occurring on its Springfield cast iron distribution system. The Commission further finds that this course of conduct led to the existence of a substantial threat to public safety, which necessitated the immediate and accelerated replacement of the majority of the cast iron system and the expenditure of significant sums that would not have been spent but for CILCO's imprudence.

*Id*. at 24-25. The Commission then concluded that this imprudence necessitated disallowance of some of the costs of replacing the cast iron system:

> The Commission … finds that allowing the Springfield system to deteriorate to the point of creating a public safety hazard necessitated an accelerated renewal program which led to a level of expenditures that would not ordinarily have been required had CILCO been conducting business in a reasonably prudent manner.
>
> The Commission is of the opinion that such a course of conduct requires the disallowance of some of the expenses associated with the Springfield renewal program….

*Id*. at 29-30. The Commission rejected arguments that sought to disallow all costs, instead finding that "the disallowances should be imposed only to the extent that the expenses and investment exceed the levels that would have been incurred absent imprudence on the part of CILCO." *Id*. at 40. Staff calculated the additional costs by "comparing the present value of the amount actually expended by CILCO on the renewal program, with the present value of the total amount that would have been expended had CILCO undertaken an eight year renewal program beginning in 1994." *Id*. at 30. The Commission accepted this methodology, with a modification to the discount rate proposed by other parties. *Id*. at 30-35, 40-42.

The reasoning and analysis in CILCO is applicable here. Peoples Gas' failure to perform corrosion inspections and related maintenance caused a certain level of accelerated and additional activities to come into compliance. The same analysis holds for additional violations discovered by the Commission's consultant. To the extent that these costs exceed the costs that would have been incurred without the Company's imprudent failure to comply with applicable pipeline safety regulations, those costs constitute imprudently incurred costs for which recovery must be denied. The arguments by the Companies witnesses, discussed below, that no imprudent or incremental costs exists because all costs were incurred to come into compliance ignores the law and the Commission's order as discussed above.

**ii. Staff's Proposed Disallowances**

Peoples Gas included $540,000 in test year fees for Liberty Consulting Group and Huron Consulting Group related to the Liberty Audit follow up work, even though such expenses were prohibited to be included in the test year by the Stipulation and Commission Order. ICC Staff Ex. 1.0, pp. 32-33, lines 779-782. Staff contends that the existence and inclusion of prohibited expenses is not an isolated event and notes the Company's failure to track costs. However, Peoples Gas maintains that "No such costs have been identified so no tracking system has been required." Peoples Gas further asserts that there were no such charges as described in paragraphs (4) and (11) for 2008, 2009, or the test year. *Id*., lines 784-787.

The Company also states that "Liberty Consulting has not identified any violations of the Illinois Gas Pipeline Safety Act ("the Act") or its implementing regulations as a result of their investigation of Peoples Gas' pipeline safety practices. Therefore, no incremental costs have been incurred above prudent and reasonable costs necessary to comply with the Act." NS-PGL Ex. ED-2.0, p. 7. Staff witness Burk in ICC Staff Exhibit 23.0 refuted the Company's position by identifying a number of code violations discovered by the Liberty Audit. Company witness Doerk does not challenge Mr. Burk's interpretation of the selected Liberty Audit conclusions as code violations. NS-PGL Ex. ED-3.0, p. 7, lines 134-135. Therefore, the premise for the Company's statement above is unsustainable and must be rejected.

Company witness Schott similarly states that "[b]ased on the rebuttal testimony of Mr. Doerk, there have been no known non-performance or violations since the date of that Order, therefore no such incremental costs have been incurred. It would have been a waste of resources to develop a tracking mechanism for such costs where no such costs existed." NS-PGL Ex. JFS-2.0, p. 14. With respect to "non-performance", it has already been determined in Docket No. 06-0311 that Peoples Gas failed to follow cathodic protection inspection and remediation requirements in a timely manner, as acknowledged by Peoples Gas in Finding (4) quoted above. ICC Staff Ex. 1.0, p. 25, lines 544-566.

The *06-0311 Order* prohibits Peoples Gas from seeking recovery of "costs or expenses solely attributable to" these violations. *06-0311 Order*, p. 8. The assertion that there have been no incremental costs from "non-performance" because there has allegedly been "no known non-performance … since the date of that Order" is illogical. The *06-0311 Order* clearly prohibits recovery of costs or expenses incurred solely as a result of Peoples Gas' non-performance before entry of the order. Peoples Gas cannot credibly dispute that it incurred costs or expenses after the date of the *06-0311 Order* to perform cathodic protection inspection and remediation requirements related to its pre-order violations. The question is whether and to what extent those costs or expenses were solely attributable to the earlier non-performance. This task could have been relatively easy and straight-forward if Peoples Gas had implemented a tracking system as ordered by the Commission. While Staff cannot directly calculate the amount of costs or expenses solely attributable to Peoples Gas' pre-order non- performance because of Peoples Gas' failure to track, Staff is confident that costs or expense for which recovery is prohibited did occur and are reflected in the test year. *Id*, lines 567-584.

As Staff witness Darin Burk explained in his rebuttal testimony (ICC Staff Ex. 23.0, pp. 8-10), Peoples Gas' non-compliance resulted in a backlog of required pending corrective actions and Peoples Gas hired contractors to perform troubleshooting and perform corrective actions in 2008. The 2010 future test year costs utilized in this case are based on extrapolations and escalations of 2008 costs. ICC Staff Ex. 15.0, p. 26. The additional costs incurred in 2008 to eliminate the backlog (in comparison to the costs that would have been incurred in 2008 without the prior violations) are imprudently incurred costs for which recovery is prohibited under the *06-0311 Order*. This is only one example of an additional cost attributable to Peoples Gas' pre-order violations. Other examples of additional costs attributable solely to the violations would be costs for re-performing work improperly performed the first time or any increased costs of performing work in 2008 versus the earlier period when it should have been performed.

As noted above and explained in more detail in the testimony of Staff witness Darin Burk (ICC Staff Exhibit 23.0), violations of the Pipeline Safety Act and its implementing regulations were discovered by the Commission's consultant. Once again, costs to remedy those violations should have been tracked by the Company pursuant to the 06-0311 Order so that incremental costs caused solely by those violations could be identified. Because of the Company's failure to implement a tracking mechanism, no direct measurement of such incremental costs can be made.

It is clear as explained above that the Company incurred and seeks recovery of costs that fit within the recovery prohibition from the *06-0311 Order*. Therefore, Mr. Schott's assertion that "[i]t would have been a waste of resources to develop a tracking mechanism for such costs where no such costs existed" is completely erroneous. The Company's decision to not track these costs is contrary to the Commission's order, and any adverse consequences from that decision should be borne by the Company and not ratepayers. ICC Staff Ex. 15.0, pp. 26-27, lines 586-618.

Company witness Schott also contends that Staff's adjustment is "against public policy" by "[n]ot allowing recovery of costs to 'come into compliance.'" NS-PGL Ex. JFS-2.0, p. 14. Mr. Schott ignores the fact that Staff witness Hathhorn does not recommend disallowance of all costs to "come into compliance." ICC Staff Ex. 15.0, p. 23, lines 500-509. Rather, she recommends disallowance of costs or expenses solely attributable to the cathodic inspection requirement violations specified in the 06-0311 Order and any incremental costs caused solely by violation of the Act or its implementing regulations discovered by the Commission's consultant. The Commission's order and Staff's recommendations are legal and proper, as discussed above, and prohibit recovery of costs necessitated by the Company's imprudent non-compliance with pipeline safety regulations.

Furthermore, the Commission's *06-0311 Order* and Staff's proposed adjustment are consistent with public policy. If a utility violates applicable statutes or rules that result in that utility incurring more costs than it would have otherwise incurred without those violations, even if those additional costs are to come into compliance with the applicable requirement, then ratepayers should not bear the additional costs resulting from the utility's violations. To allow otherwise would essentially reward or condone the utility's violations and would not be just and reasonable. ICC Staff Ex. 15.0, p. 28, lines 625-636.

### iii. Calculation of the Adjustment

The Company claims that Staff's adjustment is arbitrary. NS-PGL Ex. JFS-2.0, p. 15. The Company's claim is baseless. Any lack of precision in Staff's adjustment is solely due to the Company not operating the required internal tracking mechanism to account for the incremental costs. Therefore, it was necessary for Staff's adjustment to be based upon a reasonable estimate. The calculation of Staff's adjustment considered the timing of the work supporting the audit, issuance of the report, implementation of corrective actions (many still in progress), and the timing of the test year. ICC Staff Ex. 1.0, p. 34, lines 819-825. Staff witness Hathhorn testified and the Company did not dispute her understanding that the distribution expenses would contain most if not all of the costs at issue. Staff's direct testimony described the development of the disallowance to the test year based upon 6 months actual and 6 months forecast of 2008 costs. Much of the work associated with the audit was performed in 2008, and the audit report was issued in August 2008. These facts are uncontested, as Mr. Doerk's testimony confirms that the Company started responding to the Liberty audit findings during the audit period. NS-PGL Ex. ED-3.0, p. 8, lines 163-164 and p. 9, lines 184-186. In addition, as explained above, other actions to address the violations identified in the

*06-0311 Order* occurred in 2008. Test year expenses were developed by escalating 2008 expenses 2% for 2009 and another 1.8% for 2010. ICC Staff Ex. 1.0, p. 35, footnote 6.

For example, for every $1 million in 2008 charges, $1.038 million is included in the test year, or a cumulative 3.8% increase. Therefore, Staff's 5.0% reduction of costs disallows the 3.8% increase due to inflation of the distribution expenses from 2008 plus 1.2% (5.0% less 3.8%) for corrective actions not allowable for cost recovery under the Stipulation and MOU and *06-0311 Order*, such as the fees from the Liberty Consulting Group and Huron Consulting Group. NS-PGL Ex. SM-2.0, p. 4. While Staff is unable to calculate a precise disallowance given the Company's failure to implement a tracking mechanism, it is clear that significant work was performed in 2008 relative to the violations identified in the *06-0311 Order* and discovered by the Commission's consultant. While Staff does not know the exact amount of costs or expenses incurred in this regard, or the exact amount of those costs or expenses representing additional costs that would not have otherwise been incurred, 5% of the cost category including all such costs is a reasonable estimate given the information available to the parties and the Commission. ICC Staff Exhibit 15.0, pp. 30-31, lines 659-681.

The Company's statements concerning the test year belie the facts. Company witness Doerk testified that he did not know how the test year was actually developed (Tr. pp. 622-623) even though he claimed in surrebuttal that there are no contractor costs related to corrosion control trouble shooting reflected in the test year. NS-PGL Ex. ED-3.0, p. 10, lines 193-194. Mr. Doerk's surrebuttal goes on to explain that "there are no Huron Consulting costs related to the Liberty Consulting pipeline safety audit in the test year." Id., p. 11, lines 213-214. At hearing, Mr. Doerk could not testify whether he was aware that Staff had to make an adjustment in direct testimony to remove such expenses.

#### iv. Further Discussion of the Commission's Standards for Cost Recovery of Prudent and Reasonable Costs

The Company's interpretation of what is and is not a prudent and reasonable cost sheds light on why no internal tracking mechanism was maintained as ordered by the Commission. Mr. Doerk testified that he was responsible for the Commission directive from the *06-0311 Order* to implement a tracking system. Tr., p. 636. At various points in his surrebuttal testimony, he testified that costs were not above prudent and reasonable, or prudent and necessary. NS-PGL Ex. ED-3.0, pp. 7-10. Mr. Doerk testified at hearing that he defines these terms as "costs that would be normally incurred to remain compliant and perform work. It's work that the Company is required to perform." Tr., p. 627. It appears the witness did not consider whether any prior violations contributed to the cost incurred as discussed above and in Findings (4) and (11) of the *06-0311 Order*. This is revealed in much of Mr. Doerk's cross examination, including the following:

> Q. And in your opinion, regardless of the Company's prior violations that work could never be[ ] unreasonable and imprudent?
>
> A. That work was all work that was required to be done in order to bring the system up to its proper level. It was all pending work that was required to be done.
>
> Q. And because of that, in your opinion, it's not relevant why the Company had to do that work in that particular year?
>
> A. That work would have been generated by current inspections. Any time you do inspections, some of them will generate a corrective action. Next year there is going to be corrective action, this year there is corrective action.

Id., p. 631-632.

Clearly few if any costs could ever be found imprudent or unreasonable notwithstanding a utility's failure to properly maintain its system if the only inquiry is whether the costs were incurred to maintain the system. Under the Company's analysis, as in the *Commonwealth Edison Co.* decision discussed above, a utility could perform its corrosion inspection and maintenance activities in any manner it chose -- timely or untimely, efficiently or inefficiently -- and the Commission would be limited to determining merely whether the amount paid for the work actually performed was reasonable. In analyzing whether costs have been prudently incurred Staff not only reviews the price paid for the goods or services, but also analyzes the reason or reasons for the purchase of the goods or services. If an imprudent or improper action is what caused a cost to be incurred, then that cost is not a prudently incurred cost even if the price paid for the good or service is otherwise reasonable. Here, additional costs resulting from Company's violations are not prudently incurred costs, and the *06-0311 Order* and Staff's proposed disallowance are proper and consistent with public policy. ICC Staff Ex. 15.0, pp. 28-29, lines 636-644.

Company witness Schott also testified as to his opinion of recoverable costs. It became clear though, at the hearing, that Mr. Schott had no responsibility for implementing the tracking mechanism required of the *06-0311 Order*. His testimony merely presents his interpretation of the *06-0311 Order*, of which he was neither involved nor assigned follow up duties for tracking costs. He had no operational duties for or independent knowledge of the costs at issues; he deferred all such questions to

Mr. Doerk. Tr., p. 130, 138. Therefore, for the purpose of deciding this issue, his testimony should be given no weight.

Furthermore, Mr. Schott's arguments do not stand up to scrutiny. Mr. Schott presented an analogy concerning a trucking company and concluded that, "Incremental costs incurred **as a result of** violations should not be recoverable. Costs incurred **to avoid** violations should be recoverable." NS-PGL Ex. JFS-2.0, p. 15, lines 258-267 (emphasis in original). Speaking hypothetically, since no actual Company records are available for the Commission to review, Staff agreed that incremental costs incurred as a result of violations should not be recoverable in rates. However, the Company may have incurred two, three, or four times the normal test-year level of expense amount in order to avoid a violation. Such escalated costs should not be recoverable simply because they were incurred to avoid violations. The prudence and reasonableness of the costs need to be considered. ICC Staff Ex. 15.0, p. 31, lines 668-695.

Mr. Schott also testified at hearing that he interprets the *06-0311 Order* to not require the Company to track costs solely attributable to Peoples Gas not performing corrosion inspections in a timely manner. Tr., p. 136, August 26, 2009. He further testified that he has no independent knowledge from Mr. Doerk of the nature of the costs at issue. *Id*., p. 138. Finally, while first stating he did not agree that costs currently incurred to perform maintenance or repair work that should have been performed in a prior year, and for which there was no reason or justification for delaying such work, may constitute imprudently incurred costs in the current year for ratemaking purposes (*Id*., pp. 140), he later agreed that notwithstanding the fact that a utility pays a prudent price for some bidder's service it is possible that those costs may not have been prudently incurred. *Id*., p. 147.

In summary, Staff's adjustment is sound, reasonable, supported by the facts of the *06-0311 Order* and the instant case, has a sound legal underpinning based on the *Commonwealth Edison Co.* decision and the CILCO order discussed above, is necessary in order to produce just and reasonable rates, and should be adopted by the Commission.

**5. Customer Accounts**

**a. Uncollectibles Expense Related to Sales Revenues Adjustment**

**6. Customer Service and Information**

**a. Advertising (Agreed in Part)**

While the Companies accepted part of Staff's proposed adjustments to advertising expense, they did not accept that part of Staff witness Wilcox's adjustment related to advertising that Staff witness Wilcox found to be primarily promotional, goodwill, or institutional in nature. The Commission should accept Staff's proposed adjustment for advertising that is primarily good will and institutional in nature. Section 9-225 of the Act states in part:

> In any general rate increase requested by any gas or electric utility company under the provisions of this Act, the Commission shall not consider, for the purpose of determining any rate, charge or classification of costs, any direct or indirect expenditures for promotional, political, institutional or goodwill advertising, unless the Commission finds the advertising to be in the best interest of the Consumer or authorized as provided pursuant to subsection 3 of this Section.

220 ILCS 5/9-225(2). Section 9-225 of the Act defines goodwill or institutional advertising as:

> … any advertising either on a local or national basis designed primarily to bring the utility's name before the general public in such a way as to improve the image of the utility or to promote controversial issues for the utility or the industry.

220 ILCS 5/9-225(1)(d).

Based on his review of the Companies' advertising material, Staff witness Wilcox proposed adjustments to disallow advertising expenses for the "Safety, Reliability, and Warmth" Campaign ("SRW") because those advertisements were primarily promotional, goodwill, or institutional in nature. Mr. Wilcox specifically explained that the substance of the campaign is promotional even though the words "safety" and "reliability" are used. ICC Staff Exhibit 6.0, pp. 4-6, lines 81-117; Schedules 6.3 P and 6.3 N.

While the Companies accepted part of Mr. Wilcox's proposed adjustments (NS-PGL Ex. SM-2.0, pp. 6-7, lines 140-143), they contest the parts of Mr. Wilcox's adjustments associated with the SRW Campaign. The Companies' witness Moy argued that the key message strategy of the campaign was to educate customers how the Companies deliver safe, clean, and reliable natural gas to improve customers' lives. Ms. Moy further asserted that the energy education advertising in the SRW Campaign focused on three main customer benefits: (1) conserving/managing home natural gas use, (2) billing and payment options, and (3) staying safe and understanding the use and maintenance of the natural gas delivery function. NS-PGL Ex. SM-2.0, p. 6, lines 97-113. Ms. Moy explained that the elements of the advertisements that Mr. Wilcox takes issue with are emphasized in the advertisements merely as a creative communication strategy used to catch the customer's attention. NS-PGL Ex. SM-2.0, p. 5, lines 144-160. Ms. Moy also argued that the costs should be recoverable because even without the SRW Campaign the Companies would still incur costs for energy education and that forms of media other than bill inserts and the corporate website are necessary in order to reach a wider audience. NS-PGL Ex. SM-3.0, p. 6, lines 114-123.

The Companies' arguments fail to withstand scrutiny. The Companies' argument that the promotional and good will elements are the primary means of drawing attention to the advertisements ignores the fact that those attention-getting elements are in fact the primary purpose of the advertisements. In fact, in Company-provided photographs of how the advertisements were positioned, the promotional and good will elements are the only ones that are legible.[2] These photographs are presented in Attachment 1 to this brief. Presumably, the Companies believe these photographs are the best way to present the advertisements in their actual context, since the Companies themselves provided the photographs. Viewing the advertisements, one necessarily concludes that sprinkling passing references to energy conservation or payment options into the advertisement's fine print does not transform the primary message one receives from the advertisement.

The Companies' argument that they should recover the costs of the SRW Campaign because they would incur costs for customer education even without the SRW Campaign should be rejected. The evidence demonstrates that the Companies already incur costs for customer education about energy efficiency and billing options outside the SRW Campaign. In fact, those costs are included in the test year and are not the subject of a proposed adjustment. These advertisements are presented in ICC

[2] See ICC Staff Cross Ex. Moy 22, pp. PGL 0001484, PGL 0001485, and PGL 0001528 (PGL LHW 1.07b Attachment 01))

Staff Cross Ex. Moy 22 and ICC Staff Cross Ex. Moy 23.[3] An example of these advertisements for each Company is presented in Attachment 2 to this brief. Even the most cursory comparison of these advertisements with those in the SRW Campaign reveals that they provide much more substantive information than those in the SRW Campaign. The evidence in this proceeding demonstrates that the SRW Campaign is not the primary way the Companies provide information to customers about energy efficiency or payment options. Neither are energy efficiency or payment options the primary message of the SRW Campaign.

The Companies' argument that the SRW Campaign allows them to reach a wider audience with a more powerful message than using bill inserts or the corporate website is troubling. It is not clear who, besides the customers who receive the bills with the bill inserts, the Companies are trying to reach. If it is someone other than the Companies' customers (i.e. a Nicor customer, a tourist, etc), then it is not clear why it is reasonable for the Companies customers to pay for it through rates.

For all the foregoing reasons, the Commission should accept all of Staff witness Wilcox's adjustments to advertising expenses.

### 7. Administrative & General

#### a. Injuries and Damages Expenses

Staff witness Ostrander proposed adjustments to replace the 2010 expense accrual component of the injuries and damages reserve with a normalized level of injuries and damages operating expense for the 2010 test year. The 2010 expense

[3] See ICC Staff Cross Ex. Moy 22., pp. PGL 0001496 - PGL 1527, PGL 0001529 - PGL 1530 (PGL LWH 1.07b Attachment 01); ICC Staff Cross Ex. Moy 23, pp. NS 0000759 - NS 0000792 (NS LWH 1.03b Attachment 01).

accrual component of the injuries and damages reserve represents the Companies' estimate of what payments will be made in the future for injuries and damages claims incurred during the 2010 test year. Since the amount of incurred claims can fluctuate significantly from year to year, it is more appropriate to utilize a normalized level of injuries and damages expense for ratemaking purposes. ICC Staff Ex. 3.0, pp. 11-12 and ICC Staff Ex. 17.0, pp. 10-13.

The Companies assert that the injuries and damages amounts initially proposed in the 2010 test year operating expenses are reasonable. NS-PGL Gas Ex. CMG-2.0, pp. 3-4. Yet, for the most recent five year period, 2004 – 2008, the actual payments for injuries and damages claims in 4 of the 5 years were less than the amount the Companies accrued in the 2010 test year. ICC Staff Exhibit 17.0, Schedules 17.2 N and P, p. 2, lines 1-5. A normalized operating expense amount should reflect the expected annual recurring level that the Companies expect to pay, apart from unusual conditions. Historical payments (experience) are a good standard against which to evaluate an expected recurring level of expense. Since the 2010 expense accruals are greater than historical experience, the Companies' injuries and damages expense accruals should be decreased to reflect a normalized level of expense in the Companies' 2010 test year operating expenses.

The Companies accepted Mr. Ostrander's proposed adjustments to injuries and damages expenses contingent upon consistent adjustments with respect to the injuries and damages reserves in rate base. NS-PGL Ex. SM-3.0, p. 4. The Companies believe that there is a direct correlation between the amount of injuries and damages expense and the amount of the injuries and damages reserve amount which would warrant that any adjustment made to expense should also be made to the reserve. NS-PGL Ex. JH-3.0, p. 12. For purposes of determining a revenue requirement, Staff does not agree that there is a direct correlation between the injuries and damages reserve and expense amounts. See Section IV. RATE BASE, G. Reserve for Injuries and Damages, for Staff's explanation of why there is no need for corresponding adjustments with respect to the injuries and damages reserves in rate base.

The adjustments recommended by Staff witness Ostrander to reflect a normalized level of injuries and damages operating expense for the 2010 test year are appropriate and should be adopted by the Commission.

#### 8. Revenues

##### a. Sales Revenues Adjustment

### D. Depreciation (Uncontested Except for Derivative Adjustments from Contested Adjustments)

### E. Taxes Other Than Income Taxes (Payroll and Invested Capital Taxes) (Uncontested Except for Derivative Adjustments from Contested Adjustments)

In direct testimony, Staff witness Hathhorn presented adjustments to include in operating expenses the incremental increase in invested capital taxes ("ICT") that will result from the increased operating income approved in this case. ICC Staff Ex. 1.0, Schedules 1.12 P and N, Invested Capital Taxes Adjustment. Staff explained that the ICT adjustments will need to be updated to reflect the final Commission approved rate of return and rate base approved in this case. Staff's methodology is consistent with the Commission Order in Docket Nos. 07-0241/07-0242 (Cons.) on this issue and is appropriate since the Companies do not anticipate any changes in their proposed test year capital structure. ICC Staff Ex. 1.0, pp. 30-31, lines 719-727. The Companies agreed with Staff's proposal. NS-PGL Ex. SM-2.0, p. 4. Therefore, the ICT Adjustments in Appendix A and B to Staff's Initial Briefs must be updated to reflect the final conclusions of the Commission in this case.

### F. Income Taxes (Including Interest Synchronization) (Uncontested Except for Derivative Adjustments from Contested Adjustments)

## VI. RATE OF RETURN

### A. Overview

### B. Capital Structure

#### 1. Peoples Gas

Peoples Gas has an actual average 2010 capital structure comprising $532,238,953 long-term debt or 40.33%, $19,113,513 short-term debt or 1.45%, and $768,405,875 common equity or 58.22%. ICC Staff Ex. 22.0, Schedule 22.3P. The Company proposed a hypothetical capital structure comprising 44% long-term debt and 56% equity.

The Company's proposed hypothetical, imputed capital structure, which excludes short-term debt, produces a lower overall rate of return for the Company than its forecasted average 2010 capital structure, which includes short-term debt. In addition, Therefore, to reduce issues in this case, Staff will accept for purposes of this proceeding Peoples Gas' proposed hypothetical capital structure of 0% short-term debt, 44% long-term debt and 56% common equity even though Peoples Gas clearly uses short-tem debt to finance rate base. ICC Staff Exhibit 22.0, pp. 3-4. Although Staff is not contesting the Peoples Gas' proposed capital structure, Staff requests the Commission's Order summarize Staff's reason for doing so as described above.

### 2. North Shore

North Shore has an actual average 2010 capital structure comprising $72,476,045 long-term debt or 41.44%, $6,843,865 short-term debt or 3.91%, and $95,578,042 common equity or 54.65%. ICC Staff Ex. 22.0, Schedule 22.3N. The Company proposed a hypothetical capital structure comprising 44% long-term debt and 56% equity.

The Company's proposed hypothetical, imputed capital structure, which excludes short-term debt, produces an overall rate of return of 7.90%. The Company's forecasted average 2010 capital structure, which includes short-term debt, produces an overall rate of return of 7.85%. The overall rates of return produced by both capital structures are very similar. Therefore, to reduce issues in this case, Staff will accept for purposes of this proceeding North Shore's proposed hypothetical capital structure of 0% short-term debt, 44% long-term debt and 56% common equity even though North Shore clearly uses short-tem debt to finance rate base. Although Staff is not contesting the North Shore's proposed capital structure, Staff requests the Commission's Order summarize Staff's reason for doing so as described above.

## C. Cost of Long-Term Debt

### 1. Peoples Gas

#### a. 9-230 Adjustment (Uncontested)

The Company and Staff agree that an adjustment to Peoples Gas' cost of long-term debt is necessary to reflect its stand alone financial strength. NS-PGL BAJ-2.0, p. 20; ICC Staff Ex. 8.0, p. 13. The actual cost of long-term debt for Peoples Gas reflects the Standard & Poor's ("S&P") and Moody's credit ratings for the Company, which non-utility affiliates affected. S&P downgraded the credit ratings of the Company to A- from AA- on September 26, 2002.[4] Moody's downgraded the credit ratings of the Company to Aa3 from Aa2 on September 23, 2002.[5] Staff witness Michael McNally testified that affiliation with unregulated or non-utility companies adversely affected Peoples Gas' credit ratings. ICC Staff Exhibit 7.0, pp. 27-28. In determining a reasonable rate of return for establishing rates, Section 9-230 of the Public Utilities Act prohibits the inclusion of any incremental risk or increased cost of capital, which is the direct or indirect result of the public utility's affiliation with unregulated or non-utility companies. Since all but one of the outstanding debt series of Peoples Gas were issued after the downgrades occurred were issued after the downgrades occurred and those downgrades were due to the utilities' affiliation with unregulated companies, the costs associated with such issues need to be adjusted to eliminate the increased cost associated with the lower rating. ICC Staff Ex. 8.0, p. 13.

From an analysis of concurrent bond yield spreads, Staff witness Kight-Garlisch lowered the interest rate on the Series NN bonds to 4.57% from 4.625%, the Series SS bonds to 6.75% from 7%, the Series MM bonds to 3.94% from 4.00%, the Series TT bonds 30 basis points to 7.70% from 8.0%, the New Issue 2009 bonds to 7.43% from 7.75% and New Issue 2010 bonds to 7.58% from 7.9%. ICC Staff Ex. 8.0, pp. 17-19.

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[4] Standard & Poor's Ratings Direct - Research, North Shore Gas' Ratings Lowered; Outlook Stable, September 26, 2002; Peoples Gas Light & Coke's Ratings Cut; Outlook Stable, September 26, 2002.

[5] Moody's Investors Service, Rating Action: Peoples Gas Light and Coke Company – Moody's Downgrades With Negative Outlooks The Debt of Peoples Energy Corp., Peoples Gas Light and Coke Company, and North Shore Gas Company, September 23, 2002; Moody's Investors Service, Rating Action: North Shore Gas Company – Moody's Downgrades With Negative Outlooks The Debt of Peoples Energy Corp., Peoples Gas Light and Coke Company, and North Shore Gas Company, September 23, 2002.

The Series KK, LL, OO, QQ and RR bonds of Peoples Gas were issued as insured tax-exempt bonds to the Illinois Development Finance Authority ("IDFA"). The repayment of the principal and interest on the bonds issued to the IDFA is secured by an insurance policy, purchased by Peoples Gas. As a consequence of that insurance, the IDFA bonds were rated AAA at the time of issuance. All five bond series were issued after the ratings downgrades and therefore reflect the increased risk of the unregulated affiliates. Had Peoples Gas' credit ratings not been downgraded, the insurance premium would have been lower since Peoples Gas would have posed less credit risk to the insurers of the bonds. Therefore, Ms. Kight-Garlisch reduced the recoverable insurance fees for each of the issues and the associated annual amortization of those fees to reflect the lower credit risk had Peoples Gas' rating remained Aa2/AA-. ICC Staff Ex. 8.0, pp. 20-21.

Ms. Kight-Garlisch began with the total amount of the insurance fee paid by Peoples Gas on each tax-exempt series and subtracted amortization through December 31, 2010. She then reduced the December 31, 2010 unamortized debt expense balance by half, which thereby reduced the amortization of debt expense by the amount attributed to that portion of the insurance fee. ICC Staff Ex. 8.0, pp. 20-21.

Although she does not agree with the manner in which Company witness Johnson calculated the insurance cost adjustment, for purposes of reducing issues in this case, Ms. Kight-Garlisch adjusted her cost of debt to reflect half the adjustment she proposed in her direct testimony. The revised cost of long-term debt for Peoples Gas is 5.28%. ICC Staff Ex. 22.0, p. 5.

### b. Interest Rate on Series OO Bonds (Contested)

Staff and the Company do not agree on the interest rate to be applied to the Series OO auction rate bonds. As mentioned above, the Series OO auction rate bonds were issued as insured tax-exempt bonds to the IDFA. ICC Staff Ex. 8.0, p. 19. When Staff witness Kight-Garlisch filed her direct testimony she adjusted the interest rate on the Series OO bonds to reflect the most recently available auction rate of .998% set at the April 29, 2009 auction. Id., p. 20. That auction rate which she used was provided to her by the Company and appears on Company Exhibit BAJ 2.5P. That April 29th auction along with every other auction since March 2008 was a failed auction. ICC Staff Exhibit 22.0, p. 5. When there is a failed auction, according to the terms of the bonds, Peoples Gas must pay the default rate which is 175% of LIBOR (London Interbank Offered Rate) capped at 14%. NS-PGL BAJ 2.0 2Rev. Since February 2009 the LIBOR has been less than 1% (0.329%, 0.470%, 0.520%, 0.418% and 0.319% on the following dates in 2009: 1/14, 2/18, 3/25, 4/29, and 6/3 respectively). NS-PGL Ex. BAJ-2.5P. While the Company claims Ms. Kight-Garlisch's rate is excessive that argument should be rejected since that rate represents the actual current cost incurred by the Company on the series OO bonds. ICC Staff Ex. 22.0, p. 5.

In rebuttal, the Company argues that it could refinance these bonds with a fixed rate of 7.16%, however that argument has no sound business basis. While interest rates have fallen and investors in these bonds may not be earning a rate they originally desired, that is not a valid reason for the Company to bail out those investors by remarketing or refinancing the debt at a greater cost to the Company. Id., p. 6. Rather than trying to dump these low cost bonds, the Company should be embracing them since they result in a lower cost of debt for the Company. Id. The Company's argument that they want to lock in a fixed rate due to fluctuating interest rates, ignores the fact that back in 2003 when the Company issued the OO bonds that same risk existed yet the Company chose to issue these auction rate bonds. Id., pp. 6-7. In surrebuttal Mr. Johnson argues that an average rate of 4.08% should be used for the bonds (1% for 6 months as proposed by Staff and 7.16% as proposed by the Company). NS-PGL Ex. BAJ-3.0, p. 5. Staff finds that proposal unacceptable. Trying to accurately forecast interest rates is problematic as shown on Staff witness Kight-Garlisch's Schedule 22.5. That schedule shows that the accuracy diminishes as the forecast period lengthens. In addition, while current rates may be low when compared to a historical basis, there is still room for rates to move even lower. ICC Staff Ex. 22.0, p. 7. As Staff witness Kight-Garlisch testified, "No one can predict with certainty when interest rates will begin to rise, the rate at which they will rise, how long they will rise before falling again, the rate at which they will fall, or even whether they will rise before they fall further." Id. For all of the above reasons, the Commission should adopt Staff witness Kight-Garlisch recommendation to continue the use of actual spot interest rates rather than forecasted interest rates to estimate the Company's cost of debt.

### 2. North Shore

The Company and Staff agree that North Shore's embedded cost of long-term debt for average 2010 equals 5.49%. The actual cost of long-term debt for North Shore reflects the Standard & Poor's ("S&P") and Moody's credit ratings for the Company, which non-utility affiliates affected. S&P downgraded the credit ratings of the Company to A- from AA- on September 26, 2002.[6] Moody's downgraded the credit ratings of the Company to Aa3 from Aa2 on September 23, 2002.[7] Staff witness Michael McNally testified that affiliation with unregulated or non-utility companies adversely affected North Shore's credit ratings. ICC Staff Exhibit 7.0, pp. 27-28. In determining a reasonable rate of return for establishing rates, Section 9-230 of the Public Utilities Act prohibits the inclusion of any incremental risk or increased cost of capital, which is the direct or indirect result of the public utility's affiliation with unregulated or non-utility companies. Since two of the outstanding debt series of North Shore were issued after the downgrades occurred and those downgrades were due to the utilities' affiliation with unregulated companies, the costs associated with such issues need to be adjusted to eliminate the increased cost associated with the lower rating. ICC Staff Ex. 8.0, p. 13. The Company agrees that it is reasonable to adjust North Sore's cost of long-term debt to reflect its stand-alone financial strength. NS-PGL Ex. BAJ-2.0, p.20.

North Shore issued the Series N-2 bonds on April 29, 2003 and Series O on November 3, 2008, after the utility was downgraded by S&P and Moody's due to its non-utility affiliations. Therefore, Ms. Kight-Garlisch adjusted the interest rates to reflect the lower rate that would have been obtained for the Series N-2 and Series O bonds

[6] Standard & Poor's Ratings Direct - Research, North Shore Gas' Ratings Lowered; Outlook Stable, September 26, 2002; Peoples Gas Light & Coke's Ratings Cut; Outlook Stable, September 26, 2002.

[7] Moody's Investors Service, Rating Action: Peoples Gas Light and Coke Company – Moody's Downgrades With Negative Outlooks The Debt of Peoples Energy Corp., Peoples Gas Light and Coke Company, and North Shore Gas Company, September 23, 2002; Moody's Investors Service, Rating Action: North Shore Gas Company – Moody's Downgrades With Negative Outlooks The Debt of Peoples Energy Corp., Peoples Gas Light and Coke Company, and North Shore Gas Company, September 23, 2002.

had the downgrade not occurred. She followed the same methodology to adjust the bonds as she did for Peoples Gas. The adjustment lowered the interest rate on the Series N-2 bonds to 4.57% from 4.625% and the Series O bonds 25 basis points to 6.75% from 7.0%. ICC Staff Ex. 8.0, pp. 16-17.

### D. Cost of Short-Term Debt

#### 1. Peoples Gas

#### 2. North Shore

### E. Cost of Common Equity

Three parties presented analyses of the Companies' costs of common equity: ComEd, CUB-City, and Staff. The Companies estimated both North Shore's and Peoples Gas's cost of common equity to be 11.87%, regardless of whether or not any of the Companies' proposed riders are adopted. NS-PGL Ex. PRM-2.0, p. 8. CUB-City estimated both North Shore's and Peoples Gas's cost of common equity to be 8.58%, assuming no riders are adopted. If Riders VBA and UEA and stabilizing changes in rate design are adopted, CUB-City recommends a 32.5 basis point downward adjustment, for a cost of equity of 8.255%. CUB-City Ex. 2.0, p. 56. Staff estimated North Shore's cost of common equity to be 9.79% and Peoples Gas's cost of common equity to be 9.69%, both of which include a 10 basis point adjustment for Rider VBA. ICC Staff Ex. 7.0R, p. 28. Staff recommended further adjustments to North Shore's and Peoples Gas's costs of common equity of 20 basis points and 65 basis points, respectively, should the Commission authorize Rider UEA.[8] In addition, Staff recommended a rate of return on the common equity factor for Rider ICR of 8.06%, which represents a 163 basis point adjustment from the base cost of equity, should the Commission approve Rider ICR for Peoples Gas in this proceeding. ICC Staff Ex. 7.0R, pp. 34-35.

### 1. Peoples Gas

#### a. Staff's Analysis

Staff witness Michael McNally estimated Peoples Gas's and North Shore's investor-required rates of return on common equity to be 9.69% and 9.79%, respectively. ICC Staff Ex. 7.0R, p. 21. Those required returns include a 10 basis point downward adjustment to reflect the reduction in risk associated with Rider VBA, which was authorized in the Companies' last rate case, but do not reflect the effects of the new riders the Companies' propose.

Mr. McNally measured the investor-required rate of return on common equity with discounted cash flow ("DCF") and Capital Asset Pricing Model ("CAPM") analyses. Mr. McNally applied those models to a sample of nine natural gas utility companies ("Gas Group"). The Gas Group was the same sample used by Company witness Moul. To select that sample, Mr. Moul started with the universe of gas utilities contained in the basic service of Value Line, which consists of 12 companies. He then eliminated three companies due to the location or the diversification of their operations. The nine remaining companies, AGL Resources, Atmos Energy, Laclede Group, New Jersey

[8] The Companies have withdrawn their Rider UEA proposals (NS-PGL Ex. VG-3.0, p. 38) and, instead, are seeking approval of uncollectibles riders under Section 19-145 of the PUA in ICC Docket Nos. 09-0419 and 09-0420. The cost of common equity adjustments Staff proposed for Rider UEA should be applied to the new uncollectible riders as well. ICC Staff Ex. 21.0, p. 20.

Resources, Nicor, Northwest Natural Gas, Piedmont Natural Gas, South Jersey Industries, and WGL Holdings, compose the Gas Group. North Shore Ex. PRM-1.0 Rev., p. 3; Peoples Gas Ex. PRM-1.0 Rev., p. 3. The table below summarizes Staff's process for determining Peoples Gas's and North Shore's costs of common equity (before uncollectibles riders or Rider ICR).

| | Peoples Gas | North Shore |
|---|---|---|
| Gas Group DCF | 10.23% | 10.23% |
| Gas Group CAPM | 9.95% | 9.95% |
| Gas Group Average | 10.09% | 10.09% |
| Adjustments | | |
| Financial Risk | -0.30% | -0.20% |
| Rider VBA | -0.10% | -0.10% |
| Cost of Common Equity Before Riders UEA and ICR | 9.69% | 9.79% |

As will be explained later, further adjustments would be required if the Commission were to adopt uncollectibles riders or Rider ICR.

### i. DCF Analysis

DCF analysis assumes that the market value of common stock equals the present value of the expected stream of future dividend payments. Since a DCF model incorporates time-sensitive valuation factors, it must correctly reflect the timing of the dividend payments that stock prices embody. The companies in Mr. McNally's Gas Group pay dividends quarterly. Therefore, Mr. McNally applied a quarterly DCF model. ICC Staff Ex. 7.0R, p. 4.

Mr. McNally employed a multi-stage, non-constant DCF model in his DCF analysis. Mr. McNally explained that, while a non-constant growth DCF model is a more elaborate model with additional unobservable growth rate variables that are likely subject to greater measurement error than the analyst growth rate estimates Staff uses in constant-growth DCF analyses, the cost of common equity estimate derived from a constant-growth DCF model is appropriate to use only if the near-term growth rate forecast for each company in the sample is expected to equal its average long-term dividend growth. In this case, the expected near-term growth level for the Gas Group (6.65%) was over 60% greater than that expected for the overall economy, as measured by GDP growth (approximately 4%). Mr. McNally explained that no company could sustain a growth rate greater than that of the overall economy, or it would eventually grow larger than the economy of which it is a part. Moreover, since utilities in particular are generally below-average growth companies, the sustainability of an above average growth rate is particularly dubious. Thus, given the large difference between the near-term growth rates for the Gas Group companies and the overall growth of the economy, the continuous sustainability of the near-term growth rates for the Gas Group is highly unlikely. Therefore, Mr. McNally concluded that the measurement error associated with a constant-growth DCF analysis exceeds that associated with a non-constant growth DCF model, making the latter model preferable. ICC Staff Ex. 7.0R, pp. 4-5.

Mr. McNally's non-constant growth DCF model incorporated three stages of dividend growth. The first, a near-term growth stage, is assumed to last five years. For this stage, Mr. McNally used Zacks growth rate estimates as of May 14, 2009. The second stage is a transitional growth period that spans from the beginning of the sixth year through the end of the tenth year. The growth rate employed in the transitional growth period equals the average of the Zacks growth rate and the "steady-state" stage growth rate. Finally, the third, or "steady-state," growth stage commences at the end of the tenth year and is assumed to last into perpetuity. For this stage, Mr. McNally utilized the implied 20-year forward U.S. Treasury rate in ten years, which reflects current expectations of the long-term overall economic growth during the steady-state growth stage of his non-constant DCF model.[9] An implied 20-year forward U.S. Treasury rate in ten years of 4.59% was derived from the 10- and 30-year U.S. Treasury rates as of May 14, 2009 using the following formula:

$${}_{20}f_{10} = [(1+{}_{30}r_0)^{30} / (1+{}_{10}r_0)^{10}]^{1/20} - 1$$

Where ${}_{20}f_{10}$ = the implied 20-year forward U.S. Treasury rate in ten years;
${}_{30}r_0$ = the current 30-year U.S. Treasury rate; and
${}_{10}r_0$ = the current 10-year U.S. Treasury rate.

ICC Staff Ex. 7.0R, pp. 6-7.

An expected stream of dividends was then estimated by applying the growth rate estimates for those three stages to the May 14, 2009 dividend. The discount rate that equates the present value of this expected stream of cash flows to the company's May 14, 2009 stock price equals the market-required return on common equity. Based on this growth, stock price, and dividend data, Mr. McNally's DCF estimate of the cost of common equity was 10.23% for the Gas Group. ICC Staff Ex. 7.0R, pp. 3 and 9.

[9] Excepting a small premium for interest rate risk, the implied 20-year forward U.S. Treasury rate in ten years represents the risk-free rate of return during the 20-year period beginning in 10 years and ending 30 years from today, as implied by current 10- and 30-year U.S. Treasury rates. The overall economic growth rate and the risk-free rate of return should be similar since both are a function of production opportunities and consumption preferences. ICC Staff Ex. 7.0R, p. 15.

### ii. Risk Premium Analysis

According to financial theory, the required rate of return for a given security equals the risk-free rate of return plus a risk premium associated with that security. The risk premium methodology is consistent with the theory that investors are risk-averse and that, in equilibrium, two securities with equal quantities of risk have equal required rates of return. Mr. McNally used a one-factor risk premium model, the Capital Asset Pricing Model, to estimate the cost of common equity. In the CAPM, the risk factor is market risk, which cannot be eliminated through portfolio diversification. ICC Staff Ex. 7.0R, pp. 10-11.

The CAPM requires the estimation of three parameters: beta, the risk-free rate, and the required rate of return on the market. For the beta parameter, Mr. McNally combined adjusted betas from Value Line, Zacks, and a regression analysis. The average Value Line, Zacks, and regression beta estimates were 0.66, 0.53, and 0.49, respectively. The Value Line regression employs 259 weekly observations of stock return data regressed against the New York Stock Exchange ("NYSE") Composite Index. Both the regression beta and Zacks betas employ sixty monthly observations; however, while Zacks betas regress stock returns against the S&P 500 Index, the regression beta regresses stock returns against the NYSE Index. Since the Zacks beta estimate and the regression beta estimate are calculated using monthly data rather than weekly data (as Value Line uses), Mr. McNally averaged those results to avoid over-weighting that approach. He then averaged that result with the Value Line beta, which produced a beta for the Gas Group of 0.59. ICC Staff Ex. 7.0R, pp. 16-20. For the risk-free rate parameter, Mr. McNally considered the 0.10% yield on four-week U.S. Treasury bills and the 4.10% yield on thirty-year U.S. Treasury bonds. Both estimates were measured as of May 14, 2009. Forecasts of long-term inflation and the real risk-free rate imply that the long-term risk-free rate is between 4.3% and 5.1%. Thus, Mr. McNally concluded that the U.S. Treasury bond yield is currently the superior proxy for the long-term risk-free rate. ICC Staff Ex. 7.0R, pp. 11-15. Finally, for the expected rate of return on the market parameter, Mr. McNally conducted a DCF analysis on the firms composing the S&P 500 Index. That analysis estimated that the expected rate of return on the market equals 14.01%. ICC Staff Ex. 7.0R, pp. 15-16. Inputting those three parameters into the CAPM, Mr. McNally calculated a cost of common equity estimate of 9.95% for the Gas Group. ICC Staff Ex. 7.0R, p. 20.

**iii. Recommendation**

Based on his DCF and risk premium models, Mr. McNally estimated that the cost of common equity for the Gas Group is 10.09%. Mr. McNally adjusted the Gas Group's investor required rate of return downward 20 basis points for North Shore and 30 basis points for Peoples Gas to reflect the lower financial risk of the Companies relative to the Gas Group. He then adjusted the Companies' costs of equity downward by 10 basis points to reflect the reduction in risk associated with Rider VBA, which, along with the same 10 basis point adjustment, was authorized in the Companies' last rate case. Thus, Mr. McNally estimated the investor-required rates of return on common equity to be 9.79% for North Shore and 9.69% for Peoples Gas. ICC Staff Ex. 7.0R, p. 21.

To determine the 20 basis point adjustment for North Shore and 30 basis point adjustment for Peoples Gas to reflect the lower financial risk of the Companies relative to the Gas Group, Mr. McNally first compared the values for the financial ratios that result from Staff's proposed revenue requirement to Moody's guidelines for the regulated gas distribution industry. Based on those Moody's guidelines, Staff's revenue requirement recommendations produce financial ratios that are commensurate with an A1 credit rating for North Shore and an Aa2/Aa3 credit rating for Peoples Gas. In contrast, the Gas Group's average financial ratios for 2006-2008 are indicative of a level of financial strength that is commensurate with a credit rating between A3 and Baa1, which is consistent with the current average credit ratings Moody's has assigned the Gas Group. The Gas Group's lower level of financial strength indicates that it is riskier than either of the Companies. Thus, given the difference between the implied forward-looking credit ratings for the Companies and the average credit rating of the Gas Group, the sample's average cost of common equity needed to be adjusted to determine the final estimate of the Companies' costs of common equity. ICC Staff Ex. 7.0R, pp. 22-24.

Using 30-year utility debt yield spreads published by Reuters, Mr. McNally calculated the yield spreads between the credit ratings implied by the financial ratios for the Companies and those of the Gas Group. This produced yield spreads of 33 basis points for North Shore and 50 basis points for Peoples Gas. He then multiplied those yield spreads by 60%, which is the percent of the overall credit rating that Moody's assigns to the financial ratios. This produced cost of equity adjustments for North Shore and Peoples Gas of 20 basis points and 30 basis points, respectively. ICC Staff Ex. 7.0R, p. 26.

#### iv. Rider UEA / Uncollectibles Rider

Mr. McNally testified that Rider UEA would reduce the volatility in, and ensure more timely collection of, bad debt expense and, thus, reduce the Companies' risk.

Therefore, if uncollectibles riders are adopted, downward adjustments to the Companies' rates of return on common equity will be necessary to recognize the reduction in risk associated with the authorization of the uncollectibles riders. ICC Staff Ex. 7.0R, p. 30.

To estimate the appropriate risk adjustment for Rider UEA, Mr. McNally employed three distinct approaches. The first approach estimated the effect the adoption of UEA would have on the Companies' Moody's credit ratings. The adjustment was then calculated from the resulting change in implied yield spreads. The second approach utilizes the Companies' estimates of the effects UEA would have had on the variability of their operating incomes over the last 10 years. That reduction in operating income variability was translated into a new estimate of the beta factor used in the CAPM. The adjustment was then calculated from the change in the CAPM cost of equity estimate resulting from the new beta estimate. The third approach also utilizes the Companies' estimates of the effects UEA would have had on their operating incomes over the last 10 years. However, this approach uses an iterative process of adjusting the cost of equity estimate downward to offset the increased operating income resulting from the adoption of UEA. Those approaches produced adjustment estimates ranging from 10 to 30 basis points for North Shore and from 10 to 120 basis points for Peoples Gas. Based on the midpoints of those ranges, Mr. McNally recommended adjustments to North Shore's and Peoples Gas's costs of common equity of 20 basis points and 65 basis points, respectively, should the Commission authorize the implementation of Rider UEA. ICC Staff Ex. 7.0R, pp. 30-34. Since the Companies have filed for approval of uncollectibles riders under Section 19-145 of the PUA in lieu of

Rider UEA and Section 19-145 (1) allows the Companies to recover uncollectibles expense for 2008 going forward and (2) limits the Commission's options on review to either approval of the riders as filed or approval of them as modified (220 ILCS 5/19-145(b)), the aforementioned adjustments to the costs of common equity are appropriate for the new uncollectible riders and should be adopted by the Commission.

**v. Rider ICR**

Mr. McNally testified that, in comparison to rate base cost recovery, the recovery of the capital costs of projects run through Rider ICR would be more timely. Further, Rider ICR effectively eliminates the risk that prudent and reasonable project costs will not be recovered. Since Rider ICR would improve the timeliness and certainty of cash flows, it would reduce the Companies' risk. Thus, if adopted, a downward adjustment to the cost of common equity factor in Rider ICR would be necessary. ICC Staff Ex. 7.0R, p. 34.

Specifically, Mr. McNally recommended a 163 basis point adjustment to the base cost of equity that he recommend for Peoples Gas. That adjustment equals one-half of the spread between the current yield for AAA-rated, 30-year utility bonds (6.43%) and Mr. McNally's base cost of equity recommendation for Peoples Gas (9.69%). Mr. McNally reasoned that if Rider ICR protected the Company against all risk of non-recovery of investments in the ICR program, a return consistent with AAA-rated long-term utility bonds would be warranted; in contrast, if Rider ICR had no effect on Peoples Gas's risk, the base cost of equity recommendation for the Company would be warranted. Mr. McNally explained that while Rider ICR eliminates the risk of non-recovery of prudent and reasonable costs, the prudency and reasonableness of Rider

ICR expenditures is still subject to annual reviews. Thus, Mr. McNally recommended the midpoint between the AAA bond yield and the full cost of common equity. ICC Staff Ex. 7.0R, pp. 35-36.

### b. Companies' Analysis

Company witness Moul estimated the Companies' costs of common equity using DCF, risk premium, and CAPM analyses, which he applied to a sample of nine gas utility companies. Based on his analysis, he recommended an 11.87% cost of equity for both North Shore and Peoples Gas. Peoples Gas Ex. PRM-1.0, pp. 2-3; Peoples Gas Ex. PRM-1.0, pp. 2-3; NS-PGL Ex. PRM-2.0, p. 8. Unfortunately, Mr. Moul's analysis contains several errors that led him to over-estimate the Companies' costs of common equity. The most significant flaws in Mr. Moul's analysis of the Companies' cost of common equity are his (1) use of historical data in each of his models; (2) inappropriate estimates of the common equity risk premium for his proxy groups in his Risk Premium Model; (3) inclusion of an unwarranted leverage adjustment in his DCF and CAPM estimates; and (4) inclusion of an unwarranted size premium adjustment in his CAPM estimate. ICC Staff Ex. 7.0R, pp. 36-37.

#### i. Historical Data

Mr. Moul used historical data to estimate the current dividend yield in his DCF analysis, the A-rated utility bond default premium and the equity risk premium in his Risk Premium Model analysis, and the equity risk premium in his CAPM analysis. However, Mr. Moul's use of historical data is problematic for several reasons. First, historical data favors outdated information that the market no longer considers relevant over the most-recently available information. Second, historical data reflects conditions that may not continue in the future. Third, the use of average historical data implies that securities data will revert to a mean, a proposition which is highly questionable and completely unsupported in the record. Even if securities data were mean reverting, there is no method for determining the true value of that mean. Consequently, sample means, which depend upon the measurement period used, are substituted. However, any measurement period chosen to estimate the mean is entirely arbitrary, as the measurement period that provides the best estimate of the true mean is unknowable. Thus, the results produced by average historical data are unreliable. ICC Staff Ex. 7.0R, p. 37.

#### ii. Risk premium analysis flaws

In determining the equity risk premium, Mr. Moul began with a 6.23% base equity risk premium estimate representing the historical earnings spread between investment grade public utility bonds and the S&P Utilities Index for the periods 1974-2007 and 1979-2007. Mr. Moul adjusted the 6.23% equity risk premium down to 5.50% in recognition of the lower risk of his proxy group in comparison to the S&P Public Utilities Index. He then added the 5.50% equity risk premium to a projected 6.25% A-rated utility bond yield estimate, which resulted in a cost of common equity estimate of 12.25%. ICC Staff Ex. 7.0R, pp. 40-41; NS-PGL Ex. PRM-2.0, pp. 7-8.

Mr. Moul's risk premium analysis contains several flaws that undermine the reliability of the resulting estimates. First, Mr. Moul's base equity risk premium estimate is calculated from historical data, which is inappropriate. As discussed previously, the magnitude of an average historical risk premium depends upon the measurement period used, as Mr. Moul's own testimony demonstrates. For example, had Mr. Moul used the 1966-2007 measurement period, his base equity premium estimate would have been 4.84% rather than 6.23%, which would need to be adjusted downward even farther for the less risky Gas Group. Second, Mr. Moul added a risk premium measured from an investment grade bond index to an estimate of A-rated bond yield without providing any support that the two are compatible. Third, Mr. Moul provided no quantitative support for the adjustments he made in deriving estimates of the equity risk premium for the Gas Group from the base equity risk premium. ICC Staff Ex. 7.0R, p. 40.

**iii. Leverage Adjustment**

Mr. Moul argued that, when a company's book value exceeds its market value, the risk of a company increases if the capital structure is measured with book values of capital rather than market values of capital. Such a notion is absurd. The intrinsic risk level of a given company does not change simply because the manner in which it is measured has changed. Such an assertion is akin to claiming that the ambient temperature changes when the measurement scale is switched from Fahrenheit to Celsius. Mr. Moul's argument confuses the measurement tool with the object to be measured. Specifically, capital structure ratios are merely indicators of financial risk; they are not sources of financial risk. <u>Financial risk arises from contractually required debt service payments; changing capital structure ratios from a market to book value basis does not affect a company's debt service requirements</u>. ICC Staff Ex. 7.0R, p. 42.

The Commission rejected the use of leverage adjustments in Docket Nos. 01-0528/01-0628/01-0629 (Cons.), 99-0120/99-0134 (Cons.), and 94-0065. Order, Docket Nos. 01-0528/01-0628/01-0629 (Cons.), March 28, 2002, pp. 12-13; Order, Docket Nos.

99-0120/99-0134 (Cons.), August 25, 1999, p. 54; Order, Docket No. 94-0065, January 9, 1995, pp. 92-93. In fact, the same leverage adjustment arguments were rejected by the Commission in the Companies' last rate case. That Order quite clearly sets forth, in great detail, the reasons such a leverage adjustment should be rejected. Order, Docket Nos. 07-0241/07-242 (Cons.), February 5, 2008, pp. 95-96.

**iv. Size Adjustment**

Mr. Moul added a risk premium based on firm size to his CAPM analysis. However, Mr. Moul did not provide any evidence to demonstrate that a size premium is warranted for <u>utilities</u>. The study reported in Ibbotson Associates, which forms the basis of Mr. Moul's size-based risk premium adjustment, is not restricted to utilities. Rather, it is based on the entire population of NYSE, AMEX, and NASDAQ-listed securities, which are heavily weighted with industrial stocks. To assume, as Mr. Moul does, that a characteristic drawn from the general (entire market) can be applied to the specific (utilities) is logically fallacious. Thus, the entire basis of Mr. Moul's size-based risk premium is questionable at best. In fact, in direct contrast with Mr. Moul's claims, a study by Annie Wong, reported in the *Journal of the Midwest Finance Association*, specifically found no justification for a size premium for utilities. ICC Staff Ex. 7.0R, pp. 43-47.

Even for non-utilities, evidence of the existence of a size-based risk premium is not very strong. Ibbotson Associates data shows that, out of a 1926-2007 study period, small stocks consistently out-performed large stocks only during the 1963-1983 period. Further, Fernholz found that a statistical property he termed the "crossover effect" was the primary cause of the difference between large and small company stock returns.

That is, when a stock in a large stock portfolio experiences a random negative price change that moves it into a smaller stock portfolio, the negative return is assigned to, and therefore reduces, the return on the large stock portfolio. Conversely, when that same stock experiences a random positive price change that moves it back into the large stock portfolio, the positive return is assigned to, and therefore increases, the return on the smaller stock portfolio. Thus, the "small stock effect" may be less a market return phenomenon than a statistical anomaly due to a modeling deficiency. ICC Staff Ex. 7.0R, p. 45.

A study by Jensen, Johnson, and Mercer found that small stock premiums may be a period-specific phenomenon related to monetary policy. Jensen, et. al. observed a size premium during monetary expansions, when the supply of loanable funds increases and investors are more likely to invest in speculative, small company stocks. However, during monetary contractions, as the supply of loanable funds decreases, investors are more likely to switch from speculative investments to safer ones – the well-known "flight to quality" – and no size premium is observed. That investors would consider the smaller firms in the regulated utility sector to be speculative investments is counter-intuitive; and Mr. Moul has not supported that premise. Moreover, since Jensen, et. al. did not control their measurement of the small stock premium for risk as measured by beta or other means, the "size premium" they analyzed may already be reflected in the betas of smaller companies, rendering an additional risk adjustment such as Mr. Moul proposes unnecessary. ICC Staff Ex. 7.0R, p. 46.

Finally, Mr. McNally explained that Mr. Moul's application of the historical size-based risk premiums, as quantified and published by Ibbotson Associates, is inconsistent with the manner in which Ibbotson Associates measured them. While Mr. Moul adds the historical size premium to his CAPM-based risk premium analysis which is based on adjusted Value Line betas, the Ibbotson Associates size-based risk premiums are a function of raw betas. Thus, the "size premium" Mr. Moul adds to his CAPM result is already captured by the adjustment Value Line applies to the betas Mr. Moul used in his CAPM analysis. Any further adjustment is duplicative. ICC Staff Ex. 7.0R, p. 47.

### 2. North Shore

See Section VI(E)(1) above.

## F. Weighted Average Cost of Capital

### 1. Peoples Gas

Staff recommends a 7.75% rate of return on Peoples Gas' rate base. (ICC Staff Exhibit 22.0, Schedule 22.1) This rate of return incorporates the 5.28% embedded cost of long-term debt proposed by Staff (ICC Staff Exhibit 22.0, p. 5) and the 9.69% rate of return Staff witness Michael McNally recommends for Peoples Gas' common equity. ICC Staff Exhibit 7.0, pp. 20-29.

### 2. North Shore

Staff recommends a 7.90% rate of return on North Shore's rate base. ICC Staff Exhibit 22.0, Schedule 22.1. This rate of return incorporates the 5.49% embedded cost of long-term debt agreed on by North Shore and Staff (ICC Staff Exhibit 22.0, Schedule 22.1) and the 9.79% rate of return Staff witness Michael McNally recommends for North Shore's common equity. ICC Staff Exhibit 7.0, pp. 20-29.

## VII. WEATHER NORMALIZATION – AVERAGING PERIOD (Uncontested)

## VIII. PROPOSED RIDER ICR (PGL)

Rider ICR is an infrastructure cost recovery rider that Company witness Ms. Grace described as follows:

> Peoples Gas's proposed Rider ICR will recover costs associated with the replacement of cast iron and ductile iron main and connecting facilities including services, meters and regulators. It will also recover the costs of other mains, citygate stations, regulator stations and incremental operation and maintenance expenses related to the replacement program. Costs recoverable under Rider ICR will be offset by savings that are estimated to be generated by the replacement program.

Peoples Gas Ex. VG-1.0, p. 35. While Ms. Grace provides testimony about the operation of Rider ICR, she does not provide support for the need or justification for Rider ICR. Besides Ms. Grace, the Company submitted the testimony of Mr. Schott and Mr. Marano in support of proposed Rider ICR. As explained below, their testimony fails to provide adequate support to justify adoption of a rider recovery mechanism via Rider ICR.

### A. Rider Recovery Is Only Appropriate Where the Need or Justification for Rider Recovery is Adequately Supported

The alternative methods by which rates are set by the Commission was succinctly summarized by the First District appellate court as follows:

> The theory behind public utility regulation is that the Commission should fix rates that "might properly be supposed to result from free competition." *State Public Utilities Comm'n v. Springfield Gas & Electric Co., 291 Ill. 209, 218, 125 N.E. 891, 896 (1919)*. It is undisputed that the Commission sets rates in two ways -- by base rates or by an automatic-cost-recovery mechanism. Base rates attempt to recover a utility's costs through estimating the total revenues necessary to recover its operating costs plus a cost of investor capital using a specific formula. *Citizens Utilities Co., 124 Ill. 2d at 200-01, 124 Ill. Dec. 529, 529 N.E.2d at 512-13*.

> There are circumstances, however, where particular utility costs are unique enough that circumstances warrant a recovery through an automatic-cost-recovery mechanism. *Citizens Utility Board v. Illinois Commerce Comm'n, 166 Ill. 2d 111, 138, 651 N.E.2d 1089, 1102, 209 Ill. Dec. 641 (1995)*. In *City of Chicago v. Illinois Commerce Comm'n, 13 Ill. 2d 607, 150 N.E.2d 776 (1958)*, the Illinois Supreme Court highlighted the Commission's discretionary authority to allow a rate recovery for a utility's costs through a purchased-gas adjustment tariff.

*Ill. Power Co. v. Ill. Commerce Comm'n*, 339 Ill. App. 3d 425, 434 (1st Dist. 2003) (emphasis added). Thus, automatic adjustment clauses or riders are a discretionary alternative to the traditional approach of setting rates through base rates.

In *City of Chicago v. Illinois Commerce Comm'n*, 13 Ill. 2d 607 (1958) the Illinois supreme court determined, in a case of first impression, that the Commission was authorized under the Public Utilities Act to approve an automatic adjustment clause in a proper case. The court found that the Commission's authority to approve changes in rates included the power to approve provisions that affect the dollar-and-cents cost of the product sold and was not limited to approving rates stated in terms of dollars and cents. *Id*. at 611-12. As explained by the court:

> it is clear that the statutory authority to approve rate schedules embraces more than the authority to approve rates fixed in terms of dollars and cents. The present automatic adjustment clause is a set formula by which the price of natural gas to the ultimate consumer is fixed by inserting in the formula the wholesale price of natural gas as established by the FPC. The Public Utilities Act, taken as a whole, contemplates that a rate schedule may contain provisions which will affect the dollar-and-cents cost of the product sold.

*Id*. at 611. The supreme court concluded that the Illinois PUA vested "the Commission with power to authorize an automatic adjustment clause to be filed in a rate schedule **in the proper case**." *Id*. at 614 (emphasis added).

As suggested by language in the supreme court's opinion in *City of Chicago*, a decision to allow rider recovery must be adequately supported by the facts and circumstances of the rider under consideration. In *A. Finkl & Sons Co. v. Illinois Commerce Comm'n*, 250 Ill. App. 3d 317 (1st Dist. 1993), the court found that the Commission's approval of a rider to recover costs associated with demand-side management ("DSM") programs violated the prohibition against single issue ratemaking:

> In the present case, the Commission authorized Edison to charge customers for DSM program costs without considering whether other factors offset the need for additional charges. The order violates the prohibition against single-issue ratemaking. The order thereby isolates one operating expense for full recovery without considering whether changes in other expenses or increased sales and income obviate the need for increased charges to consumers, which may result impermissibly in ratepayers facing additional charges for direct and indirect additional revenues to cover Edison's expenses and pay a return to its investors.

*Id*. at 325-326. While all riders would seem to raise single issue ratemaking concerns since they are typically used to recover specific or isolated costs, the court made clear that all riders are not prohibited by the rule against single issue ratemaking. Rather, the court recognized that "[r]iders are useful in alleviating the burden imposed upon a utility in meeting unexpected, volatile or fluctuating expenses," but found that the DSM related expenses at issue were ordinary expenses that "reveal no greater potential for unexpected, volatile or fluctuating expenses which Edison cannot control, than costs incurred in estimating base ratemaking." *Id*. at at 326-327. Thus, the *Finkl* opinion establishes that rider recovery is exempt from the prohibition against single issue ratemaking when there is adequate justification or need for rider recovery – such as alleviating the burden imposed upon a utility in meeting unexpected, volatile or fluctuating expenses.

In *Central Ill. Light Co. v. Illinois Commerce Comm'n*, 255 Ill. App. 3d 876 (3rd Dist. 1993) ("*CILCO v. ICC*"), *affirmed in part and reversed in part*, *Citizens Util. Bd. v. Illinois Commerce Comm'n*, 166 Ill. 2d 111 (1995) ("*CUB v. ICC*"), the Third District appellate court and Illinois supreme court both upheld the Commission's approval of a rider to recover coal tar clean-up expenditures for costs associated with cleaning up environmental damage resulting from former manufactured gas plant operations. Significantly, the Third District's opinion made clear that adequate justification for rider recovery existed in rejecting arguments that the proposed rider violates the prohibitions against single-issue and retroactive ratemaking as well as the Commission's test year rules:

> In Finkl, the First District reversed an order of the Commission which had allowed Commonwealth Edison to utilize a rider to recover costs associated with demand-side management programs. Although the court found the rider in that case to violate both the prohibition against single-issue and retroactive ratemaking, and to contravene the Commission's "test year" requirements, **we do not interpret the opinion as holding that all riders are prohibited**. We note the opinion states with apparent approval that riders are useful in alleviating the burden imposed on utilities in meeting unexpected, volatile or fluctuating expenses. However, in the case before the court, the First District found the demand-side management expenses were not of such a nature as to require rider treatment, and could be readily addressed through traditional base rate proceedings.
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> * * *
>
> In the instant case, we find no abuse of discretion on the part of the Commission in concluding that coal tar remediation costs can be recovered through a rider mechanism. The record shows these costs will vary widely from year to year depending on the type of remediation activities: from relatively small sums in the thousands (investigation costs) to the millions of dollars (actual cleanup costs). **We view these costs as the type of unexpected, volatile and fluctuating costs which are more efficiently addressed through a rider mechanism.** Therefore, we find the Commission had the authority to authorize a rider as the preferred method of recovery, and that under the circumstances such authorization did not constitute an abuse of discretion.

*Id*. at 884-885 (emphasis added).

In the subsequent appeal to the supreme court, the court found that the prohibition against single-issue ratemaking does not constrain the Commission's ability to approve direct recovery of unique costs when rider recovery is warranted:

> The prohibition against single-issue ratemaking requires that, in a general base rate proceeding, the Commission must examine all elements of the revenue requirement formula to determine the interaction and overall impact any change will have on the utility's revenue requirement, including its return on investment. **The rule does not circumscribe the Commission's ability to approve direct recovery of unique costs through a rider when circumstances warrant such treatment.**

*Id*. at 137-138 (emphasis added). The supreme court found that there was adequate support for rider recovery of coal tar clean-up expenses:

> In the generic coal-tar order at issue in this appeal, the Commission stated that, given the wide variations and the difficulties in forecasting the costs of investigation and remediation activities, riders can generally be expected to provide a more accurate and efficient means of tracking costs and matching such costs with recoveries than would base rate recovery methods. Numerous witnesses testified to the uncertain and variable nature of the expenses for coal-tar clean up. We find that the proposed recovery through a rider mechanism, outside the context of a traditional rate proceeding, does not violate the prohibition against single-issue ratemaking.

*Id*. at 138-139 (emphasis added).

In *City of Chicago v. Illinois Commerce Comm'n*, 281 Ill. App. 3d 617 (1st Dist. 1996) the court upheld the Commission's order directing Commonwealth Edison Company ("ComEd") to remove local franchise fees from base rates for all customers and to localize recovery of those costs by a separate line item charge on the bills of customers residing in the municipality charging the fee. In response to an argument that the rider violated the prohibition against single-issue ratemaking, the court noted that "**[t]he Commission has the power to authorize riders in a proper case** and such authorization will not be reversed absent an abuse of discretion." *Id*. at 627. The court also explained that “[s]ingle-issue ratemaking is prohibited because it considers changes in isolation, thereby ignoring potentially offsetting considerations and risking understatement or overstatement of the overall revenue requirement.” *Id*. The court also observed that while the supreme court’s decision in *CUB v. ICC* found that a rider was appropriate for fluctuating costs, “it did not limit the use of a rider only to those instances where costs are unexpected, volatile or fluctuating.” *Id*. at 628. While acknowledging that riders must be closely scrutinized because of the danger of single issue ratemaking, the court concluded that the danger of ignoring some items that might have an impact on the overall revenue requirement did not exist under the facts of this case:

> Here, however, that danger was not present. The proposed restructuring was exactly that--a reallocation which did not have any impact whatsoever on Edison's overall revenue requirement. The franchise fees were already included in Edison's overall rate structure; the Commission's order simply redistributed them. Because the rider here "merely facilitates direct recovery of a particular cost, without direct impact on the utility's rate of return" (*Citizens Utility Board*, 166 Ill. 2d at 138, 651 N.E.2d at 1102), it was not an abuse of discretion for the Commission to use it as the mechanism of cost recovery.

*Id*. at 628-629.

While the Commission clearly has the discretionary authority under the PUA to provide for rider recovery of costs **in appropriate circumstances**, the Company must demonstrate that adequate justification exists for the specific recovery proposed in Rider ICR. As explained below, the Company has failed to provide appropriate justification for Rider ICR.

### B. Rider ICR Has Not Been Adequately Supported

Company witness Schott testified that proposed Rider ICR is "consistent with points raised by Staff in the last rate case" and "includes many of the modifications proposed by Commission Staff in that case." Peoples Gas Ex. JFS-1.0, p. 13. Staff witness Mr. Lazare explained that Staff's primary position in the previous case was to reject the proposed rider because the need and justification for rider recovery of certain costs through Rider ICR in that docket had not been established and was not supported by the evidence. ICC Staff Ex. 9.0, p. 3. The Staff proposed changes discussed by Mr. Schott sought to address the scenario of the Commission approving Rider ICR over its objections by mitigating the adverse impacts of a proposal that Staff considered to be fundamentally flawed. The fact that changes were proposed for that limited purpose should not be construed in any way as Staff support for Rider ICR. *Id*.

Mr. Schott testified that capital has become "more expensive to obtain" in the current financial crisis and that proposed Rider ICR provides greater "certainty of recovery on and of the investment in cast iron main" essential to "to keep the capital costs associated with the infrastructure improvement reasonable." Peoples Gas Ex. JFS-1.0, p. 14. Mr. Lazare observed that Mr. Schott's position is unsupported and that Mr. Schott provides no specific evidence concerning what the capital costs for the program would be with and without Rider ICR. ICC Staff Ex. 9.0, p. 4.

Staff witness Ms. Kight-Garlisch analyzed Mr. Schott's claim that the Company needs a method to finance the expenditures for replacement of the mains "at a reasonable cost with prompt and fair rate recovery", such as with Rider ICR. ICC Staff Ex. 8.0, p. 22. Ms. Kight-Garlisch observed that Rider ICR is not the only method for "prompt and fair rate recovery" to finance an accelerated main replacement program, and that the Company rejected the possibility of relying on traditional rate case fillings with a future test year or a deferral mechanism. *Id*.; *see also* ICC Staff Ex. 8.0, Attachment B, p. 1. Staff sought support for Mr. Schott's claims. "However, the Company has provided no analysis to support its <u>need</u> for a Rider ICR to raise sufficient capital to provide adequate, efficient, reliable and safe utility service at a reasonable cost." *Id*.; *see also* ICC Staff Ex. 8.0, Attachment B, pp. 2-7. Indeed, the response to each request for analyses, research, projections or models supporting the Company's claim was that no such analyses, research, projections or models were created or available. ICC Staff Ex. 8.0, Attachment B, pp. 2-7. As such, the record does not support the Company's claim and cannot support the request for approval of Rider ICR.

While Company witness Mr. Marano presents testimony which he indicates is designed to support the proposed Rider ICR (Peoples Gas Ex. SDM-1.0, p. 2), Mr. Marano's testimony does not support the adoption of a rider to collect infrastructure costs. He focuses instead on the need for an accelerated program to replace the current network of cast iron and ductile iron mains and how that can best be accomplished. However, he does not discuss why a rider mechanism is needed to recover the associated costs. ICC Staff Ex. 9.0, p. 4. Mr. Marano is clear on this matter, testifying as follows:

> My testimony will provide my opinion and support for the accelerated replacement of PGL's gas mains and services infrastructure, based on the need for reduction of future risk to the public, the public good created by a modern asset-based gas distribution system and the economic advantages of an accelerated program.

Peoples Gas Ex. SDM-1.0, p. 3. Mr. Marano states the "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" is presented by Company witnesses Schott and Grace. *Id*. at 3-4.

The need for an accelerated infrastructure replacement program and the cost recovery mechanism for such a program are two different issues. One issue concerns whether the program is needed. If the answer is yes, the second issue concerns how the program should be funded. Mr. Marano's testimony addresses the first issue concerning whether the accelerated program is justified. However, even if an accelerated program is supported, that does not provide support for a rider mechanism. The normal mechanism for recovering infrastructure investments of any kind is base rates. Mr. Marano does not explain why a rider mechanism would be justified in this case over traditional recovery through base rates. Therefore, Staff submits that Mr. Marano's testimony does not provide adequate support for adoption of proposed Rider ICR. ICC Staff Ex. 9.0, pp. 4-5. While an accelerated infrastructure replacement program is a necessary prerequisite to a rider mechanism for recovery of the costs of such a program, the mere fact that such an accelerated program is justified does not automatically support or justify rider recovery.

Mr. Lazare also pointed out that the Company seeks funding for an accelerated replacement program that has yet to be developed. *Id*. at 5-6. The testimony of Company witness Marano focused on why an accelerated replacement program is needed and what he believes is the preferred approach. When Staff sought to learn more about the plan earlier in the case, the Company responded that "Mr. Marano's testimony does not purport to describe an implementation plan already fully developed by PGL". ICC Staff Ex. 9.0, p. 5 (Peoples Gas Response to PL 2.12). In response to a different data request from Staff, the Company explicitly stated that "[a]t this point, without knowing whether Rider ICR will be approved, Peoples Gas has engaged only in preliminary discussions regarding an accelerated program implementation plan such as described in Mr. Marano's testimony." *Id*. (Peoples Gas Response to PL 2.11(a)). Mr. Lazare testified that it is difficult to assess the need for a recovery mechanism without knowing the Company's funding needs for that rider. *Id*. at 6.

The Company should present its implementation plan before any extraordinary recovery mechanism is considered. Then, the Commission could assess that plan and decide whether it is sufficiently well-conceived to justify the adoption of an extraordinary rider recovery mechanism. *Id*. The Company did not provided a detailed explanation of how its accelerated main replacement program will be implemented until its surrebuttal testimony which provided insufficient time for Staff and parties to respond in this case. The record in this case does not analyze that plan or otherwise contain support for the Company's proposed Rider ICR. The lack of support for the plan leaves Rider ICR without justification. Therefore, as discussed below in Section IX.B below, Staff recommends that the plan be considered in a separate proceeding.

For all the foregoing reasons, Staff recommends that Rider ICR not be approved in this proceeding.

**C. Tariff Issues**

Staff witness Hathhorn proposed eleven recommendations concerning Rider ICR should the Commission approve the tariff. ICC Staff Exhibit 1.0, pages 36-44. The Company accepted Staff's first, second, fourth, fifth, sixth, seventh, and eighth recommendations shown below. ICC Staff Exhibit 15.0, Attachment G, reflects Rider ICR with the changes accepted by the Company in its rebuttal testimony:

- First: Section C(a) be clarified to state, "The annual amount to be billed under Rider ICR shall not exceed the product of Annual ICR Base Rate Revenues multiplied by 5%."

- Second: Section H be clarified to require the annual petition, testimony, and reconciliation statement be filed each year no later than March 31.

- Fourth: The scope of the annual reconciliation referred to in Section H of the proposed Rider include a determination whether all costs recovered through Rider ICR were prudently incurred, just and reasonable.

- Fifth: Section I-Annual Internal Audit of Rider ICR, be revised to add language to the proposed Rider ICR requiring the annual internal audit to include at least the following tests:

  1) test that costs recovered through Rider ICR are not recovered through other approved tariffs;

  2) test customer bills that all Rider ICR Adjustments are being properly billed to customers in the correct time periods;

  3) test that Rider ICR revenues are properly stated; and

  4) test that actual costs are being identified and recorded properly to be reflected in the calculation of the rates and reconciliation.

- Sixth: Section B be modified to reflect the Company's updated initial qualified infrastructure plant ("QIP") percentage for House Regulators, Account 383, of 90%.

- Seventh: Factor IOM that provides for the recovery of incremental operating and maintenance costs through Rider ICR be removed from the rider.

- Eighth: Incentive compensation costs be specifically excluded for cost recovery under Rider ICR.

In rebuttal testimony, Staff withdrew its third and tenth recommendations from direct testimony. ICC Staff Ex. 15.0, p. 33, lines 723-742. Two recommendations of Staff witness Hathhorn remain contested. The Company contests Staff's ninth recommendation that no charges under Rider ICR be made until the Company's plan for its proposed accelerated infrastructure replacement program, as recommended by Staff witness Stoller in Staff Exhibit 14.0, is approved by the Commission. The Company opposes Staff witness Stoller's recommendation that the Commission must first approve the Company's accelerated infrastructure replacement plan. Based upon this position, the Company opposes Staff witness Hathhorn's recommendation as well. NS-PGL Ex. VG-2.0, p.53. However, should the Commission agree with Mr. Stoller that the Commission must first approve the Company's accelerated infrastructure replacement plan, the Company should not be permitted to collect charges under Rider ICR for such plan until approved by the Commission. ICC Staff Ex. 15.0, p. 34, lines 748-755.

Finally, concerning Staff witness Hathhorn's eleventh recommendation that the actual savings factor ("ActSav") be updated at least every three years, the Company agreed that a triennial update of the factor is sufficient but disagrees to the proposed tariff language allowing updates "sooner if demonstrated to be necessary by the Company or any other party." NS-PGL Ex. VG-2.0, p. 53, lines 1173-1180. However, the Company argues that if the Commission wishes to review the factor more frequently, the Commission could initiate a proceeding to do so. Id. The Company does not dispute the Commission's authority to review the factor more frequently, and the revised tariff language provides the same opportunity to update the factor with a showing of evidence as would be necessary in a separate proceeding. Including Staff's proposed language in the tariff makes clear that this factor may need to be updated if circumstances warrant. ICC Staff Ex. 15.0, pp. 34-35, lines 762-771.

Staff's proposed language is as follows:

Section H-Annual Reconciliation, be modified as follows:

> ActSav= Actual savings, which is determined as $6,000.00 times the actual number of miles of cast iron and ductile iron main abandoned in the reconciliation year. <u>The Company shall update ActSav no less than every three years. The first such update shall be required in the Company's third annual reconciliation proceeding, but may be updated sooner if demonstrated to be necessary by the Company or any other party.</u> ICC Staff Exhibit 1.0, page 44, lines 1029-1041, omitting language for withdrawn tenth recommendation.

To require a separate proceeding places an unnecessary burden on the Commission and other parties seeking an update.

### D. Return on Common Equity Factor

As briefly discussed in the Rate of Return section of Staff's initial brief, Staff witness McNally recommended a rate of return on common equity factor for Rider ICR of 8.06%, should the Commission approve Rider ICR in this proceeding. Mr. McNally explained that that rate of return represents a 163 basis point adjustment from the base cost of equity he recommended for Peoples Gas to reflect the reduction in risk resulting from Rider ICR. Adoption of Mr. McNally's recommendation would require a change to the tariff language for Rider ICR for the cost of common equity factor. ICC Staff Ex. 7.0R, p. 35.

## IX. STAFF PROPOSALS REGARDING ACCELERATION OF CAST AND DUCTILE IRON MAIN REPLACEMENT PROGRAM FOR PEOPLES GAS

### A. Proposal To Order Peoples Gas To Undertake Accelerated Program Under Section 8-503

Staff witness Harold Stoller, Director of the Energy Division of the Commission Staff, in which the Commission's Pipeline Safety Program is located, testified in direct testimony ICC Staff Ex. 14.0. regarding Peoples Gas' proposal to commence an accelerated cast and ductile iron main replacement program. Mr. Stoller testified that he was absolutely convinced by the direct testimony of Peoples Gas' witness, Mr. Salvatore Marano (Peoples Gas Exhibit SDM-1.0 Rev.), of the need for Peoples Gas to replace on an accelerated basis its current cast and ductile Iron low-pressure mains with polyethylene and coated steel medium-pressure facilities. In Mr. Stoller's opinion, what Mr. Marano has described was a gas distribution system which is in serious need of major renovation to keep it safe for the citizens of the City of Chicago. Staff Ex. 14.0, p. 2, lines 45-47. In Mr. Stoller's opinion, the accelerated main replacement program should be approved when a sufficiently detailed plan for that project has been reviewed by an independent consultant for the Commission. ICC Staff Ex. 28.0, p. 2, lines 40-44.

Mr. Stoller testified that as Director of the Energy Division he had encountered a number of situations that he considers similar to this one. Mr. Stoller described five situations in which either Commission Staff or an independent consultant determined that an Illinois utility had a serious problem with the condition of its electric or gas delivery system that required focused attention by the utility. In each of those cases, while the Commission Staff or a consultant identified the problems, the utility agreed, or the Commission ordered the utility, to remedy the problem and hire a consultant, or directed its Staff, to monitor the progress of the utility in fulfilling that obligation. ICC Staff Ex. 14.0, pp. 2-4, lines 51-94.

Mr. Stoller testified that Peoples Gas' current situation presents issues that were inherent in each of the five situations he described in his direct testimony. In each of those situations, the Commission was presented with what Mr. Stoller described as a problem that it could not reasonably decline to address. Those problems, prior to being brought to the attention of the Commission, were, in one sense, “the utilities’ problems,” theirs to have managed and resolved in the normal course of running their business and providing adequate, reliable and safe public utility service. In Mr. Stoller’s experience, the Commission has not routinely taken upon itself responsibility to “micro-manage” utilities; that is, the Commission does not try to tell utilities how to run their businesses. However, when the described critical infrastructure problems came to the attention of the Commission, those were not, in Mr. Stoller’s opinion, situations in which the Commission could simply acknowledge the existence of the problems and commend the utilities to resolve them. In each of the five examples Mr. Stoller identified, the Commission took the additional steps, when confronted with a significant utility infrastructure deficiency problem, of, first, securing the utilities’ agreement, or ordering the utility when an agreement was not forthcoming, to resolve the problem and, then, putting in place a process through which the Commission could monitor the utility’s progress in carrying out the Commission’s order or the utility’s agreement. That is the process that Mr. Stoller testified should occur in this instance. *Id*., p. 5, lines 115-130.

That being the case, and this issue having been brought to the attention of the Commission as part of Peoples Gas’ Rider ICR filing, Mr. Stoller testified that the issue has in some sense become as much of an issue for the Commission to deal with as it once may have been an internal utility management issue for Peoples Gas to resolve. Mr. Stoller does not believe that the Commission can simply permit Peoples Gas to move on to accomplish the cast and ductile iron main replacement program as it sees fit over time. What the Marano testimony indicates to Mr. Stoller is that Peoples Gas' approach has not worked in the past. He does not believe the Commission can reasonably and responsibly rely on Peoples Gas to resolve the problem on its own going forward without in some way keeping a close eye on the situation. Id., p. 6, lines 151-159.

Mr. Stoller testified that, in a broad sense, he views the situation regarding Peoples Gas' cast and ductile iron main system as similar to that which might be presented if Peoples Gas were to file with the Commission a petition under Section 8-406 of the Public Utilities Act ("Act") (220 ILCS 5/8-406), identifying a significant project to replace a large part of its gas distribution system. Were the Commission to concur with the identified urgent need to undertake the construction program, whether for purposes of satisfying a standard of "public convenience or necessity" identified in Section 8-406, or preserving public safety as Mr. Stoller believes is the case here, it could then enter an order under Section 8-503 of the PUA that obliged Peoples Gas to commence the construction program to repair and improve its existing plant. *Id*., p. 4, lines 98-106.

Mr. Stoller testified that he believes, no matter the source or the circumstances of the information coming to the Commission's attention that a utility has a significant problem with its facilities that is compromising, or might compromise in the future, its ability to provide adequate, reliable and safe public utility service, the Commission has an obligation to act. *Id*., pp. 4-5, lines 106-110. The significant difference between a typical situation where a utility has petitioned the Commission for an order under Sections 8-406 and 8-503 of the Act and this situation is that the current situation is one where the issue was recognized by the utility nearly thirty years ago, and now the utility is asking indirectly for authorization to undertake a twenty-year accelerated program to accomplish what its consultants told it nearly thirty years ago should be done by about twenty years from now.

Section 8-503 of the PUA explicitly authorizes the Commission to "direct" a utility to make "additions, extensions, repairs, improvements or changes" to its "existing plant, equipment, apparatus, facilities or other physical property" if they are "necessary and ought reasonably to be made" or are "necessary and should be erected, to promote the security or convenience of its employees or the public or promote the development of an effectively competitive electricity market, or in any other way to secure adequate service or facilities …." 220 ILCS 5/8-503. Specifically, Section 8-503 provides, in relevant part, as follows:

> Sec. 8-503. Whenever the Commission, after a hearing, shall find that additions, extensions, repairs or improvements to, or changes in, the existing plant, equipment, apparatus, facilities or other physical property of any public utility or of any 2 or more public utilities are necessary and ought reasonably to be made or that a new structure or structures is or are necessary and should be erected, to promote the security or convenience of its employees or the public or promote the development of an effectively competitive electricity market, or in any other way to secure adequate service or facilities, the Commission shall make and serve an order authorizing or directing that such additions, extensions, repairs, improvements or changes be made, or such structure or structures be erected at the location, in the manner and within the time specified in said order; ….

220 ILCS 5/8-503. Staff submits that Section 8-503 authorizes the Commission to require Peoples Gas to undertake an accelerated cast and ductile iron main replacement program, and provides authority for the Commission to adopt Mr. Stoller's

recommendations to require Peoples Gas to undertake an accelerated program under the terms and conditions specified by Mr. Stoller and discussed below.

### B. Proposal To Require Peoples Gas To Submit Implementation Plan For Approval In Separate Docket With Analysis By Outside Expert Retained By The Commission And Paid For By Peoples Gas

Mr. Stoller testified that Peoples Gas has, through the Marano testimony, identified what Mr. Stoller considers to be a convincing case to justify replacing the cast and ductile iron mains in its distribution system on an expedited basis. While Mr. Marano did not focus exclusively, or even primarily, on pipeline safety issues in his testimony, i.e. he also addressed the issue of a cost recovery rider, Mr. Stoller's perspective in his testimony was based exclusively on maintaining public safety and not on other justifications for Mr. Marano's proposal. *Id*., pp. 5-6, lines 135-140. The issue of whether there is a need to accelerate replacement of cast and ductile iron mains is separate and distinct from the issue of the appropriate recovery mechanism.

Mr. Stoller testified that while others might disagree with his characterization of Peoples Gas' distribution system, the Marano testimony led him to conclude that the system is old, it is antiquated, and it is approaching the point that further aging and deterioration will eventually cause replacement to maintain public safety to become an emergency matter rather than one which can be reasonably planned and executed. *Id*., p. 6, lines 142-146. Whether or not the twenty-year replacement program Mr. Marano has advocated, and with which Mr. Stoller agrees, will get the job done soon enough is probably anybody's guess. However, Mr. Stoller testified that he is convinced that Peoples Gas should begin the replacement program very soon to avoid the possibility of a later emergency situation. *Id*., lines 146-149. Mr. Marano seems to agree, given his testimony that "there is a need to pursue a more accelerated approach of upgrading the system to prevent or mitigate foreseeable future risk of system and asset failure" (Peoples Gas Ex. SDM-1.0 Rev., p. 2, lines 35-37) and "[a]ccelerating the replacement of these higher risk materials [cast and ductile iron mains] will increase system safety and reduce the likelihood of subjecting the public and customers to the adverse effects of pipe failure." *Id*., p. 6, lines 125-127. Mr. Marano's most significant conclusion regarding the timing of the proposed accelerated main replacement program is that "[i]f in the future . . . failures which could pose a risk to the general public manifest themselves, a reactive acceleration of the replacement program at that time could present costly and difficult management issues as opposed to a more proactive planned approach …." *Id*., p. 29, lines 520-524.

Mr. Marano is apparently suggesting through his surrebuttal testimony that the Commission would itself have sufficient internal resources to thoroughly evaluate any twenty-year accelerated main replacement program plan that he provided. NS-PGL Ex. SDM-3.0, p. 4, lines 88-91. Mr. Marano is entirely mistaken. ICC Staff Ex. 28.0, p. 2, lines 5-52. The Commission does not employ on its Staff any experts in large industrial construction project planning. Therefore, Staff could not, based upon its own internal resources, bring to bear sufficient resources and adequate professional expertise to evaluate the plan for the Commission. Apparently, as is the case with Staff, Peoples Gas also has insufficient expertise or resources among its own personnel to develop the twenty-year plan since Peoples Gas is hiring the Jacobs firm to write its plan. Mr. Marano himself testified that the "proposed accelerated program is indeed a very large undertaking requiring careful management, planning and execution." NS-PGL Ex. SDM-3.0,, p. 4, lines 84-85; ICC Staff Ex. 28.0, pp. 2-3, lines 51-59.

As to a timeline for plan review, if Mr. Marano's filing of Peoples Gas' "plan" with his surrebuttal testimony is meant to suggest a timeline that is to end with the order in this docket, that proposal is entirely unrealistic even if the Commission had the necessary Staff expertise to conduct a thorough evaluation of the plan. As Mr. Marano has testified, Peoples Gas itself employed the services of a professional consulting firm to work on the plans that he presented with his surrebuttal testimony (NS-PGL Ex. SDM-3.0 Rev., p. 4, lines 70-72) and that work apparently consumed several months. This rate case is not a proceeding where a massive, two-decade long infrastructure replacement program should be evaluated, particularly since the plan was not submitted until surrebuttal testimony; rather, that program should be evaluated in a proceeding entirely separate and apart from this rate case. ICC Staff Ex. 28.0, p. 3, lines 60-70.

### C. Proposal To Require Peoples Gas To Periodically Submit Updates With Analysis By Outside Expert Retained By The Commission And Paid For By Peoples Gas

The Commission should order Peoples Gas to undertake the twenty-year program. The Commission should also order Peoples Gas to bring a plan for that twenty-year program to the Commission for approval, subject to analysis by a consultant hired by the Commission and paid for by Peoples Gas. The Commission should then, assuming that the program is approved, or approved as modified, by the Commission, order or secure Peoples Gas' agreement to return to the Commission about every three years thereafter until the conclusion of the program with an update on the program's progress, also to be analyzed by an independent consultant hired by the Commission at Peoples Gas' expense if that is the Commission's desire.

Peoples Gas witness Marano testified that Peoples Gas has found, in its research on existing riders, "no reference to independent consultant oversight being ordered by Commissions in other states." NS-PGL Ex. SDM -2.0, p. 9, lines 200-202. Mr. Stoller testified that he did not find particularly relevant what Peoples Gas found in their research about what commissions have ordered in other states. Mr. Stoller stated that his experience in this state, based on the situations he described in his direct testimony, is that continuing oversight by the Commission and its Staff, based on initial and continuing expert consultant evaluation, is absolutely essential to (i) effective monitoring by this Commission of significant utility programs that have come to its attention and (ii) the successful completion of those programs. Without that oversight, Mr. Stoller is convinced that backsliding and delays of which the Commission would not be aware, or of the reasons for those events, are far too likely. ICC Staff Ex. 28.0, p. 4, lines 95-105.

Mr. Stoller presented as an example of what can occur, without trying to assess or imply error or fault, what has occurred with Peoples Gas' own cast and ductile iron main replacement program. ICC Staff Ex. 28.0, p. 4, lines 106-107. Mr. Marano mentioned in his direct testimony the Zinder and Kiefner studies of Peoples Gas' distribution systems. The first of those two studies, the Zinder study (Zinder Report No. ER-048 of May 22, 1981, "Zinder Report") recommended a fifty-year cast iron main replacement program. The Zinder Report indicates that it evaluated and made recommendations regarding approximately 1,679 miles of cast iron main in Peoples

Gas' distribution system. The Zinder Report identified a total 8,867,000 feet of 4-inch, 6-inch, 8-inch and 12-inch cast iron pipe that should be replaced over the 50 years from 1981. Zinder Report, p. vi. Peoples Gas' witness Mr. Doerk contends in his testimony that "more than 45% of the cast and ductile iron main system has been replaced" since 1981. Peoples Gas Ex. ED-2.0, lines 110-112. Mr. Doerk might be referring to different cast iron mains than were studied by both Zinder and Mr. Marano. However, almost thirty years later after the Zinder Report, Mr. Marano is testifying about an <u>accelerated</u> replacement program for approximately 1,630 miles of cast iron main in Peoples Gas' distribution system. Mr. Stoller's testimony is that it is not at all clear that there has been much progress made in replacing cast iron main in Peoples Gas' distribution system in the past thirty years. ICC Staff Ex 28.0, pp. 4-5, lines 107-123.

What is apparent from looking at Figure 8 on page 16 of the Kiefner and Associates report of March 1, 2007, is that Peoples Gas will need to nearly triple the average annual rate of cast and ductile main replacement that they have attained over about the last ten years to remove all cast and ductile iron main from their distribution system in the next twenty years. Staff Ex. 28.0, p. 5, lines 124-128. Mr. Stoller testified that it is now nearly thirty years after the Zinder Report and the Commission now has before it a recommendation from Mr. Marano for an <u>accelerated</u> main replacement program that would take the remaining twenty years of the fifty years originally recommended by the Zinder Report. Staff Ex. 28.0, p. 5, lines 129-131. If Peoples Gas had followed the recommendations of the Zinder Report of thirty years ago, the Commission would likely not find itself today in a situation where Mr. Marano is recommending an "accelerated" cast and ductile iron main replacement program. Mr.

Stoller indicated that it is not clear from the evidence why, nearly thirty years after the fifty-year recommendation was first made, we are now faced with an accelerated twenty-year recommendation. Mr. Stoller's position is that the Commission has no process in place today, nor sufficient resources to institute a process, for continuing oversight of the main replacement program that is in any way equivalent to what has worked for the Commission and utility customers in other circumstances and that Mr. Stoller is recommending in this situation. ICC Staff Ex. 28.0, p. 5, lines 132-140.

The plan that Mr. Marano presented with his surrebuttal testimony is not the final plan with which Peoples Gas would begin the twenty-year accelerated main replacement program. Mr. Marano testified that the Commission should be able, with what he presented with his surrebuttal testimony to "track PGL's progress should the accelerated program be approved." NS-PGL Ex. SDM 2.0, p. 9, lines 205-206. However, what Mr. Marano actually provided with his surrebuttal testimony was described in his rebuttal testimony as a "preliminary program and construction plan" (*Id*. at lines 104-105) and as an "initial phase evaluation." Peoples Ex. SDM-2.0, line 155. It is absolutely clear to Mr. Stoller that the Commission should <u>not</u> commit in this docketed proceeding to approval, without independent expert analysis and monitoring, of any twenty-year accelerated main replacement program based on the plan Mr. Marano provides with his surrebuttal testimony.

Mr. Stoller testified that the Commission should not permit itself to be found in a similar position a decade or two from now; that is, with yet another recommendation for a "hurry-up" program. It is well past high time for an accelerated main replacement program to get underway for the reasons that Mr. Marano and Mr. Stoller have both identified, and for there to be adequate oversight of the program to assure that it gets completed as required and as promised.  There has been no specific expert consultant or Commission oversight of Peoples Gas' cast iron main replacement program for the last thirty years, and Mr. Stoller believes that maintaining public safety into the future demands that the experience of the past thirty years not be repeated. ICC Staff Ex. 28.0, p. 6, lines 141-149.

### D. Staff Conclusion Regarding Accelerated Cast and Ductile Main Replacement Program

It is Mr. Stoller's very firm recommendation, based on his experience over a period of ten years with several other Illinois utilities that have experienced significant problems with deteriorated and unsatisfactory conditions of portions of their infrastructure, that the Commission should not seriously consider ordering Peoples Gas to undertake the twenty-year accelerated main replacement program without also providing for independent expert consultant evaluation prior to the Commission's approval of the plan and for continuing consultant monitoring and review of implementation of that plan.  Mr. Stoller's recommendation that the Commission order the twenty-year replacement program to be undertaken and his recommendation that there be expert consultant evaluation for the Commission of that plan initially and periodically throughout its life are conditional on each other.  It is Mr. Stoller's very firm opinion that the twenty-year program is vital for the future of public safety of Peoples Gas' distribution system, and it is also his very firm opinion that, without expert review and monitoring, the program is unlikely to be successful in replacing the antiquated infrastructure that it is focused on or being an economically sound project.  ICC Staff Ex. 28.0, p. 6, lines 151-164.

Accordingly, Staff recommends that the Commission accept all of Mr. Stoller's recommendations as described above.

## X. OTHER NEW RIDERS

### A. Rider UEA (Withdrawn)

### B. Rider FCA (NS) (Uncontested)

The Company proposed to add Rider FCA, Franchise Cost Adjustment. The purpose of Rider FCA is to recover the cost of franchise expenses in the form of either reduced rate service or monetary contributions. These costs are recovered solely from the customers residing within the boundaries of the local governmental units receiving such reduced rate service or monetary compensation. The Company proposes to recover franchise costs from appropriate customers on a monthly basis under Rider FCA. The Company proposes to file an information sheet on or before April 20th of each year that specifies the franchise cost adjustment charges to be applicable for the subsequent 12 months. The amount to be recovered would be based on the actual costs of providing reduced rate service or other monetary contribution to the local governmental units during the previous calendar year.

Based on his review of this new rider, and because the Commission has approved similar riders for other utilities, Mr. Boggs recommended that Rider FCA be approved. ICC Exhibit 11.0, pp. 20-22.

### C. Rider GCA (NS) (Uncontested)

The Company proposed to add Rider GCA, Governmental Agency Compensation Adjustment. Some local governmental units have enacted ordinances that require various fees from utilities and/or cause utilities to incur costs to supply gas service to customers who live within the governmental unit. Rider GCA would allow the Company to recover the fees and costs imposed upon it by local governmental units from the customers who live within the boundaries of the respective governmental unit on a per customer basis. Rider GCA describes seven conditions that would allow North Shore to recover costs under the rider. It is reasonable for the Company to recover costs and fees relating to gas delivery that are imposed by local governmental units from the customers who reside within the boundaries of each governmental unit imposing such costs. Rider GCA is set-up to allow the Company to make adjustments throughout the year that would allow quicker recovery of the fees and/or costs that are imposed and could possibly mitigate larger adjustments that may cause customer hardship if the Company waited until the end of a calendar year to recover the costs. Gradual increases in recovery of the costs throughout the year would prove more affordable to customers than large annual increases if the Company waited until the end of the calendar year to make adjustments to the tariff. Also, the Commission would be able to closely monitor and act on periodic Company proposals to increase and speed up the cost recovery process.

Based on his review of this new rider, and because the Commission has approved similar riders for other utilities, Mr. Boggs recommended that Rider GCA be approved. ICC Exhibit 11.0, pp. 22-24.

# XI. COST OF SERVICE

## A. Overview

## B. Embedded Cost of Service Study

### 1. Uncontested Issues

#### a. Sufficiency of ECOSS for Rate Design

Both North Shore and Peoples Gas provided a cost of service study ("COSS") with their filing in their respective Schedules E-6. ICC Staff Ex. 10.0, pp. 12 and 36. Staff witness Harden found both North Shore's and Peoples Gas's COSS to be an <u>acceptable tool</u> for setting rates in these dockets. Id., pp. 13 and 36.

### 2. Contested Issues

#### a. Classification of Uncollectible Account Expenses Account No. 904

See X., B., 2. Account 904 Uncollectible Expense

#### b. Sales Revenues Adjustments

In AG/CUB/City witness Mr. David Effron's direct testimony he recommended that the Companies sales forecasts in the test year be updated to reflect a significantly lower current price of gas compared to that projected at the time the sales forecasts were originally prepared. AG/CUB/City Ex. 1.0, p. 14. Staff witness Harden testified that the sales forecast is a variable used in determining the distribution charge and further explained it was her understanding that if the price of gas used in the model is lower, than the sales forecast model will forecast higher customer usage which would result in lower distribution rates. However, as explained by Ms. Harden updating the sales forecast for the price of gas would not affect the Companies' total revenue requirement nor the revenue requirement allocated to a class. ICC Staff Ex. 24.0, p. 19.

Staff witness Harden agreed with Mr. Effron that there should be an update in the sales forecasts, but did not agree with Mr. Effron's gas price. (Id., p. 20) Ms. Harden explained that Staff witness Dr. Rearden's gas price should be used instead of Mr. Effron's. While the Companies did not agree with the AG and Staff that the price of gas should be updated in the sales forecast model and indicated that there should not be an update unless all of the variables in the model were updated as well (Id., p. 20), Staff and the Companies were able to come to agreement on what the price of gas should be for certain other adjustments in particular "uncollectible expense, Company used gas, North Shore franchise gas costs, gas and storage, working capital and Peoples Gas cushion gas." Tr., p. 914, August 27, 2009. Given the above, Staff's position is that same price of gas from the Companies' surrebuttal should also be used for Mr. Effron's sales forecast adjustment.

With regard to the Companies' position that there should be no update in the sales forecast model unless all of the variables in the model are updated, Staff witness Harden does not agree with the Companies' witness Clabot's position on this issue. Ms. Harden, while acknowledging it might be desirable to update everything, found it to not be critical. ICC Staff Ex. 24.0, p. 21. Ms Harden pointed out that the update in price would not affect the revenue requirement and no other party has provided updates to the other variables in the sales forecast model. Id. Ms. Harden pointed out it would be impractical to properly review and analyze all the new sales forecast variables if they were provided so late in the proceeding, but the price of gas should be updated and used to develop an updated sales forecast. Id.

# XII. RATE DESIGN

## A. Overview

## B. General Rate Design

### 1. Allocation of Rate Increase

The Companies and Staff have each proposed their own rates in this proceeding. Staff witness Harden's rates are attached to her rebuttal testimony as schedules, 24.1 N for North Shore and 24.1 P for Peoples Gas. Each one's rates are based upon their own recommendations for what the Companies' revenue requirement should be. However, it should come as no surprise to either Staff or the Companies that the Commission may approve a revenue requirement that is different than what both Staff and the Companies propose. Once the Commission determines a revenue requirement, Ms. Harden's Schedule 24.1 can be modified to quickly set final rates for the Companies.

The idea behind Ms. Harden's Schedule 24.1 is that in general, Ms. Harden agreed with the Companies proposed rate design with the exception of the Companies' handling of Account 904-uncollectible expense cost allocation and their desire for an increase in the amount or percentage of fixed cost recovered through the customer charge. ICC Staff Ex. 24.9, p. 12. Given that general agreement with the Companies' rate design with the exception of their handling of Account 904 expenses and the increase in fixed cost recovery through the customer charge, Ms. Harden's Schedule 24.1 N and 24.1 P adjusts the Companies' proposed rates based upon Staff's revenue requirement compared to the Companies as a ratio after accounting for Ms. Harden's position on Account 904 expenses and maintaining the same fixed cost recovery percentage of 50% for North Shore and 43% for Peoples Gas in the customer charge which was approved in the Companies last rate cases. Id., pp. 13-14. Whatever the revenue requirement is determined to be by the Commission in its final order it can be input into the schedule, which will then automatically calculate final rates. Id., p. 18. The specific details of how Ms. Harden's various rates were determined and what those rates, given Staff's revenue requirement, are discussed at pages 14 through 18 of Ms. Harden's rebuttal testimony. Id.

One significant area of disagreement between the Companies and Staff regarding where any rate increase should be allocated concerns the customer charge. As mentioned above and discussed in more detail later in this brief, Staff witness Harden recommended that the percentage of fixed costs recovered through the customer charge should remain at 50% for North Shore and 43% for Peoples Gas. The Companies on the other hand are seeking to recover a greater portion of any rate increase through an increase in the percentage of fixed cost recovered through the customer charge. Staff objects to increasing the customer charge to recover more fixed costs for a number of reasons. One objection being that the Companies have in place Rider VBA.

Rider VBA was approved by the Commission in the last rate case "in order to provide more stable and reliable revenue stream." Rider VBA was designed to address the fact that according to the Companies a significant portion of fixed costs were recovered through volumetric charges and that there could be over or under recovery based upon actual volumes. ICC Staff Ex. 10.0, p. 9. With Rider VBA North Shore's and Peoples' Gas' fixed cost percent recovered could be almost 98% for Peoples Gas and would remain at 99% for North Shore based upon the proposals in their testimony. Id. Since Rider VBA gives the Companies fixed cost recovery that is so high, it is not necessary to allow the Companies to recover more fixed costs through the customer charge or all Account 904 uncollectible expense solely through the customer charge.

Because the Companies have Rider VBA they are unique from the other gas utilities in Illinois that do not have a Rider VBA. While other utilities in Illinois (Nicor Gas, AmerenCILCO Gas, AmerenCIPS Gas and AmerenIP Gas) sought approval of decoupling riders like the Companies Rider VBA and were denied, those utilities were allowed to recover 80% of their fixed costs through the customer charge. ICC Staff Ex. 24.0, p. 6. The Companies cannot cite to any prior Commission decision where a utility was allowed both a decoupling rider like the Companies Rider VBA and high percentage fixed cost recovery through the customer charge like the other gas utilities in Illinois. The Commission should deny the Companies request to become that utility.

**2. Account 904 Uncollectible Expense**

Staff witness Harden recommended that Account 904-uncollectible expense be apportioned to customer, distribution, and demand cost classifications so that the expenses are recovered from the blend of charges that comprise the uncollectible expense. Her position is consistent with the Commission's order in the Companies' last rate case. ICC Staff Ex. 10.0, pp. 5-6. In North Shore's and Peoples' last rate case, the Commission directed the Companies to do two things with respect to Account 904-uncollectible expense. First, the Companies were directed to segregate out uncollectible expense associated with sales customers' gas purchases from transportation customers' uncollectible expenses so that there were differentiated distribution rates for sales and transportation customers. The goal being that transportation customers who buy gas from suppliers other than North Shore and Peoples gas would not pay rates that included uncollectible expenses for gas purchases for sales customers who purchase their gas through the purchased gas adjustment clause ("PGA"). North Shore/Peoples Gas, Ex. VG-1.0, p. 11-12; ICC Staff Exhibit 10.0, pp 3-4; Docket No. 07-0241/0242, Order at 230. In the current docket, the Companies' witness Grace agreed to continue this "differentiation" between sales and transportation customers, but believes the differentiation should be reflected in the customer charge. North Shore Ex. VG-1.0, p. 12; Peoples Gas VG-1.0, p. 13.

The second direction given to the Companies by the Commission was that because uncollectible expenses were found to be "… classified as a combination of customer costs, demand costs, and commodity costs including gas costs" (ICC Docket No. 07-0241/0242, Order at 201; Tr. 42) uncollectible expense should be apportioned by relative weight to not only the customer cost classification but also demand and commodity classifications. ICC Docket No. 07-0241/0242, Order at 201. That direction was based upon the Staff's analysis in the docket which the Commission found to be "clear, thorough and highly persuasive." Id.

In their filings for these rate cases, the Companies followed some of the direction given to them by the Commission concerning Account 904 uncollectible expense but did not follow all of the Commission's direction. The Companies did provide for differentiated rates for sales and transportation customers in their filings (North Shore Ex. VG-1.0, p. 12; Peoples Gas VG-1.0, p. 13), but they ignored the Commission's direction on apportioning uncollectible expense to not only the customer classification but also to apportion some of the uncollectible expense to demand and commodity classifications. Tr., p. 45-48, August 24, 2009.

Staff and the Companies have a fundamental disagreement regarding Account 904 uncollectible expense. Staff and the Companies do not agree on whether those expenses are solely customer costs. The Companies position is that Account 904 uncollectible expense are “solely … a customer cost.” NS-PGL Ex. JCHM-2.0. Staff’s view is uncollectible expense is comprised of both fixed and variable charges, i.e., the customer charge, distribution charge and demand charge” (ICC Staff Exhibit 10.0, p. 4) and therefore the expenses are not solely a customer cost. Stated another way, since uncollectible expense results from an unpaid bill and that unpaid bill is composed of three parts (customer charge, distribution charge and demand charge) and all three parts are not paid, the cost (i.e., the uncollectible expense) should be allocated to all three parts and not just one part, i.e., the customer charge. It is surprising that the Companies took the position that they did in this docket, given that the Commission addressed this issue in the Companies’ last rate case. As previously stated, the Commission accepted Staff’s proposal/analysis in the last rate case that “Account 904 expenses should be classified as a combination of customer costs, demand costs, and commodity costs including gas costs.” Docket No. 07-0241/0242, Order at 201. The Commission should again reject the Companies’ position and put an end to this dispute once and for all.

Consistent with Staff’s position in the last rate case, it was illogical to Staff witness Harden to allow the recovery of the uncollectible costs solely through the customer charge, which is a fixed charge, when one of the charges which comprises two-thirds of a customer's bill (gas costs) will vary by usage. Id. p. 6. Even the Companies' witness Hoffman-Malueg agreed "that a high cost of gas could be one attributable factor as to why a customer does not pay their bill." NS-PGL Ex. JCHM-3.0, pp. 4-5. Since gas costs will vary by usage, the only reasonable position to Staff, is that some recovery of the uncollectible expense must occur based upon usage rather than seeking one hundred percent recovery through the non-usage based fixed customer charge. ICC Staff Ex. 10.0, p. 6.

The Companies through the testimony of witnesses Ms. Hoffman Malueg and Ms. Grace, raise several arguments against Staff's position concerning Account 904 uncollectible expense. One of the Companies' arguments in rebuttal against the Commission's decision in the last rate case was that if Account 904 uncollectible expense was to be classified by relative weight of the revenue requirement and the revenue requirement is derived from components including expense accounts (e.g., Account 904) there is a circularity problem with the Commission's/Staff's position. NS-PGL Ex. JCHM-2.0, p. 3. However in surrebuttal testimony, Companies' witness Ms. Hoffman Malueg acknowledges that Ms. Harden's clarification through the discovery process demonstrated that Staff's position <u>is not</u> circular in nature. NS-PGL Ex. JCHM-3.0, p. 2. As Ms. Harden explained the uncollectible expense in each customer class is apportioned based on the relative percentage or weight <u>of costs</u> <u>other than uncollectible expense</u> to the demand, customer and commodity classifications. NS-PGL Ex. JCHM-2.3 (Staff witness Harden response to PGL-NS 7.06 (d) (emphasis added)).

Another argument raised by the Companies against Staff's position is that the Commission's order in 2007 "… did not appear to set a generally applicable policy considering that other gas utilities have not been directed to use the approach stated in the 2007 Final Order. NS-PGL Ex. JCHM-3.0, p. 2  Companies' witness Ms. Hoffman Malueg fails to recognize the obvious - that the order in 07-0241/0242 which addressed Account 904 uncollectible expense was specifically directed to the Companies while the orders for the other gas utilities were for utilities who had their own different set of facts and circumstances and were specifically addressed to those other gas utilities  As Staff witness Ms. Harden testified the Companies have not provided any new information about Account 904 in this docket which warrants a revision to the Commission's ruling on the issue from its prior order, the Companies have only provided a new argument about customer migration discussed below. ICC Staff Ex. 10.0, p. 4.

The Companies also argue that even though gas usage is a cause for uncollectible costs in Account 904, given the other varying causes for why a customer does not pay their bill, the decision to classify Account 904 solely to the customer classification, is appropriate for the various reasons stated in Companies' witness Ms. Hoffman Malueg's rebuttal testimony. NS-PGL Ex. JCHM-3.0, pp. 2-3.  The fact that the Companies do not dispute that gas usage is a cause for uncollectible expense yet the Companies continue to assign all of the costs to the customer charge component of the bill highlights the narrow focus of their position.  The Companies want to recover all of the costs through the fixed customer charge no matter what the evidence shows. Staff's position on the other hand, is broader and more encompassing of the evidence in the record and not results driven like the Companies proposal.

Companies' witness Ms. Grace makes a Rider VBA/customer migration argument against Staff's proposal concerning Account 904 uncollectible expense. Ms. Grace, like Companies' witness Ms. Hoffman Malueg believes that Account 904 costs are customer related. NS-PGL Ex. VG-3.0, p. 4. For that reason, she believes that the differentiation of gas cost related Account 904 Costs should be reflected in different customer charges instead of different distribution charges for sales and transportation customers (Currently the Companies have different distribution charges for sales and transportation customers). Id. Ms. Hoffman Malueg then makes the point that due to the fact that sales and transportation customers have different distribution charges, there have been different Rider VBA charges and credits for sales and transportation customers. Id. Ms. Grace's VBA argument seems to be that if Account 904 costs are put into the customer charge for both sales and transportation customers, those customers would be better able to compare the delivery charge costs of the Companies' sales service versus its transportation service since the number of Rider VBA baselines would be reduced from four to two. Id., p. 6. Ms. Grace also argues that by having different distribution rates rather than different customer charges, the migration of customers from sales to transportation has skewed the differentiation of revenues between sale and transportation service. Id., p. 4. It is Staff's position that there is little benefit from going from four to two VBA calculation adjustments (ICC Staff Ex. 24.0, p. 5) and if migration is a problem for Rider VBA then it should be addressed at the conclusion of the Rider VBA pilot when Rider VBA will be evaluated rather than modifying the pilot in midstream. Id., p. 4.

Finally, Companies' witness Ms. Grace argues that due to recent enactment of Senate Bill 1918 (Public Act 096-0333) Account 904 costs that are recovered through base rates must be identifiable and accurately quantified. NS-PGL Ex. VG-3.0, p. 20. Ms. Grace seems to imply that Staff witness Harden's costs are not identifiable and accurately quantified yet the example she provides in her surrebuttal testimony establishes the opposite. Clearly they are identifiable given that Ms. Grace is able to quantify them for purposes of arguing that an improper amount of Account 904 costs would be refunded under Ms. Harden's rate design proposal. See, NS-PGL Ex. VG-3.0, p. 22. As to whether the amount is accurately quantified, any difference between Ms. Harden's amount and Ms. Grace's amount is due to the fundamental difference of opinion between Staff and the Companies as to whether Account 904 costs are solely customer costs.

### 3. Uniform Numbering of Service Classifications

As demonstrated in Staff witness Harden's table 1 from direct testimony, North Shore Gas and Peoples Gas for the most part have the same customer classes, but each Company has different service classification numbers to identify customer classes. ICC Staff Ex. 10.0, p. 10. Staff witness Harden recommended that in order to limit confusion for customers with accounts in both service territories and to simplify the rate-making process there would be a benefit by the Companies adopting a uniform set of service classification numbers. Id. In rebuttal Staff witness Harden testified that the Companies should be ordered to assess their customer information system and adopt a uniform numbering system for their service classifications in their next rate case.

In surrebuttal testimony, Companies' witness Grace indicated that the Companies would "assess their customer information systems to determine if they can implement uniform numbering of their service classifications. If those assessments yield no identifiable problems, the Utilities will propose uniform service classifications in their next rate cases." NS-PGL Ex. VG-3.0, p. 9.

The Companies proposal set forth above in surrebuttal is acceptable to Staff. Therefore Staff considers this issue to no longer be contested between it and the Companies. The Commission's final order in this matter should reflect the resolution of the issue as set forth by Companies' witness Grace in her surrebuttal testimony.

## C. Service Classification Rate Design

### 1. Uncontested Issues

#### a. North Shore Service Classification Nos. 2 and 3 Eligibility Criterion

The Companies' witness Ms. Grace proposed to impose eligibility requirements for Service Classification Nos. 2 and 3 to prevent customers from shifting between the two classes. She argued that this would prevent large customers from taking service below their cost of service. North Shore Ex. VG 1.0, pp. 20-21. No party objected to these eligibility requirements. Staff witness Mr. Sackett recommended that the Commission approve these charges. ICC Staff Ex. 24.0, p. 4.

#### b. North Shore Service Classification No. 3

North Shore proposed several changes for service classification No. 3. Those changes include or impact: (1) going to a flat demand charge, (2) setting the customer charge at cost, (3) the distribution charge, (4) the stand by service charge, (5) eliminating the requirement for customers to sign a contract and (6) modifying the term of service.

North Shore proposes to change the demand charge per therm for S.C. No. 3 from a two-step declining block rate structure to a flat rate of 61.719 cents per therm. According to the Company this proposed rate should recover 67% of the Company's costs. ICC Staff Ex. 10.0, p. 25. Staff witness Harden recommended approval of a flat demand charge for S.C. No. 3 customers after reviewing the Company's Schedule E-9 and various responses to data requests. She agreed with the Company that implementing a flat demand charge would help to mitigate bill impacts for customers forced to move from S.C. No. 2 to S.C. No. 3. As additional support to the flat demand charge, she noted that a flat demand charge avoids encouraging greater consumption by removing the lower demand charge on usage greater than 10,000 therms. Id., p. 26.

With regard to the customer charge, the Company proposes to set the customer charge at the cost of $760 for both sales and transportation customers, which would be a15% increase. Id. Staff witness Harden recommended approval of the proposed customer charge given that the current forecast for sales customers for 2010 is zero and seven customers are forecasted for 2010. In her opinion setting the charge at cost will better ensure that new S.C. No. 3 customers will not be subsidized by another customer class. Id., p. 27.

With regard to the distribution charge, Staff witness Harden recommended approval of North Shore's proposed distribution charge for S.C. No. 3 because she believes it is best to set all components of this class at rates that will recover the cost of providing service to Large Volume Demand Service customers. ICC Staff Ex. 10.0, p. 27.

With regard to the Standby Service Charge, for North Shore service class No. 3, North Shore's witness Ms. Grace proposed to increase the Standby Service Charge from 4 to 11 cents per therm of standby demand. North Shore Ex. VG 1.0, p. 21. Ms. Grace provided justification in her NS Workpapers VG-1.13(b) and her responses to Staff DR DAS 6.10. No party objected to the increases in this charge. Staff Witness Mr. Sackett recommended that the Commission approve this charge. Staff Ex. 26.0, p. 45. Staff witness Harden found the charge reasonable as well. ICC Staff Ex. 10.0, p. 27.

North Shore also proposed a change for S.C. No. 3 with respect to the current requirement that customers sign a contract. According to the Company a contract is no longer going to be required provided that the Commission approves the proposed eligibility requirement for S.C. No. 2 that those customers must have 41,000 therms of use or less based on a 24 month average. Various other tariff revisions were proposed related to the elimination for the contract requirement (North Shore Ex. VG-1.0, p. 22) which Ms. Harden found acceptable. ICC Staff Ex. 10.0, p. 28.

Finally, the Company proposed an initial term of service through April 30th following the commencement of service. The Company also proposed that the service automatically extend for an additional 12 month period, but if service terminated before the end of the initial 12 month term or any subsequent 12 month term, all amounts due to the Company must be paid including the demand charge for the unexpired portion of the remaining period but if a customer transfers to S.C. No. 2 because that customer no longer meets the minimum usage requirement of 41,000 therm average, the Company will waive the remaining fixed cost charges. ICC Staff Ex. 10.0, pp. 28-29. Staff witness Harden recommended approval of all of these changes. Id., p. 29.

### c. North Shore Service Classification No. 5

North Shore proposed to eliminate service class No. 5, Standby Service which currently 79 customers take service under. With the elimination of service class No. 5, thirty-two standby sales customers would move to S.C. No. 2 meter class 1, thirty-two standby sales would move to S.C. No. 2 meter class 2 and fifteen standby sales customers would move to S.C. No. 2 meter class 3. Staff witness Harden supported the elimination to S.C. No. 5. Ms. Harden explained that this proposal would bring together customers that have similar usage patterns or cost characteristics. ICC Staff Ex. 10.0, p. 30-32. Ms. Harden did recommend that the increase in S.C. No. 2 should be spread more evenly as discussed else where in this brief with regard to S.C. No. 2. Id., p. 32.

### d. North Shore Service Classification No. 6

North Shore service classification No. 6 is Contract Service for Electric Generation. The rates for this class are the result of negotiation between two parties and are set forth in a contract. North Shore is proposing no changes for Service Class No. 6. ICC Staff Ex. 10.0, p. 32.

### e. Peoples Gas Use of Equal Percentage of Embedded Cost Method ("EPECM")

Peoples Gas presented a cost of service study ("COSS") in its filing in Schedule E-6. Staff witness Harden explained that Peoples Gas's "COSS shows the distribution of revenue responsibility by customer class is necessary to achieve equalized rates of return on investment by customer class for the Company's proposed revenue requirement. The COSS identifies the revenues, costs, and profitability for each class of service and is the basis for the rate design. Generally, the Company prepared the COSS utilizing three major steps: (1) cost functionalization; (2) cost classification; and (3) cost allocation of all the costs of the utility's system to customer classes. (Peoples Gas Ex. JCHM-1.0, pp. 2, 7-8)." ICC Staff Ex. 10.0, p. 35. Ms. Harden further explained how Peoples Gas used the COSS to determine proposed rates. In particular, the COSS is the basis for setting service classes' rates at the cost to provide the service and the basis for determining revenue requirement for the small residential and general service classes using the Equal Percentage of Embedded Cost Method ("EPECM"). Id., p. 35. The EPECM is used to allocate proportionately the proposed increase for the small residential and general service classes. EPECM has been used by Peoples Gas in its last three rate cases, Docket Nos. 91-0586, 95-0032 and 07-0242. Peoples Gas Ex. VG-1.0, p. 8; ICC Staff Ex. 10.0, p. 36. According to Ms. Harden, the EPECM provides a gradual increase toward the cost to provide services for small residential by balancing the percentage increase with the general service class. Id. Ms. Harden testified that she agreed the EPECM is appropriate for Peoples Gas by proportionally allocating the increase over the two classes which helps to mitigate bill impact on small residential customers. Finally, Staff witness Harden found the Company's embedded COSS to be an acceptable guidance tool for setting rates in this docket. Id.

#### f. Peoples Gas Service Classification Nos. 2 and 4 Eligibility Criterion

The Companies' witness Ms. Grace proposed to impose eligibility requirements for Service Classifications Nos. 2 and 4 to prevent customers from shifting between the two classes. She argued that this would prevent large customers from taking service below their cost of service. Peoples Gas Ex. VG 1.0, p. 22. No party objected to these eligibility requirements. Staff witness Mr. Sackett recommended that the Commission approve these charges. ICC Staff Ex. 24.0, p. 4.

### g. Peoples Gas Service Classification No. 4

Peoples Gas proposed several changes for service classification No. 4. Those changes include or impact: (1) going to a flat demand charge, (2) setting the customer charge at cost, (3) the distribution charge, (4) the stand by service charge, (5) eliminating the requirement for customers to sign a contract and (6) modifying the term of service.

Peoples Gas proposes to change the demand charge per therm for S.C. No. 4 from a two-step declining block rate structure to a flat rate of 66.707 cents per therm. According to the Company this proposed rate should recover 55% of the Company's costs. ICC Staff Ex. 10.0, p. 49. Staff witness Harden recommended approval of a flat demand charge for S.C. No. 4 customers after reviewing the Company's Schedule E-9 and various responses to data requests. She agreed with the Company that implementing a flat demand charge would help to mitigate bill impacts for customers forced to move from S.C. No. 2 to S.C. No. 4. As additional support to the flat demand charge, she noted that a flat demand charge avoids encouraging greater consumption by removing the lower demand charge on usage greater than 7,500 therms. Id., p. 50.

With regard to the customer charge, the Company proposes to set the customer charge at the cost of $750 for both sales and transportation customers, which would be a 33% increase. Id. Staff witness Harden recommended approval of the proposed customer charge given that currently there is only one customer taking service under

S.C. No. 4 and seven sales customers are forecasted for 2010. In her opinion setting the charge at cost will better ensure that new S.C. No. 4 customers will not be subsidized by another customer class and the change will only affect one current customer. Id., p. 51.

With regard to the distribution charge, Staff witness Harden recommended approval of Peoples Gas proposed distribution charge for S.C. No. 4 because she believes it is best to set all components of this class at rates that will recover the cost of providing service to Large Volume Demand Service customers. ICC Staff Ex. 10.0, p. 51.

With regard to the Standby Service Charge, for Peoples Gas service class No. 4, Peoples Gas' witness Ms. Grace proposed to increase the Standby Service Charge for Peoples Gas' SC No. 4 from 20 to 33 cents per therm of standby demand. Peoples Gas Ex. VG 1.0, p. 23. Ms. Grace provided justification in PGL Workpapers VG-1.13(b) and her responses to Staff DR DAS 6.10. No party objected to the increase in this charge. Staff Witness Mr. Sackett recommended that the Commission approve this charge. ICC Staff Ex. 26.0, p. 45. Staff witness Harden found the charge reasonable as well. ICC Staff Ex. 10.0, p. 51.

Peoples Gas also proposed a change for S.C. No. 4 with respect to the current requirement that customers sign a contract. According to the Company a contract is no longer going to be required provided that the Commission approves the proposed eligibility requirement for S.C. No. 2 that those customers must have 41,000 therms of use or less based on a 24 month average. Various other tariff revisions were proposed related to the elimination for the contract requirement (Peoples Gas Ex. VG-1.0, p. 24) which Ms. Harden found acceptable. ICC Staff Ex. 10.0, p. 52.

Finally, the Company proposed an initial term of service through April 30th following the commencement of service. The Company also proposed that the service automatically extend for an additional 12 month period, but if service terminated before the end of the initial 12 month term or any subsequent 12 month term, all amounts due to the Company must be paid including the demand charge for the unexpired portion of the remaining period but if a customer transfers to S.C. No. 2 because that customer no longer meets the minimum usage requirement of 41,000 therm average, the Company will waive the remaining fixed cost charges. ICC Staff Ex. 10.0, pp. 51-52. Staff witness Harden recommended approval of all of these changes. Id., p. 53.

**h. Peoples Gas Service Classification No. 5**

Peoples Gas' service classification No. 5 is Contract Service for Electric Generation. The rates for this class are the result of negotiation between two parties and are set forth in a contract. Peoples Gas is proposing no changes for Service Class No. 5. ICC Staff Ex. 10.0, pp. 53-54.

**i. Peoples Gas Service Classification No. 6**

Peoples Gas proposed to eliminate service class No. 6, Standby Service which currently 35 customers take service under. With the elimination of service class No. 6, six standby sales customers would move to S.C. No. 2 meter class 1, thirteen standby sales customer would move to S.C. No. 2 meter class 2 and twelve standby sales customers would move to S.C. No. 2 meter class 3. Staff witness Harden supported the elimination to S.C. No. 6. Ms. Harden explained that this proposal would bring together customers that have similar usage patterns or cost characteristics. ICC Staff Ex. 10.0, pp. 54-57. Ms. Harden did recommend in direct that the increase in S.C. No. 2 should be spread more evenly as discussed below in this brief with regard to S.C. No. 2. (Id., p. 57), however in rebuttal she found the Companies proposed rates to be reasonable. ICC Staff Ex. 24.0, p. 11.

#### j. Peoples Gas Service Classification No. 8

Service Class No. 8 is Compressed Natural Gas Service. Peoples Gas is proposing to decrease the customer charge by 2% and increase the distribution charge by 44% for S.C. No. 8. The Company wants the service classification set at cost. Peoples Gas Ex. VG-1.0, p. 25; ICC Staff Ex. 10.0, p. 57. According to Staff witness Harden, Schedule E-9 reflects a 2.7% decrease for retail customers while also show that any other usage appears to cause no greater than a 2.5% increase for retail customers. For transportation customers, Schedule E-9 shows a 2.31% decrease for Choices For You ("CFY") customers with no usage in a given month and a 16.7% decrease for Rider SST customers who have no usage in a given month. E-9 also shows that for any other usage, that usage causes no greater than a 3% increase for transportation customers. Id., pp. 57-58. Staff witness Harden recommended approval of the Company's proposed changes to S.C. No. 8 given that she found setting this rate at cost of service to be appropriate and the bill impact of the changes appeared reasonable based upon information the Company provided in response to Staff Data Request CLH 1.01 and the information contained in Schedule E-9. Id. p. 58. Staff witness Harden did propose her own rates for S.C. No. 8 as explained in her rebuttal testimony and shown on Schedule 24.1. ICC Staff Ex. 24.0, p. 18.

### 2. Contested Issues

#### a. North Shore Service Classification No. 1

Staff witness Harden addressed both the customer charge and distribution charge for S.C. No. 1. There is no agreement between Staff and the Company regarding the customer charge and some agreement regarding the distribution charge. The Company seeks a higher percentage of recovery of fixed costs through the customer charge than Staff and wants sales and transportation customers to have different customer charges. ICC Staff Ex. 10.0, pp. 13-14. Staff witness Harden recommended that for the Company's service classification No. 1 the customer charge for both sales and transportation customer should remain the same for both customers and that the customer charge for both sales and transportation customers should be set at 50% of the class revenue requirement determined in the docket. Id., p. 15. Ms. Harden's position is consistent with the Commission's order in the Company's last rate case. Id. The Company on the other hand wants to recover more fixed costs (56%) through the customer charge. Id., p. 9. Staff cannot support the Company recovering a higher percentage of fixed costs through customer charge given that the Company has Rider VBA in place as a pilot program which is intended to address the recovery of fixed costs and allowing North Shore to recover a higher percentage of fixed costs through the customer charge would change the dynamics of the pilot program. Staff's position is that the pilot program should be maintained as designed so that its success or failings can be measured throughout the life of the pilot. Id.

In the event the Commission allows the Company to increase the percentage of fixed costs recovered through the customer charge which it should not, Ms. Harden recommended that the customer charge for both sales and transportation customers be set the same. The percentage recovery in that case would be 55% of the class fixed costs. Id., pp. 14-15.

On the subject of the distribution charge there is some agreement between Staff and the Company on certain points. The Company wants to maintain its two step declining block rate structure. After accounting for customer charge revenues, the Company proposes a first block of 0 to 50 therms, which would recover two-thirds of the customer, demand and commodity costs. Id. The second block for usage greater than 50 therms would recover the rest of the revenue requirement. Id., pp. 15-16. The Company would recover Account 904 costs solely through the customer charge accordingly, Account 904 costs which currently to some extent are recovered through the distribution charge would be removed from the distribution charge. Id, p. 16. Staff witness Harden supports maintaining the current two-step declining block rate structure, which is consistent with the Commission's order in the last rate case. However, as previously discussed Ms. Harden opposes removing Account 904 costs from the distribution charge. Id. Ms. Harden recommended that after the customer charge revenues are subtracted from the class revenue requirement, the remaining revenue requirement should be recovered so that two-thirds is recovered from the first block and one-third from the second block. Id., pp. 16-17.

#### b. North Shore Service Classification No. 2, Customer Charge

The Company proposes several changes for Service Classification No. 2. First, the Company proposes to add a third meter class, Meter Class 3. ICC Staff Ex. 10.0, p. 17. Second, the Company proposes different customer charges for sales and transportation customers unless Rider UEA is approved. Id., p. 21. Third, the Company is seeking to increase the customer charge. Id. With regard to meter classes currently there are two meter classes, Meter Class 1 (usage of up to 700 cubic feet per hour) and Meter Class 2 (usage over 700 cubic feet per hour). The Company is proposing a third meter class, Meter Class 3 (usage greater than 2,300 cubic feet per hour). North Shore Ex. VG-1.0, pp. 17—18. Staff witness Harden testified that it is appropriate to add Meter Class 3 to address interclass subsidy. In direct testimony, Staff witness Harden testified that to address bill impacts on Meter Class 3 customers, the cost recovery for that class should be implemented at a slower pace for the customer charge than the Company proposes. ICC Staff Ex. 10.0, p. 20. However, in rebuttal, Staff witness Harden testified that apart from her disagreement with the Company concerning Account 904 cost allocation and the increase in fixed cost recovery, she found the Companies proposed rates to be reasonable. Company witness Valerie Grace's bill impacts exhibit demonstrated to Ms. Harden, that on a dollar basis, the bill impacts for customers would not have the extreme monthly or annual increase that concerned her in her direct testimony for high usage and average usage customers. ICC Staff Ex. 24.0, p. 11. In rebuttal, Company witness Grace proposed an alternative rate design for S.C. No. 2 which was intended to mitigate the impact of spreading the subsidy on those customers with smaller usage. Id., p. 12. Ms. Harden found that alternative unnecessary given that she no longer believed there would be rate shock for average to higher usage customers based upon Ms. Grace's bill impacts exhibit. Id.

With regard to the customer charge for the S.C. No. 2, Ms. Harden disagreed with and recommended that the Commission reject the Company's proposal to recover gas related Account 904 costs solely through the customer charge, to have differentiated charges for sales and transportation customers and to increase the percentage of fixed costs recovered in the customers charge. ICC Staff Ex. 10.0, p. 22. As discussed earlier with respect to S.C. No. 1, Ms. Harden recommended that the customer charge for sales and transportation customers should be the same which is consistent with the last rate case order. She also does not support recovering a higher percentage of fixed costs through customer charge given that the Company has Rider VBA in place as a pilot program which is intended to address the recovery of fixed costs and allowing North Shore to recover a higher percentage of fixed costs through the customer charge would change the dynamics of the pilot program. As previously discussed, Staff's position is that the pilot program should be maintained as designed so that its success or failings can be measured throughout the life of the pilot. Id., p. 22. Staff witness Harden did not take issue with the Companies proposal to maintain its current distribution rate structure of a three-step declining block rate structure. ICC Staff Ex. 10.0, p. 23. She testified that maintaining a three-step declining block rate structure provided continuity for the class. Id., p. 24.

### c. Peoples Gas Service Classification No. 1

Staff witness Harden addressed both the customer charge and distribution charge for S.C. No. 1. There is no agreement between Staff and the Company regarding the customer charge and some agreement regarding the distribution charge. The Company seeks a higher percentage of recovery of fixed costs through the customer charge than Staff and wants sales and transportation customers to have different customer charges. ICC Staff Ex. 10.0, p. 38. Staff witness Harden recommended that for the Company's service classification No. 1 the customer charge for both sales and transportation customer should remain the same for both customers and that the customer charge for both sales and transportation customers should be set at 50% of the class revenue requirement determined in the docket. Id. Ms. Harden's position is consistent with the Commission's order in the Company's last rate case. Id. The Company on the other hand wants to recover more fixed costs (54%) through the customer charge. Id., p. 37. Staff cannot support the Company recovering a higher percentage of fixed costs through customer charge given that the Company has Rider VBA in place as a pilot program which is intended to address the recovery of fixed costs and allowing Peoples Gas to recover a higher percentage of fixed costs through the customer charge would change the dynamics of the pilot program. Staff's position is that the pilot program should be maintained as designed so that its success or failings can be measured throughout the life of the pilot. Id., p. 38.

In the event the Commission allows the Company to increase the percentage of fixed costs recovered through the customer charge which it should not, Ms. Harden recommended that the customer charge for both sales and transportation customers be set the same. The percentage recovery in that case would be 54% of the class fixed costs. Id., pp. 38-39.

On the subject of the distribution charge there is some agreement between Staff and the Company on certain points. The Company wants to maintain its two step declining block rate structure. After accounting for customer charge revenues, the Company proposes a first block of 0 to 50 therms, which would recover 65% of the customer, demand and commodity costs. Id., p. 39. The second block for usage greater than 50 therms would recover the rest of the revenue requirement. Id. The Company would recover Account 904 costs solely through the customer charge accordingly, Account 904 costs which currently to some extent are recovered through the distribution charge would be removed from the distribution charge. Id. Staff witness Harden supports maintaining the current two-step declining block rate structure, which is consistent with the Commission's order in the last rate case. However, as previously discussed Ms. Harden opposes removing Account 904 costs from the distribution charge. Id., p. 40. Ms. Harden recommended that after the customer charge revenues are subtracted from the class revenue requirement, the remaining revenue requirement should be recovered so that 65% is recovered from the first block and 35% from the second block. Id., p. 40.

#### d. Peoples Gas Service Classification No. 2, Customer Charge

The Company proposes several changes for Service Classification No. 2. First, the Company proposes to add a third meter class, Meter Class 3. ICC Staff Ex. 10.0, p. 40. Second, the Company proposes different customer charges for sales and transportation customers unless Rider UEA is approved. Id., p. 45. Third, the Company is seeking to increase the customer charge. Id. With regard to meter classes and the same as with North Shore, currently there are two meter classes, Meter Class 1 (usage of up to 700 cubic feet per hour) and Meter Class 2 (usage over 700 cubic feet per hour). The Company is proposing a third meter class, Meter Class 3 (usage greater than 3,000 cubic feet per hour). Peoples Gas Ex. VG-1.0, pp. 18-20. Staff witness Harden testified that it is appropriate to add Meter Class 3 to address interclass subsidy. In direct testimony, Staff witness Harden testified that to address bill impacts on Meter Class 3 customers, the cost recovery for that class should be implemented at a slower pace for the customer charge than the Company proposes. ICC Staff Ex. 10.0, p. 44. However, in rebuttal, Staff witness Harden testified that apart from her disagreement with the Company concerning Account 904 cost allocation and the increase in fixed cost recovery, she found the Companies proposed rates to be reasonable. Company witness Valerie Grace's bill impacts exhibit demonstrated to Ms. Harden, that on a dollar basis, the bill impacts for customers would not have the extreme monthly or annual increase that concerned her in her direct testimony for high usage and average usage customer. ICC Staff Ex. 24.0, p. 11. In rebuttal Company witness Grace proposed an alternative rate design for S.C. No. 2 which was intended to mitigate the impact of spreading the subsidy on those customers with smaller usage. Id., p. 12. Ms. Harden found that alternative unnecessary given that she no longer believed there would be rate shock for average to higher usage customers based upon Ms. Grace's bill impacts exhibit. Id.

With regard to the customer charge for the S.C. No. 2, Ms. Harden disagreed with and recommended that the Commission reject the Company's proposal to recover gas related Account 904 costs solely through the customer charge, to have differentiated charges for sales and transportation customers and to increase the percentage of fixed costs recovered in the customers charge. ICC Staff Ex. 10.0, p. 46. As discussed earlier with respect to S.C. No. 1, Ms. Harden recommended that the customer charge for sales and transportation customers should be the same which is consistent with the last rate case order. She also does not support recovering a higher percentage of fixed costs through customer charge given that the Company has Rider VBA in place as a pilot program which is intended to address the recovery of fixed costs and allowing North Shore to recover a higher percentage of fixed costs through the customer charge would change the dynamics of the pilot program. As previously discussed, Staff's position is that the pilot program should be maintained as designed so that its success or failings can be measured throughout the life of the pilot. Id., p. 46.

Staff witness Harden did not take issue with the Companies proposal to maintain its current distribution rate structure of a three-step declining block rate structure. ICC Staff Ex. 10.0, p. 48. She testified that maintaining a three-step declining block rate structure provided continuity for the class. Id.

## D. Tariffs – Other Tariff Issues

### 1. Uncontested Issues - North Shore and Peoples Gas

#### a. General Terms and Conditions

As described in the direct testimony of Staff witness Boggs, the Companies proposed a minor definitional change to provide clarity to its General Terms and Conditions. Mr. Boggs recommends that the change be approved for both Companies. ICC Exhibit 11.0, pp. 13-14 and p. 34.

#### b. Service Activation Charges

There are two categories of Service Activation Charges. Both recover a portion of costs relating to starting gas service at a premise and apply to customers moving into or within North Shore's service territory.

The first category is referred to as a Succession Turn-on. A Succession Turn-on occurs when one customer discontinues service concurrently with a new customer that moves into the same premises and requests new gas service. In this instance, meter readings are simply recorded for the out-going and in-coming customers. The second category is referred to as a Straight Turn-on. A Straight Turn-on occurs when a customer requests new service at a location which previously never had service or a prior customer had cancelled service some time before new service is requested. In this instance, gas service is turned on and pilot lights are re-lit on appliances.

**i. Succession Turn-on Fee**

**(a) North Shore Gas**

The Company proposed a decrease in the Succession Turn-on fee from $18 to $15. Under the Company's proposal, North Shore would only recover 90% of its current cost of service, which is less than the 95% that was approved in its previous rate case. NS-PGL Ex. VG-1.0 Rev, p. 24.

Staff witness Boggs recommended that the Succession turn-on fee be decreased to $16.59. This would allow the Company full recovery of its cost of service and would still reduce the monthly fee obligation of the ratepayers. ICC Staff Exhibit 11.0, pp. 4-5.

In her rebuttal testimony North Shore witness Grace stated that North Shore would prefer that the succession turn on activation fee be set at $16.50, which is Mr. Bogg's recommendation rounded to the nearest 50 cents. In response to the Companies' data request PGL-NS 8.06, Mr. Boggs stated that he was not opposed to this rounding proposal. NS-PGL Ex. VG-2.0 Rev., p. 49.

In the rebuttal testimony of Staff witness Boggs, he stated that he had no opposition to this proposal and recommended that the fee be set at $16.50. ICC Staff Exhibit 25.0, p. 2.

#### (b) Peoples Gas

Peoples Gas is proposing to increase the Succession Turn-on fee from $12 to $15. A study was performed to measure the costs of these activities and is summarized in Peoples Gas Ex. VG-1.9. The study shows that the cost for a succession turn-on is $15.52. NS-PGL Ex. VG-1.0, p. 26.

At the current rate of $12, the Company is recovering 77% of the current cost of service. At the proposed rate, the Company would be recovering 97% of the cost of service. Staff witness Boggs agreed with the Company that the restructuring of the Service Activation Charge more effectively assigns cost responsibility to those who caused the cost. Mr. Boggs reviewed the supporting documentation (Peoples Gas Response to Staff Data Request ENG 1.12 and Attachments 1 and 2) that the Company provided, and found it an acceptable basis for the proposed charge. ICC Exhibit 11.0, p.27.

### ii. Straight Turn-on Fee

#### (a) North Shore Gas

North Shore's proposed charge, which would recover a significant portion of, but not all, costs is $35.00 for a straight turn-on. There will be no change in the current $5.00 charge for relighting each appliance over four. NS-PGL Ex. VG-1.0, p. 24.

According to Staff witness Boggs, the Company is proposing to increase the Straight Turn-on fee from $28 to $35. The Company provided its cost basis for this proposed change in its response to Staff Data Request ENG 1.44. According to Attachment 2 of North Shore's response to Staff Data Request ENG 1.44 in this case, the $28 fee allowed the Company to recover 63% of its then cost of service. That same data request response indicates that if the Commission approves the Company's Straight Turn-on fee increase proposal in this case, the Company would be able to recover 80% of its current cost of service which has decreased since the Company's last rate case from $44.28 to $43.91. ICC Staff Exhibit 11.0, pp. 6-7.

The proposed increase would allow the Company to come closer to 100% cost recovery while minimizing rate shock to customers. The restructuring of the Straight Turn-on fee more effectively assigns cost responsibility. After reviewing the supporting documentation (North Shore Response to Staff Data Request ENG 1.44 and Attachments 1 and 2) that the Company has provided, Mr. Boggs found the Company's support to be an acceptable basis for the charges and recommends that the Service Activation Charge be set at $35. ICC Staff Exhibit 11.0, pp. 6-7.

**(b) Peoples Gas**

Peoples Gas is proposing to increase the Straight Turn-on fee from $20 to $25. A study was performed to measure the costs of these activities and is summarized in Peoples Gas Ex. VG-1.9. The study shows that the cost for a straight turn-on is $47.78. Peoples Gas' proposed charge, which is increased to collect a greater percentage of costs from customers causing their incurrence but would still recover only a portion of these costs, is $25.00 for a straight turn-on. There will be no change in the current $5.00 charge for relighting each appliance over four. NS-PGL Ex. VG-1.0 Rev., p. 26.

According to Staff witness Boggs, the Company provided the cost basis for this proposed change in its response to Staff Data Request ENG 1.12. According to Attachment 2 of Peoples Gas' response to Staff Data Request ENG 1.12, the $20 fee allowed the Company to recover 44% of its then cost of service but recovers 42% of its current cost of service. If the Commission approves the Company's Straight Turn-on fee increase proposal, the Company would be able to recover 52% of the cost of service. This gradual increase would allow the company to come closer to 100% cost recovery while minimizing the rate shock to customers. ICC Staff Exhibit 11.0, pp. 27-28.

The increase will allow the Company to recover 52% of the cost of service. This would be an increase from the 42% recovery rate the Company is receiving at the current charge of $20. Mr. Boggs agrees with the Company that the restructuring of the Service Activation Charge more effectively assigns cost responsibility to those who cause the cost. Mr. Boggs reviewed the supporting documentation (Peoples Gas Response to Staff Data Request ENG 1.12 and Attachments 1 and 2) that the Company provided, and found them an acceptable basis for the charge. ICC Staff Exhibit 11.0, pp. 27-28.

### c. Service Reconnection Charges

#### i. North Shore Gas

According to the direct testimony of Staff witness Boggs, Service Reconnection Charges are assessed to a customer whose gas was turned off for a variety of reasons. Each customer is entitled to a waiver of one reconnect charge in a 12-month period if the service is discontinued for non-payment, except in a situation in which the customer requested disconnection and then wanted to be reconnected within 12 months or in a situation in which the service has been disconnected at the main. There are three types of service reconnections following an involuntary disconnection for which North Shore currently charges customers: 1) basic reconnections which require only a meter turn-on;

2) reconnections which require installing a new meter to replace a meter that has been removed; and 3) reconnections that involve excavating at the main. ICC Staff Exhibit 11.0, p. 8.

In response to Staff Data Request ENG 1.44, North Shore provided documentation (NS ENG-1.44 Attachment 1) that indicates the cost of service to the Company for a basic reconnection is $65.88. Basic reconnection represents 86% of the Company's total reconnection services and over 50% of all reconnection costs.

The Company proposes to increase the basic reconnection fee from $50 to $60. In the direct testimony of Mr. Boggs, he states that increasing the fee to $60 so that the Company can recover 91% of its cost of service is reasonable. ICC Staff Exhibit 11.0, p. 9. The same $60 reconnection fee would also apply to any customer who requests service discontinuance and subsequently requests service reinstatement within 12 months.

The Company is also proposing to increase the reconnection fee when the meter has to be reset from $90 to $125. In response to Staff Data Request ENG 1.44, North Shore provided documentation (NS ENG-1.44 Attachment 1) that indicates the cost of service to the Company for reconnection of service when the meter has to be reset is $256. With the proposed fee increase, the Company will be able to recover 49% of the cost of service that it incurs for reconnections that include a meter reset. Presently, the Company is recovering 35% of the cost of service. ICC Staff Exhibit 11.0, pp. 9-10.

According to Staff witness Boggs, allowing a gradual fee increase would ease the rate shock to affected customers and the restructuring of the fee more effectively assigns cost responsibility. *Id*. at 10. Mr. Boggs recommends approval of the reconnection fee, when the meter has to be reset, of $125.

Additionally, in the situation where service has to be reconnected at the main, the Company is proposing to increase the fee from $275 to $350. In response to Staff Data Request ENG 1.44, North Shore provided documentation (NS ENG-1.44 Attachment 1) that indicates the cost of service to the Company for reconnection where service has to be reconnected at the main is $1,989. ICC Staff Exhibit 11.0, pp. 10-11.

Staff witness Boggs states in his direct testimony that with the proposed fee increase, the Company will be able to recover 18% of the cost of service that it incurs by excavating to reconnect service at the main. Presently, the Company is recovering 14% of the cost of service. Allowing a gradual fee increase would ease rate shock to affected customers. However, in future rate cases, Mr. Boggs recommends that the Company propose to continue to move toward full cost recovery and request a higher percentage of the cost of service to reconnect a customer when service has been discontinued by excavating either to cut the service pipe or shut off service at the main. Mr. Boggs has not made any specific increase recommendations at this time, because the percentage increase would have to be analyzed during the next rate case and attempt to balance reasonableness and rate shock mitigation. He further states that the customers who are causing these costs should be contributing a larger amount to the Company's cost recovery through reconnection fees. (ICC Staff Exhibit 11.0, pp. 11-12)

Mr. Boggs recommends approval of the reconnection fee, where service must be reconnected at the main, of $350.

### ii. Peoples Gas

The Company proposes to increase the basic reconnection fee from $50 to $60. In response to Staff Data Request ENG 1.12, Peoples Gas provided documentation (PGL ENG-1.12 Attachment 1) that indicates the cost of service to the Company for a basic reconnection is $78.59. Basic reconnection represents 91% of the Company's total reconnection services and over 61% of all reconnection costs.

Staff witness Boggs testified that increasing the fee to $60 so that the Company can recover 76% of its cost of service is reasonable. The same $60 reconnection fee would also apply to any customer who requests service discontinuance and subsequently requests service reinstatement within 12 months. Accordingly, Mr. Boggs recommends approval of the $60 reconnection fee. ICC Staff Exhibit 11.0, p. 30.

The Company is also proposing to increase the fee for reconnection of service, when the meter has to be reset, from $100 to $125. In response to Staff Data Request ENG 1.12, Peoples Gas provided documentation (PGL ENG-1.12, Attachment 1) that indicates the cost of service to the Company for reconnection of service when the meter has to be reset is $229. With the proposed fee increase, the Company will be able to recover 55% of the cost of service for reconnections that include a meter reset. Presently, the Company is recovering 44% of the cost of service.

According to Mr. Boggs, allowing a gradual fee increase would ease the rate shock to affected customers and the restructuring of the reconnection fee more effectively assigns cost responsibility to those who caused the cost. Mr. Boggs recommends approval of the reconnection fee, when the meter has to be reset, of $125. ICC Staff Exhibit 11.0, pp. 30-31.

Additionally, in the situation where service has to be reconnected at the main, Peoples Gas is proposing an increase to its reconnection fee. The Company is proposing to increase the fee from $275 to $350. In response to Staff Data Request ENG 1.12, the Company provided documentation (PGL ENG-1.12, Attachment 1) that indicates the cost of service to the Company for reconnection where service has to be reconnected at the main is $2,189. Presently, the Company is recovering 14% of the cost of service. Allowing a gradual fee increase would ease rate shock to affected customers. However, in future rate cases, Mr. Boggs recommends that the Company propose to continue to move toward full cost recovery and request a higher percentage of the cost of service to reconnect a customer when service has been discontinued by excavating either to cut the service pipe or shut off service at the main. Mr. Boggs is not making any specific increase recommendations at this time, because the percentage increase would have to be analyzed during the next rate case and attempt to balance reasonableness and rate shock mitigation. He further states that the customers who are causing these costs should be contributing a larger amount to the Company's cost recovery through reconnection fees. ICC Staff Exhibit 11.0, pp. 31-32.

With the proposed fee increase, the Company will be able to recover 16% of the cost of service that it incurs by excavating to reconnect service at the main. Presently, the Company is recovering 13% of the cost of service. Allowing a gradual fee increase would ease the rate shock to affected customers and the restructuring of the reconnection fee more effectively assigns cost responsibility to those who caused the cost**.** Mr. Boggs recommends approval of the reconnection fee, where service must be reconnected at the main, of $350. *Id*.

### d. Second Pulse Capability

#### i. North Shore Gas

North Shore is proposing to insert a February 14, 2008, grandfathering date into the Second Pulse Data Capability paragraph so that the language remains accurate after the effective date for the tariff sheet changes (Third Revised Sheet No. 18).

Staff witness Boggs states that certain meters, meter correctors and daily demand measurement devices are capable of delivering a “second pulse” signal to specialized devices that can capture and transmit metering data. Second Pulse Data Capability can provide this signal and cause real-time usage readings to become available to customers. While the Company is not required to provide such capability, a few large volume customers have requested to tap into the second pulse output to help manage their gas usage.

Mr. Boggs further states that the grandfathering date, February, 14, 2008, is also the effective date of the previous revision of the tariff sheet. If the proposal is approved, the paragraph language would reflect the effective date of the tariff sheet changes. Prior to February 14, 2008, if a customer wanted the Second Pulse Data Capability, upon request, the company would install the device that provides the second pulse signal. The requestor then paid the labor and materials costs for installation directly to the Company because it was not considered a rate base item. The grandfathering date is important because it would assure that customers who have previously had Second Pulse Data Capability installed and have paid for it will not be charged the current $14 monthly fee for the capability. ICC Staff Exhibit 11.0, p. 12-13.

Mr. Boggs recommends approval of the language to accommodate the grandfathering date of February 14, 2008.

### ii. Peoples Gas

The discussion and recommendation above for North Shore Gas are the same for Peoples Gas. ICC Staff Exhibit 11.0, pp. 32-34.

### e. Rider 1

### i. North Shore Gas

The Company proposes to rearrange the first paragraph on Tariff Sheet No. 31 by removing the portion of the first sentence that includes “the provisions of the Energy Assistance Act of 1989 as amended by” and add “Energy Assistance Act” later in the sentence.

Staff witness Boggs recommends approval of the Company’s proposal because the proposed sentence modification does not result in a substantive change and makes the tariff language easier to read. ICC Staff Exhibit 11.0, p. 14.

Also, the Company proposes to change the abbreviation “Nos” to “No” in the second and sixth paragraph headings. Mr. Boggs states that since the second and sixth paragraphs refer to only one account, the singular version of the abbreviation would be appropriate for these paragraph headings. ICC Staff Exhibit 11.0, p. 15.

### ii. Peoples Gas

Peoples Gas proposes various sentence restructuring and word changes to Rider 1, Additional Charges for Taxes and Customer Charge Adjustments. According to Staff witness Boggs, the proposed changes make the rider easier to read and understand. Mr. Boggs recommends approval of the proposed revisions. ICC Staff Exhibit 11.0, p. 37.

#### f. Rider 2

##### i. North Shore Gas

In North Shore's last rate case, Docket Nos.07-0241 and 07-0242 Cons., the Company's transportation programs completed a transitional period that allowed it to continue to provide transportation service to its customers until new programs were implemented. Riders FST-T, SST-T, LST-T, and P-T were created to continue transportation service during the transition period. Currently throughout Rider 2, there are numerous references to Service Class No. 5 and the transitional transportation tariffs. The Company now proposes to eliminate the Rider acronyms "FST-T, SST-T, LST-T, P, P-T" in the headings and within the text, because the Company has proposed to eliminate these riders.

If the Commission approves the elimination of the transitional transportation tariffs in this proceeding, then Mr. Boggs recommends references to them be eliminated from Rider 2 language. ICC Staff Exhibit 11.0, pp. 37-38.

##### ii. Peoples Gas

The discussion and recommendation above for North Shore Gas are the same for Peoples Gas. ICC Staff Exhibit 11.0, pp. 37-38.

#### g. Riders 4 and 5

##### i. North Shore Gas

In Rider 4, Extensions of Mains and/ or Rider 5, Gas Service Pipe, the Company proposes to broaden the description of who might request a main extension or gas service pipe installation. It is likely that these riders were previously written with the assumption that a requester of a main extension or gas service pipe installation would be a current individual customer. The Company proposes to modify language in the riders to make clear that requests for extension of a gas main may also originate from a person (applicant) or a group of persons (applicants) who are not existing customers. The proposed language modification provides clarity in that it recognizes that a person or groups of persons who are not customers of record could potentially request a main extension or gas service pipe installation.

Accordingly, Mr. Boggs recommends approval of this language change. ICC Staff Exhibit 11.0, p. 16-17.

Also, only in Rider 4, the Company proposes to add a paragraph that would appear as the second paragraph in the Rider if the Commission approves the change. The paragraph would read:

> If the Company shall receive such a request from a person proposing to develop property and such person is not a customer or an applicant for service, then the Company may require a deposit from such a person and the amount of the deposit shall not exceed the cost of the excess extension. For purposes of computing any main deposit, the free limit for extension shall be the amount available to a single applicant for service.

North Shore Ex. VG-1.1, p. 25.

When receiving a request to extend a main with a “person” with whom the Company is not continuing or establishing a service relationship, it is reasonable for the Company, at its discretion, to require a deposit on work to be performed where said deposit’s maximum amount is equal to that currently in place for existing customers.

The Company, also, proposes to make various “housekeeping” changes to Riders 4 and 5 to further clarify and remove outdated language. Each of the existing paragraphs has various word and sentence reconstruction proposals.

Mr. Boggs states that the proposed language and sentence changes add clarity and make the paragraphs easier to read without changing the substance of the current tariff language and he recommends their approval. ICC Staff Exhibit 11.0, p. 18.

The Company has also proposed specific "housekeeping" changes that apply only to Rider 5. In paragraphs one, five and six, the Company proposes minor word changes that improve the clarity of the sentences in the respective paragraphs.

Mr. Boggs recommends approval of the Company's proposed changes to the respective paragraphs.

Also, the Company proposes to add a paragraph to the end of Rider 5 that reads:

> "If there is no customer at the premises, a person who is not a customer or an applicant for service, but who is proposing to develop property, may request installation, replacement, enlargement, relocation, modification or disconnection of service pipe under this rider. For the limited purpose of determining whether the Company or such person is responsible for the Company's cost; such person shall be treated as a customer under this rider and such person shall be responsible for providing the Company the information required to perform work required under this rider."

ICC Staff Exhibit 11.0, p. 19.

Mr. Boggs recommends approval of this proposal because, the proposal reasonably allows the Company to treat a property developer similar to an existing customer when determining who is responsible for costs associated with service pipe modifications performed under this rider. ICC Staff Exhibit 11.0, p. 19.

Regarding a reference to Rider 5 in Rider SBO, the Company proposes to remove the reference to Service Classification 5 and proposes another minor sentence modification elsewhere in Rider SBO.

If the Commission approves the Company's proposed elimination of the transitional transportation tariffs, then references to those tariffs should be eliminated from Rider SBO. In addition, the proposed minor sentence modification will make the tariff easier to read. Therefore, Mr. Boggs supports the proposed changes. ICC Staff Exhibit 11.0, p. 20.

#### ii. Peoples Gas

The discussion and recommendations above for North Shore Gas are the same for Peoples Gas, except that Peoples Gas did not propose any change regarding Rider SBO. ICC Staff Exhibit 11.0, pp. 38-41.

### h. Account 385 Facilities Charge

#### i. Peoples Gas

Peoples Gas proposed to eliminate the Facilities Charge. Since the Docket Nos. 07-0241/07-0242 Cons. Commission's order, Integrys has revised many of its accounting policies to establish uniformity across its companies. As a result, the meters for about 781 customer accounts have been reclassified under Account No. 385, resulting in more than a few customers that would require direct billing. NS-PGL Ex. VG-1.0, p. 31.

In his direct testimony, Staff witness Boggs conditioned his support for approval of the Company's proposal on the addition of a third meter class to Service Class 2, because, then, the reasons underlying the rationale for the Facilities Charge would no longer exist. ICC Exhibit 11.0, pp. 35-36.

In the rebuttal testimony of Company witness Grace, she stated that costs for 781 customer accounts have been reclassified under Account No. 385, resulting in more than a few customers that would require direct billing. As it would be complex and burdensome to provide direct billing for this large number of accounts, the Facilities Charge should be eliminated. NS-PGL Ex. VG-2.0, p. 50.

In the rebuttal testimony of Mr. Boggs, he agreed with Ms. Grace and stated that regardless of whether the Commission approves a third meter class for S.C. No. 2, he recommends that the Facilities Charge be eliminated and that the Company be allowed to recover Account 385 costs through a Customer Charge to the appropriate rate class rather than try to collect the costs through a Facilities Charge. ICC Staff Exhibit 25.0, pp. 2-3.

### 2. Volume Balancing Adjustment (Rider VBA)

#### a. Establishment of new margins

Staff witness Hathhorn testified that she did not have any objections to the Companies' proposed rate case margins related to its direct case. ICC Staff Ex. 1.0, pp. 44-45, lines 1044-1054 and Attachment A. However, she recommended that the Companies provide updates to the monthly rate case margin schedule as the case progresses, to the extent possible, as the Commission must approve the final rate case margins to be applied to Rider VBA from this proceeding. *Id.*, lines 1054-1059. The Companies stated they may be able to provide updates as the case progresses provided that sufficient information is available to develop charges that would arise from such updates. The Companies also stated they will provide final Rider VBA rate case margins, based on the approved distribution charges, to the Commission with their compliance filing. NS-PGL Ex. VG-2.0. p. 5, lines 91-93. In discovery, the Companies provided their new monthly VBA rate case margins based on their rebuttal revenue requirements. ICC Staff Ex. 15.0, Attachment H.

The Commission should require the Companies to provide final Rider VBA rate case margins, based on the approved distribution charges, with their compliance filing. Staff further recommends that the Commission direct the Companies to publicly file the Rider VBA rate case margins compliance filings on e-Docket so that the Commission determined margins are publicly available. Staff is not aware of any confidential information that would be contained in such a filing, and the Companies witness Grace could not identify any potential confidential information during cross examination. Tr., p. 198, August 24, 2009.

### b. Change in annual report (Uncontested)

Staff also recommended that the Companies, rather than Staff, prepare the annual report on the Companies' rates of return and the effect on that return of Rider VBA, as required by the Final Order in Docket Nos. 07-0241/07-0242 (Cons). *In re North Shore Gas Company and The Peoples Gas Light and Coke Company*, ICC Docket No. 07-0241/07-0242 (Cons.), p. 152 (Order, Feb. 5, 2008). The Companies agreed with Staff's recommendation. NS-PGL Ex. VG-2.0, pp. 53-54, lines 1182-1186. Therefore, Staff recommends the following paragraph be included in the Commissions Findings and Ordering section of the final order in this case:

> (x) The Companies shall annually prepare a report on the Companies' rates of return and the effect on that return of Rider VBA. The report shall be submitted to the Commission and Staff at the same time of its filing a petition seeking initiation of an annual reconciliation proceeding to determine the accuracy of its Reconciliation Adjustment.

### E. Bill Impacts

## XIII. TRANSPORTATION ISSUES

### A. Overview

### B. Uncontested Issues

#### 1. Elimination of Transportation Transition Riders

The Companies' witness Ms. Grace proposed to eliminate riders Full Standby Transportation - Transition Service ("FST-T"), Selected Standby Transportation - Transition Service ("SST-T"), Large Standby Transportation Transition Service ("LST-T"), Transportation Balancing - Transition Service ("TB-T") (Peoples Gas only), and Pooling – Transition Service ("P-T"). Peoples Gas Ex. VG 1.0, p. 32; North Shore Ex. VG 1.0, p. 29. No party objected to the elimination of these riders. Staff witness Mr. Sackett recommended that the Commission approve this proposal. Staff Ex. 12.0R, p. 5.

#### 2. Riders FST, SST and P Charges

The Companies' witness Ms. Grace proposed to reduce the Administrative Charge for Riders FST and SST from $11.24 to $9.87 per account for Peoples Gas (Peoples Gas Ex. VG 1.0, p. 28) and from $8.94 to $7.32 per account for North Shore. (North Shore Ex. VG 1.0, p. 26). Ms. Grace provided justification for these reductions in Exhibit VG-1.10. No party objected to the reduction in either of these charges. Staff witness Mr. Sackett recommended that the Commission approve these charges. Staff Ex. 12.0R, p. 14.

### 3. Intra-Day Nomination Rights

CNE witness Ms. Rozmialski proposed to expand nomination rights to accept an intra-day nomination in a manner similar to the recently approved Nicor Gas practice. CNE Ex. 1.0, p. 20. The Companies' witness Mr. Dobson accepted that proposal. NS-PGL Ex. RD-1.0 Rev., pp. 18-20. Staff witness Mr. Sackett supported CNE's intra-day proposal, as agreed to by the Companies, in his rebuttal testimony. Staff Exhibit 26.0R, p. 46. Staff also supports incorporation of tariff language that codifies the Companies' current practice of allowing a revised nomination for supplier cuts. The tariff language incorporating that practice as an explicit right is appropriate. Finally, it is Staff's understanding, based on statements made by counsel for the Company in connection with the brief outline that identified this issue as uncontested, that the Companies have agreed to revise their tariffs to include language that explicitly sets forth the existing practice.

### 4. Storage Credit

Staff witness Mr. Sackett proposed in his revised direct testimony that the Companies change the manner in which they provide a credit to Rider CFY participants for the savings that each Company receives due to reduced Working Gas inventory in the system storage assets. Mr. Sackett proposed that the credit be based upon the customer's Maximum Daily Quantity ("MDQ") instead of a fixed per-customer credit. Staff Exhibit 12.0R, pp. 20-22. The Companies' witness Ms. Grace agreed to Staff's proposal in her rebuttal testimony. NS-PGL Ex. VG 2.0, pp. 62-63. Mr. Sackett also asked the Companies to justify not issuing the same type of credit for large-volume transportation customers for the savings that each Company receives due to reduced

Working Gas inventory in the system storage assets in the same manner as the credit provided to small-volume transportation customers. Staff Exhibit 12.0R, pp. 21-22. Ms. Grace agreed to provide this credit in her rebuttal testimony. NS-PGL Ex. VG 2.0, pp. 55-57.

#### 5. Diversity Factors

Staff witness Mr. Sackett proposed in his revised direct testimony that the Companies update the Diversity Factors used in the Riders SST, FST and P. Staff Exhibit 12.0R, pp. 22-25. The Diversity Factors are used to discount the capacity and charges for transportation customers based on the fact that not all transportation customer's peaks coincide with the Companies' peaks. The Companies' witness Ms. Grace agreed to Staff's proposal in her rebuttal testimony. NS-PGL Ex. VG 2.0, p. 55.

#### 6. Standby Commodity Charge

Staff witness Mr. Sackett proposed in his revised direct testimony that the Companies change the Standby Commodity Charge ("SCC") from the Commodity Gas Charge ("CGC") plus (NCGC x (1-DF)) to the Chicago city gate ("CCG"). The existing charge did not reflect the cost to Peoples for customers to use standby and created an arbitrage opportunity to play the standby charge against the market price. Staff Exhibit 12.0R, p. 42. The Companies' witness Mr. Dobson agreed to Staff's proposal in his rebuttal testimony and clarified that the appropriate CCG would be the Daily Price for Rider SST and the average Monthly Price for Rider FST. NS-PGL Ex. RD-1.0, pp. 18-20.

### 7. Maximum Daily Quantity (MDQ) Calculation

RGS witness Mr. Crist proposed that the Companies revise their method of determining the MDQ for their customers. RGS Ex. 1.0, p. 31. The Companies' witness Mr. McKendry agreed to round the MDQ of transportation customers to the nearest therm instead of dekatherm. NS-PGL Ex. JM-1.0, p. 23. Staff does not oppose RGS' and the Companies' apparent resolution of this issue.

### 8. Rider SST Unbundled Allowable Bank

Staff witness Mr. Sackett proposed in his revised direct testimony that the Companies should unbundle the Allowable Bank from Rider SST Standby Service. Staff Ex. 12.0R, pp. 25-42. Under the current and proposed tariffs, larger transportation customers under Rider SST would have to select standby service to have a bank. The Companies' witness Mr. Dobson objected to Staff's proposal (NS-PGL Ex. RD-1.0 Rev., pp. 3-18), but indicated in surrebuttal that if the Commission wanted to unbundle the Allowable Bank it would be more appropriate to direct the Company to develop such a proposal between the rate cases and file it in their next rate case. NS-PGL Ex. RD-2.0, pp. 2 and 13. Further discussion between Staff and the Companies produced an agreement to develop an unbundling proposal as set forth in the Companies' responses to OGC DR 3.01. ICC Staff Cross Exs. Grace 5 and 6. Specifically, the Companies stated that they were willing,

> (1) to work in good faith with Staff on a collaborative basis, prior to filing their next rate cases, to develop proposals for unbundling standby and storage services that are provided to S.C. Nos. 2 (North Shore and Peoples Gas), 3 (North Shore), and 4 (Peoples Gas) customers under Riders FST and SST, (2) to file proposed tariff changes to implement any mutually acceptable proposals developed through that collaborative process in their next rate case filings, and (3) if and to the extent such

> mutually acceptable proposals are not developed through the collaborative process, to address such unbundling in their next rate case filings.

*Id*. Staff recommends that the Commission accept the process to develop an unbundling proposal as set forth above as the resolution of this issue, and direct the Companies to take the above-described actions.

#### 9. Elimination of Rider TB - Transportation Balancing Service

The Companies' witness Ms. Grace proposed to eliminate rider Transportation Balancing Service - ("TB") because there are no customers on it. Peoples Gas Ex. VG 1.0, p. 32. No party objected to the elimination of these riders. Staff witness Mr. Sackett recommended that the Commission approve this proposal. Staff Ex. 12.0R, p. 5.

### C. Large Volume Transportation Program

#### 1. Super Pooling on Critical Days

CNE witness Ms. Rozumialski recommended that the Companies allow for incorporation of super-pooling in the calculation of Critical Day penalties an after-the-fact accounting correction as approved by the Commission in Nicor Gas's last rate case, Docket No. 08-0383. CNE Ex. 1.0, p. 25-26. Super pooling would allow transporters to net over and under deliveries of their customers in order to determine Critical Day charges. In rebuttal, CNE witness Ms. Rozumialski pointed out that "Nicor Gas Company had similar concerns [in its 2008 rate case (Docket No. 08-0363)] regarding its billing system and administrative burden. Through collaborative efforts between the utility and CNE-Gas in that proceeding, parties were able to agree upon a process in that proceeding that resolved Nicor's concerns." CNE-Gas Exhibit 2.0, p. 7. The Commission's order from Nicor's 2008 rate case stated the following on the issue:

> CNE contended that it is amenable to Nicor's proposal whereby a supplier would apply for a waiver of the penalty portion of the Unauthorized Use Charge on a Critical Day for those "commonly-managed Rider 13 non common-ownership groups" when these groups substantiate that their other Rider 13 groups have excess deliveries of sufficient quantity to alleviate all, or a portion of, the unauthorized gas condition….
>
> Subsequent to the time when the Initial Briefs were filed, CNE and Nicor reached an accord, in which Nicor agreed that it will implement its proposed alternate super-pooling process as was summarized in CNE's Initial Brief at pages 38-41, (set forth above)….
>
> *The compromises set forth above between CNE and Nicor are reasonable, practical processes* and they are hereby adopted, as is set forth above.

Order, Docket No. 08-0363, pp. 126-127 (March 25, 2009) (emphasis added).

In this case, CNE provides CNE Exhibit 2.1 which is a tariff sheet from Nicor Gas Rider 13 Supplier Transportation Service which states:

> In the event a Rider 13 group incurs Unauthorized Use Charges on a Critical Day, the Group Manager may have the right to submit a written request for waiver of the $6 per therm non-purchased gas portion of the Unauthorized Use Charges within fifteen (15) days of the issuance date of the bill. The Group Manager shall provide the Company with written documentation which demonstrates that its other commonly-managed Rider 13 Groups' Critical Day deliveries would have eliminated the Unauthorized Use condition in whole or in part.

CNE proposes here to incorporate that Commission-approved method from Nicor Gas' tariff.

The Companies' witness Mr. McKendry rejected this proposal by raising the same objections that the Companies raised in their 2007 rate cases; principally, that this proposal would require significant revision of the billing systems. NS-PGL Ex. JM-1.0, pp. 12-14. In surrebuttal, Mr. McKendry continues to reject this proposal based on the responsibilities that the Company would have to review the appeal of each marketer.

> The Utilities ultimately have the responsibility to review, adjust balancing and bill accordingly. Because of the effect on labor and our billing schedule (timeliness of billing), automating the process (which would be a very extensive undertaking) would have to be strongly considered…. The [administrative] burden is largely on the Utilities. The suppliers would submit a request for a credit and, presumably, provide support for the request. We, however, must then review the accuracy of the request and, if it conforms to the applicable super pooling requirements, balance the contracts and bill based on the outcome of that day's balancing. Regardless of what is provided, calculated or created by the third party we are still ultimately responsible for completing such a process. The third party would be just a participant in the process. The Utilities would have to perform this aggregated final review, perform adjustments and prepare for billing…. Ms. Rozumialski has not specified or given an example of what the third party would submit and how it would work. We could receive from 30 or so suppliers their own interpretation of super pooling and related calculations and supporting material. Again this leaves it up to the Utilities to review and verify if super pooling warrants a waiver of penalties…

NS-PGL Ex. JM-2.0, pp. 4-5.

In rebuttal testimony, Staff witness Mr. Sackett supported CNE's super-pooling proposal. Mr. Sackett noted that "CNE specifically altered its proposal from that made in the last [Peoples Gas rate] case to be consistent with the Commission's decision in Nicor Gas' last rate case. (Order, Docket No.08-0363, March 25, 2009, p. 126)." Staff Exhibit 26.0R, p. 47. The Commission rejected CNE's super-pooling proposal in Peoples Gas:' last rate case due to concerns with billing system complexity and excessive utility involvement with suppliers and their customers:

> Accordingly, for purposes of calculating annual cycling compliance, *the Utilities can predictably employ an "ad hoc process that will run tangentially to their existing processing and, therefore will not require [structural modifications to billing systems]"*. PGL Ex. TZ-3.0 at 16. In contrast, critical and supply surplus days are temporally and quantitatively erratic. To apply super-pooling to such unpredictable events, when the appropriate treatment of stand-alone accounts will have to be determined each time, would present the *billing system complexity* the Utilities reasonably want to avoid. Id. at 14. Moreover, it would likely and *excessively entangle the utilities in the relationship between suppliers and individual customers with respect to allocation of daily gas deliveries*. Id. at 17.

Order, Docket Nos. 07-0241/07-0242/Cons, pp. 283 (February 5, 2008) (emphasis added).

In between rate cases, (Docket nos. 07-0241/0242 cons. and the instant case), CNE made a similar proposal in the Nicor Gas rate case (Docket No. 08-0363). Nicor Gas countered with an after-the-fact calculation process. This process, which was approved by the Commission in the Nicor rate case as discussed above, addresses each of the concerns raised in Docket Nos. 07-0241/2 cons. Specifically, Staff believes that CNE's proposal is an "ad hoc process that will run tangentially to their existing processing and, therefore will not require [structural modifications to billing systems]" as mentioned by the Commission in the earlier Peoples Gas and North Shore rate case.

In light of the fundamental differences between the proposals that CNE made in the last rate case and the instant case, which is identical to the process approved by the Commission in Nicor Gas' last case, the Commission should approve CNE's recommendation here. Staff believes that the burden of the review is not onerous given the fact that this review process would occur after the bill is received, which is after the Critical Day is past (CNE Ex. 1.0, pp. 25-26 and CNE Ex. 2.1) and that, in this respect, it would be similar to any other billing discrepancy which a supplier could raise. Additionally, this should make it unnecessary to modify the billing system. Furthermore, the Nicor Gas method allows the utility to work on the billing discrepancy directly with suppliers, who pay the Critical Day penalties (through the Imbalance Account Charge) under Rider P (ILL. C. C. NO. 28, Second Revised Sheet No. 95 and ILL. C. C. NO. 17, Second Revised Sheet No. 89 Peoples Gas Ex. VG-1.1, p. 70; North Shore Ex. VG-1.1, p 60) instead of with customers and therefore would not entangle the Companies in the supplier/customer relationship.

Staff's review of the evidence shows that the Companies have not provided evidence that they are unable to implement CNE's proposal, nor have they shown how they differ from Nicor Gas.

### D. Small Volume Transportation Program (Choices for You$^{SM}$ or "CFY")

#### 1. Allocation of and Access to Company-owned Assets

RGS witness Mr. Crist proposed that the Commission order that the Companies provide CFY suppliers with more flexibility with storage. Mr. Crist provides three purposes for storage. "First, storage provides a *seasonal hedge* by allowing Alternative Suppliers to inject gas into storage during the injection season (roughly April through October), when spot prices are typically low, and withdraw gas from storage during the withdrawal season (roughly November through March), when spot prices are typically high. Second, storage facilities allow Alternative Suppliers to *hedge daily price volatility* in natural gas markets and meet day-to-day fluctuations in demand. Third, storage can reduce the need for more expensive *pipeline capacity* during periods of peak demand." RGS Ex. 1.0, p. 9.

Mr. Crist's point is that the injection and withdrawal rights under CFY reflect the rigidity of on-system storage with regimented injections and withdrawals. "Under the Companies' rules, Alternative Suppliers are prevented from varying the amount of gas withdrawn from and injected into storage on a month-to-month basis even though such flexibility could be provided using the storage assets that Choice For You customers pay for. Instead, the amount of storage capacity withdrawn from and injected into storage on a daily and monthly basis is a fixed number that is administratively determined by the Companies with a limited consideration of actual weather." RGS Ex. 1.0, pp. 11-12.

So, CFY suppliers are treated as though the injections that they are making are going directly into Manlove field. The more flexible *storage* assets in the Companies' portfolios are the off-system storage assets (NS-PGL Ex. RD-2.0, p. 7), which the CFY customers do pay for equally. "Despite the fact that the Companies recover the same amount of storage costs from both sales and Choices For You customers, Choices For You customers have a lesser allocation of the daily and monthly injection and withdrawal rights compared to the sales customers." RGS Ex. 1.0, p. 10. Even though the Aggregation Balancing Gas Charge ("ABGC") excludes Firm Transportation contracts, the CFY supplier flexibility does not reflect the flexibility of the off-system portion of those storage assets for which these customers and suppliers do pay for equally with sales customers. *Id.*[10]

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[10] Rider AGG provides as follows:

> The [Required Daily Delivery Quantity] RDDQ shall be calculated using the Company's estimation procedure. This procedure incorporates the unique heating and non-heating factors for each customer in the Pool, actual weather forecasts, an adjustment for Pool Unaccounted for Gas, the applicable [Monthly Storage Activity] MSA *divided by the number of days in the month,* an adjustment based on the Pool Coefficient to provide weather sensitivity as described in Section I, an adjustment to meet the Storage Carryover requirement in Section I, and an adjustment to meet the carry forward requirements in Section H.
>
> The factors used to derive the RDDQ shall be provided to the CFY Suppliers. *On each Non-Critical Day, the CFY Supplier shall deliver a gas quantity within the range defined by the RDDQ, plus or minus 10 percent of the RDDQ* (rounded to the nearest dekatherm). On each Critical Supply Surplus Day and on each Critical Supply Shortage Day, the CFY Supplier shall deliver a gas quantity equal to the RDDQ. At the end of each month, the Monthly Adjusted Deliveries shall be within plus or minus 5 percent of the [Required Monthly Delivery Quantity] RMDQ (rounded to the nearest dekatherm).

(continued…)

Mr. Crist points to an example of this disparity.

> Not having the same level of storage rights that the Companies have (on a per-customer basis) deprives Alternative Suppliers of the ability to fully hedge daily price volatility and meet day-to-day fluctuations in demand, and they must supplement the need for additional pipeline capacity during periods of peak demand….Alternative Suppliers have no flexibility associated with the rights that the allocated storage assets should provide.

RGS Ex. 1.0, p. 12.

The Companies' witness Mr. Dobson rejected the RGS proposal because CFY customers know in advance a volume that they are required to deliver, they can deviate from that quantity by 10%, and they are shielded from the realities of constraints of on and off-system storage by the Companies. NS-PGL Ex. RD-1.0 Rev., p. 27-28. However, Mr. Dobson admitted that he had not read RGS Ex. 1.1 which is the Nicor Gas tariff for Customer Select suppliers. Tr., p. 388. Mr. Dobson was apparently not concerned with learning the details of RGS' proposal to modify CFY to be similar to this other program. Consequently, his testimony should be considered in this light.

Staff believes that the Companies' current program raises longstanding concerns previously identified and addressed by the Commission in Docket No. 01-0470:

> The Commission finds the Company's proposal problematic because it requires that suppliers withdraw or inject the same amount of gas on each day of a given month and, therefore, deprives [alternative gas suppliers] of the ability to hedge daily price volatility, meet day-to-day demand fluctuations and supplement needs for additional pipeline capacity during peak demand periods through storage use.

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ILL. C. C. NO. 28, First Revised Sheet No. 113 and ILL. C. C. NO. 17, Second Revised Sheet No. 100 Rider AGG, Aggregation Service, Applicable to Rider CFY, Section E - Delivery Determination, Peoples Gas Ex. VG-1.1, p. 82; North Shore Ex. VG-1.1, p. 66.

In re: The Peoples Gas, Light and Coke Company, Docket 01-0740, p. 39 (Order, March 5, 2002).

Comparing Rider AGG (the CFY Supplier tariff) with Nicor Gas Rider 16 (RGS 1.1) reveals significant differences between the two programs in daily delivery targets, daily storage activity and monthly storage activity. Comparing the daily delivery targets shows that the Companies use (customer's estimated daily usage + the *required* storage activity) ±10% (Rider AGG, Aggregation Service, Applicable to Rider CFY, Section E - Delivery Determination, Peoples Gas Ex. VG-1.1, p. 82; North Shore Ex. VG-1.1, p. 66. ) while Nicor Gas uses the customer's estimated daily usage ±10% + the *allowed* storage activity.[11] Under Nicor Gas' Customer Select, *daily* storage activity is a

[11] Nicor's Rider 16 provides as follows:

> Daily Delivery Range.
>
> For the winter period, the Supplier's daily delivery range will be a *maximum of the estimated daily use of the Group plus 10 percent and a minimum of the estimated daily use of the Group less 10 percent less the Group's daily storage withdrawal capacity*. At the end of the month, a Supplier's total deliveries, adjusted for unaccounted for gas, must be within the range of the total estimated daily use of the Group for the month plus 5 percent and the total of the daily minimum level for the month.
>
> For the summer period, the Supplier's daily delivery range will be a *maximum of 110 percent of the estimated daily use of the Group plus the Group's daily storage injection capacity and a minimum of the estimated daily use of the Group less 10 percent*. At the end of the month, a Supplier's total deliveries, adjusted for unaccounted for gas, must be within the range of the total of the daily maximum level for the month and the total estimated daily use of the Group for the month less 5 percent.
>
> On a day when the Company has issued an Operational Flow Order, the Daily Delivery Range may be adjusted to address the Company's operational concerns. On a Critical Day, the Supplier shall deliver the greater of 1) the Supplier's firm supply requirements as estimated on October 1, or 2) 34 percent of the Group's current MDCQ.

RGS Ex, 1,1, 9th Revised Sheet No. 75.6 (emphasis added).

right or option[12]; under CFY it is an obligation. (Rider AGG, Aggregation Service, Applicable to Rider CFY, Section E - Delivery Determination, Peoples Gas Ex. VG-1.1, p. 82; North Shore Ex. VG-1.1, p. 66.) Additionally, the monthly storage inventory targets for the Companies are fixed numbers. RGS Ex. 1.0, pp. 11-12. On the other hand, Nicor Gas only requires the bank to be filled to 95% and only be emptied down to 35%. Also, it provides for monthly inventory *ranges* that provide for flexibility in how the suppliers use their storage. RGS Ex. 1.1, p. 4.[13]

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[12] Nicor Gas' Rider 16 provides as follows:

> Daily Storage Withdrawal Capacity:
>
> During the winter period, defined as November 1 through April 30, a Supplier may withdraw up to 1.6 percent times the Group's storage inventory as of November 1 on any day that is not a Critical Day or an OFO Shortage Day. If, at the end of any calendar month, the Supplier's storage inventory is less than forty (40) percent of the Supplier's inventory as of the preceding November 1, then the Supplier's Daily Withdrawal Capacity will be reduced from 1.6 percent to 1.2 percent. If, at the end of any calendar month, the Supplier's inventory is less than 25 percent of the Supplier's inventory as of the preceding November I, the Supplier's Daily Withdrawal Capacity will be further reduced to 0.9 percent.
>
> Daily Storage Injection Capacity: During the summer period, defined as May I through October 31, a Supplier may nominate on any day that is not an OFO Surplus Day up to 0.8 percent of the storage capacity assigned to the Group to be injected into storage.

RGS Ex. 1.1, 9th Revised Sheet No. 75.5 – 75.6.

[13] Nicor Gas' Rider 16 provides as follows:

> Storage Inventory Target Levels: Suppliers will meet the following storage inventory target levels at the end of each calendar month: January 35% to 60% of the storage capacity; February 15% to 35% of the storage capacity; March 0% to 35% of the storage capacity; April 0% to 35% of the storage capacity; May 15% to 100% of the storage capacity; June 15% to 100% of the storage capacity; July 45% to 100% of the storage capacity; August 45% to 100% of the storage capacity; September 45% to 100% of the storage capacity; October 95% to 100% of the storage capacity; November 55% to 100% of the storage capacity; December 55% to 75% of the storage capacity.

RGS Ex. 1.1, 9th Revised Sheet No. 75.6.

Mr. Crist provides a compelling case for changing the CFY program to reflect the increased injection and withdrawal flexibility of off-system storage assets for which CFY customers pay. It is clear from comparing Rider AGG, Aggregation Service to Nicor Gas' Rider 16 – Supplier Aggregation Service (RGS Ex. 1.1) that Customer Select provides significantly more injection and withdrawal flexibility than Choices For You. Therefore, Staff recommends that the Commission order the Companies to implement the following which are based on the Nicor program,

1. daily injection and withdrawal rights based on the methods provided in RGS Ex. 1.1 – Daily Storage Withdrawal Capacity and Daily Storage Injection Capacity.
2. monthly targets for injections and withdrawals based on the method provided in RGS Ex. 1.1 – Storage Inventory Target Levels.
3. daily delivery targets provided by the Companies based on the best estimate of the customer's daily usage with a daily tolerance of ±10% like RGS Ex. 1.1 – Daily Delivery Range.

In the alternative, Staff recommends that the Commission order a workshop process with the Companies, Staff and Suppliers to review the CFY Program, compare it to Nicor Gas' Customer Select program, and develop new injection and withdrawal rights that better reflect the flexibility of all storage assets.

#### 2. Payment for Company-owned Assets / Aggregation Balancing Gas Charge

RGS witness Mr. Crist proposed that if the Commission did not provide greater access to storage as discussed above, then the ABGC should be reduced to reflect the limited storage use. RGS Ex. 1.0, p. 18. No one offered testimony to refute this position.

However, Staff believes that Mr. Crist did not provide sufficient basis for his recommended reduction since he did not show that his proposal to reduce the ABGC by 34% would be cost-based and that it would achieve the equity that he argued was lacking by his comparisons in RGS Ex 2.2. See, Tr., p. 563. If the Commission orders the workshop advocated by Staff above on the issue of Allocation of and Access to Company Owned Assets, then the RGS' primary issue is being addressed and the ABGC should be considered in that context and not changed here.

### 3. Allocation of Administrative Costs and Related Charges

RGS witness Mr. Crist proposed that the administrative costs currently allocated to CFY customers for the administration of the CFY program be instead allocated to those customers that are *eligible* to take service under CFY. "The Companies charge an administrative cost which is included in the Aggregation Charge and additional charges called the "LDC Billing Options Charge" to the Alternative Suppliers that elect to continue having the Companies issue a bill for the delivery charges and the Alternative Supplier's gas supply charges. [Mr. Crist argues that t]hese charges should be eliminated and any costs for such services should be included in the base rates of the Rate 1 and Rate 2 customers." RGS Ex. 1.0, pp. 19-20. Mr. Crist contends his proposal should be adopted here because the Commission approved this practice in Docket No. 08-0363 for Nicor Gas. RGS Ex. 1.0, pp. 19-21. Additionally, Mr. Crist argues that the Companies have not provided any evidence for the incremental nature of these costs. He cites numerous responses to data requests which he provides in

RGS Ex. 2.3, and concludes that “the Companies have no support for the Administrative charges that are assessed to the CFY program.” RGS. 2.0R, p. 11 Mr. Crist also proposed that the $1.3 million in costs should be disallowed and the “overall revenue requirement should be reduced by $1,317,557” because “the Companies made no attempt to remove the AGG/CFY costs from base rates”. RGS. 2.0R, pp. 14-15. It is not clear if Mr. Crist also advocates the exclusion of the corollary $210,228 from North Shore revenue requirement. North Shore Ex. VG-1.10.

The Companies’ witness Ms. Grace rejected the first proposal because the costs recovered through these charges are incremental to the CFY Program and the Companies exclude gas cost related to bad debt costs from the base rates of transportation customers because they do not cause those costs. She believes that the treatment of both of these costs should be the same. NS-PGL Ex. VG-2.0 Rev., p. 64. Ms. Grace argues in her surrebuttal testimony that these costs are truly incremental costs. “The Gas Transportation Services Department provides services for the Utilities’ gas transportation programs and not for their retail sales customers. Also, the CFY billing and PEGASys systems are not used to service retail sales customers.” NS-PGL Ex. VG-3.0, p. 36 Ms. Grace also rejects RGS proposal to reduce the revenue requirement and refutes the allegation of over-recovery by stating “customer charges have been reduced by administrative costs related to the Utilities’ transportation programs and the Utilities’ revenues arising from their proposed charges equals their proposed revenue requirements. These reductions, including a reconciliation of proposed revenue requirements and revenues arising from the Utilities’ proposed charges, are reflected in workpapers PGL VG-1.6-1.10 WP for Peoples Gas and NS VG-1.6-1.9 WP for North Shore." NS-PGL Ex. VG-3.0, pp. 36-37.

Staff sees merit in Ms. Grace's arguments, and declines to support RGS' proposals because the record indicates that Ms. Grace provided at least partial justification of these costs in her *workpapers*. Ms. Grace's complete response to the RGS data requests, which Mr. Crist did not put in his narrative testimony but was attached to his testimony as an exhibit, states, "*See Ms. Grace's direct testimony, exhibits and workpapers for the support for the Riders FST, SST, P and AGG charges.* The requested information is not maintained in and cannot be retrieved in the requested level of detail." RGS Exhibit 2.3, Companies' Responses to RGS Data Request 1.42 (emphasis added). RGS failed to even address these supporting workpapers in its testimony. Staff believes this failure is fatal to RGS case.

While Staff witness Mr. Sackett supported a similar proposal in Nicor Gas' last rate case, Docket No. 08-0363, it is clear that his support for this treatment was linked to his support for the Memorandum of Understanding ("MOU"). Furthermore, this issue was uncontested in that case because Nicor Gas agreed to this treatment *before Staff accepted a settlement on all Customer Select issues*. In contrast, the Companies have contested this treatment of administrative costs. Also, under cross examination in the present docket Mr. Sackett was asked about his testimony in the Nicor Gas case, and he clarified that the reasons given in that testimony regarding the benefit to all eligible customers and the energy efficiency plan were those of the Customer Select Gas Suppliers and not his own. Tr., pp. 1051-1053; RGS Cross Exhibit Sackett-33A.

Therefore, Staff recommends that the administrative charges proposed by the Companies be approved by the Commission.  However, if the Commission orders the workshop advocated by Staff above, then the Administrative Costs should be reviewed in that context.

### 4. Rider SBO Issues

RGS witness Mr. Crist raises two issues regarding service under Rider SBO, which is the Companies' Single Billing Option Service.  The first regards the Companies' refusal to allow customers with arrearages with the Companies of greater than 60 days receiving service under this rider.  "A CFY Billing Customer that is receiving Rider SBO service can be removed from this rider and changed to their default billing mechanism pursuant to Section D(1) if the customer has Company Charge arrearages that are at least 60 days past due." RGS Ex. 1.0, p. 24.

The Companies' witness Mr. McKendry rejected this proposal because it is more complicated than the current process.  He also argues that this provision was originally a protection against the supplier having to be seen as a collection agent for the utility, citing that this could have a "negative impact on competition." NS-PGL Ex. JM-1.0, p. 16.

However, Staff believes that the supplier should have the option of keeping those customers on SBO if they are willing to shoulder that risk.  Since the Company charges are paid first, the supplier has just as much of an incentive to collect as the Companies would.  Despite Mr. McKendry stating that "Alternative suppliers are not obligated, under Rider SBO, to accept or print bill messages" (NS-PGL Ex. JM-1.0, p. 16), he eventually acknowledges that Rider SBO (RGS Cross Ex. 38- McKenrdy) does require the supplier to put “other information provided by the Company” on the bill, so his objection is unfounded. (Tr. pp.312-313) Therefore, Staff believes that the Commission should find that the supplier under Rider SBO can continue to serve their customers in arrears under the rider. However, if the Commission orders the workshop advocated by Staff above, then the service to customers in arrears issue could be considered in that context and not changed here.

The second Rider SBO issue raised by Mr. Crist is the treatment of those customers that sign up for CFY and have a credit balance with the Companies. He proposes that the balance which is currently refunded to the customer be transferred automatically to the supplier’s account. RGS Ex. 1.0, pp. 26-27.

The Companies’ witness Mr. McKendry also rejected this proposal because it is more complicated than the current process. He states that it would be difficult for the Companies to verify each supplier contract to ensure that the customer had made such a request. NS-PGL Ex. JM-1.0, pp. 16-17. He also claimed that it would require significant re-programming to automate this process. NS-PGL Ex. JM-2.0, p. 6. No one refuted this claim.

Staff does not support transferring a credit balance for a transferred customer to the supplier’s account unless there is a specific provision in the *Companies’* contract with its customers regarding credit balances. Staff would not support requiring such a provision as it is inconsistent with the handling of customer termination of budget billing and would be an unnecessary additional administrative burden to the Companies . The Companies must continue to return the balance directly to those customers leaving the budget billing plan. Just because the marketers claim that provision exists or could exist in their contracts with the customer, there is no way for the Companies to verify that claim for each case.

### 5. New Customer Issues

RGS witness Mr. Crist proposed that customers should be allowed to begin service with Peoples Gas/North Shore as a transportation customer rather than being forced to start as a sales customer and subsequently switch to a transportation customer. Mr. Crist argues that this is confusing to CFY customers. RGS Ex. 1.0, pp. 29-30.

The Companies' witness Mr. McKendry rejected this proposal because a customer cannot sign up for CFY while its service is pending. He also claimed that the most important reason why he rejected the proposal is that it would be inconsistent with language added to 220 ILCS 5/19-115(g)(7) by Senate Bill 171 (enacted as Public Act 95-1051). NS-PGL Ex. JM-1.0, pp. 20-21. Specifically, Mr. McKendry claimed that RGS's proposal "is inconsistent with allowing customers a minimum of 10 business days from the Utilities' notice to rescind contracts with their suppliers. While Staff has not seen the parties' legal arguments on this issue and reserves the right to respond to those arguments in its reply brief, Staff does not see a legal impediment to RGS' proposal. A right to rescind service with an alternative gas supplier is neither prohibited nor prevented by allowing a customer to start utility service as a transportation customer.

The Companies' witness Mr. McKendry may also be referring to language in paragraph 6 of subsection (c) of Section 19-115 (*see* Tr., pp. 277-281) that not only requires the utility to provide written notification of a switch to a customer, but also prevents the utility from switching service until 10 days after such notice:

> (6) Within 2 business days after electronic receipt of a customer switch from the alternative gas supplier and confirmation of eligibility, the gas utility shall provide the customer written notice confirming the switch. The gas utility shall not switch the service until 10 business days after the date on the notice to the customer.

220 ILCS 5/19-115(g)(6). While Staff would agree with the implication in Mr. McKendry's argument that a customer's right to rescind supply service with an alternative gas supplier applies whether the customer is changing an existing service or requesting new service (*see* 220 ILCS 5/19-115(g)(7)), the language prohibiting a utility from switching service until 10 days after notice of a switch is not applicable to a request for new service as a transportation customer because the prohibition at issue specifically refers to performing a switch and does not refer to new service. The Commission should confirm that Section 19-115(g)(6) does not prevent customers from taking new service as transportation customers and does not prohibit service to new transportation customers from commencing on less than 10 days notice. Staff further notes that paragraph 7 of subsection (g) of Section 19-115 provides that an "alternative gas supplier shall provide each customer the opportunity to rescind its agreement without penalty within 10 business days after the date on the gas utility notice to the customer." 220 ILCS 5/19-115(g)(7). Thus, the Commission should also indicate that this language necessarily requires utilities to provide notice that a request has been received to begin new service as a transportation customer.

However, if the Commission orders the workshop advocated by Staff above, then the New Customer Issues could be considered in that context and not changed here.

### 6. Customer Switching Issues

RGS witness Mr. Crist proposed that customers should be allowed to switch from sales service to CFY right up to the 10 *business*-day window required by Senate Bill 171 instead of the 19 calendar-day process the Companies adopted after the passage of the law. RGS Ex. 1.0, p. 28.

The Companies' witness Mr. McKendry rejected this proposal because the Companies' process ensures that in the extreme case a customer may need 19 calendar days to achieve the 10 *business*-day rescind period mandated by the law. NS-PGL Ex. JM-1.0, pp. 18-20.

The Companies' process is automated and arbitrary. RGS Cross Ex. McKendry-38. Furthermore, it goes beyond the requirements of the new requirements enacted pursuant to Senate Bill 171. *See* RGS Cross Ex. McKendry-10. Therefore, it should not remain at 19-calendar days. Staff believes that the policy should be rewritten to reflect the language in the law. This would result in "up to 19 days" but only in the extreme circumstance. However, if the Commission orders the workshop advocated by Staff above, then the Customer Switching Issues could be considered in that context and not changed here.

### 7. Administrative Improvements to Supplier Billing System and PEGASys System Improvements

RGS witness Mr. Crist proposed that the Companies should print certain information on the supplier bills. He list four pieces of information that suppliers would like in that convenient format, two of which are already included (deposit balance and carry forward volume). The other two (inventory volume and storage capacity volume) are only available on the PEGASys. RGS Ex. 1.0, pp. 30-31; RGS Ex. 2.0R, pp. 23-24.

The Companies' witness Mr. McKendry rejected this proposal because all this information is available to the suppliers on PEGASys. NS-PGL Ex. JM-1.0, pp. 21-22. Staff recommends that the Commission direct the Companies to provide the information requested by the suppliers in the manner requested. While the information is already available, the record establishes the convenience of receiving the information in the manner requested and does not establish any significant administrative burden to provide the information as requested. However, if the Commission orders the workshop advocated by Staff above, then the Administrative Improvements could be considered in that context and not changed here.

## XIV. CONCLUSION

Staff respectfully requests that the Illinois Commerce Commission approve Staff's recommendations in this docket.

Respectfully submitted,

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