STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

North Shore Gas Company	**:**	
	:	**09-0166**
Proposed general increase in natural gas rates. (Tariffs filed February 25, 2009)	**:** **:**	
	:	
The Peoples Gas Light and Coke Company	**:**	**09-0167**
	:	
Proposed general increase in natural gas rates. (Tariffs filed on February 25, 2009)	**:** **:**	**Cons.**

ORDER

__________ __, 20__

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ORDER

By the Commission:

PROCEDURAL HISTORY

On February 25, 2009, North Shore Gas Company ("North Shore" or "NS") filed with the Illinois Commerce Commission ("Commission"), and pursuant to Section 9-201 of the Public Utilities Act (the "Act")[1], the following revised tariff sheets: ILL. C.C. No. 17, Title Sheet and ILL. C.C. No. 17, Sheet Nos. 1, 4, 6, 8, 10, 11-12, 14-15, 18-19, 21, 26-28, 31-39, 41-52, 65-87, 89, 91, 96-100, 104, 107, 112-114, and 120-152. This tariff filing embodied a proposed general increase in gas service rates, three new Riders (one of which since has been withdrawn), and revisions of other terms and conditions of service. The tariff filing was accompanied by direct testimony, other exhibits, and other materials required under Parts 285 and 286 of Title 83 of the Illinois Administrative Code (the "Code"), 83 Ill. Admin. Code Parts 285 and 286.

On February 25, 2009, The Peoples Gas Light and Coke Company ("Peoples Gas" or "PGL") filed with the Commission, and pursuant to Section 9-201 of the Act, the following revised tariff sheets: ILL. C.C. No. 28, Title Sheet and ILL. C.C. No. 28, Sheet Nos. 1, 2, 3-5, 7, 9, 10-11, 13-14, 16, 19-21, 24, 27, 28-29, 31-39, 41-53, 66-93, 95-100, 102-106, 110, 113, 118-120, 127, and 130-163. This tariff filing embodied a proposed general increase in gas service rates, two new Riders (one of which since has been withdrawn), and revisions of other terms and conditions of service. The tariff filing was accompanied by direct testimony, other exhibits, and other materials required under Parts 285 and 286 of the Code.

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[1] 220 ILCS 5/9-201.

Notice of the proposed tariff changes reflected in this rate filing was posted in North Shore's and Peoples Gas' (the "Utilities" or "Companies") business offices and published in secular newspapers of general circulation in the Utilities' respective service areas, as evidenced by publishers' certificates, in accordance with the requirements of Section 9-201(a) of the Act and the provisions of 83 Ill. Admin. Code Part 255.

The Commission issued Suspension Orders as to North Shore's tariff filing on March 25, 2009, that suspended the tariffs to and including July 24, 2009, and further initiated Docket 09-0166. On July 8, 2009, the Commission issued a Resuspension Order that suspended these tariffs to, and including, January 24, 2010.

The Commission issued Suspension Orders as to Peoples Gas' tariff filings on March 25, 2009, that suspended the tariffs to and including July 24, 2009, and initiated Docket 09-0167. On July 8, 2009, the Commission issued a Resuspension Order that suspended these tariffs to, and including, January 24, 2010.

On April 1, 2009, North Shore and Peoples Gas each filed motions for protective orders in each Docket, pursuant to 83 Ill. Admin. Code §§ 200.190 and 200.430.

On April 2, 2009, Staff of the Commission ("Staff") filed a motion to consolidate Dockets 09-0166 and 09-0167, pursuant to 83 Ill. Admin. Code § 200.600.

On April 3, 2009, North Shore and Peoples Gas each filed motions for case management orders in each Docket, pursuant to Section 10-101.1 of the Act[2] and 83 Ill. Admin. Code §§ 200.190, 200.370, and 200.500.

Pursuant to notice duly given in accordance with the law and the rules and regulations of the Commission, a pre-hearing conference was held in the two Dockets before duly authorized Administrative Law Judges ("ALJs") of the Commission, at its offices in Chicago, Illinois, on April 7, 2009. More than ten days prior to April 7, 2009, notice of this status hearing had been provided by the Chief Clerk of the Commission to municipalities in the Utilities' service areas, in accordance with the requirements of Section 10-108 of the Act[3]. On April 7, 2009, at the status hearing, after addressing certain aspects of how consolidation would affect the conduct of these cases, the ALJs granted Staff's motion to consolidate.

On April 10, 2009, the ALJs issued briefing schedules for the then-pending motions for protective and case management orders.

On April 15, 2009, the Utilities moved for leave to replace the confidential and public versions of the direct testimony of Mr. Schott with public versions (removing all prior confidentiality designations).

[2] 220 ILCS 5/10-101.1.

[3] 220 ILCS 5/10-108.

Rulings on motions are discussed further below.

Petitions to Intervene.

Petitions to Intervene were filed or appearances were entered on behalf of the Attorney General of the State of Illinois (the "Attorney General" or "AG"); the Citizens Utility Board ("CUB"); the City of Chicago (the "City") (collectively, CUB and the City are "CUB-City" or "City-CUB", their having used both terms in different filings) (collectively, the AG, CUB, and the City are "AG-CUB-City or also "GCI" for "Governmental and Consumer Intervenors"); Constellation NewEnergy-Gas Division, LLC ("CNE-Gas"); Abbott Laboratories, Inc. ("Abbott") on behalf of the Illinois Industrial Energy Consumers ("IIEC"); Retail Gas Suppliers ("RGS") an ad hoc group comprised of Dominion Retail Incorporated; Interstate Gas Supply of Illinois, Inc. (Interstate Gas Supply); Prairie Point Energy, LLC, d/b/a Nicor Advanced Energy, LLC ("NAE"); Vanguard Energy Services, LLC ("Vanguard"); and the Utility Workers Union of America, AFL-CIO, Local Union No. 18007 ("Union") (collectively, all of the foregoing parties are the "Intervenors"). All petitions were granted by the ALJs. ***[Please note, as of the submission of this draft Proposed Order, the Union's petition is pending.]*** Abbott/IIEC, after its petition was granted, filed a Motion to Withdraw, which was granted.

Pre-Hearing Testimony.

On February 25, 2009, the Utilities filed their respective direct testimony together with their respective Part 285 filings. On May 7, 2009, the Utilities filed revised public versions of the direct testimony of Mr. Schott. On May 20, 2009, May 29, 2009 and June 3, 2009, North Shore and Peoples Gas filed errata to several of their direct testimony (that of Mr. Doerk, Ms. Grace, Ms. Gregor, Ms. Hoffman Malueg, Mr. Marano, and Mr. Moul) and their Part 285 submissions. On August 31, 2009, the Utilities filed errata to the direct testimony of Mr. Marano.

On June 10, 2009, Staff and the Intervenors filed their respective direct testimony. On July 7, 2009, Staff filed Errata to their Direct Testimony of Mr. Michael McNally and their Direct Testimony of Mr. David Sackett. On August 25, 2009, CUB-City filed revisions to the Direct Testimony of Mr. Christopher C. Thomas. On August 28, 2009 GCI filed errata to the direct testimony for Mr. Rubin for GCI, and AG-CUB filed errata to the direct testimony of Mr. Rubin for AG-CUB.

On July 8, 2009, the Utilities filed the rebuttal testimonies of their witnesses. On July 21, 2009 the Utilities moved for leave to file revised rebuttal testimony instanter in light of the revised direct testimony of Staff witness Mr. Sackett. On July 22, 2009, the Utilities submitted errata to their rebuttal testimony. On August 18, 2009, the Utilities moved for leave to file a corrected exhibit instanter. On August 26, 2009 the Utilities filed errata to the rebuttal testimony of Mr. Johnson. On August 28, 2009, the Utilities filed errata to the rebuttal testimony of Mr. Moul.

On August 4, 2009, Staff and the Intervenors filed their respective rebuttal testimony. On August 7, 2009 Staff filed errata to their rebuttal testimony of Staff witness Mr. McNally. On August 11, 2009, Staff filed errata to the rebuttal testimony of Staff witnesses Ms. Harden, Mr. Ostrander, and Ms. Hathhorn. On August 20, August 24, and August 27, 2009, RGS filed errata to the rebuttal testimony of RGS witness Mr. Crist. On August 26, 2009, Staff filed errata to the rebuttal testimony of Ms. Hathhorn. On August 27, 2009, AG-CUB submitted errata to the rebuttal testimony of Mr. Effron. On August 28, 2009, GCI filed errata to the rebuttal testimony for Mr. Rubin for GCI, and AG iled errata to the rebuttal testimony of Mr. Rubin for AG-CUB.

On August 17, 2009 the Utilities filed the surrebuttal testimonies of their witnesses. On August 21, 2009, the Utilities filed errata to the surrebuttal testimony of Mr. Moul. On August 25, 2009, the Utilities filed errata to the surrebuttal testimony of Ms. Moy. On August 31, 2009, the Utilities filed errata to the surrebuttal testimony of Mr. Marano.

The Evidentiary Hearing.

The evidentiary hearing was held on August 24, 2009 through August 28, 2009, at the offices of the Commission in Chicago, Illinois. At the evidentiary hearings, the Utilities, Staff, and the Intervenors entered appearances and presented testimony. The following witnesses testified on behalf of the Utilities: Bradley A. Johnson, Treasurer North Shore Gas Company and The Peoples Gas Light and Coke Company; Brian M. Marozas, Manager, Planning Modeling and Contract Administration, Integrys Business Support, LLC; Christine M. Gregor, Director Operations Accounting North Shore Gas Company and The Peoples Gas Light and Coke Company; David W. Clabots, Manager Sales and Revenue Forecasting, Integrys Business Support, LLC; Edward Doerk, Vice President, Gas Operations The Peoples Gas Light and Coke Company and North Shore Gas Company; Joylyn C. Hoffman Malueg, Rate Case Consultant – Regulatory Affairs, Integrys Business Support, LLC; James F. Schott, Vice President – Regulatory Affairs, Integrys Energy Group, Inc., The Peoples Gas Light and Coke Company, and North Shore Gas Company; John Hengtgen, Rate Case Consultant, Regulatory Affairs, Integrys Business Support, LLC; John J. Spanos, Vice President, Valuation and Rate Division, Gannett Fleming, Inc.; Michael A. Small, Assistant Controller Financial and Accounting Services, Integrys Business Support, LLC; Paul R. Moul, Managing Consultant, P. Moul & Associates; Sharon Moy, Rate Case Consultant, Regulatory Affairs, Integrys Business Support, LLC; Valerie H. Grace, Manager, Gas Regulatory Services, Integrys Business Support, LLC; Salvatore D. Marano, Managing Director, Jacobs Utilities Practice; Thomas L. Puracchio, Manager, Gas Storage, Integrys Business Support, LLC; Richard Dobson, Manager, Gas Supply, The Peoples Gas Light and Coke Company and North Shore Gas Company, Integrys Business Support, LLC; John McKendry, Senior Leader, Gas Transportation Services, The Peoples Gas Light and Coke Company and North Shore Gas Company, Integrys Business Support, LLC; James C. Hoover, Director, Compensation, Integrys Energy Group, Inc.; Steven M. Fetter, President, Regulation UnFettered; Alan Felsenthal, Managing Director, Huron Consulting Group; and Christine Phillips, Manager, Benefits Accounting, Integrys Business Support, LLC.

The following witnesses testified on behalf of Staff: Dianna Hathhorn, Accountant, Accounting Department Financial Analysis Division; Bonita A. Pearce, Accounting Department, Financial Analysis Division; Mike Ostrander, Accountant, Accounting Department, Financial Analysis Division; Mary H. Everson, Accountant, Financial Analysis Division; Richard W. Bridal II, Accountant, Accounting Department, Financial Analysis Division; Larry H. Wilcox, Accountant, Financial Analysis Division; Michael McNally, Senior Financial Analyst, Finance Department, Financial Analysis Division; Sheena Kight-Garlisch, Senior Financial Analyst, Finance Department, Financial Analysis Division; Peter Lazare, Senior Economic Analyst, Rates Department; Financial Analysis Division; Cheri L. Harden, Rate Analyst, Rates Department; Financial Analysis Division; Christopher Boggs, Rate Analyst, Rates Department, Financial Analysis Division; David Sackett, Economic Analyst, Policy Program, Energy Division; Brett Seagle, Engineering Department, Energy Division; Harold L. Stroller, Director, Energy Division; Darin Burk, Pipeline Safety Program Manager, Energy Division; and David Rearden, Policy Program, Energy Division.

GCI's witnesses were David J. Effron, Consultant; Scott J. Rubin, Consultant, except that the City did not sponsor the direct and rebuttal testimony of Mr. Rubin on behalf of AG-CUB only and the City did not sponsor the rebuttal testimony of Mr. Effron on behalf of AG-CUB.

CUB-City's witnesses were Edward C. Bodmer, Consultant; and Christopher C. Thomas, Director of Policy, CUB.

CNE Gas' witness was Lisa A. Rozumialski, Manager of Gas Operations, CNE Gas.

RGS' witness was James L. Crist, President, Lumen Group.

All parties were given the opportunity to cross-examine witnesses. Certain of the testimony was received by affidavit given the waiver of cross-examination by Staff and all parties and without objection. The affidavits were marked and admitted as exhibits.

Further, during the evidentiary hearing, various witnesses on behalf of Staff and various parties submitted oral errata to their pre-filed testimony, as reflected in the transcripts. The Utilities, Staff, and Intervenors filed revised versions of the affected pre-filed testimony reflecting the oral errata presented at the evidentiary hearing (see the earlier discussion of errata filings). Certain additional materials were received into the record thereafter by order of the ALJs. On September 14, 2009, the ALJs marked the record "Heard and Taken".

Rulings on Motions.

On April 7, 2009 a Status hearing was held, as stated above. The ALJs granted Staff's motion to consolidate these Dockets.

On April 17, 2009, the ALJs issued an order granting the Utilities' motion to remove the confidentiality designations from the direct testimony of Mr. Schott.

On April 27, 2009, the ALJs issued an Order for a Case Management Plan and Schedule in these dockets. Also on April 27, 2009, and after considering all of the parties' arguments, the ALJs entered a Protective Order for these Dockets.

On July 22, 2009, the ALJs granted the Utilities' request for Leave to File Revised Rebuttal Testimony Instanter.

On August 25, 2009, the ALJs denied Staff's August 21, 2009, motion to strike portions of the Surrebuttal testimony of Mr. Marano.

On August 25. 2009, the ALJs granted Staff's motion to strike a portion of the surrebuttal testimony of Mr. Moul.

On October __, 2009, the ALJs ***[granted/ denied]*** the Union's September 29, 2009, motion for leave to file an Initial Brief instanter.

Post-Hearing Briefs.

On September 29, 2009, the Utilities, Staff, the AG, the City (as to Peoples Gas' proposed infrastructure rider), CUB (as to that rider), CUB-City, CNE-Gas, RGS, and the Union each filed an Initial Brief ("Init. Br.").

On October 5, 2009, per direction of the ALJs, the Utilities submitted a draft Proposed Order and ___________ submitted draft position statements.

On October 9, 2009, the Utilities, __________, and _________ each filed Reply Briefs ("Rep. Br.").

On __________, the ALJs issued their Proposed Order.

On ______________, Briefs on Exceptions ("BOE") were filed by __________.

On ____, Reply Briefs on Exceptions ("RBOE") were filed by __________.

This Order considers all of the positions and arguments set out in the exceptions briefs and reply briefs listed above.

I. INTRODUCTION

A. Summary of Standards

In addressing the issues raised in these consolidated Dockets, and in our consideration of the extensive evidentiary record, the Commission is governed by a number of basic legal principles.

In contested rate case proceedings the Commission must establish rates that are just and reasonable, with the burden of proof on the utility to establish the justness and reasonableness of a proposed rate. 220 ILCS 5/9-201(c); <u>Business and Professional People for the Public Interest v. Illinois Commerce Comm'n.</u>, 146 Ill. 2d 175, 208 (1991)

("*BPI II*"). The Act requires the Commission to establish rates which are just and reasonable for the utility, its stockholders, and customers. *Id.*

While many of the presented issues are now uncontested, due to agreements and acceptance of positions in order to narrow the issues among the parties, many disputed issues remain. The Commission will consider all of the uncontested and contested issues presented. We are mindful that all rulings and directives contained in this final Order must be within our jurisdiction, lawful, and based exclusively on record evidence. 220 ILCS 5/10-103, 10-201(e)(iv); Business and Professional People for the Public Interest v. Illinois Commerce Comm'n, 136 Ill. 2d 192, 201, 227 (1989) ("*BPI I*").

B. Nature of Operations

1. North Shore

North Shore is a local distribution company engaged in the business of transporting, purchasing, storing, distributing and selling natural gas at retail to approximately 158,000 residential, commercial, and industrial customers within fifty-four communities in Lake and Cook Counties, Illinois. NS Ex. JFS-1.0 at 5; NS Ex. ED-1.0 at 3. North Shore employs approximately 170 people. NS Ex. JFS-1.0 at 5. North Shore is a wholly owned subsidiary of Peoples Energy Corporation, which in turn is a wholly owned subsidiary of Integrys Energy Group, Inc. ("Integrys"). *Id*.

North Shore's distribution system consists of approximately 2,280 miles of gas distribution mains. NS Ex. ED-1.0 at 3. North Shore owns approximately 95 miles of gas transmission lines. *Id*. Its distribution system is most commonly operated at a pressure of 45 pounds per square inch ("PSI"), while the transmission system operates at a pressure of 250 PSI. *Id*. While North Shore does not own any storage fields, it does purchase storage services from Peoples Gas, pursuant to a storage services agreement that was approved by the Commission. *Id*. In addition, North Shore owns a liquid propane production facility used for peaking purposes. *Id*.

The physical configuration of North Shore's system is a dispersed/multiple city-gate, integrated transmission/distribution and multi pressure-based system. NS Ex. ED-1.0 at 3. It is designed to provide gas service to all customers entitled to be attached to the system, to deliver volumes of natural gas to all sales and transportation customers, and to meet the aggregate peak design day capacity requirements of all customers entitled to service on the peak day. *Id*. at 4. A gas utility system sized only to accommodate average gas demands would not be able to meet system peak demands. *Id*.

2. Peoples Gas

Peoples Gas is a local distribution company engaged in the business of transporting, purchasing, storing, distributing, and selling natural gas at retail to approximately 850,000 residential, commercial, and industrial customers within the City of Chicago. PGL Ex. JFS-1.0 at 6; PGL Ex. ED-1.0 at 3. This service territory covers an area of about 237 square miles and has a population of approximately three million people. PGL Ex. JFS-1.0 at 6. Peoples Gas employs approximately 1,110 people, all within the City of Chicago. *Id*. Peoples Gas is a wholly owned subsidiary of Peoples Energy Corporation, which in turn is a wholly owned subsidiary of Integrys. *Id.*

Peoples Gas' distribution system consists of approximately 4,025 miles of gas distribution mains. PGL Ex. ED-1.0 at 4. It owns approximately 425 miles of gas transmission lines. *Id.* The distribution system is most commonly operated at a pressure range of 0.25 to 25 PSI, while the transmission system operates at pressures up to 300 PSI or more. *Id.* Peoples Gas also owns a storage field, Manlove Field. *Id.*

The physical configuration of Peoples Gas' system is a dispersed/multiple city gate, integrated transmission/distribution and multi pressure-backed system. PGL Ex. ED-1.0 at 4. It is designed to provide gas service to all customers entitled to be attached to the system, to deliver volumes of natural gas to all sales and transportation customers, and to meet the aggregate peak design day capacity requirements of all customers entitled to service on the peak day. *Id.* A gas utility system sized only to accommodate average gas demands would not be able to meet system peak demands. *Id*.

II. TEST YEAR (Uncontested)

The Utilities each proposed calendar year 2010, the twelve months ending December 31, 2010, as their future test year. PGL Ex. SM-1.0 at 4; NS Ex. SM-1.0 at 4. The 2010 test year data were based on the Utilities' forecasted 2010 revenues, expenses, and rate base items, subject to appropriate adjustments. PGL Ex. SM-1.0 at 5, 6; PGL Ex. CMG-1.0 Rev. at 5; NS Ex. SM-1.0 at 5, 6; NS Ex. CMG-1.0 at 5. No party contested the proposed test year. The Commission approves the test year as reasonable.

III. REVENUE REQUIREMENT

The formula for determining a utility's costs of service -- its "revenue requirement" -- is well established. RR = OE + (ROR x RB). A utility's revenue requirement ("RR") equals: (1) its operating expenses ("OE") plus (2) a reasonable rate of return ("ROR") on its capital investments ("RB") (the capital investments to which the rate of return is to be applied are referred to as its "rate base"). *E.g.,* Commonwealth Edison Co. v. Illinois Commerce Comm'n, 322 Ill. App. 3d 846, 849 (2d Dist. 2001).

A. North Shore

North Shore's existing rates do not allow it to recover its costs of service. North Shore's direct case supported in detail a base rate revenue requirement[4] of

[4] Consistent with the revenue requirement formula discussed above, each utility's base rate revenue requirement is the sum of (1) its base rate operating expenses plus (2) its operating income requirement. *E.g.,* NS Ex. SM-1.1 at Sched. C-1, lines 1, 22, 23; PGL Ex. SM-1.1 at Sched. C-1, lines 1,22, 23. The operating income requirement number is simply the product of multiplying the utility's rate

$87,279,000, which meant that its cost recovery shortfall (its revenue deficiency) under existing rates in the 2010 test year would be $21,986,000. NS Ex. SM-1.0 at 2; NS Ex. SM-1.1 at Sched. C-1. The extensive evidence supporting North Shore's rate base, operating expenses, and rate of return is discussed in Sections IV, V, and VI, *infra*, respectively.

North Shore's rebuttal testimony supported a lower revenue requirement of $85,314,000, reducing the cost recovery shortfall to $20,021,000. NS-PGL Ex. SM-2.0 at 2; NS-PGL Ex. SM-2.1N at Sched. C-1. The reductions reflected that North Shore, in its rebuttal, agreed with or accepted in order to narrow the issues, in whole or in part, numerous Staff- and intervenor-proposed adjustments, and updated certain items, including the items affected by the cost control measures adopted in light of the economic downturn, a decreased forecasted price of natural gas for 2010, increased pension expenses, and a reduced rate of return. NS-PGL Ex. SM-2.0 at 2-5; NS-PGL Ex. SM-2.2N at Sched. C-2; NS-PGL Ex. JFS-2.0 at 6-7; NS-PGL Ex. JFS-2.1;[5] NS-PGL Ex. BAJ-2.0 2 Rev. at 22.

Finally, North Shore's surrebuttal testimony supported a further-reduced revenue requirement of $83,305,000, meaning its test year cost recovery shortfall under current rates would be $18,105,000. NS-PGL Ex. SM-3.0 Rev. at 3; NS-PGL Ex. SM-3.1N at Sched. C-1, line 3. The additional reductions reflected that North Shore, in its surrebuttal, again agreed with or accepted, in whole or in part, numerous Staff- and intervenor-proposed adjustments and updated certain items. NS-PGL Ex. SM-3.0 Rev. at 2, 3, 4; NS-PGL Ex. SM-3.2N at Sched. C-2; NS-PGL Ex. JFS-3.0 at 6; NS-PGL Ex. JFS-3.1 [6]

The Commission approves North Shore's final revised revenue requirement, subject to two revisions: first, the Commission does not approve Staff's proposed injuries and damages expenses and, therefore, does not approve the related rate base adjustment that North Shore proposed in an effort to narrow the issues (*see* Section(V)(C)(7)(a), infra); and, second, the revenue requirement figure must be revised for the uncontested merger costs adjustment approved by the Commission (*see* Section (V)(B)(7)(n), *infra*). [***ALTERNATIVE (if the Commission approves North Shore's proposal to narrow the issues regarding injuries and damages***

base by its cost of capital. *E.g.,* NS Ex. SM-1.1 at Sched. A-2, lines 1-7, and Sched. C-1, line 23; PGL Ex. SM-1.1 at Sched. A-2, lines 1-7, and Sched. C-1, line 23.

The revenue requirement figures for North Shore and Peoples Gas do not include the Cost of Gas, the Environmental Activities costs, and the Enhanced Energy Efficiency Program costs recovered through Rider 2, Rider 11, and Rider EEP, respectively. *E.g.,* NS Ex. SM-1.0 at 2; PGL Ex. SM-1.0 at 2.

[5] Mr. Schott's rebuttal and surrebuttal testimony each presented an attached list of adjustments proposed by Staff and intervenors with which the Utilities agreed, or accepted in order to narrow the issues, in whole or in part.

[6] North Shore's and Peoples Gas' surrebuttal figures incorporated the proposal they made, in an attempt to narrow the issues, on the subject of injuries and damages expenses and reserves, that is discussed in Section V(C)(7)(a), *infra*.

expenses): The Commission approves North Shore's final revised revenue requirement, subject to one revision, *i.e.,* the revenue requirement figure must be revised for the uncontested merger costs adjustment approved by the Commission (*see* Section (V)(B)(7)(n), *infra*).] North Shore is entitled to recover these costs (its revenue requirement) as discussed below in Sections III through VI. The remaining contested adjustments proposed by Staff and intervenors should not be approved, as discussed in Sections IV, V, and VI, *infra*.

B. Peoples Gas

Peoples Gas' existing rates also do not allow it to recover its costs of service. Peoples Gas' direct case supported in detail a base rate revenue requirement of $624,054,000, which meant that its cost recovery shortfall under existing rates as of the 2010 test year would be $161,920,000. PGL Ex. SM-1.0 at 2; PGL Ex. SM-1.1 at Sched. C-1, line 1. The causes of the cost under-recovery are discussed *infra*. The extensive evidence supporting Peoples Gas' rate base, operating expenses, and rate of return is discussed in Sections IV, V, and VI, *infra*, respectively.

Peoples Gas' rebuttal testimony supported a lower revenue requirement of $584,499,000, meaning its test year cost recovery shortfall under current rates would be decreased to $122,365,000. NS-PGL Ex. SM-2.0 at 2; NS-PGL Ex.. SM-2.1P at Sched. C-1, line 1. The decreases reflected that Peoples Gas, in its rebuttal, agreed with or accepted in order to narrow the issues, in whole or in part, numerous Staff- and intervenor-proposed adjustments, and updated certain items, including the items affected by cost control measures adopted in light of the economic downturn, a decreased forecasted price of natural gas for 2010, and a reduced rate of return. NS-PGL Ex. SM-2.0 at 2, 2, 3 - 5; NS-PGL Ex. SM-2.2P at Sched. C-2; NS-PGL Ex. JFS-2.0 at 6 - 7; NS-PGL Ex. JFS-2.1; NS-PGL Ex. BAJ-2.0 2Rev. at 22.

Finally, Peoples Gas' detailed surrebuttal testimony supported a further-reduced revenue requirement of $574,038,000, meaning its test year cost recovery shortfall under current rates would be $113,178,000. NS-PGL Ex. SM-3.0 Rev. at 3; NS-PGL Ex. SM-3.1P at Sched. C-1, line 3. The additional reductions reflected that Peoples Gas, in its surrebuttal, again agreed with or accepted, in whole or in part, numerous Staff- and intervenor-proposed adjustments and updated certain items. NS-PGL Ex. SM-3.0 Rev. at 2, 3, 4; NS-PGL Ex. SM-3.2P at Sched. C-2; NS-PGL Ex. JFS-3.0 at 6; NS-PGL Ex. JFS-3.1.

The Commission approves Peoples Gas' final revised revenue requirement, subject to two revisions: first, the Commission does not approve Staff's proposed injuries and damages expenses and, therefore, does not approve the related rate base adjustment that Peoples Gas proposed in an effort to narrow the issues (*see* Section(V)(C)(7)(a), infra); and, second, the revenue requirement figure must be revised for the uncontested merger costs adjustment approved by the Commission (*see* Section (V)(B)(7)(n), *infra*). [***ALTERNATIVE (if the Commission approves Peoples Gas' proposal to narrow the issues regarding injuries and damages expenses)***: The Commission approves Peoples Gas' final revised revenue requirement, subject to one revision, *i.e.,* the revenue requirement figure must be revised for the uncontested merger costs adjustment approved by the Commission (*see* Section (V)(B)(7)(n), *infra*).]. Peoples Gas is entitled to recover these costs (its revenue requirement) through its rates as discussed below in Sections III through VI. Staff's and intervenors' contested proposed adjustments should not be approved, as discussed in Sections IV, V, and VI, *infra*.

IV. RATE BASE

A. Overview/Summary/Totals

1. North Shore

In its direct case, North Shore proposed a rate base of $179,245,000, including $398,803,000 of Gross Utility Plant, less $165,670,000 of Accumulated Provision for Depreciation and Amortization (commonly referred to as the "Depreciation Reserve"), and various other additions and subtractions. NS Ex. JH-1.0 at 2: NS Ex. JH-1.1 at Sched. B-1.

In it's rebuttal case, North Shore proposed a rate base of $178,936,000, reflecting adjustments proposed by Staff and intervenors that the utility agreed with or accepted in whole or in part and certain updates. NS-PGL Ex. JH-2.0 at 2-4; NS-PGL Ex. JH-2.1N (Sched. B-1); NS-PGL Ex. JH-2.1N (Sched. B-2); NS-PGL Ex. JFS-2.0 at 6-7; NS-PGL Ex. JFS-2.1.

In its surrebuttal case, North Shore proposed a rate base of $179,927,000, reflecting adjustments proposed by Staff and intervenors that the utility agreed with or accepted in whole or in part, certain updates, and the correction of prior calculation errors in the figures for Materials and Supplies and Gas in Storage. NS-PGL.Ex. JH-3.0 at 2, 4-6; NS-PGL Ex. JH-3.1N (Sched. B-1); NS-PGL Ex. JH-3.2N (Sched. B-2); NS-PGL Ex. JFS-3.0 at 6; NS-PGL Ex. JFS-3.1.

North Shore supported its rate base primarily through the detailed testimony of six witnesses. NS-PGL Init. Br. at 27 (citing NS Ex. JH-1.0; NS Ex. JH-1.1; NS-PGL. Ex. JH-2.0; NS-PGL Exs. JH-2.1N, JH-2.2N, JH-2.3N, JH-2.4N, JH-2.5N, JH-2.6N, JH-2.7N; NS-PGL Ex. JH-3.0; NS-PGL Exs. JH-3.1N, JH-3.2N, JH-3.4N, JH-3.5N, JH-3.6N, JH-3.7N, JH-3.8, JH-3.10N; NS Ex. ED-1.0; NS Ex. ED-1.1; NS-PGL Ex. ED-2.0; NS-PGL Ex. ED-3.0; NS Ex. CMG-1.0; NS Ex. CMG-1.1; NS-PGL Ex. CMG-2.0; NS-PGL Exs. CMG-2.1N, CMG-2.2N, CMG-2.3N, CMG-2.4N, CMG-2.5N; NS-PGL Ex. CMG-3.0; NS-PGL Exs. CMG-3.1N, CMG-3.2N; NS Ex. JJS-1.0; NS Ex. JJS-1.1; NS-PGL Ex. JCH-1.0; NS-PGL Ex. JCH-2.0; NS-PGL Ex. CMP-1.0; NS-PGL Exs. CMP-1.1, CMP-1.2, CMP-1.3).

The Commission approves North Shore's final revised rate base, subject to removal of the injuries and reserves damages adjustment that it made in an effort to narrow the issues. *See* Section V(C)(7)(a), *infra*. [***ALTERNATIVE (if the Commission approves North Shore's proposal to narrow the issues regarding injuries and***

damages expenses): The Commission approves North Shore's final revised rate base.] The detailed evidence in the record warrants this conclusion.

2. Peoples Gas

In its direct case, Peoples Gas direct case proposed a rate base of $1,396,058,000, including $2,525,147,000 of Gross Utility Plant, less $1,070,104,000 for the Depreciation Reserve, and various other additions and subtractions. PGL Ex. JH-1.0 at 2, *et seq*.; PGL Ex. JH-1.1 at Sched. B-1.

In its rebuttal case, Peoples Gas proposed a rate base of $1,298,740,000, reflecting adjustments proposed by Staff and intervenors that the utility accepted in whole or in part and certain updates. NS-PGL Ex. JH-2.0 at 2, 3-4, *et seq*.; NS-PGL Ex. JH-2.1P (Sched. B-1); NS-PGL Ex. JH-2.1P (Sched. B-2); NS-PGL Ex. JFS-2.0 at 6-7; NS-PGL Ex. JFS-2.1.

In its surrebuttal case, Peoples Gas in its proposed rate base of $1,300,750,000, reflecting adjustments proposed by Staff and intervenors that the utility accepted in whole or in part, certain updates, and the correction of prior calculation errors in the figures for Materials and Supplies and Gas in Storage. NS-PGL Ex. JH-3.0 at 2, 4 - 6, *et seq*.; NS-PGL Ex. JH-3.1P (Sched. B-1); NS-PGL Ex. JH-3.2P (Sched. B-2); NS-PGL Ex. JFS-3.0 at 6; NS-PGL Ex. JFS-3.1.

Peoples Gas supported its rate base primarily through the detailed testimony of eight witnesses. NS-PGL Init. Br. at 28 (PGL Ex. JH-1.0; PGL Ex. JH-1.1; NS-PGL. Ex. JH-2.0; NS-PGL Exs. JH-2.1P, JH-2.2P, JH-2.3P, JH-2.4P, JH-2.5P, JH-2.6P, JH-2.7P; NS-PGL Ex. JH-3.0; NS-PGL Exs. JH-3.1P, JH-3.2P, JH-3.3P, JH-3.4P, JH-3.5P, JH-3.6P, JH-3.7P, JH-3.8, JH-3.9, JH-3.10P; PGL Ex. ED-1.0 Rev.; PGL Ex. ED-1.1; NS-PGL Ex. ED-2.0; NS-PGL Ex. ED-3.0; PGL Ex. CMG-1.0; PGL Ex. CMG-1.1; NS-PGL Ex. CMG-2.0; NS-PGL Exs. CMG-2.1P, CMG-2.2P, CMG-2.3P, CMG-2.4P, CMG-2.6P; NS-PGL Ex. CMG-3.0; NS-PGL Exs. CMG-3.1P, CMG-3.2P; PGL Ex. JJS-1.0; PGL Ex. JJS-1.1; NS-PGL Ex. JCH-1.0; NS-PGL Ex. JCH-2.0; NS-PGL Ex. CMP-1.0; NS-PGL Exs. CMP-1.1, CMP-1.2, CMP-1.3; NS-PGL Ex. AF-1.0; NS-PGL Ex. AF-2.0; NS-PGL Ex. TLP-2.0; NS-PGL Ex. TLP-3.0; NS-PGL Exs. TLP-3.1, TLP-3.2, TLP-3.3).

The Commission approves Peoples Gas' final revised rate base, subject to removal of the injuries and reserves damages adjustment that it made in an effort to narrow the issues. *See* Section V(C)(7)(a), *infra*. [***ALTERNATIVE (if the Commission approves North Shore's proposal to narrow the issues regarding injuries and damages expenses)***: The Commission approves Peoples Gas' final revised rate base.] The detailed evidence in the record warrants this conclusion.

B. Uncontested Issues

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

a. The Record

The Utilities, Staff, AG, and CUB agree that the natural gas prices for the purposes of cushion gas (Peoples Gas only), gas in storage, and cash working capital should be updated based upon data in the Utilities' August 2009 Gas Charge filings, the most recent data in the evidentiary record. NS-PGL Ex. CMG-3.0 at 2-3; NS-PGL Ex. JH-3.0 at 4, 5, 6; AG-CUB Ex. 4.0 at 4; Staff Ex. 27.0 at 13-17; Tr. at 914-915.

b. Commission Analysis and Conclusions

The Commission finds that the use of the gas prices based on data in the Utilities' August 2009 Gas Charge filings to update the natural gas prices for purposes of cushion gas (Peoples Gas only), gas in storage, and cash working capital to be reasonable.

2. Plant

a. Original Cost Determinations as to Plant Balances as of 12/31/2007

i. The Record

Utilities witness Mr. Hengtgen's proposal that the Commission's final Order include an original cost determination as to each utility is uncontested. Mr. Hengtgen proposed that the Order make such determinations, pursuant to 83 Ill. Adm. Code Part 510 and its Appendix A, regarding Peoples Gas' and North Shore's Gross Utility Plant balances as of December 31, 2007. PGL Ex. JH-1.0 at 17-18; NS Ex. JH-1.0 at 14.

Staff witness Mr. Bridal agreed that such a determination be included in the Commission's final Order. He recommended that the Order state in part:

> It is further ordered that the $2,525,147,000 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 $398,983,000 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.

Staff Ex. 5.0 at 8-9. The Utilities agreed. NS-PGL Ex. JH-2.0 at 17–18. No witness disagreed.

ii. Commission Analysis and Conclusions

We accept Staff's and the Utilities' recommendation to have the final order include original cost determinations pursuant to 83 Ill. Adm. Code 510 and Appendix A thereto, as follows:

It is further ordered that the $2,525,147,000 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 $398,983,000 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.

The Commission finds that this proposed language is reasonable, appropriate and agreed on. Therefore, it is approved. The language accordingly is set forth in the Findings and Ordering section of this Order, *infra*.

b. Capitalized Union Wages

See Section V(B)(2) of this Order, *infra*.

c. Capitalized Civic, Political, and Related Activities

See Section V(B)(7)(f) of this Order, *infra*.

d. Net Dismantling

i. The Record

North Shore and Peoples Gas proposed to change the accounting for the net dismantling (*i.e.*, the cost of removal of an asset, net of salvage) portions of their Depreciation Reserves from a cash basis to an accrual basis, effective January 1, 2010. NS Ex. CMG-1.0 at 20; PGL Ex. CMG-1.0 Rev. at 21- 22. No testimony opposed that proposal.[7] North Shore and Peoples Gas request that the final Order contain language expressly approving the proposal, so that it will be clear that it has been approved.

ii. Commission Analysis and Conclusions

The Commission approves as reasonable and appropriate the Utilities' proposal.

e. Gathering System Pigging Project (PGL)

i. The Record

[7] At one point, there was a disagreement between Staff and the Utilities regarding an aspect of the net dismantling computations, but, after the Utilities presented further testimony, Staff accepted the Utilities' approach. NS-PGL Ex. SM-2.0 at 5-6; Staff Ex. 18.0 at 3.

One of the many Peoples Gas projects expected to enter service before the end of the test year is the Gathering System Pigging Project, in which approximately $500,000 will be spent in 2009. NS-PGL Cross Ex. Effron 29. Staff witness Mr. Seagle initially objected to the inclusion of this project in rate base, but after receiving further information, Mr. Seagle agreed that the project was properly included in Peoples Gas' rate base. Tr. at 911.

ii. Commission Analysis and Conclusions

The Commission finds the Gathering System Pigging Project to be appropriate as it is prudent, reasonable, and used and useful. Therefore, it should be included in Peoples Gas' rate base.

f. Cushion Gas – Recoverable (PGL)

i. The Record

There is no dispute as to the amount of recoverable cushion gas to include in Peoples Gas' rate base. As discussed in Section IV(B)(1), *supra*, the parties have now agreed as to the price to be used. Thus, Peoples Gas' recoverable cushion gas additions should be valued at $349,000 and $381,000 for 2009 and 2010, respectively. *See* NS-PGL Ex. JH-3.3P, p. 1.

ii. Commission Analysis and Conclusions

The Commission finds that the use of the gas prices based on data in the Utilities' August 2009 Gas Charge filings to update the natural gas prices for purposes of recoverable cushion gas (Peoples Gas only) to be reasonable, as stated earlier. Thus, Peoples Gas' recoverable cushion gas additions valued at $349,000 and $381,000 for 2009 and 2010, respectively, are approved.

g. Cushion Gas – Non-Recoverable (PGL)

i. The Record

There is no dispute as to the amount of non-recoverable cushion gas. Thus, Peoples Gas' non-recoverable cushion gas additions should be valued at $6,628,000 and $7,236,000 for 2009 and 2010, respectively. *See* NS-PGL Ex. JH-3.3P, p. 1, line 3.

ii. Commission Analysis and Conclusions

The Commission finds that the use of the gas prices based on data in the Utilities' August 2009 Gas Charge filings to update the natural gas prices for purposes of non-recoverable cushion gas (Peoples Gas only) to be reasonable, as stated earlier. Thus, Peoples Gas' non-recoverable cushion gas additions valued at $6,628,000 and $7,236,000 for 2009 and 2010, respectively, are approved.

h. Capitalized Savings Plan Costs

i. The Record

AG-CUB-City witness Mr. Effron initially proposed to capitalize a portion of the Savings and Investment Plan cost based on the Utilities' responses to data requests AG 3.21 and AG 3.67. AG-CUB-City Ex. 1.0 at 23. Subsequently, after receiving further information, Mr. Effron withdrew his adjustment as no longer necessary. AG-CUB Ex. 4.0 at 11.

ii. Commission Analysis and Conclusions

The Commission finds that the withdrawal of the adjustment to capitalize a portion of the Savings and Investment Plan cost to be uncontested, and the proposal is not necessary. Therefore, we approve the withdrawal.

3. Accumulated Reserve for Depreciation and Amortization

a. Inventory Reclassification

i. The Record

Staff witness Ms. Hathhorn proposed adjustments to the Depreciation Reserve, Gas in Storage (as to Peoples Gas), and Accumulated Deferred Income Taxes related to inventory reclassification. The Utilities accepted those adjustments. NS-PGL Ex. JH-2.0 at 4; NS-PGL Ex. JH-2.2N at Sched. B-2;. NS-PGL Ex. JH-2.2P at Sched. B-2. *See* Section V(B)(8)(a), *infra*, for the operating expenses side of this subject.

ii. Commission Analysis and Conclusions

The Commission finds that Staff's adjustments to the Depreciation Reserve, Gas in Storage (as to Peoples Gas), and Accumulated Deferred Income Taxes related to inventory reclassification to be reasonable and uncontested. Therefore, these adjustments are approved.

4. Materials and Supplies Correction

a. The Record

The Utilities corrected an error in the original level of materials and supplies. NS-PGL Ex. JH-3.0 at 4-5. The corrected levels are shown on line 5 of the Revised Schedule B-1 for each of the Utilities, NS-PGL Exs.JH-3.1N and JH-3.1P.

b. Commission Analysis and Conclusions

The Commission finds that the corrected levels of materials and supplies to be reasonable. Therefore, these amounts are approved.

5. Gas in Storage

a. The Record

The Utilities corrected an error in the original Gas in Storage calculations, and used the final updated figures for the price of natural gas. NS-PGL Ex. JH-3.0 at 5-6. The uncontested amounts for Gas in Storage are shown on line 6 of the Revised Schedule B-1 for each of the Utilities, in NS-PGL Exs. JH-3.1N and JH-3.1P.

b. Commission Analysis and Conclusions

The Commission finds that the corrected original gas in Storage calculations, and using the final updated figures for the price of natural gas discussed earlier to be reasonable. Therefore, these amounts are approved.

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

a. The Record

In order to refine the methodology for amortizing the remaining pre-merger unamortized costs, the Utilities 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, effective January 1, 2010. PGL Ex. CMG-1.0 at 20; NS Ex. CMG-1.0 at 19. This change (1) will eliminate the need for the actuary to prepare a separate accounting valuation; and (2) will reflect an additional decrease to pension costs and an additional increase to welfare costs in the test year. *Id.* No witness objected to this change. North Shore and Peoples Gas request that the final Order contain language expressly approving the proposal, so that it will be clear that it has been approved.

b. Commission Analysis and Conclusions

The Commission finds that the Utilities' proposal 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 to be uncontested and appropriate. Thus, the Commission approves this change in methodology.

C. Plant

1. Forecasted Plant Additions

a. North Shore and Peoples Gas

The Utilities' forecasted plant additions have changed some, in response to the economy, since the time of the Utilities' initial filing in February 2009. In their direct testimony, the Utilities supported their forecasted plant additions but also stated that they were adopting cost control measures that would be reflected in their rebuttal testimony. In response to data requests before their rebuttal testimony, the Utilities stated, in March 2009, the reduced level of plant additions. *See* Staff Ex. 4.0 at 4.

b. Staff

[Insert]

c. AG

[Insert]

d. CUB-City

[Insert]

e. North Shore and Peoples Gas Response

AG-CUB's proposed adjustments are without merit and should not be adopted. Staff agrees with the Utilities' revised adjustments. Staff Ex. 18 at 3; Staff Init. Br. at 12-13. The Utilities submit that, as they refined their budgets, the forecast plant additions changed again, increasing slightly from the March 2009 estimate although remaining below their original forecasts. In response to subsequent data requests, the Utilities in July 2009 sent out the revised forecast. NS-PGL Cross Exs. Effron 26 and 28. The Utilities also explained why the forecasts had changed and the details of the changes, both in testimony and in response to data requests. NS-PGL Ex. ED-3.0 at 3; NS-PGL Cross Exs. Effron 27 and 29. The forecasts have not changed since that time.

The Utilities note that AG-CUB's continued use of the outdated March 2009 forecasted Plant Additions is arbitrary and improper. The Utilities maintain that it is appropriate to rely on the latest, most accurate forecast of plant additions, which is the information that the Utilities and Staff have used. According to the Utilities, it is quite reasonable to conclude that the most recent forecast information is the most accurate, as 2009 is well under way, and planning for 2010 is further along than earlier in the year. The current forecast reflects additional high priority public improvements and system improvements that will be completed. NS-PGL Ex. ED-3.0 at 3. The Utilities' latest forecast plant additions should therefore be used. *Id*. at 3.

f. Commission Analysis and Conclusions

The Commission finds that AG-CUB witness Mr. Effron's proposed use of the interim plant additions numbers from March 2009 is not reasonable, not supported by any credible evidence, and would deny the Utilities recovery for projects that are actually in their budgets and will be serving customers. AG-CUB has provided no reasonable basis for advocating use of older data instead of the latest information. Staff has reviewed the evidence and does not contest the Utilities' rebuttal levels of forecasted plant additions. Staff Ex. 18.0 at 3. The Commission approves the Utilities' forecasted plant additions.

2. Gathering System Phase 2 Project (PGL)

a. Peoples Gas

Peoples Gas' only gas storage facility is Manlove Field. Gas is injected underground into the former water-bearing aquifer, so that it can be extracted when needed to serve customers. An integral component of the field is a network of pipes that are used when extracting gas from the field. This gathering system at Manlove has been used to serve customers for many years. Peoples Gas states that much of the existing gathering system is not designed and configured to be pigged. Thus, one purpose of the Gathering System Replacement Project is to have modern, pig-compatible pipes. PGL Ex. TLP-1.0 at 9. Peoples Gas submits that this is a multi-year project that will cost tens of millions of dollars. PGL Ex. TLP-1.0 at 8; PGL Ex. ED-1.1 at line 3.

b. Staff

[Insert]

c. Peoples Gas Response

In response to Staff's assertions regarding the usefulness of the proposed project, Peoples Gas presents several reasons to modernize the system and replace aging and corroding pipes. Peoples Gas states that one important maintenance tool is "pigging," that is, to send a large object, known as a pig, through the pipes, which serves to clean them and de-water them. NS-PGL Ex. TLP-2.0 at 2. Second, the existing pipes have been developing corrosion, which has reliability implications. NS-PGL Ex. TLP-3.0 at 2-3. Staff conceded that the replacement pipes will have the same function as the pipes currently in use, and such pipes are critical to the operation of the storage field. Tr. at 911-912.

In response to Staff's argument regarding how much of the project to include in rate base using a 2010 test year, because the project will not be complete in 2010, Peoples Gas provides evidence regarding the amount to be spent in 2009 as well as a forecast of 2010. Peoples Gas establishes $1,500,000 is being spent in 2009 for the engineering study that will help chart which pipes will be replaced in which years. NS-PGL Ex. TLP-2.0 at 6; NS-PGL Ex. TLP-3.0 at 4. Further, Peoples Gas forecasts $5.7 million to be spent in 2010. NS-PGL Ex. TLP-2.0 at 6; NS-PGL Cross Ex. Effron 29. Peoples Gas maintains that although the overall scope of the project – for example, whether the project will last ten years or only eight – is not yet known, based on the analyses that have already been performed, it is clear that the forecasted 2010 work will need to proceed or be accelerated. NS-PGL Ex. TLP-3.0 at 4-5; NS-PGL Ex. SDM-3.0 at 15-16.

d. Commission Analysis and Conclusions

The Commission finds that the Gathering System Replacement Project is reasonable and necessary in order to maintain and improve the gathering system, which provides useful service to customers. Further, the Commission finds that Staff's proposed disallowance of a certain portion of the project expenditures should not be adopted. Peoples Gas has established that $1,500,000 will be spent in 2009 and that reasonable forecasts show that at least $5,700,000 will be spent in 2010. Staff does not dispute the 2009 amount and has not shown the 2010 forecasts to be unreasonable. Therefore, the Commission rejects Staff's proposed disallowance.

3. Capitalized Incentive Compensation

See Section V(C)(1) of this Order.

4. Capitalized Non-Union Base Wages

See Section V(C)(2) of this Order.

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

1. The Record

North Shore and Peoples Gas propose to change the accounting for the net dismantling, which proposal is uncontested and is discussed in Section IV(B)(2)(d), *supra*.

Staff and intervenors have not proposed any independent adjustments to the Depreciation Reserve. All of their proposed adjustments to the Reserve are derivative of their proposed adjustments to other items, as is shown in their Schedules. Staff Ex. 15.0 at Sched. 15.4P, line 13, and Sched. 15.4N, line 13; AG-CUB Ex. 4.1 at Sched. B-3; AG-CUB Ex. 4.2 at Sched. B-3.

2. Commission Analysis and Conclusions

Accordingly, apart from the net dismantling point, the Depreciation Reserve should include the appropriate derivative calculations. There is no dispute regarding how those calculations are performed. The Commission approves the levels set forth in the Utilities' surrebuttal testimony, subject to the derivative impacts of the Commission's rulings on the applicable contested adjustments discussed elsewhere in this Order.

E. Cash Working Capital

Cash working capital is the amount of funds required to finance the day-to-day operations of a utility. The cash working capital requirement is included as part of each of the Utilities' rate base for ratemaking purposes. PGL Ex. JH-1.0 at 19; NS Ex. JH-1.0 at 15-16. To determine the cash working capital requirement, a lead-lag study analyzes the differences between the revenue lags and the expense leads of a utility. Three broad categories of leads and lags are considered: 1) lag times associated with the collection of revenues owed to the utility; 2) lead times associated with the payment of what are commonly called "pass-through" taxes and "energy assistance charges," and 3) lead times associated with the payments for goods and services received by the utility. PGL Ex. JH-1.0 at 20. The Utilities performed a lead-lag study closely conforming to the methodology adopted by the Commission in the Utilities' last rate cases, *In re North Shore Gas Co., et al.*, ICC Docket Nos. 07-0241/07-0242 (Order Feb. 4, 2008) ("*Peoples 2007*"). PGL Ex. JH-1.0 at 20. The only contested aspect of the Utilities' lead-lag cash working capital study relates to pass-through taxes.

1. Pass-Through Taxes

a. North Shore and Peoples Gas

The Utilities maintain that the pass-through taxes and energy assistance charges are not recorded as revenue or expense on the income statement, but their collection and payment cause a timing difference in the cash flow that needs to be accounted for. PGL Ex. JH-1.0 at 23- 24; NS Ex. JH-1.0 at 20. The Utilities explain that they bill customers for the pass-through taxes in its normal billing process, and the rate payers do not pay the bills immediately to the Utilities when they receive their bills. The payment by the rate payers (or collections by the Utilities) occurs over several months after bills are issued. According to the Utilities, this "lag" in collection is the basis for the Utilities' calculation and use of lag days in its lead lag study. There is a corresponding expense (payment) lead because the Utilities do not remit the taxes to the taxing authorities on the same day they issue the bills to the customers. The due dates of the taxes are based on statutory due dates or various agreements with the taxing authorities. This payment "lead" is the basis for the Utilities' calculation of or use of lead days in its lead-lag study. The Utilities conducted an analysis as approved by the Commission in their last rate cases.

b. Staff

[Insert]

c. North Shore and Peoples Gas Response

The Utilities refuted Staff's argument, describing the types of pass-through taxes and energy assistance charges and noting that the majority of the pass-through taxes and energy assistance charges were taxes or charges imposed by law on the Utilities and not the customers and were either collected through a separate charge prescribed by law or described within the statute as a charge for utility service. NS-PGL Ex. JH-2.0 at 12.

The Utilities note that the pass-through taxes are not recorded as revenue or expense but they do create timing issues in the collection and payment of the taxes. NS-PGL Ex. JH-2.0 at 13; NS-PGL Ex. JH-3.0 at 8.

According to the Utilities, it is not necessary that the Utilities have the same method ordered for Northern Illinois Gas Company ("Nicor Gas"), because the facts are different. Nicor Gas reportedly collects pass-through taxes, holds them for a time, and then remits the money to various municipalities. NS-PGL Ex. JH-3.0 at 8-9. The Utilities observe that Nicor Gas bases its payments on actual cash collections from customers, which is now different from the Utilities. Peoples Gas states that it entered into an agreement with the City of Chicago, dated December 21, 2005, under which it pays, at a specific time, an estimate of the pass-through taxes owed to the City. Prior to this agreement, Peoples Gas states that it paid its taxes based on actual cash receipts from customers. NS-PGL Ex. JH-3.9*.* North Shore and Peoples Gas submit that they use this same process for all pass-through taxes, whether covered by the City agreement or not. NS-PGL Ex. 2.0 at 14. According to the Utilities, there is a significant difference in methodology; Nicor Gas uses actual cash receipts so it knows it has collected the taxes and holds the money for a period of time before payment, the Utilities make payments based on estimates and whether actually collected or not so the Utilities are uncertain if they have actually received the taxes before or after they have been paid.

d. Commission Analysis and Conclusions

Staff concedes that the Utilities had proposed a methodology that matched what the Commission approved in the Utilities' last rate cases. The Commission declines to adopt Staff's proposed methodology regarding the pass-through taxes. Staff's use of the methodology ordered by the Commission in the Nicor Gas case, as opposed to the Utilities' last rate cases, is not appropriate here given the facts of this proceeding nor is there support in the record for Staff's conclusion or result. While Staff's proposed methodology might have been appropriate in Nicor Gas' situation, it does not reflect the Utilities' facts here. In particular, Nicor Gas uses actual cash receipts so it knows it has collected the taxes, whereas the Utilities make payments based on estimates so the Utilities are uncertain if they have actually received the taxes before or after they have been paid. Because of the Utilities' method of remitting pass-through taxes based on estimates and not knowing if the taxes have actually been collected, the Utilities' calculations of pass-through taxes show an overall cash working capital close to zero, reflecting: the lags and leads nearly cancelling each other out. The Commission finds that the Utilities' proposed net working capital amount is reasonable and appropriate, and is consistent with the treatment in each of the Utilities' last rate cases. The record establishes that for the tax payments to the City of Chicago of $171 million, the net cash working capital amount is a negative $40,000. NS-PGL Ex. JH-3.0 at 10-11.

2. All Other (Uncontested)

All other cash working capital components are uncontested. The figures shown on the Utilities' Revised Schedule B-8's in NS-PGL Exs. JH-3.6N and JH-3.6P are therefore approved.

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

1. The Record

The Utilities have shown, on their original Schedule B-9s, the projected balances of Accumulated Deferred Income Taxes at December 31, 2009 and December 31, 2010, and the average amount for the test year. PGL Ex. JH-1.0 at 15-16; NS Ex. JH-1.0 at 12. The Utilities updated and revised those figures in rebuttal and ultimately in surrebuttal. NS-PGL Ex. JH-3.1N and JH-3.1P. Other than derivative adjustments from contested adjustments, the Utilities' surrebuttal figures are not disputed by any party.

2. Commission Analysis and Conclusions

The Commission finds the figures in the Utilities' surrebuttal reasonable and appropriate subject to with the derivative adjustments stemming from contested issues as discussed elsewhere in this Order.

G. Reserve for Injuries and Damages

See Section V(C)(7)(a) of this Order *infra*.

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

1. North Shore and Peoples Gas

In its original Part 285 filing, Peoples Gas, in calculating its rate base, included its net pension asset of $141,131,000 and its net OPEB liability of $85,935,000. *See, e.g.*, PGL Schedule B-1.2 in PGL Ex. JH-1.1.

In its original Part 285 filing, North Shore, in calculating its rate base, included its net pension liability of $2,880,000 and its net OPEB liability of $10,280,000. See, *e.g*., NS Schedule B-1.2 in NS Ex. JH-1.1.

2. Staff

[Insert]

3. AG

[Insert]

4. CUB-City

[Insert]

5. North Shore and Peoples Gas Response

Utilities witness Mr. Felsenthal testifies that Staff and the AG-CUB err in stating that the Peoples Gas pension asset was funded by ratepayer funds. Further, Mr. Felsenthal states that Staff, who argues that Peoples Gas' pension asset should be excluded from rate base, inconsistently argues that North Shore's pension liability should be included in rate base. AG-CUB's witness, in contrast, excluded both. Finally, Mr. Felsenthal testifies to the inconsistent treatment proposed by both Staff and the AG-CUB for including Peoples Gas' and North Shore's other postretirement benefits ("OPEB") in their respective rate bases but excluding Peoples Gas' pension asset. NS-PGL Ex. AF-1.0 at 1-2.

A utility's accrued pension liability generally results from pension expense calculated based on Financial Accounting Standard ("FAS") 87 being greater than pension contributions. NS-PGL Ex. AF-1.0 at 20-21. A pension asset, however, is created in two ways: (1) contributions to the pension fund; and (2) negative pension expense. Pension plan contributions are based on management decisions with various legal considerations contained in the Employee Retirement Income Security Act of 1972 ("ERISA") and the Internal Revenue Code ("IRC"). *Id*. at 6. The constraints regarding pension funding include: required minimum and maximum contribution levels deductible for income tax purposes and the utility's responsibility to protect the interests of the plan participants and beneficiaries. *Id.* However, pension expense, which is based on FAS 87, represents the annual pension cost that is actuarially determined in a manner that charges each period with the net cost of such benefits attributable during that annual period. *Id*. at 6. The funding rules set forth under ERISA and the IRC are different than the methodology used to determine pension expense under FAS 87. *Id*. With the adoption of FAS 87, the trigger between pension expensing and pension funding was eliminated. *Id*. at 19.

The other way to create a pension asset is for the annual pension cost computed under FAS 87 to be a negative expense – meaning that the expected return on plan assets exceeds other components of pension cost. *Id*. at 9. An additional reason for negative expense, particularly relevant to Peoples Gas, is the result of pension plan participants accepting lump-sum distributions in lieu of a stream of pension plan benefits, thereby eliminating pension plan obligations and triggering the recognition of a portion of unrealized gains. *Id*.

While Staff only reviews the last five years, Mr. Felsenthal testifies that for the eight year period, beginning with 1996 (the year after Peoples Gas' second to last rate case, ICC Docket No. 95-0032, through and including 2003), there was aggregate negative pension expense (credits) each year totaling $174.3 million. NS-PGL Ex. AF-2.0 at 5. The Utilities state that Staff did not address the negative pension expense in the prior eight years, and it certainly does not change the numbers for the prior eight years. NS-PGL Init. Br. at 42. Further, Mr. Felsenthal notes that the prepaid pension asset is the cumulative difference between what has been contributed to the pension plan by Peoples Gas, using investor-supplied funds, and what has been expensed under FAS 87. NS-PGL Ex. AF-1.0 at 10. Because the ratemaking process is based on expense, Mr. Felsenthal states that the prepaid pension asset also represents amounts that have been contributed by Peoples Gas to the pension fund that have not been recovered, or that have been treated as a negative pension expense. *Id*.

Mr. Felsenthal testifies that customers benefit in two ways in the years that there was negative pension expense through reduced: (1) operating expenses; and (2) need for additional rate cases. NS-PGL Ex. AF-1.0 at 14; 15. Negative pension expense benefits investors only to the extent it reduces cash funding requirements – there is no immediate cash benefit. *Id*. at 14.

Mr. Felsenthal disagrees with Staff's argument that the pension asset should be excluded from rate base because it was funded by normal operating revenues collected from ratepayers and represents funds supplied by ratepayers. *Id*. at 17-18. First, he states that it is established regulatory principle that ratepayers pay for service and their payments do not give them ownership of the Utilities assets. *Id*. at 18. Second, for Staff's position to be accepted, Staff would have to show that each dollar comprising the pension asset was funded through billings to customers which, in turn, were contributed to the pension fund. *Id*. Mr. Felsenthal testifies that this is not the case as many of those contributions to the fund went to paying pension benefits to retirees. *Id*. The periodic pension expense is to pay for that periods pension cost, no more, no less. *Id*. Also, Mr. Felsenthal also states that Staff's argument that the pension asset should not be included in rate base because it is a timing difference should be rejected. NS-PGL Ex. AF-2.0 at 3. He states that rate base is computed with many items that are timing differences, such as deferred taxes, which is not excluded from rate base. *Id*.

Because Peoples Gas has not been allowed by the Commission to include its pension asset in rate base, Mr. Felsenthal concludes that investors are not allowed to earn a return on their investment. *Id*. at 20. He notes that this serves as an incentive for Peoples Gas to make only the minimum required pension plan contribution, which results in greater risk to employees as to the availability of sufficient pension plan funds to pay ultimate plan benefits. *Id*. The Utilities state that this is also contrary to Illinois law, which requires the Commission to establish rates that give the utility the opportunity to earn its authorized return. *E.g.,* Illinois Bell Tel. Co. v. Illinois Commerce Comm'n, 414 Ill. 275, 286 (1953); Citizens Utilities Co. of Ill. v. Illinois Commerce Comm'n, 153 Ill. App. 3d 28, 30 (3d Dist. 1987). NS-PGL Init. Br. at 43. Finally, Mr. Felsenthal adds that Peoples Gas does not have access to the pension plan assets themselves and as a result, such assets are not a source of cash to People Gas. *Id*. at 12.

The Utilities add that recently, the Illinois Appellate Court for the Second Judicial District issued an opinion that affirmed the Commission's decision in Commonwealth Edison Company's ("ComEd") 2005 rate case (ICC Docket No. 05-0597) that excludes ComEd pension asset from rate base but allows ComEd to recover at ComEd's cost of long-term debt an $803 million contribution to the pension plan that was made using funds supplied by ComEd's ultimate parent company.[8] *ComEd 2005 Appeal* at 17. The Appellate Court reasoned that ComEd had failed to carry its burden of proving that recovery of the $803 million contribution at ComEd's full cost of capital was reasonable or that there was not a less expensive alternative to funding the contribution than that full cost of capital. *Id*. at 16-17. Therefore, the Utilities explain that the question on appeal did not revolve around whether the funds used to contribute to the pension plan

[8] *Commonwealth Edison Co. v. Illinois Commerce Comm'n, et al.*, Nos. 2-06-0184 Cons. (Ill. App. Ct. 2d Dist. Sept. 17, 2009 ("*ComEd 2005 Appeal*").

were investor-supplied, but around whether financing the contribution at the utility's full cost of capital, rather than its cost of long-term debt, was proven to be reasonable. NS-PGL Init. Br. at 43-44.

Mr. Felsenthal testified that the only significant difference between the facts in the 2005 ComEd rate case and the instant proceedings is that the source of the pension asset is not as direct. NS-PGL Ex. AF-1.0 at 27. He stated that the source of Peoples Gas' pension asset is a combination of debt and equity investors – either through direct contributions (similar to ComEd) or through negative pension expense, a non-cash credit reducing cash flows producing a requirement to obtain investor funds to "pay" for other cash expenses. *Id*. Mr. Felsenthal adds that, in either case, the source of the prepaid pension asset is the investor, not the ratepayer, requiring a return on such investment. *Id*. Thus, the Utilities state that neither the Commission's decision in ComEd's 2005 rate case nor *ComEd 2005 Appeal* supports denying Peoples Gas a rate of return on its pension asset. NS-PGL Init. Br. at 44. Moreover, given the evidence in this case, the appropriate rate of return on the pension asset is the utility's overall cost of capital. *Id*.

For the same reasons that it is appropriate to include the pension asset in Peoples Gas' rate base, Mr. Felsenthal testifies that North Shore's pension liability should be included in its rate base. In fact, because Peoples Gas' pension asset, North Shore's pension liability, and the Utilities' OPEB liabilities each represent a commitment to pay retirees, either a pension or a promised health and welfare benefit, there is no reason to treat them differently. NS-PGL Ex. AF-1.0 at 23.

The Utilities state that their main position is that the accrued pension liability and pension asset, along with the OPEB liabilities, should be included in their respective rate bases. The Utilities state, however, that if the Commission concludes that the Peoples Gas pension asset should not be included in its rate base, then North Shore's pension liability should be excluded, and the Utilities' respective OPEB liabilities should be excluded. With respect to North Shore's accrued pension liability, Mr. Felsenthal notes that AG-CUB-City witness Mr. Effron agrees that there should be consistent treatment of Peoples Gas' pension asset and North Shore's pension liability and he does not consider either one in his calculation of the Utilities' rate bases. NS-PGL Ex. AF 1.0 at 21.

6. Commission Analysis and Conclusions

In order to include an asset in rate base, a utility must show that the asset was paid for with investor funds. A pension asset, which is created through contributions to the pension fund and/or negative pension expense, is no different. However, it is clear that contributions to the pension funds are made by the Utilities and are made not based upon the expense reflected in rates but upon ERISA rules and the IRC. The expense, calculated pursuant to FAS 87, is to pay for a particular period's pension cost, no more, no less. The Commission finds that the source of the funds that created Peoples Gas' pension asset is investors and not ratepayers. Therefore, Peoples Gas' pension asset should be included in its rate base.

Furthermore, because Peoples Gas' pension asset, North Shore's pension liability, and the Utilities' OPEB liabilities each represent a commitment to pay retirees, either a pension or a promised health and welfare benefit, the Commission finds that there is no reason to treat them differently. Therefore, North Shore's pension liability and the Utilities' OPEB liabilities should be included in rate base as well.

V. OPERATING EXPENSES

A. Overview/Summary/Totals

1. North Shore

North Shore proposes operating expenses and operating income figures of $67,004,000 and $16,301,000, reflecting adjustments proposed by Staff and intervenors that the utility agreed with or accepted in whole or in part and certain updates. NS-PGL Ex. SM-3.0 Rev. at 2, 3, *et seq*.; NS-PGL Ex. SM-3.1N (Sched. C-1); NS-PGL Ex. SM-3.2N (Sched. C-2); NS-PGL Ex. JFS-3.0 at 6; NS-PGL Ex. JFS-3.1.

North Shore supported its operating expenses primarily with the detailed testimony of six witnesses. NS-PGL Init. Br. at 45 (citing NS Ex. SM-1.0; NS Ex. SM-1.1; NS-PGL Ex. SM-2.0; NS-PGL Exs. SM-2.1N, SM-2.2N, SM-2.3N, SM-2.4N, SM-2.5N, SM-2.6N, SM-2.7N, SM-2.8N, SM-2.9N; NS-PGL Ex. SM-3.0 Rev.; NS-PGL Exs. SM-3.1N, SM-3.2N, SM-3.3N, SM-3.4N, SM-3.5N, SM-3.6N, SM-3.7N, SM-3.8N; NS Ex. CMG-1.0; NS Ex. CMG-1.1; NS-PGL Ex. CMG-2.0; NS PGL Exs. CMG-2.1N, CMG-2.2N, CMG-2.3N, CMG-2.4N, CMG-2.5N, CMG-2.6N; NS-PGL Ex. CMG-3.0; NS-PGL Exs. CMG-3.1N, CMG-3.2N; NS Ex. JJS-1.0; NS Ex. JJS-1.1; NS Ex. MAS-1.0; NS-PGL Ex. JCH-1.0; NS-PGL Ex. JCH-2.0; NS-PGL Ex. CMP-1.0; NS-PGL Exs. CMP-1.1, CMP-1.2, CMP-1.3).

The Commission approves North Shore's final revised operating expenses, subject to two revisions: first, the Commission does not approve Staff's proposed injuries and damages expenses, which were incorporated in North Shore's proposal made in an effort to narrow the issues (*see* Section(V)(C)(7)(a), *infra*); and, second, the operating expenses figure must be revised for the uncontested merger costs adjustment approved by the Commission (*see* Section (V)(B)(7)(n), *infra*). [***ALTERNATIVE (if the Commission approves North Shore's proposal to narrow the issues regarding injuries and damages expenses)***: The Commission approves North Shore's final revised operating expenses, subject to one revision, *i.e.,* the figure must be revised for the uncontested merger costs adjustment approved by the Commission (*see* Section (V)(B)(7)(n), *infra*).] North Shore is entitled to recover these costs (its operating expenses) as discussed below. The detailed evidence in the record warrants this conclusion.

2. Peoples Gas

Peoples Gas proposes operating expenses of $455,540,000, reflecting adjustments proposed by Staff and intervenors that the utility agreed with or accepted in whole or in part and certain updates. NS-PGL Ex. SM-3.0 Rev. at 2, 3, *et seq*.; NS-PGL

Ex. SM-3.1P (Sched. C-1); NS-PGL Ex. SM-3.2P (Sched. C-2); NS-PGL Ex. JFS-3.0 at 6; NS-PGL Ex. JFS-3.1.

Peoples Gas supported its operating expenses primarily with the detailed testimony of eight witnesses. PGL Ex. SM-1.0; PGL Ex. SM-1.1; NS-PGL Ex. SM-2.0; NS-PGL Exs. SM-2.1P, SM-2.2P, SM-2.3P, SM-2.4P, SM-2.5P, SM-2.6P, SM-2.7P, SM-2.8P, SM-2.9P, SM-2.10P. NS-PGL Ex. SM-3.0 Rev.; NS-PGL Exs. SM-3.1P, SM-3.2P, SM-3.4P, SM-3.5P, SM-3.6P, SM-3.7P, SM-3.8P, SM-3.9P, SM-3.10P; PGL Ex. CMG-1.0 Rev.; PGL Ex. CMG-1.1; NS-PGL Ex. CMG-2.0; NS-PGL Exs. CMG-2.1P, CMG-2.2P, CMG-2.3P, CMG-2.4P, CMG-2.6P; NS-PGL Ex. CMG-3.0; NS-PGL Exs. CMG-3.1P, CMG-3.2P; PGL Ex. JJS-1.0; PGL Ex. JJS-1.1; PGL Ex. MAS-1.0; NS-PGL Ex. JCH-1.0; NS-PGL Ex. JCH-2.0; NS-PGL Ex. ED-2.0; NS-PGL Ex. ED-3.0***;*** NS-PGL Ex. JFS-2.0; NS-PGL Ex. JFS-2.1; NS-PGL Ex. JFS-3.0, NS-PGL Ex. JFS-3.1; NS-PGL Ex. CMP-1.0; NS-PGL Exs. CMP-1.1, CMP-1.2, CMP-1.3; NS-PGL Init. Br. at 46-47 (citations).

The Commission approves Peoples Gas' final revised operating expenses, subject to two revisions: first, the Commission does not approve Staff's proposed injuries and damages expenses, which were incorporated in Peoples Gas' proposal made in an effort to narrow the issues (*see* Section(V)(C)(7)(a), *infra*); and, second, the operating expenses figure must be revised for the uncontested merger costs adjustment approved by the Commission (*see* Section (V)(B)(7)(n), *infra*). [***ALTERNATIVE (if the Commission approves Peoples Gas' proposal to narrow the issues regarding injuries and damages expenses)***: The Commission approves Peoples Gas' final revised operating expenses, subject to one revision, *i.e.,* the figure must be revised for the uncontested merger costs adjustment approved by the Commission (*see* Section (V)(B)(7)(n), *infra*).] Peoples Gas is entitled to recover these costs (its operating expenses) as discussed below. The detailed evidence in the record warrants this conclusion.

B. Uncontested Issues

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

a. The Record

The Utilities, Staff, AG, and CUB agree that the natural gas prices for the purposes of company use gas, uncollectibles expense, and North Shore's franchise gas should be updated based upon data in the Utilities' August 2009 Gas Charge filings. NS-PGL Ex. CMG-3.0 at 2-3; 5, 6; NS-PGL SM-Ex. 3.0 Rev. at 7-8; AG/CUB Ex. 4.0 at 9-10, 11, 12; Staff Ex. 27.0 at 17-19, 19-20; Tr. at 914-915.

b. Commission Analysis and Conclusions

The Commission finds that the use of the gas prices based on data in the Utilities' August 2009 Gas Charge filings to update the natural gas prices for purposes of company use gas, uncollectibles expense, and North Shore franchise gas to be reasonable.

2. Union Wages

a. The Record

Staff witness Ms. Dianna Hathhorn proposed to reduce the rate bases of North Shore and Peoples Gas by $15,000 and $98,000, respectively, and operating expenses of North Shore and Peoples Gas by $69,000 and $582,000 (before income taxes), respectively, to correct an error in calculating test year union wages at the non-union rate. Staff Ex. 1.0 at 29, Sched. 1.2 P, p. 1, Sched. 1.4 P, p. 1, Sched. 1.2 N, p. 1, col, and Sched. 1.4 N, p. 1. AG-CUB-City and the Utilities agreed. AG-CUB-City Ex. 1.0 at 17; NS-PGL Ex. SM-2.0 at 4, 5; NS-PGL Ex. JH-2.0 at 4. No witness opposed those adjustments.

b. Commission Analysis and Conclusions

The Commission finds that the adjustments to reduce the rate bases of North Shore and Peoples Gas by $15,000 and $102,000, respectively, and operating expenses of North Shore and Peoples Gas by $69,000 and $531,000 (gross amounts), respectively, are appropriate. Therefore, each of these amounts is approved.

3. Company Use Gas

a. The Record

AG-CUB's proposal to include North Shore's cost of company use gas for 2010 test year, which was inadvertently omitted from North Shore's direct testimony figures and Part 285 filing, is uncontested. AG-CUB-City Ex. 1.0 at 23; NS-PGL CMG-2.0, Sched. 2.6N.

b. Commission Analysis and Conclusions

The Commission finds that the inclusion in operating expenses of North Shore's cost of company use gas for 2010 test year is appropriate and uncontested. Thus, this amount is approved. For the discussion of the update of the gas price, *see* Section V(B)(1) of this Order, *supra*.

4. IBS Charges

a. The Record

AG-CUB's proposal to reduce the operating and maintenance expenses of North Shore and Peoples Gas by $360,000 and $7,493,000 (gross amounts), respectively, for test year 2010 for Integrys Business Support, LLC ("IBS") charges based on the Utilities' responses to Staff data request DLH 4.06 is uncontested. AG-CUB-City Ex. 1.0 at 16-17; NS-PGL Ex. SM-2.0 at 5.

b. Commission Analysis and Conclusions

The Commission finds that the adjustments to reduce the operating and maintenance expenses of North Shore and Peoples Gas by $360,000 and $7,493,000 (gross amounts), respectively, for the test year is appropriate and uncontested. Thus, these reductions are approved.

5. Distribution

a. Gasoline and Fuel

i. The Record

Staff witness Mr. Seagle originally proposed to decrease the Utilities' transportation fuel costs for the test year. Staff Ex. 13.0 at 13-17. The Utilities corrected and updated Staff's calculations. NS-PGL Ex. CMG-2.0 at 7. Mr. Seagle agreed with the revised adjustments. Staff Ex. 27.0 at 3. No witness disagreed.

ii. Commission Analysis and Conclusions

The Commission agrees with the Utilities and Staff that the test year fuel prices, as originally proposed, are higher than current prices. Therefore, the Commission approves the Utilities' correction and updates of these costs. The Utilities revised adjustments are approved.

6. Customer Accounts

a. Uncollectible Expense Except for AG-CUB Sales Revenues Adjustment – Related

i. The Record

There is no contested issue regarding uncollectibles expenses, except for the derivative impact on uncollectibles expenses resulting from AG-CUB's proposed adjustment to the Utilities' sales revenues, discussed in Section V(C)(5) of this Order.[9]

ii. Commission Analysis and Conclusions

The Commission finds that uncollectibles expense is uncontested, except for the derivative impact resulting from AG-CUB's proposed adjustment to the Utilities' sales revenues, discussed in Section V(C)(5) of this Order.

7. Administrative & General Expenses

[9] The only aspect of the determination of uncollectibles expenses as such that was at issue in these cases was the impact of natural gas prices, but the Utilities, Staff, and AG-CUB ultimately agreed to use of the LIFO prices from data in the Utilities' August 2009 Gas Charge filings, as discussed in Section V(B)(1), *supra*.

a. Account 921

i. The Record

Staff proposed adjustments to limit the amount of test year amount of Office Supplies and Expenses. Staff Ex. 3.0 at 8. The Utilities revised Staff's adjustments. NS-PGL Ex. CMG-2.0 at 4-5. Staff accepted the revisions. Staff Ex. 17.0 at 3. No witness opposed the revised adjustments.

ii. Commission Analysis and Conclusions

The Staff's adjustment as revised by the Utilities to limit the amount of test year Office Supplies and Expenses is appropriate and uncontested. Therefore, these revised adjustments are approved.

b. Interest on Budget Payment Plans

i. The Record

Staff's proposal to decrease operating and maintenance expenses of North Shore and Peoples Gas by $118,000 and $618,000, respectively, is uncontested. Staff Ex. 3.0 at 13-14; NS-PGL Ex. SM-2.0 at 5.

ii. Commission Analysis and Conclusions

The Commission finds Staff's adjustment to decrease operating and maintenance expenses of North Shore and Peoples Gas by $118,000 and $618,000, respectively, for test year interest expense on budget payment plan balances to be appropriate and uncontested. Thus, the adjustments are approved.

c. Interest on Customer Deposits

i. The Record

Staff witness Mr. Ostrander's proposal to decrease operating and maintenance expenses of North Shore and Peoples Gas by $85,000 and $950,000, respectively, is uncontested. Staff Ex. 3.0 at 14-16; NS-PGL Ex. SM-2.0 at 5.

ii. Commission Analysis and Conclusions

The Commission finds Staff's adjustments to decrease operating and maintenance expenses of North Shore and Peoples Gas by $85,000 and $950,000, respectively, for test year interest expense on customer deposits to be appropriate and uncontested. Thus, these adjustments are approved.

d. Lobbying

i. The Record

Staff's proposal to reduce operating and maintenance expenses of North Shore and Peoples Gas by $2,000 and $12,000, respectively, in order to disallow lobbying costs included in the dues paid by the Utilities is uncontested. Staff Ex. 6.0 at 3-4; NS-PGL Ex. SM-2.0 at 5.

ii. Commission Analysis and Conclusions

The Commission finds Staff's adjustment to reduce operating and maintenance expenses of North Shore and Peoples Gas by $2,000 and $12,000, respectively, in order to disallow certain lobbying costs to be appropriate and uncontested. Therefore, such reductions are approved.

e. Social and Service Club Dues

i. The Record

Staff's proposal to reduce operating and maintenance expenses of North Shore and Peoples Gas by $8,000 and $52,000, respectively, for certain service club membership dues is uncontested. Staff Ex. 6.0 at 4; NS-PGL Ex. SM-2.0 at 5.

ii. Commission Analysis and Conclusions

The Commission finds that Staff's adjustments to reduce operating and maintenance expenses of North Shore and Peoples Gas by $8,000 and $52,000, respectively, for certain service club membership dues to be appropriate and uncontested. Therefore, such reductions are approved.

f. Civic, Political, and Related Activities

i. The Record

Staff's proposal to reduce the rate bases of North Shore and Peoples Gas by $6,000 and $14,000, respectively, and their operating and maintenance expenses by $10,000 and $23,000 (gross amounts), respectively, for expenses associated with lobbying and related activities is uncontested. Staff Ex. 6.0 at 6-7; NS-PGL SM-Ex. 2.0 at 5; NS-PGL Ex. JH-2.0 at 4.

ii. Commission Analysis and Conclusions

The Commission finds that Staff's adjustments to reduce the rate bases of North Shore and Peoples Gas by $6,000 and $14,000, respectively, and operating and maintenance expenses for North Shore and Peoples Gas by $10,000 and $23,000 (gross amounts), respectively, for expenses inherent with lobbying and related activities that were included in the Civic, Political and Related Activities account to be appropriate and uncontested. Thus, these adjustments are approved.

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

i. The Record

Staff proposed an adjustment to reduce the operating expenses of Peoples Gas by $86,000 for non-union merit increases relating to the Utilities' response to Staff data request DLH 4.06. Staff Ex. 1.0, Schedule 1.8P, footnote (e). The Utilities agreed. NS-PGL Ex. SM-2.0 at 4. No witness opposed this adjustment.

ii. Commission Analysis and Conclusions

The Commission finds that Staff's adjustment to reduce the operating expenses of Peoples Gas by $86,000 for non-union merit increases to be appropriate and uncontested. Therefore, such adjustment is approved.

h. Liberty Audit Outside Contractor Fees (PGL)

i. The Record

Staff and AG-CUB proposed an adjustment to reduce Peoples Gas' operating and maintenance expense by $540,000 to remove the fees of certain consultants related to the Liberty Audit follow up work. Staff Ex. 1.0 at 32-33 and Sched. 1.13 P, line 1; AG-CUB-City Ex. 1.0 at 25. The Utilities agreed. NS-PGL Ex. SM-2.0 at 4, 5. No witness opposed this adjustment.

ii. Commission Analysis and Conclusions

The Commission finds that the adjustment to reduce Peoples Gas' operating and maintenance expense by $540,000 to remove the fees of Liberty Consulting Group and Huron Consulting Group related to the Liberty Audit follow up work to be appropriate and thus, is approved.

However, the Utilities continue to contest the remaining portion of Staff's adjustment related to the Liberty Audit, which is addressed at Section V(C)(4)(a) of this Order, *infra*.

i. Rate Case Expenses

i. The Record

Staff recommends that the Commission find the amounts expended by the Utilities for rate case expense in this proceeding are just and reasonable and consistent with Section 9-229 of the Public Utilities Act (220 ILCS 5/9-229). Staff Ex. 17.0 at 14-15. The Utilities agreed. NS-PGL Ex. SM-3.0 Rev. at 4.

AG-CUB witness Mr. Effron initially proposed an adjustment to reduce Peoples Gas' rate case expenses on the theory that there was a double counting of certain costs. AG-CUB-City Ex. 1.0 at 25-26. Utilities witness Ms. Moy explained and showed that there was no double counting. NS-PGL SM-2.0 at 8. Mr. Effron then agreed that his adjustment was not necessary. AG-CUB Ex. 4.0 at 11-12.

ii. Commission Analysis and Conclusions

The Commission finds that the amounts expended by the Utilities for rate case expense in this proceeding are just and reasonable and consistent with Section 9-229 of the Public Utilities Act (220 ILCS 5/9-229) assuming without deciding its applicability to rate cases pending on its enactment. Thus, these amounts are approved. Further, the Commission finds that the withdrawal of the AG-CUB adjustment to reduce Peoples Gas' rate case expense to be uncontested and correct. Therefore, we approve the withdrawal.

j. Franchise Requirements Expenses (NS)

i. The Record

AG-CUB proposed an adjustment to reduce North Shore's franchise requirement expenses. AG-CUB-City Ex. 1.0 at 26. Ms. Gregor updated the adjustment as discussed in Section V(B)(1), *supra*. NS-PGL Ex. CMG-2.0 at 8. Mr. Effron agreed with the updated adjustment. AG-CUB Ex. 4.0 at 12.

ii. Commission Analysis and Conclusions

The Commission finds that North Shore test year franchise requirement expenses should be updated as agreed. Thus, North Shore's revised adjustment is approved.

k. Regulatory Asset – Welfare

i. The Record

Staff and AG-CUB proposed adjustments to the amortization of regulatory assets for welfare costs, which the Utilities accepted. NS-PGL Ex. SM-3.0 Rev. at 1, 2, 4. No witness opposed those adjustments as corrected and updated.

ii. Commission Analysis and Conclusions

The Commission finds the Utilities' revised adjustments for the amortization of regulatory assets for welfare costs to be appropriate and uncontested. Therefore, these amounts are approved.

l. Regulatory Asset – Pension

i. The Record

Utilities witness Ms. Moy proposed corrected adjustments relating to the amortization of regulatory assets for pension costs. NS-PGL Ex. SM-3.0 Rev. at 6-7. The adjustments are uncontested.

ii. Commission Analysis and Conclusions

The Commission finds the Utilities' adjustments for the amortization of regulatory assets for pension costs to be appropriate and uncontested. Therefore, these amounts are approved.

m. Employee Benefits Update

i. The Record

The Utilities provided updated 2010 test year numbers for the Utilities' respective pension and benefits expenses figures in their operating expenses. NS-PGL Ex. CMP-1.0 (in its entirety). No witness opposed those updates.

ii. Commission Analysis and Conclusions

The Commission finds that the updated 2010 test year numbers for the Utilities' respective pension and benefits expenses figures in their operating expenses to be appropriate and uncontested. Thus, these amounts are approved.

n. Merger Costs and Savings

i. The Record

Staff proposed adjustments to reconcile the most recent actual and projected Costs to Achieve with the total recovery of merger costs since the effective date of the tariffs approved in Peoples Gas' and North Shore's last rate cases. Staff Ex. 2.0 at 7. In rebuttal, Staff revised the adjustments. Staff Ex. 16.0 at 16-18. In surrebuttal testimony, Ms. Moy agreed with Staff's calculations to reconcile total merger costs expected to recover with actual costs incurred but using July 31, 2009 forecast data in NS-PGL Exs. SM 3.8N and SM-3.8P. NS-PGL Ex. SM-3.0 Rev. at 6. Staff agreed with the revised adjustments in NS-PGL Cross Ex. Pearce 25. No contested issue remains.[10]

ii. Commission Analysis and Conclusions

The Commission finds that Staff's revised adjustments to merger costs as presented in NS-PGL Cross Ex. Pearce 25 to be appropriate and uncontested. Therefore, these amounts are approved.

8. Depreciation

a. Inventory Reclassification

i. The Record

[10] Because they were not reflected in NS-PGL Exs. SM-3.1N and SM-3.1P, Revised Schedules C-1, and NS-PGL Exs. SM-3.2N and SM-3.2P, Revised Schedules C-2, the adjustments should be were nt reflected in the Utilities' overall Surrebuttal revenue requirement figures but they should be reflected accordingly in this final Order . NS-PGL Ex. SM-3.0 Rev. at 6.

Staff witness Ms. Hathhorn's proposal to reduce the operating expenses of North Shore and Peoples Gas by $2,000 and $18,000, respectively, in order to reflect the impact of inventory reclassifications is uncontested. Staff Ex. 1.0 at 30, Scheds. 1.11 N and 1.11 P; NS-PGL Ex. SM-2.0 at 4.

ii. Commission Analysis and Conclusions

The Commission finds that the reduction of the Utilities' operating expenses to reflect the impact of the inventory reclassifications to be appropriate and uncontested. Thus, the adjustments are approved. See also Section IV(B)(3)(a) of this Order, *supra*.

b. IBS Mainframe

i. The Record

AG-CUB's proposal to amortize the remaining book value of the IBS mainframe server as of the beginning of 2010 over three years is uncontested. AG-CUB-City Ex. 1.0 at 24- 25; NS-PGL Ex. SM 2.0 at 5.

ii. Commission Analysis and Conclusions

The Commission finds the amortization of the remaining book value of the IBS mainframe server beginning in 2010 over three years to be appropriate and uncontested. Therefore, it is approved.

9. Taxes Other Than Income Taxes

a. Real Estate Taxes

i. The Record

Staff's proposal to decrease the expense for real estate taxes of North Shore and Peoples Gas by $45,000 and $207,000, respectively, to reflect actual 2008 real estate taxes is uncontested. Staff Ex. 5.0 at 4-6; NS-PGL Ex. SM-2.0 at 5.

ii. Commission Analysis and Conclusions

The Commission finds Staff's adjustment to decrease the Utilities' expense for real estate taxes to be appropriate and uncontested. Therefore, the adjustment is approved.

10. Revenues

a. Accounting Charge Revenues

i. The Record

The Utilities propose that the natural gas prices for the purposes of the accounting charge revenues be updated based upon the data in the Utilities' August

2009 Gas Charge Filings, as with the other items adjusted based on natural gas prices. NS-PGL Ex. 3.0 Rev. at 8. This is uncontested.

ii. Commission Analysis and Conclusions

The Commission finds that the Utilities' proposal to update the accounting charge revenue for natural gas prices data in their August 2009 Gas Charge Filings to be appropriate and uncontested; thus, it is approved.

11. GRCF

a. The Record

The Utilities' Gross Revenue Conversion Factors (the amounts by which the rate increases must be increased for income taxes and uncollectibles to allow recovery of the costs of service) are uncontested. NS Ex. SM-1.1 at Sched. A-2; PGL Ex. SM-1.1 at Sched. A-2. Staff's Initial Brief contained a very slight discrepancy in terms of rounding of the factor for North Shore to fewer digits, but the factors remain uncontested.

b. Commission Analysis and Conclusions

The Commission finds that the Utilities' Gross Revenue Conversion Factors to be appropriate and uncontested, and thus, they are approved.

C. Contested Issues

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

a. Staff

[Insert]

b. AG

[Insert]

c. CUB-City

[Insert]

d. North Shore and Peoples Gas Response

The Utilities maintain that the disallowances proposed by Staff and AG-CUB would deny the Utilities recovery of prudent and reasonable expenses, are not in the long-term interests of customers, and are not lawful.

The Utilities note that no witness challenged the testimony of the Utilities' witness, James Hoover, the Director of Compensation of the Utilities' ultimate parent company, with over 25 years of experience in human resources, regarding the prudence and reasonableness of the Utilities' total compensation levels and each of the incentive compensation plans at issue. The Utilities state that the uncontradicted testimony established, among other things, that: (1) the Utilities design their total cash compensation packages (base pay plus target incentive pay) at market median based on other energy service companies based on data from Towers Perrin, a nationally recognized compensation and benefits firm; (2) the Utilities design their total compensation programs, including their incentive compensation programs, in order to attract and retain a sufficient, qualified, and motivated work force; and (3) attracting and retaining such a work force benefits customers by making sure there are enough employees to perform needed work, by maintaining and improving the quality of work, and reducing the expenses associated with recruiting and retaining new employees. *E.g.,* NS-PGL Ex. JCH-2.0 at 6-8. The Utilities further explain that, even in today's economic environment, the Utilities' approach is prudent and reasonable, and that the alternative of moving more compensation to base pay would put them at a disadvantage in the labor market. NS-PGL Ex. JCH-2.0 at 7. Mr. Hoover's testimony also established, among other things, that:

- The Utilities have submitted testimony and evidence establishing that the "financial" metrics of the non-executive and executive plans are net income metrics. Net income metrics have both a cost side and a revenue side. Even though the Commission has not approved net income metrics in prior cases, it has approved cost control and cost reduction metrics.[11] So, logically, the costs tied to net income metrics should be allowed.

- The operational measures "behind" the financial measures in the non-executive plan have direct benefits to customers, such as reducing system leaks.

- The targets are set each year to motivate employee behavior and are considered achievable stretch goals designed to motivate employee achievement from a competitive level to an outstanding level.

- The metrics involving achievements by affiliates benefit Illinois customers, because it encourages the sharing of best practices.

NS-PGL Ex. JCH-1.0 at 3-8; NS-PGL Ex. JCH-2.0 at 2-4.

[11] The Commission repeatedly has recognized that incentive compensation programs that reward employees for controlling or reducing costs benefit customers. *See, e.g., In re Commonwealth Edison Co.*, ICC Docket No. 01-0423, at 129 (Order March 28, 2003); *In re Consumers Illinois Water Co.*, ICC Docket No. 03-0403, at 14-15 (Order April 13, 2004); *In re Northern Illinois Gas Co.*, ICC Docket No. 95-0219, 1996 Ill. PUC Lexis 204, *62 (Order April 3, 1996).

In regard to Staff's and AG-CUB's arguments regarding stock plans, the Utilities maintain that stock plans are an important part of the overall total compensation package, again are designed to help attract and retain a qualified and motivated work force, and that without them the Utilities' compensation packages would be less competitive because their labor market competitors, both energy and non-energy companies, offer compensation packages that include base pay, incentive pay, and stock plans. NS-PGL Ex. 1.0 at 9; NS-PGL Ex. 2.0 at 4.[12]

The Utilities submit that the cross-examination of Staff's witness showed that the application of the Commission's past standards is illogical and unreasonable. Even when the total compensation paid to employees is prudent and reasonable, the Utilities maintain that the application of the Commission's past decisions would result in arbitrary and illogical selective disallowances depending on the metrics of the incentive portions of the compensation. Tr. at 719-727. Further, the Utilities note that such a determination based on metrics also makes no sense because Staff's witness admitted that the fact that a metric benefits shareholders does not necessarily mean that it is contrary to the interests of customers, and that if a metric benefits both shareholders and customers that does not mean shareholders should bear all of the costs associated with the metric. Tr. at 714 – 715.

The principle that a utility should recover its prudent and reasonable costs of service is well-established. For example, in *CUB*, the Supreme Court of Illinois stated that:

> A public utility is entitled to recover in its rates certain operating costs. *(*<u>Citizens Utilities Co. v. Illinois Commerce Comm'n</u> *(1988), 124 Ill.2d 195, 200-01, 124 Ill.Dec. 529, 529 N.E.2d 510*.) In setting rates, the Commission must determine that the rates accurately reflect the cost of service delivery and must allow the utility to recover costs prudently and reasonably incurred. (220 ILCS 5/1-102(a)(iv) (West 1992).)

CUB, 116 Ill. 2d at 121.

It is settled law, moreover, that employee salaries are operating expenses and, as such, are recoverable in full so long as they are prudent and reasonable. *See, e.g.,* <u>Villages of Milford v. Illinois Commerce Comm'n</u>, 20 Ill. 2d 556, 565 (1960) ("*Milford*").

The Utilities state that in their 2007 rate cases, the Commission approved the Utilities' incentive compensation costs associated with two of their five plans. *Peoples 2007* at 66-67. The allowed costs were (1) the costs associated with the 45% of the non-officers "TIA" plan metrics that were "operational" and (2) all of the costs associated with the individual performance bonus plan. *Id*. The Utilities note that, as to the compensation costs disallowed in their 2007 rate case, the disallowance of the other costs is pending on appeal by the Utilities.

[12] As to the fourth costs "bucket", Mr. Hengtgen made the point that the capitalized amounts disallowed under the Order in the 2007 rate cases are on appeal. NS-PGL Ex. JH-2.0 at 16.

According to the Utilities, in the 2005 ComEd rate case (ICC Docket No. 05-0597), the Commission allowed the utility to recover half of its incentive compensation costs. *In re Commonwealth Edison Co.*, ICC Docket No. 05-0597 (Order July 26, 2006) ("*ComEd 2005*") at 95-97. ComEd appealed and the Illinois Appellate Court for the Second Judicial District recently affirmed. *ComEd 2005 Appeal* at 9-14.

The Second District, as the Utilities observe, noted established law on a utility's recovery of its prudent and reasonable costs, adding that the costs must pertain to the utility's tariffed services, citing DuPage Util. Co. v. Illinois Commerce Comm'n, 47 Ill. 2d 550, 560 (1971) ("*DuPage*"), which distinguished *Milford. ComEd 2005 Appeal* at 10-11. In *DuPage,* the Court, in affirming the disallowance of half of the salaries of three company officers of a utility with 840 customers, distinguished *Milford*. In *DuPage*, however, the Commission found and the evidence supported that the salaries were excessive rather than reasonable, including evidence that the officers only worked part-time and maintained only a minimal contact with the utility's day to day operations, and their salaries were disproportionately high in relation to comparable utilities. *DuPage*, 47 Ill. 2d at 560. According to the Utilities, there is no claim, much less any evidence, of excessive compensation on those or any other grounds in the instant cases. Rather, the Utilities state that the only evidence is to the contrary. The Second District also cited Candlewick Lake Utilities Co. v. Illinois Commerce Comm'n, 122 Ill. App. 3d 219, 226 (2d Dist. 1983) ("*Candlewick*"). *ComEd 2005 Appeal* at 14. *Candlewick* involved the salary of one company officer, "the Commission noted that it based its decision on the unusual circumstances of an absent non-resident president, the past financial difficulties of the utility including a bankruptcy reorganization, the presence of various management and clerical employees to run the day-to-day operations of the utility, and the fact that the president's duties are undocumented." *Candlewick*, 122 Ill. App. 3d at 226. Again, the instant cases do not involve any claim, much less evidence, of any such circumstances.

Moreover, the Utilities respectfully contend that the circumstances and holdings of *DuPage* and *Candlewick*, where the Commission and the Appellate Court relied on evidence that the employees were not performing work for the utilities and evidence of excessive compensation, support the conclusion that the Commission incentive compensation cost recovery standards are lawful where the evidence is that total compensation is prudent and reasonable and there is no claim, much less evidence, of the kinds of circumstances involved in *DuPage* and *Candlewick*. Thus, the Utilities contend that the Second District's opinion is not consistent with the Illinois Supreme Court's decisions holding that a utility is entitled to recover its prudent and reasonable costs, such as *CUB*.

Finally, the Utilities point out that the Second District relied on the fact that the Commission had approved half of ComEd's incentive compensation costs:

> If we were deciding this issue in a vacuum, we might agree with ComEd. However, in this case, three other performance-based components of the incentive plan existed. Thus, the Commission could have reasonably concluded that the earnings-per-share portion of the plan

> provided only a tangential benefit to ratepayers. Indeed, the Commission characterized this portion of the incentive plan as "generic and broad" in contrast to the other three more specific components. Moreover, precedent exists for apportioning employee compensation costs between equity holders and ratepayers where an employee's duties only partially benefit ratepayers. See Candlewick Lake Utilities Co., 122 Ill. App. 3d at 226. Meischeid's testimony that such plans benefit everyone necessarily entails the proposition that they provide only some benefit to customers and thus provides an adequate basis for the Commission's decision to apportion these costs. Moreover, the notion that an earnings-per-share-based employee incentive plan provides benefits to shareholders is hardly a controversial proposition.

ComEd 2005 Appeal at 14.

Here, Staff proposes to disallow almost 100% of the Utilities' incentive compensation costs (even though they include some operational metrics, such as system leak reductions). Thus, the "tangential benefit" and "apportionment" reasoning of the Second District does not apply here.

e. Commission Analysis and Conclusions

The Utilities presented uncontested evidence that their total compensation levels and the designs of their incentive compensation plans are prudent and reasonable from an operational perspective, help attract and retain a sufficient and qualified workforce, and help reduce recruiting and retention costs. While the Utilities present evidence supported by an expert in human resources, neither the Staff witness nor the AG-CUB witness is an expert on human resources. Although the Commission continues to find the benefits to customers of attracting and retaining such a work force to be a very general benefit to customers, it cannot be denied that it is a benefit given the evidence in the record. The Commission also finds that, while net income metrics are "financial" under our past decisions, they do involve a cost control / reduction side as well as a revenues side, so they have both shareholder and customer benefits. The Utilities' evidence on the plans' encouraging the sharing of best practices among affiliates, while also general, has not been contested by any other testimony. The evidence also shows that the Utilities set their targets in a reasonable manner. Moreover, if the system leak target recently was not achieved, that demonstrates not only that the plans include some operational metrics but that it is reasonable to give incentives for reducing system leaks to encourage achieving the target peformance.

It is a settled general principle that employee salaries are operating expenses and, as such, are recoverable in full so long as they are prudent and reasonable. *See, e.g., Milford*, 20 Ill. 2d at 565. That principle does not apply when circumstances like those of *DuPage* or *Candlewick* are shown or when the evidence otherwise shows that compensation is excessive (and, therefore, is not reasonable). The *DuPage* and *Candlewick* cases, however, involve circumstances that no party contends apply here. The evidentiary record is to the contrary.

The Commission also is concerned that, despite its having approved a substantial amount of incentive compensation cost recovery for the Utilities in their 2007 rate cases, Staff proposes to disallow almost 100% of the Utilities' incentive compensation costs in the instant cases. The "tangential benefit" and "apportionment" reasoning of the Second District opinion in the ComEd 2005 appeal does not apply to the Staff proposal. Moreover, Staff proposes near-complete disallowances even though the plans include some "operational" metrics, such as metric tied to system leak reductions. The Commission also is troubled that the evidence shows that Staff's application of the Commission's standards leads to illogical and inconsistent results, as well as to complete disallowances even when customer benefits are shown.

The Commission accordingly finds, based on the evidence in the record in these consolidated Dockets, that Staff's and AG-CUB's proposed adjustments should not be adopted. The Commission finds based on the evidence of the instant cases that the Utilities' costs at issue are prudent and reasonable, and they benefit customers in multiple respects.

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

a. Staff

[Insert]

b. North Shore and Peoples Gas Response

The Utilities agree to certain reductions in the Utilities' non-union base wages that they accepted in their rebuttal testimony. Staff appropriately proposed, based on data request responses of the Utilities, to reduce non-union base wages in charges from Integrys Business Support to the Utilities (the reductions were among the cost control measures adopted in light of the economic downturn) and to make a correction that reduced Peoples Gas' non-union base wages. The Utilities accepted and incorporated those reductions in their rebuttal testimony. NS-PGL Ex. SM-2.0 at 4 and fn. 3. That was discussed in Section V(B)(7)(g) of this Order, *supra*.

However, the Utilities do not agree with the further proposals by Staff to reduce even further both Peoples Gas' and North Shore's non-union base wages.

The Utilities state that it was inappropriate to retroactively look back on the February 2009 increases based on general CPI data from May 2009, and that the lower level of wage increases that Staff hypothesizes would result in non-competitive salaries. *NS-PGL Ex JCH-2.0* at 5.

The Utilities submit that Staff's proposal also is flawed as to both 2009 and 2010 because of its reliance on general CPI information and its rejection of labor market data. According to the Utilities, reliance on that general CPI data for this purpose is not realistic given the facts of these cases. NS-PGL Ex. JCH-2.0 at 9. The Utilities provide forecasts relying on market data provided by the World at Work 2008-2009 Salary

Budget Survey and input from Towers Perrin human resources consultants, subject to the reductions made as part of the cost control measures. *Id*. at 9-10. The Utilities observe that the World At Work Salary Budget Survey is a well-known compensation tool that reports results of annually surveyed information on planned increases for the following budget year. The Utilities maintain that the use information submitted by corporations in all industries and reported in the aggregate to assist in corporate salary budget planning. *Id*. at 10. According to the Utilities, there is no valid basis for rejecting labor market data actually used by the Utilities in making human resources decisions and supported by a human resources expert in favor of general CPI information supported by a witness who is not an expert in this subject. The Utilities state that the fact that the Commission, based on other evidentiary records, has relied on general CPI information in other cases in determining salaries and wages adjustments (Staff Ex. 15.0 at 20) is not a reasonable basis for doing so given the evidence in the instant cases.

Further, the Utilities maintain that the evidence that increases proposed by Staff for both 2009 and 2010 would result in non-competitive salaries is uncontradicted. NS-PGL Ex. JCH-1.0 at 10; NS-PGL Ex. JCH-3.0 at 5.

c. Commission Analysis and Conclusions

Staff's proposal as to the 2009 step is erroneous and unreasonable. Staff proposes to escalate the Utilities' 2009 non-union base wages from 2008 actual levels based on general Consumer Price Index ("CPI") inflation data that became available in May 2009, but the Utilities increased their non-union base wages for 2009 in February 2009, three months before Staff's data became available. NS-PGL Ex. JCH-2.0 at 5. Staff's proposal for further reductions in the Utilities' non-union base wages, beyond those accepted in the Utilities' rebuttal testimony, is not justified and should be rejected.

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

a. Staff

[Insert]

b. AG

[Insert]

c. CUB-City

[Insert]

d. North Shore and Peoples Gas Response

The Utilities maintain that AG-CUB's "trend line" analysis, without more, cannot overcome Peoples Gas' testimony indicating that it would be hiring more employees. Aside from the budget, Peoples Gas' Vice President of Gas Operations testified that

Peoples Gas had specific plans to bring on new employees, in large part to comply with Commission orders. NS-PGL Ex. ED-2.0 at 6-7. According to the Utilities, as to Peoples Gas, 36 of the 47 new employees will directly relate to addressing the safety recommendations of Liberty Consulting in their August 2008 report. *Id*. Since June 2009 (and therefore post-dating the information on which AG-CUB relied), Peoples Gas stated in its surrebuttal testimony that it had hired 27 new Operations Apprentices and 5 new Operations Specialists, and was interviewing additional candidates. NS-PGL Ex. ED-3.0 at 3-4. This demonstrates, Peoples Gas explains, that Peoples Gas' forecast is realistic and that it is not going to ignore the Liberty recommendations. As to North Shore's headcount, North Shore states that its planned headcount and AG-CUB's prediction is only three employees, amounting to a disallowance of $137,000. AG-CUB-City Ex. 1.0 at 19. *See* Staff Ex. 15.0 at 31-32. The Utilities note that the Commission rejected AG-CUB's proposed headcount adjustment in *In re Northern Illinois Gas Co*., ICC Docket No. 08-0363 ("*Nicor 2008*") at 36-37 (Order March 25, 2009).

e. Commission Analysis and Conclusions

The Commission finds that the evidentiary record does not support the AG-CUB proposed headcount adjustments for either Peoples Gas or North Shore. The AG-CUB proposal is based on certain assumptions, which lack further support. In fact, Peoples Gas has submitted evidence of actual headcount increases that show the AG-CUB's assumptions to be incorrect. The difference as to North Shore is very limited and insufficient reason has been shown for differing from the utility's forecast. Therefore, the Commission rejects the AG-CUB proposal regarding headcount adjustments.

4. Distribution Expenses

a. Liberty Audit-Related Expenses (PGL)

i. Staff

[Insert]

ii. North Shore and Peoples Gas Response

Peoples Gas submits that the Staff's proposal should be rejected for two reasons. First, Peoples Gas maintains that the record is clear that Peoples Gas did not include any such incremental costs due to untimely corrosion inspections or Pipeline Safety Act violations in its test year operating expenses. *See* NS-PGL Ex. ED-2.0 at 7. Second, Peoples Gas states that the disallowance is "based" on an arbitrary figure.

In *Illinois Commerce Comm'n on its Own Motion v. The Peoples Gas Light and Coke Co*., ICC Docket No. 06-0311 (Order Dec. 20, 2006), the Commission found that Peoples Gas needed to improve its corrosion protection activities. The case ended with a stipulation between Peoples Gas and Staff that formed the basis for the Commission's final Order. Using the agreed language from the stipulation, the Commission held, in relevant part, as follows:

> 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.

Final Order, ICC Docket No. 06-0311, Ordering Paragraph 11.

According to Peoples Gas, in response to Staff's allegations in ICC Docket No. 06-0311 and to the Commission's order, Peoples Gas undertook to improve its corrosion protection program, among other things hiring additional staff with better and more specific training. Staff Ex. 23.0 at 9–10; NS-PGL Ex. ED-3.0 at 8–9. Peoples Gas notes that both the Staff and Peoples Gas witnesses agreed that these steps have improved Peoples Gas' compliance with the Pipeline Safety Act. Tr. at 942–945; NS-PGL Ex. ED-3.0 at 8. Neither witness, observes Peoples Gas, cited any outages, reliability problems, fires, explosions, leaks, or other similar problems caused by Pipeline Safety Act violations since the final order in Docket 06-0311. Peoples Gas witness Mr. Doerk said it would definitely come to his attention as head of operations if such problems occurred, and he affirmatively stated that there were no such events. NS-PGL Ex. ED-2.0 at 7–8; Tr. at 639-640.

Peoples Gas submits that the only costs incurred were the reasonable and prudent costs of complying with the Pipeline Safety Act. NS-PGL Ex. ED-2.0 at 7; NS-PGL Ex. ED-3.0 at 7. Peoples Gas notes that for each of the things cited by Mr. Burk as a violation based on the findings of the Liberty Audit, Mr. Burk agreed that Peoples Gas addressed those violations using reasonable means to comply with the Pipeline Safety Act. Tr. at 942-945. Peoples Gas maintains that what it did not do was to let the problems go, leading to incremental costs attributable to violations.

Peoples Gas disagrees with Staff witness Ms. Hathhorn's conclusion that the Commission's Order in ICC Docket No. 06-0311 required that Peoples Gas develop a tracking mechanism even if there were no relevant costs to track. Peoples Gas states that if relevant costs were incurred a tracking mechanism would have been instituted. Peoples Gas submits that there is no evidence in the record to support a need for a tracking mechanism or any such disallowance,[13] or suggesting a relationship between all distribution costs and the costs covered by the stipulation in ICC Docket

[13] Peoples Gas and Staff do agree on one cost that should be excluded from test year operating expenses. Peoples Gas spent $540,000 on fees to consultants that were erroneously included in the operating expenses in Peoples Gas' initial filing. That was corrected in the Utilities' rebuttal. *See* Section V(B)(7)(h), *infra*.

No. 06-0311. Peoples Gas also notes that whereas Mr. Burk is the architect and chief enforcer of the Commission's Order in ICC Docket No. 06-0311 (Tr. at 939-940), Ms. Hathhorn is an accountant. According to Peoples Gas, it is clear from her testimony that she misunderstood the scope of the expenses to be excluded under the order as she erroneously described her disallowance as "costs to come into compliance with the Liberty audit findings," "test year costs resulting from the Liberty Audit," and "costs to comply with the Liberty Audit." Staff Ex. 1.0 at 34-35. Further, Peoples Gas observes that Mr. Burk agreed that Peoples Gas could incur costs to come into compliance, but so long as those costs were reasonable and prudent, they would not be disallowed. Tr. at 941-942.

iii. Commission Analysis and Conclusions

Both Staff witness Mr. Burk and Peoples Gas interpret their 2007 stipulation, and the Commission's order in that case, the same way. If Peoples Gas did have something go wrong, due to a violation of the Pipeline Safety Act, and it cost incremental money to fix it, that money would have to be tracked. However, there were no such incremental costs. If Peoples Gas acted prudently and reasonably to come into compliance, for example by hiring extra inspectors, the salaries of those inspectors would *not* need to be tracked and excluded. The clear and undisputed evidence is that the only costs Peoples Gas incurred were the reasonable and prudent costs of complying with the Pipeline Safety Act. Accordingly, there were no incremental expenses to track, and no incremental expenses to exclude from test year operating expenses.

Staff witness Ms. Hathhorn's interpretation of the stipulation in the 2007 rate case lacks support. The stipulation did not establish a requirement for Peoples Gas to develop a tracking mechanism if there were not costs to track. There is no evidence in the record to support a need for a tracking mechanism or any such disallowance or suggesting a relationship between all distribution costs and the costs covered by the stipulation in ICC Docket No. 06-0311. The Commission finds that given the evidentiary record, no disallowance is proper as there were no incremental costs to track and disallow.

5. Customer Accounts

a. Uncollectibles Expense Related to Sales Revenues Adjustment

AG-CUB witness Mr. Effron's proposed adjustments to increase the Utilities' forecasted sales are not approved, as discussed in Section V(C)(5)(a), *infra*. If the Commission were to adopt those adjustments, then the Utilities' uncollectibles expense figures would need to be increased to reflect the hypothesized increased sales, as discussed in that Section, but that is moot.

6. Customer Service and Information

a. Advertising (Agreed in Part)

i. Staff

[Insert]

ii. North Shore and Peoples Gas Response

Utilities witness Ms. Moy testifies that the Utilities agree with Staff's adjustment in part. She testifies that certain advertising expenses identified by Staff could be considered of a promotional, goodwill or institutional nature. NS-PGL Ex. SM-2.0 at 6. Therefore, North Shore and Peoples Gas do not oppose the portion of Staff's adjustment disallowing the recovery of $87,000 and $198,000 from operating expenses related to advertising costs. *Id*. at 7. However, Ms. Moy testifies that she objects to the disallowance of advertising expenses related to the Utilities' Safety, Reliability and Warmth Campaign ("SRW Campaign"), because contrary to Staff's opinion, the purpose of the campaign is not promotional in nature. *Id*.

Ms. Moy states that the SRW Campaign was developed to strengthen customer awareness about the delivery services and direct customer benefits provided by the Utilities. NS-PGL Ex. SM. 2.0 at 7. Focusing on the words "Safety", "Reliability", and "Warmth", the campaign not only provides customers with service information that is made easily and readily available to them, it educates customers on three 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. *Id*. Ms. Moy testifies that Staff acknowledges that there are items of energy education presented in the SRW Campaign. NS-PGL Ex. SM-3.0 at 5. She adds that the type of creative communication strategy used in the SRW Campaign is intended to catch customers' attention particularly on energy efficiency management and customers billing options available to fit their budget and lifestyle needs. *Id*. Ms. Moy states that communicating messages to customers on energy conservation and payment plan programs lets them know that they have options and control in how they manage their bills and energy usage. She concludes that the Utilities would still incur these costs even if the SRW Campaign did not exist because the Utilities take an active approach to educate customers on the services available to them and their role on the importance of reliable and safe delivery of natural gas service. *Id*. at 6.

iii. Commission Analysis and Conclusions

The Commission finds that Staff's adjustments disallowing the recovery of $87,000 and $198,000 of advertising expenses of North Shore and Peoples Gas, respectively, to be appropriate and uncontested, and those adjustments are approved.

With respect to the Utilities' SRW Campaign, the Commission finds that the Campaign is not promotional in nature. The Campaign provides important energy education to customers regarding the conservation/management of home natural gas use, billing and payment information and safety. The Commission believes that it particularly important that customers become educated with respect to energy efficiency management and billing options available to fit their budget and lifestyle needs.

Therefore, Staff's adjustment with respect to the SRW Campaign is rejected. The advertising expenses related to the SRW Campaign are appropriate for recovery.

7. Administrative & General

a. Injuries and Damages Expenses

i. Staff

[Insert]

ii. North Shore and Peoples Gas Response

In response, the Utilities state that Staff's "normalization" proposal, which seeks to substitute Staff's averages for the Utilities' forecasts of injuries and damages expenses, is unwarranted and should not be adopted, for four reasons.

First, the Utilities explain that although the specific numbers have changed, and we deal with a future test year in the present case, the Commission is presented with much the same evidentiary record on the subject of injuries and damages expenses as it was in 2007 Peoples Gas and North Shore rate cases, in which it rejected Staff's proposed adjustments. The Utilities note that the Commission there found as follows:

> (4) Commission Analysis and Conclusion
>
> We see from the record that depending on the time periods selected for normalizing, the results will either be fairly representative or skewed. While this Commission has accepted 5-year averaging in other cases, this is obviously not a hard and fast rule. It is always necessary, when gathering any periods of data, to further apply sound and reasoned judgment. Here, we are not persuaded by the correctness of using 5 years of data for reasons that one of these years, i.e., 2002, is clearly and unmistakably different from the others. Further, we perceive that something is inherently wrong in the selection when the results change so drastically when either 3 or 4 year data is considered. So too, we are not convinced that Staff's normalization required the complex methodology that it applied especially where plain averaging has been utilized in past cases. And, we see that the use of averaging also would have produced different results. For all these reasons, and because we are not persuaded that normalization was ever required in this instance, we reject Staff's proposed adjustments.
>
> In the final analysis, the Commission finds that North Shore and Peoples Gas used the correct levels of injuries and damages expenses in calculating their revenue requirements. North Shore appropriately used its unadjusted test year level. Peoples Gas appropriately used its test year level, adjusted for a highly unusual credit recorded in fiscal year 2006

relating to a major claim that occurred in fiscal year 2002. No adjustments need be made.

Peoples 2007 at 57.

According to the Utilities, the only real change on this subject from the prior cases is that the Utilities, in an attempt to narrow the issues, have offered to accept Staff's revised figures for injuries and damages expenses if consistent changes to the reserves for injuries and damages in rate base also are made.[14]

The Utilities submit that, as in Peoples Gas' and North Shore's 2007 rate cases, Staff has failed to show that that any "normalization" of injuries and damages expenses was required in the first place. Similarly, in the instant cases, the Utilities maintain that the figures and averages for the last five years (see the following table) on their face do not support normalization. Rather, the Utilities state, they show that the amounts determined by the Utilities' forecasting process are reasonable, as illustrated by the Utilities comparison of Actual Claims Payment data. NS-PGL Ex. CMG-2.0 at 3-4.

Actual Claims Payments Data*		
	Peoples Gas	North Shore
2004	$6,032,000	$867,000
2005	$3,250,000	$735,000
2006	$5,472,000	$541,000
2007	$4,766,000	$586,000
2008	$6,877,000	$465,000
Five Year Average for 2004 to 2008 Not Escalated for Inflation	$5,279,000	$639,000
Five Year Average for 2004 to 2008 Escalated for Inflation in 2009 and 2010 Only	$5,590,000	$676,000
Utilities' Forecasted Amounts for 2010	$6,454,000	$835,000

*All figures are from Staff Ex. 17.0 at Sched. 17.2 N, p. 2., and Sched. 17.2 P, p. 2.

Second, the Utilities submit that Staff's decision to base its proposal on five year averages of actual claims payments for 2004 to 2008 is arbitrary, because the selected period lacks any foundation. The Utilities maintain that Staff offered as its sole reason for selecting that data and period that the methodology of using the average of actual

[14] In fact, the Utilities' surrebuttal rate base, revenue requirement, and revenue deficiency calculations incorporate Staff's revised figures for their injuries and damages expenses adjustments along with the consistent changes to the reserves. NS-PGL Ex. JH-3.0 at 2:, 3, 11: - 12; NS-PGL Ex. SM-3.0 at 1, 2, 4. The Utilities state, therefore, that if the Commission does not adopt Staff's proposal, then both sets of adjustments need to be backed out of the Utilities' numbers. That is correct.

claim cash payments over the most recent five years to "normalize" injuries and damages expenses was approved in In re Central Illinois Light. Co. d/b/a AmerenCILCO, et al., ICC Docket Nos. 06-0070, 06-0071, 06-0072 Cons. (Order Nov. 21, 2006) ("*Ameren 2006*"). Staff Ex. 3.0 at 12. However, according to the Utilities, that is not correct because, as in *Ameren 2006*, the Commission approved a methodology that used an average of actual claims payments and accruals over the most recent five years, which is not the Staff's proposal. *Ameren 2006* at pp. 48-49. The Utilities further state that in the 2007 cases, as quoted above, the Commission expressly recognized that, while it had used a five year period in other cases, use of a five year period "is obviously not a hard and fast rule". *Peoples 2007* at 57.

Third, the Utilities explain that Staff's approach also is arbitrary because there is no rationale for choosing the five year period over other periods that could have been selected from the same data on which Staff relied. As to Peoples Gas, the Utilities state that had Staff chosen the most recent three year period, its methodology still would have yielded a downward adjustment but it would have been $413,000, not $864,000. *See* Staff Ex. 17.0 at Sched. 17.2 P, p. 2.[15] The Utilities explain that as to Peoples Gas, had Staff chosen the most recent two year period, its adjustment would have been $290,000. *See id*.[16] As to North Shore, the Utilities state that had Staff chosen three or two year periods, the adjustments would have been slightly larger. *See* Staff Ex. 17.0 at Sched. 17.2 N, p. 2. According to the Utilities, if Staff had chosen four year periods, its proposed adjustments would have been larger for both utilities. *See id*. The Utilities discuss that in the 2007 cases, the Commission, as quoted above, also found, in part: "Further, we perceive that something is inherently wrong in the selection when the results change so drastically when either 3 or 4 year data is considered." *Peoples 2007* at 57. The Utilities maintain that, while the variances perhaps are not as drastic here, the same conclusion still should apply.

Fourth, the Utilities state that Staff's proposal, even if it had merit, should not be adopted unless consistent adjustments are made to the Utilities' reserves for injuries and damages in rate base. The Utilities present the appropriate related adjustments to the reserves should Staff's proposal be adopted in full, and, in the interests of narrowing the issues, the Utilities remain willing to accept the Staff proposal if the consistent adjustments to the reserves are made. NS-PGL Ex. JH-3.0 at 11-12. However, the Utilities maintain that the Staff proposal, even if it were to have merit, is not appropriate without those adjustments to the reserves. *Id*.; NS-PGL Ex. JH-2.0 at 15-16.

iii. Commission Analysis and Conclusions

The Commission has previously addressed similar issues in the Utilities' 2007 rate cases. In *Peoples 2007*, the Commission reviewed a similar evidentiary record on the subject of injuries and damages expenses and rejected similar proposals from Staff.

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[15] (($5,472,000 + $4,766,000 + $6,877,000) ÷ 3) x 1.029 x 1.029 = $6,041,000, rather than Staff's five year figure of $5,590,000.

[16] (($4,766,000 + $6,877,000) ÷ 2) x 1.029 x 1.029 = $6,164,000.

In reviewing the Staff's proposal, the use of five year averages of actual claims payments for 2004 to 2008 is not supported by the evidentiary record. Rather, it appears to be arbitrary, because the selected period lacks any foundation. Staff's approach also is arbitrary because there is no rationale for choosing the five year period over other periods that could have been selected from the same data on which Staff relied. Therefore, the Commission finds that Staff's proposed adjustments are not reasonable or appropriate and must be rejected.

[***Alternative (if the Commission adopts the Utilities' proposal made in an effort to narrow the issues)*****:** The Commission finds that the Staff proposed adjustments are reasonable and appropriate. However, the Commission further finds that Staff's proposed adjustments are only appropriate if the corresponding adjustments to rate base are made to be consistent with the expenses changes. Thus, the Commission approves Staff's proposed adjustments and the related rate base adjustments identified by the Utilities.]

8. Revenues

a. Sales Revenues Adjustment

i. AG

[Insert]

ii. North Shore and Peoples Gas Response

The Utilities submit that AG-CUB's Mr. Effron proposal to increase the forecasted sales revenues of North Shore by $550,000 and of Peoples Gas by $4,441,000 would lead to reduced revenues being collected under the new rates. *E.g.,* NS-PGL Ex. DWC-3.0 at 1, 2-3. According to the Utilities, the AG-CUB proposal lacks merit and should not be adopted, for five reasons.

First, the Utilities state that there is no sound reason to reject the Utilities' sales forecasts and substitute AG-CUB's proposal. The Utilities maintain that their sales forecasts are the product of detailed, thorough forecasting methodologies conducted by, and that were supported in testimony by, experienced forecasters. *See* NS Ex. BMM-1.0, and PGL Ex. BMM-1.0; NS Ex. DWC-1.0 and PGL Ex. DWC-1.0. The Utilities highlight that AG-CUB has not put forth a witness with significant training or experience, if any, as a sales forecaster. *See* AG-CUB-City Ex. 1.0 at 1-2.

Second, the Utilities submit that the AG-CUB proposal lacks merit and in fact is one-sided because it conveniently but inappropriately picks one factor out of the sales models to update and ignores all other factors, including the "Efficiency Improvements" group of variables, which includes the state of the economy, and which is more powerful than the natural gas price factor and drives down usage per customer. NS-PGL Ex. DWC-2.0 at 1, 2-5; NS-PGL Ex. DWC-3.0 at 1-2. According to the Utilities, because of timing, the economic downturn was not captured in the Utilities' sales forecasts used in their filings. NS-PGL Ex. DWC-2.0 at 2. The Utilities state that updating all of the variables, not just the single factor selected by AG-CUB, likely would result in lower sales forecasts. *Id*. at 1.

Third, the Utilities explain that the AG-CUB witness has a record of incorrectly predicting increased natural gas utilities sales and revenues. In its Order in the 2008 Nicor Gas rate case, the Commission rejected the AG-CUB's proposal to adjust upward the utility's sales forecast. In that case, the Utilities note that the Commission stated the evidence in the record showed that his approach was less accurate than that of the utility, and that the adoption of his approach in the 2004 Nicor Gas rate case had overstated billing units, causing the utility to suffer an annual revenue loss of $5.4 million since the 2004 case. *Nicor 2008* at 189-190.

Fourth, the Utilities observe that the AG-CUB proposal erroneously overlooks that, if adopted, it would be offset by necessary decreases in the test year revenues that the Utilities forecast to be recovered under their decoupling riders, Rider VBA, which would reduce the net amount of AG-CUB adjustments to $28,000 as to North Shore and $489,000 as to Peoples Gas. NS-PGL Ex. VG-3.0 at 2, 3, 21-22; NS-PGL Exs. VG-3.2N and VG-3.2P.

Finally, the Utilities state that AG-CUB's proposal also overlooks that, if adopted, it would require an increase in the Utilities' uncollectibles expense to reflect the uncollectibles associated with the forecasted increased sales. NS-PGL Ex. CMG-3.0 at 7.

In regard to Staff's comments on the AG-CUB proposal, the Utilities note that Staff did not offer support for the numbers proposed or provide any valid grounds for approving the proposal. According to the Utilities, Staff's witness also appears to lack significant training or experience as a sales forecaster, presented no additional grounds for the proposal, and was erroneous on both the merits and the impacts of AG-CUB's proposal, as well as similarly overlooking the offsets referenced above. NS-PGL Ex. DWC-3.0 at 2-3.

iii. Commission Analysis and Conclusions

The evidentiary record supports the Utilities' position that their sales forecasts are the product of detailed, thorough forecasting methodologies conducted by experienced forecasters. In contrast, the AG-CUB has not put forth a witness with significant training or experience, if any, as a sales forecaster. Further, the AG-CUB proposal lacks merit because the AG-CUB inappropriately selected one factor while ignoring all other factors utilized in the sales model. The AG-CUB proposal further lacks merit because, as the record indicates, the witness for AG-CUB has a record of incorrectly predicting increased natural gas utilities sales and revenues, including in proceedings before this Commission. Accordingly, the Commission should reject Mr. Effron's proposal. The proposal lacks any valid basis, is wrong, and it ignores all offsets.

[***Alternative (if the Commission approves the AG-CUB proposal)*****:** Although the Commission finds that the AG-CUB proposal should be adopted, the Utilities are correct regarding modifications necessary to the proposal. The net amount of the proposed adjustments, considering the offset necessitated by decreases in the test year revenues that the Utilities forecast to be recovered under their decoupling riders, Rider VBA, is reduced to $28,000 as to North Shore and $489,000 as to Peoples Gas. In addition, the record makes clear that the adoption of the AG-CUB proposal requires an increase in the Utilities' uncollectibles expense to reflected the uncollectibles associated with the forecasted increased sales.]

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

There are no contested issues relating to depreciation expense as such. The only contested aspects of the expense are the derivative impacts of contested plant adjustments.

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

There are no contested issues relating to taxes other than income taxes as such. The only contested aspects of these taxes are the derivative impacts of certain contested adjustments.

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

There are no contested issues relating to income taxes as such. The only contested aspects of income taxes are the derivative impacts of contested adjustments that affect operating income.

VI. RATE OF RETURN

A. Overview

Peoples Gas proposes a rate of return on rate base of 9.11% based on a capital structure containing 56% common equity at a cost (a rate of return on common equity or "ROE") of 11.87% and 44% long-term debt at a cost of 5.58%. North Shore proposes a rate of return on rate base of 9.06% based on a capital structure containing 56% common equity at an ROE of 11.87% and 44% long-term debt at a cost of 5.48%.

Staff and CUB-City propose far lower rates of return, based mainly on proposed lower rates of return on common equity. Staff proposes that Peoples Gas' authorized ROE be reduced from its current 10.19% to 9.69%, and that North Shore's authorized return be reduced from its current 9.99% to 9.79%. For its part, CUB-City recommends an ROE for each Utility of 8.58% without consideration of riders.

The legal standards governing a public utility's entitlement to a fair and reasonable return on its investment are well established and familiar. The classic and still-current formulations are those of the United States Supreme Court in Bluefield Water Works & Improvement Co. v. Public Service Comm'n of the State of West Virginia, 262 U.S. 679 (1923) ("*Bluefield*")) and Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944) ("*Hope*")) cases. A public utility has a constitutional right to a return that is "reasonably sufficient to assure confidence in the financial soundness of the utility and [is] adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties." *Bluefield,* 262 U.S. at 693. The authorized return on equity "should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." *Hope,* 320 U.S at 603.

Illinois law is consistent. This Commission "is charged by the legislature with setting rates which are '*just and reasonable'* not only to the ratepayers but to the utility and its stockholders." *BPI II,* 146 Ill. 2d at 208-209 (citing 220 ILCS 5/9-201); *see also* 220 ILCS 5/9-101. This Commission "fully embraces the principles set forth" in the Bluefield and Hope cases. *In re Consumers Ill. Water Co.,* ICC Docket No. 03-0403 at 41 (Order April 13, 2004).

B. Capital Structure

1. North Shore and 2. Peoples Gas (Combined Discussion)

a. North Shore and Peoples Gas

According to Utilities witness Mr. Johnson, a strong capital structure benefits the Utilities' customers by maintaining ready access to capital in all market conditions, maintaining strong credit ratings and reducing their cost of debt. NS Ex. BAJ-1.0 at 5-6; PGL Ex. BAJ-1.0 at 5-6; NS-PGL Ex. BAJ-2.0 at 3-4. Accordingly, the Utilities each proposed a capital structure of 56% common equity and 44% long-term debt. NS Ex. BAJ-1.0 at 1; PGL Ex. BAJ-1.0 at 1. This capital structure is consistent with their currently authorized capital structures. *Peoples 2007* at 73. It also approximates the Utilities' actual fiscal 2007 year-end capital structures, as well as their actual average structures over the past several years. NS Ex. BAJ-1.0 at 6; PGL Ex. BAJ-1.0 at 6. The Utilities propose no changes to their traditional practice of using short-term debt only to finance seasonal cash needs, particularly for purchased gas costs and short-term construction work in progress, and not as a permanent source of financing rate base investments. NS Ex. BAJ-1.0 at 8-9, PGL Ex. BAJ-1.0 at 8-9.

b. Staff

[Insert]

c. Other Parties

[Insert]

d. North Shore and Peoples Gas Response

The Utilities state that their proposed exclusion of short-term debt from their capital structures is consistent with this Commission's regulation of them over the past 20 years, and their planned use of short-term debt is consistent with their past practice that served as a basis for the Commission's decisions over that period. NS-PGL Ex. BAJ-2.0 2Rev. at 5, 7-8. They emphasize that they issue short-debt debt only temporarily to manage short-term cash flows at certain times of the year, typically at year-end when higher winter revenues have not been collected and seasonal cash requirements are at their highest, and in the late summer months when revenues are at their lowest. NS-PGL Ex. BAJ-2.0 2Rev. at 5-7. Therefore, they argue, they have satisfied the showing delineated in our decision in *Northern Illinois Gas Company d/b/a Nicor Gas Company,* ICC Docket No. 04-0779 (Order Sept. 30, 2005).

The Utilities reject each of Staff's arguments, adopted by CUB-City, for including a short-term debt component in their capital structures. First, this Commission has in the past rejected claims that differences between rate base and capital structure demonstrate that short-term debt is being used to finance rate base. NS-PGL Ex. BAJ-2.0 2Rev. at 8. Moreover, in these rate cases, the differences do not support Staff's theory. Peoples Gas' permanent capital <u>exceeds</u> rate base and North Shore's rate base exceeds its permanent capital by only about $11 million. NS-PGL Ex. BAJ-2.0 2Rev at 9. In addition, the Utilities' forecasted average net cash balances exceed their short-term debt balances, which indicates that cash is the source of funding for any differences between rate base and capital structure. NS-PGL Ex. BAJ-2.0 2Rev. at 9-10. The Utilities also showed that there is simply no relationship between cash working capital and net working capital. NS-PGL Ex. BAJ-2.0 2Rev. at 11-12.

e. Commission Analysis and Conclusions

The Commission finds Utilities have satisfied their burden by a preponderance of the evidence that they will use short-term debt to finance rate base in the test year. Peoples Gas' capitalization is larger than its rate base, and North Shore's capitalization is about the same size as its rate base. Moreover, both Utilities forecast net cash balances well in excess of their short-term debt balances. Finally, and perhaps most important, the Utilities propose to use short-term debt no differently than they have for at least the last 20 years, namely to borrow funds temporarily at times in the year when net cash balances and/or revenues are low. The Commission has repeatedly held that such use of short-term debt does not constitute the use of short-term debt to finance rate base, and neither Staff nor CUB-City has provided a compelling reason for the Commission to depart from its long-standing approach.

C. Cost of Long-Term Debt

1. North Shore (Uncontested)

a. The Record

North Shore accepted the Staff-adjusted average cost of long-term debt in 2010 for ratemaking purposes of 5.49%. Staff Ex. 8.1; NS-PGL Ex. BAJ-2.2N.

b. Commission Analysis and Conclusion

The Commission approves the North Shore figure as appropriate and uncontested.

2. Peoples Gas

a. Peoples Gas

Peoples Gas originally proposed a long-term debt cost of 5.96%. PGL Ex. BAJ-1.2. Peoples Gas accepted Staff's adjustments to its long-term taxable debt, but proposes two adjustments to the Staff-adjusted cost of its insured tax-exempt long-term debt. Staff accepted Peoples Gas' request that the adjustment to the insurance premium cost associated with that debt be halved to reflect the Utility's split credit rating. Staff Ex. 22.0 at 5.

The remaining issue involves Staff's reduction of the cost of Peoples Gas' Series OO auction rate bonds to less than 1%. This rate is based on the formula rate of 175% of LIBOR when auctions for these securities fail. With LIBOR near zero, the current rate on these bonds is less than 1%.

b. Staff

[Insert]

c. Other Parties

[Insert]

d. Peoples Gas Response

Peoples Gas acknowledges that the current cost of its Series OO bonds is very low and facially attractive, but the Utility warns that the formula rate could cause sharp increases in this cost as interest rates rise in the future. NS-PGL Ex. SMF-1.0 at 14. And because these bonds are held by some of the Utility's core credit banks, forcing them to earn such low returns may be detrimental to the Utility and its customers in the long-run. NS-PGL Ex. BAJ-2.0 Rev. at 17. For these reasons, Peoples Gas has concluded that these bonds are no longer a viable form of long-term financing and proposes refinance or remarket them in 2010. NS-PGL Ex. BAJ-3.0at 5. Peoples Gas proposes that its rates assume a 1% cost for this debt for half the year and a fixed rate debt cost of 7.16% for the remainder of the year. The 7.16% rate is based on indicative rates the Utility received from the market. NS-PGL Ex. BAJ-2.0 Rev. at 18; NS-PGL Ex. BAJ-2.2P.

e. Commission Analysis and Conclusion

The Commission finds that Peoples Gas' proposed treatment of its Series OO auction rate bonds is reasonable in light of the unsustainability of the near-zero return currently earned by the holders of these bonds and the likelihood of unreasonably high rates when interest rates rise in the future. The Commission finds that, as with the Utilities' other costs, Peoples Gas' rates should be based its likely costs in the test year, and not necessarily its current costs. The Commission concludes that the appropriate cost to be assigned these bonds is an average rate of 4.08% over the test year. As adjusted, Peoples Gas' average cost of long-term debt in 2010 for ratemaking purposes is 5.58%. NS-PGL Ex. BAJ-3.0 at 5.

D. Cost of Short-Term Debt

1. Peoples Gas and 2. North Shore (Combined Discussion)

The Commission finds, as stated above, that short-term debt should not be included in the Utilities' capital structures. Accordingly, this Order need not address the evidentiary record regarding the Utilities' costs of short-term debt.

E. Cost of Common Equity

1. Peoples Gas and 2. North Shore (Combined Discussion)

a. Overview

Because the Utilities' common stock is not publicly traded, their cost of equity must be estimated using capital market and financial data relied on by investors to assess the relative risk of other natural gas utilities.

i. The Utilities' Overall Position

Utilities witness Mr. Moul presented three "market" measures of the Utilities' return on equity ("ROE") based on a proxy group of natural gas utilities with an overall risk profile similar to the Utilities. Mr. Moul applied the Discounted Cash Flow ("DCF") model, the Capital Asset Pricing Model ("CAPM") and the Risk Premium model. Mr. Moul presented initial and updated results as follows:

Model	February	July
DCF	10.58%	11.41%
CAPM	12.51%	11.80%
Risk Premium	12.50%	12.25%

PGL Ex. PRM-1.0 at 4 (table); NS-PGL Ex. PRM-2.0 Rev. at 7 (table). Assigning 25% weight to his DCF results and 75% to his CAPM and Risk Premium results, Mr. Moul's updated ROE result of each Utility is 11.87%. NS-PGL Ex. PRM-2.0 Rev. at 8.

The Utilities assert that Mr. Moul's recommended ROE is also supported by the "general context" in which the Commission must determine their cost of equity. The Utilities urge the Commission to consider information beyond the traditional financial models, because each model relies on different assumptions and has its own limitations. PGL Ex. PRM-1.0 at 4.

To this end, Utilities witness Mr. Fetter, former chairperson of the Michigan Public Service Commission, identified several considerations for the Commission. In particular, Mr. Fetter warned that a reduction in the Utilities' authorized ROEs from their current levels of 10.19% (Peoples Gas) and 9.99% (North Shore) in the midst of "the most challenging economic environment during the past 80 years" would be viewed by the financial markets as "a major setback" and could lead to further downgrades of the Utilities' credit ratings, which are currently split between the "A" and "BBB" levels. Such downgrades could be particularly harmful, given the extraordinary high capital costs currently borne by BBB-rated utilities compared to their A-rated counterparts. Mr. Fetter finds recent returns authorized by this and other commissions in the mid-10% range, and suggests that the Commission take these into account as a point of comparison to the positions that Staff and the parties take in this proceeding. NS-PGL Init. Br. at 80-81.

In particular, Mr. Fetter notes that the ROEs proposed by Staff and CUB-City are at the low end of the range of returns recently issued by other state commissions and are below any ROE ordered by this Commission for a natural gas utility since at least 1972. As a former regulator, Mr. Fetter suggests that the Commission consider results from other jurisdictions because they affect investor decisions and provide the Commission "an awareness of trends in the markets" as it evaluates the results from its "tried and true" financial market models. Tr. 520-521.

The Utilities assert that Commission precedent supports the consideration of general market conditions and trends in addition to the results of the financial market models because these considerations are central to investor expectations. The Utilities point to past Commission decisions that the cost of equity must be determined from the perspective of the investor and that judgment must be applied in evaluating the results of the financial market models. NS-PGL Init. Br. at 81-82.

The Utilities argue that all of these considerations support an increase of the Utilities' cost of equity to the 11.87% level calculated by Mr. Moul.

ii. Staff's Overall Position

[Insert]

iii. CUB-City's Overall Position

[Insert]

b. DCF

i. North Shore and Peoples Gas

The DCF model expresses the value of an asset as the present value of future expected cash flows discounted at the appropriate risk-adjusted rate of return, which for common stock is the dividend yield plus future price growth. Mr. Moul estimated the dividend yield for the Gas Group by calculating its six-month average dividend yield, adjusting that average by three generally accepted methods to reflect investors' expected cash flows, and the averaging the three adjusted values. For the investor-expected growth rate, Mr. Moul evaluated an array of historical and forecast growth data from sources that are publicly available to, and relied upon by, investors and analysts. He focused on forecasts of earnings per share growth because empirical evidence supports it and because that they are most relevant to investors' total return expectations. He selected 6.00%, the approximate mid-point. Mr. Moul then applied a financial leverage adjustment to his DCF results because they are based on market prices of the Gas Group's stock, which imply a capital structure with more equity and less financial risk, but are applied to utility book values, which imply a capital structure with less equity and more financial risk. NS-PGL Init. Br. at 84-85.

ii. Staff

[insert]

iii. Other Parties

[insert]

iv. North Shore and Peoples Gas Response

Staff and CUB-City oppose Mr. Moul's financial leverage adjustment, characterizing it as another form of the "market-to-book" adjustments that this Commission has rejected in past decisions, including the Utilities' last rate cases. Staff Ex. 7.0 at 43; CUB-City Ex. 2.0 at 29-30. Although the Utilities acknowledge that the Commission rejected Mr. Moul's adjustment in the Utilities' last rate cases, they assert that this adjustment is fundamentally different than a "market-to-book" adjustment because it is not intended to maintain any given market-to-book ratio. Rather, Mr. Moul's financial leverage adjustment is intended to correct the error involved in applying a market-based cost of equity to a book value capital structure. NS-PGL Init. Br. at 86-87. The Utilities argue that Mr. McNally's own simplified example demonstrates the reasonableness of Mr. Moul's financial leverage adjustment. If a utility's market value equity is worth $110 and its market-based cost of equity is determined to be 10%, that means that investors expect to earn $1.10 on every dollar they invest. If, however, the Commission applies the 10% market-based return to the utility's book value equity of $100, the utility's return is effectively capped at $10, which means that the utility can earn a return of only 9.1% ($10/$110). Only by adjusting the utility's authorized return to 11% can the utility earn its authorized return. NS-PGL Init. Br. at 86.

The Utilities note that since their last rate cases, Staff has modified its DCF methodology. In the Utilities' last rate cases and in many cases prior, Staff relied on the "constant growth" form of DCF model, which assumes one rate of future growth, as opposed to the "non-constant growth" form of the model, which assumes multiple rates of future growth that change over time. *See Peoples 2007* at 78. In several rate cases since then, Staff has used the non-constant growth form of the model, on the basis that the growth forecasts for utilities in the near term (3-5 years) are not sustainable over the long term. NS-PGL Init. Br. at 87-88; Staff Ex. 7.0 at 4-5.

In this case, Staff witness McNally testified that the Utilities' near-term growth rates are higher than his forecast for growth in the Gross Domestic Product, and therefore use of the constant-growth DCF model gives rise to the "wholly unrealistic scenario" that the Utilities will eventually grow to the size of the entire economy. Staff Ex. 7.0 at 5; Staff Ex. 21.0 at 8-9. The Utilities respond that Staff's argument is itself unrealistic because it would take many hundreds of years for that scenario to play out, the investment horizon of investors and analysts is no more than 5 years, and GDP is not an appropriate measure of long term natural gas utility growth. NS-PGL Ex. PRM-2.0 Rev. at 15, 17.

Based on objective sources, including academics cited by Staff and the Federal Energy Regulatory Commission ("FERC"), the Utilities argue that the constant growth DCF model is appropriately applied to natural gas utilities like the Utilities because their growth rates are not significantly higher than GDP growth, much less the two to three times GDP growth that FERC uses as one of its criteria for determining whether to apply the non-constant growth form of the model. NS-PGL Init. Br. at 89-90. Based on these objective criteria, which clearly call for the application of the constant growth DCF model to the Utilities, Mr. Moul concluded that Staff's decision to switch to a non-constant form of the model reflects a subjective decision by Staff to reach lower cost of equity results. Indeed, Mr. Moul calculated the Utilities' cost of equity using Staff's constant growth DCF model and the result was 11.76%, which is over 150 basis points over Staff's non-constant growth DCF result of 10.23% and is comparable to Mr. Moul's adjusted constant growth DCF result of 11.41%. NS-PGL Ex. PRM-2.0 Rev. at 23 (table). Finally, the Utilities note that the Commission included Mr. Moul's constant growth DCF model as among the cost of equity analyses that formed "an appropriate basis to determine ROE" in their last rate cases. *Peoples 2007* at 100.

c. CAPM

i. North Shore and Peoples Gas

The CAPM determines an expected rate of return on a security by adding to the "risk-free" rate of return a risk premium that is proportional to the non-diversifiable, or systematic, risk of the security. This model requires three inputs: (1) the risk-free rate of return, (2) a "beta" that measures systematic risk, and (3) the market risk premium. For the risk-free rate of return, Mr. Moul used historical and forecast yields on 20-year Treasury bonds and selected a mid-point of 4.25% based on recent historical trends and current forecast. For the beta measurement of systematic risk, he used the average *Value Line* beta for the Gas Group, adjusted using the Hamada formula to reflect the application of this market-based measurement to the utility's book value capital structure used in ratemaking. Mr. Moul developed his market premium by averaging forecast data from *Value Line* and the S&P 500 Composite and historical data from Ibbotson Associates, all of which are sources routinely used by investors, analysts and academics. Mr. Moul also adjusted his CAPM result for the relatively small size of the Gas Group, correcting a tendency of the CAPM to understate the cost of equity of smaller companies. NS-PGL Init. Br. at 92-93.

ii. Staff

[insert]

iii. Other Parties

[Insert]

iv. North Shore and Peoples Gas Response

Staff opposes Mr. Moul's size adjustment, claiming that it "has no theoretical basis." Staff Ex. 7.0 at 43. The Utilities respond that Mr. Moul identified in detail the theory and literature supporting the general proposition that the smaller the firm, the greater its risk. PGL Ex. PRM-1.0 Rev. at 40. Moreover, Mr. Moul's adjustment is unique to the CAPM because it can significantly understate the cost of equity of smaller firms, including utilities. *Id.* Although Mr. McNally challenged the size/return relationship in general, he did not dispute Mr. Moul's observations about the CAPM's potential to understate smaller firm capital costs.

Mr. Moul challenged Mr. McNally's reliance on 90-day Treasury bills for the risk-free rate, noting that the one-day, spot rate Mr. McNally used was 0.10%, or almost zero, as a result of the financial crisis. Finding that the risk-free rate could not be essentially zero, Mr. Moul reasonably relied on *Blue Chip* forecasts. NS-PGL Ex. PRM-2.0 Rev. at 24-25.

d. Risk Premium

i. North Shore and Peoples Gas

The Risk Premium model measures the cost of equity by determining the degree to which equity has more risk than corporate debt, and adding that "equity risk premium" to the interest rate on long-term public debt. Mr. Moul estimated a 7.00% prospective yield on A-rated utility bonds based on historical and forecasted yields and taking into account the extraordinary impact on the spread in yields between A-rated utility bonds and long-term Treasuries caused by the financial crisis. NS-PGL Init. Br. at 95.

ii. Staff

[insert]

iii. Other Parties

[insert]

iv. North Shore and Peoples Gas Response

Staff's challenges to Mr. Moul's risk premium model center on his use of historical data, a topic that we cover below. The Utilities emphasize that, contrary to Mr. McNally's characterization, Mr. Moul's model is based exclusively on historical data and even when he used such data he evaluated its reasonableness under current market conditions. *See* NS-PGL Ex. PRM-2.0 Rev. at 26-27.

3. Use of Historical Data

a. Staff

[Insert]

b. Other Parties

[Insert]

c. North Shore and Peoples Gas Response

As it did in the Utilities' last rate cases, Staff criticizes Mr. Moul's use of historical data in his analyses. Staff characterizes such data as "outdated" and no longer relevant to the market, and argues that using such data "implies that securities data will revert to a mean," which is an inappropriate measure for the "random walk" of returns. Staff Ex. 7.0 at 37.

The Utilities argue that Staff's criticisms about the use of historical data apply with equal if not greater force to Staff's reliance on stock price data for the Gas Group from a single day months in the past. NS-PGL Init. Br. at 96.

The Utilities also assert that Mr. McNally mischaracterizes Mr. Moul's use of historical data. Indeed, Mr. McNally goes so far as to charge Mr. Moul with "the mechanistic use of historical data as a direct estimate of the investor expectations that are embedded in cost of common equity estimates." Staff Ex. 21.0 at 2. According to the Utilities, it is Staff that uses historical data "mechanistically" by relying on stock prices from a given day selected by its relationship to when Staff's direct testimony is due. NS-PGL Init. Br. at 98. In doing so, Staff gives no consideration to the representativeness of those particular stock prices in light of the historical and forecast information available to and relied on by investors and analysts. Even the academic literature cited by Mr. McNally indicates that daily data "hardly help at all" in estimated expected return. *Id.* at 98-99. For these reasons, the Utilities conclude that Staff's reliance on "spot" stock prices is arbitrary.

By contrast, the Utilities state, Mr. Moul consulted historical data in addition to current and forecast data to develop his model inputs. In each case, he used sources that are widely available to, and routinely relied on, by investors and analysts. In no sense did Mr. Moul use historical data arbitrarily as Mr. McNally claimed. *Id.* at 96-97.

The Utilities acknowledge that the Commission has routinely accepted Staff cost of equity analyses based on single-day stock prices. The Utilities urge the Commission to at least give additional consideration to "return analyses that are based on a broader array of relevant data such as those presented by Mr. Moul." *Id.* at 99. They point out that the Commission relied in part on Mr. Moul's DCF analysis in the Utilities' last rate cases, which was based on Mr. Moul's consideration of historical data for the dividend yield as was his DCF analysis in this case. *Peoples 2007* at 100; *see* PGL Ex. PRM-1.0 at 14-15.

4. Staff's Financial Risk Adjustment

a. Staff

[Insert]

b. Other Parties

[Insert]

c. North Shore and Peoples Gas Response

According to the Utilities, Mr. Moul assembled his proxy group, the "Gas Group," based on an evaluation of a broad range of capital market and financial data on the Utilities and other domestic natural gas utilities over the five-year period 2003-2007. Mr. Moul's evaluation considered factors related to both operating and financial risk. NS-PGL Init. Br. at 83-84. Mr. Moul concluded that on balance, the Gas Group provided "a conservative basis for measuring the [Utilities'] cost of equity because many of the risk factors are lower for the Gas Group and, overall, the Gas Group has lower risk than the [Utilities]." PGL Ex. PRM-1.0 Rev. at 12. Staff and CUB-City cost of equity witnesses each used Mr. Moul's Gas Group to apply their own market models. Staff Ex. 7.0 at 3; CUB-City Ex. 2.0 Rev. at 12.

After finding that Mr. Moul's's proxy group, the Gas Group, provided an appropriate proxy of the Utilities' "operating" risk, and using it as the basis for his own analyses, Mr. McNally adjusted his results for the difference he found in "financial" risk between the Gas Group and the Utilities, using the same type of analysis that Staff has used in many prior cases, including the Utilities' last rate cases. Staff Ex. 7.0 at 22-28; *Peoples 2007* at 80-81, 85-86. Mr. McNally reduced his results for Peoples Gas by 30 basis points and his results for North Shore by 20 basis points. *Id.* at 26.

The Utilities oppose Staff's "financial risk" adjustments, arguing that the adjustments are arbitrary and punitive in a number of ways. First, because Staff's analysis assumes that the Utilities will earn their Staff-audited revenue requirements in full, it understates the Utilities' financial risk because they are by no means guaranteed full recovery of their 2010 revenue requirements, and indeed have significantly under-recovered their revenue requirements set in their last rate cases. NS-PGL Init. Br. at 100.

Second, Staff develops hypothetical credit ratings based on this understated portrayal of the Utilities' financial risk and compares them to the Gas Group's average credit ratings, which are based on achieved performance. This "apples to oranges" comparison is illogical at best, and at worst punitive, because it assumes ideal future financial performance by the Utilities compared to actual financial performance by the Gas Group. *Id.* at 100-101.

Third, Staff wants it both ways by accepting the Gas Group as a reasonable proxy group and then making adjustments for risk variations without establishing that those risk variations are not offset by variations in other risks. The process of compiling a proxy group involves such considerations and Mr. Moul concluded as follows as to the overall risk of the Utilities and Gas Group: "On balance, the cost of equity developed from the Gas Group provides a conservative basis for measuring the [Utilities'] cost of equity because many of the risk factors are lower for the Gas Group and, overall, the Gas Group has lower risk than the [Utilities]." PGL Ex. PRM-1.0 Rev. at 12 (emphases added).

The Utilities take issue with Mr. McNally's assertion that Mr. Moul's proxy group analysis was materially skewed by the refunds the Utilities were ordered to pay in 2006 and 2007. Mr. McNally grossly overstated the net income impact of the refunds, which Mr. Moul found to be relatively small as measured by the coefficients of variation of the actual returns. NS-PGL Init. Br. at 101-102. The Utilities also take issue with Mr. McNally's claim that the Utilities' recent credit rating downgrades were due exclusively to the risk profile of their corporate parent, pointing out several aspects of the credit rating agencies' analysis that focus on the Utilities' stand-alone financial strength relative to their peers. *Id.* at 102-103.

5. Effect of Riders VBA and ICR

a. Staff

[Insert]

b. Other Parties

[Insert]

c. North Shore and Peoples Gas Response

The Utilities oppose Mr. McNally's recommendation to continue the 10-basis-point reduction for Rider VBA because, as he acknowledges, most of the companies in the Gas Group have decoupling mechanisms in place. Staff Ex. 21.0 at 27. When the Commission made the adjustment in their last rate cases, the Utilities assert, it did so to accommodate the perceived change in the Utilities' risk due Rider VBA. This is supported by the fact that the Commission rejected the Utilities' evidence that utilities in the proxy group already had decoupling mechanisms. *Peoples 2007* at 97. Therefore, the Utilities conclude, the Commission effectively assumed that the cost of equity results based on the Gas Group reflected no such mechanisms in place. NS-PGL Init. Br. at 103. They reject Staff's position that "the relatively small size of the Rider VBA adjustment is consistent with the fact that most, if not all, of the companies in the Gas Group have some sort of de-coupling rider applicable to at least a portion of their service territories" as revisionist history with no basis in the record of the Utilities' prior rate cases. *Id.* at 104.

The Utilities challenge Mr. McNally's proposed ROE of 8.06% for the ROE factor in Rider ICR as "grossly overstated." *Id.* They note that Rider VBA provides for the recovery of almost 8 times the amount of Peoples Gas' revenues than Rider ICR does, and yet the Commission adjusted Peoples Gas' ROE by only 10 basis points for Rider VBA. *Id.* The Utilities also argue that Rider ICR does not remove the risk of the Commission determining after the fact that costs incurred were imprudent and therefore not recoverable, that Mr. McNally did not support his adjustment with any cash flow or other analysis, and that the adjustment erroneously assumes full implementation of the rider. *Id.* at 104-105.

6. Commission Analysis and Conclusions

a. The Context

Traditionally, the Commission has established rates of return on common equity for utilities by employing financial models designed to quantify the likely cost of attracting capital investment during the time rates are expected to be in effect. In virtually all cases, we have relied on the DCF and CAPM models. In their last rate cases, the Utilities urged the Commission also to consider the ROEs approved in previous cases by this and other commissions. We found then, and repeat now, that the Commission does not base utility returns on those approved for other utilities, in Illinois or elsewhere.

In these cases, however, the Utilities have provided convincing evidence that the Commission should take notice, through verifiable and well regarded sources, of general market conditions and trends because this information affects directly the decisions that investors make in the market. This information is relevant to our ROE decisions because we determine what investors demand and that requires consideration of the full array of information that investors consider when they effectively set the real cost of capital for a utility. *See Illinois Bell Tel. Co.,* ICC Docket Nos. 92-0448, 93-0239 (Cons.), at 103 (Order Oct. 11, 1994).

The question that remains is what we should do with that information. We find that Utilities witness Mr. Moul provides a reasonable approach, namely that we consider general market conditions and trends, including returns recently approved by this and other commissions, in evaluating the various cost of equity analyses presented by the various analysts in our cases. We will assume that analyst recommendations that appear to be outside the range of what investors would expect are methodologically flawed, the product of unreasonable subjectivity, or both. Our decision here expands upon the principle that we enunciated in the Utilities' last rate cases, when we rejected Staff's DCF analysis on the finding that it strayed "from a zone of reasonableness to the degree where it offers an unreliable estimate of the appropriate ROE." *Peoples 2007* at 92. Accordingly, we will endeavor to base our ROE decisions on financial model results that fall within a reasonable range of investor expectations as indicated by contextual evidence such as general market conditions and returns recently approved by this Commission and others.

In these cases, we find the information on general market conditions and trends provided by the Utilities to be useful – but not determinative – in our consideration of various financial model results presented. We find the observations of Utilities witness Mr. Fetter particularly useful in placing our decision in a context informed by both market and regulatory realities. We reject the countervailing views of CUB-City witness Mr. Bodmer, whose overemphasis on "objectivity" and "subjectivity" belies the extreme bias reflected in his observations of general market conditions and trends.

b. The DCF Model

Staff's DCF analysis is based in large part on the stock prices for the utilities in the Gas Group on a single day in May of this year. Although "it is inevitable that data in pre-filed rate case testimony will reflect some degree of hindsight, at least as a starting point in the analysis," *Peoples 2007* at 91, the Utilities argue that such "spot" data is too exposed to inefficiencies caused by any number of causes, and that Staff's blind reliance on such data without considering its representativeness in light of general market conditions and trends is arbitrary. By contrast, Staff argues the Utilities' DCF analysis is based at least in part on the consideration of historical data which by its very definition is outdated, and this Commission has found in many cases that analysts have relied excessively on historical data to establish current utility equity costs.

The Commission finds that there is a middle ground between these opposing views. Although we have traditionally relied on DCF analyses based on a single day's data, we recognize the potential for inaccuracy associated with that practice and will require that such DCF analyses in the future include an evaluation of whether the day selected may have been affected by extraordinary events or conditions that caused material market inefficiencies. We will continue to favor more current data over historical data, but we will encourage analysts to take historical data into account in evaluating the reasonableness of their financial model results. We also find that forecast data routinely relied upon by investors should be referenced. Analysts who reject data that are widely available and routinely relied on by investors in favor of their own assumptions about what investors should expect will face a high burden of demonstrating why market-based investor expectations should not form the basis for this Commission's determination of ROE.

The Utilities raise serious concerns regarding Staff's decision, apparently following the Utilities' last rate cases, to change its longstanding DCF model from a constant growth to a non-constant growth form of the model. The non-constant growth form of the model is intended to reduce DCF results where a firm's near-term growth rate is unreasonably high. Staff justifies its decision to switch to the non-constant version because it believes the Utilities' short-term growth rates are not "sustainable," but this by itself is not enough. Although we stop short of adopting FERC's criteria for deciding between the two versions of the DCF model, we find that the non-constant growth version is appropriate only if the utility's near-term growth is extraordinarily high due to identifiable factors.

On this record, we cannot conclude that the near-term forecasts of growth for natural gas utilities are unreasonably high. Therefore, in these cases we consider the results of constant-growth DCF models as appropriate to determine ROE. These include Mr. Moul's unadjusted updated DCF result (10.67%) as well as his calculation of Staff's single-stage DCF result (11.76%). We address below Mr. Moul's financial leverage adjustment to his DCF result.

c. The CAPM Model

We find that the Utilities' CAPM analyses present an appropriate basis to determine ROE. For the reasons set forth above, Mr. Moul's consideration of historical information in conjunction with current and forecast data is a reasonable approach for this financial model. We also find persuasive Mr. Moul's justification for relying on *Value Line* betas to the exclusion of other sources. He investigated the methodologies and data sources used by *Value Line* and its competitors and found *Value Line* to be the only source of betas that is transparent and replicable.

Although Staff presented qualified arguments that the size-return relationship is not uniformly accepted in the financial community, Staff did not address Mr. Moul's more central argument that the same community has found reason to doubt CAPM results as they apply to smaller companies. We find that a size adjustment to the CAPM is reasonable though not required adjustment. We address below his financial leverage adjustment to his beta estimate.

d. The Utilities' Financial Leverage Adjustment

We rejected Mr. Moul's "financial leverage" adjustment in the Utilities' last rate cases, finding that the Utilities' attempt to differentiate this adjustment from the "market-to-book" adjustment that the Commission has repeatedly rejected was an attempt to "elevate[] form over substance." *Peoples 2007* at 96. The record in these cases, however, demonstrates that this is not the case. We find a fundamental difference in the two types of adjustments, and therefore that the Utilities' proposed financial leverage adjustment is not only supported by cost of equity theory but also the basic legal principle that a utility is entitled to an opportunity to earn a reasonable return on its investment.

The financial leverage adjustment is based on the well-accepted, if not irrefutable, economic theory that there is a direct relationship between a firm's risk and the amount of debt in its capital structure. Currently, there is no dispute that the Utilities' market value capital structure has more equity (and therefore less risk) than its book value capital structure. When the financial market models are used, the utility's cost of equity is estimated based on the proxy group's average market value capital structure. In order to make this result relevant to the utility's book value capital structure, an adjustment is required. Otherwise, if the market value cost of equity is applied to the utility's book value capital structure (and all other things are held equal), the utility will not earn its authorized return. NS-PGL Init. Br. 86. Using well-accepted formulas, Mr. Moul calculated the Gas Group's ROE with and without a debt component, and determined the ROE of the Gas Group with its average debt ratio to be 74 basis points higher than its ROE with no debt in its capital structure.

Absent any competing calculation of this adjustment, we find that 74 basis points is a reasonable accommodation for the necessity of applying the market-based ROE to a book value capital structure.

e. Staff's "Financial Risk" Adjustment

The Commission finds that the "financial risk" adjustment proposed by Staff in these cases is arbitrary. Although Staff justifies this adjustment as a mechanism to isolate the negative impact on the Utilities' financial risk from their affiliation with the non-utility business of their corporate parent, the adjustment suffers from fatal flaws. First and foremost, Staff's methodology compares an idealistic view of the Utilities' financial risk, in the form of hypothetical credit ratings, that assume the Utilities recover all of their 2010 Staff-audited revenue requirements, to the Gas Group's financial risk, in the form its average <u>achieved</u> credit ratings. The Commission agrees that this comparison is arbitrary, punitive and designed only to reduce utility returns.

Second, Staff's financial risk adjustment depends on the assumption that the lower financial risk associated with the Gas Group is not offset by higher operational risks. Mr. McNally presented no analysis supporting this assumption, whereas Mr. Moul stood by his conclusion that the overall risk of the Gas Group and the Utilities is similar, pointing in particular to the higher earnings volatility and the lower IGF to construction ratio as points of higher operating risk to the Utilities as offsetting Mr. McNally's finding of lower financial risk. NS-PGL PRM-2.0 Rev. at 30.

For these reasons, we find that Staff's financial risk adjustment is not appropriately applied to the financial model results developed for the Utilities.

f. Adjustments for Riders VBA and ICR

With respect to Rider VBA, the Commission found in the Utilities' last rate cases that its approval of the rider justified a 10-basis-point reduction in their ROE to account for a reduction in their "risk associated with their cash flow" as compared to the proxy group then being considered. *Peoples 2007* at 99. The Utilities argued that this comparison was unfair because many of the proxy group utilities had decoupling mechanisms in place, but the Commission rejected the Utilities' evidence on this point. *Id.* at 97-98 & n.23. By contrast, in this case, Staff concedes that most of the utilities in the Gas Group have decoupling mechanisms. Staff Ex. 21.0 at 27. The Commission finds an insufficient basis in this record to differentiate the Utilities from the Gas Group with respect to Rider VBA, and therefore concludes that no adjustment in the Utilities' ROE is justified for purposes of their 2010 test year rates.

As to Rider ICR, the Commission finds that Staff's proposed adjustment for the ROE factor is excessive. Although the Commission agrees that Rider ICR reduces Peoples Gas' risk associated with cash flow, the extent of that risk reduction depends on variables that cannot be accounted for, at least on this record. Therefore, we make no adjustment in Peoples Gas' ROE for our approval of Rider ICR.

Based on the foregoing discussion, the calculation of ROE will be affect by the following conclusions: (1) the constant growth DCF analysis performed by the Utilities and the constant growth DCF analysis of Staff as performed by the Utilities will be included in this calculation; (2) the CAPM analyses of Staff and the Utilities will be included in this calculation; (3) the Utilities' financial leverage adjustment is approved; (4) Staff's financial risk adjustment is rejected; (5) Staff's adjustments for Rider VBA and Rider ICR are rejected; (6) these decisions have been informed by evidence regarding general capital market conditions and trends, including ROEs approved by this and other commissions.

Based on its review of the record, and consistent with the conclusions above, the Commission finds that an average of the Utilities' adjusted DCF, CAPM and Risk Premium models forms an appropriate basis to determine ROE, which results in 11.87%.

F. Weighted Average Cost of Capital

1. <u>North Shore</u>

Based on the evidence in the record and the applicable legal principles, the Commission approves as just and reasonable an overall rate of return (weighted average cost of capital) for North Shore Gas of 9.06%, calculated as follows:

North Shore Cost of Capital Summary			
Cost of Capital	**Percent of Total**	**Percent Cost**	**Weighted Cost**
Long Term Debt	44.00%	5.48%	2.41%
Common Equity	56.00%	11.87%	6.65%
Total Capital			9.06%

2. Peoples Gas

Based on the evidence in the record and the applicable legal principles, the Commission approves as just and reasonable an overall rate of return (weighted average cost of capital) for Peoples Gas of 9.11%, calculated as follows:

Peoples Gas Cost of Capital Summary			
Cost of Capital	**Percent of Total**	**Percent Cost**	**Weighted Cost**
Long Term Debt	44.00%	5.58%	2.46%
Common Equity	56.00%	11.87%	6.65%
Total Capital			9.11%

VII. WEATHER NORMALIZATION – AVERAGING PERIOD (Uncontested)

A. The Record

The Utilities proposed using the average of the previous twelve years of weather data, ending in 2007, which results in 6,095 heating degree days. PGL Ex. BMM-1.0 at 8-9; NS Ex. BMM-1.0 at 8-9. No party disagreed.

B. Commission Analysis and Conclusions

The Commission finds that the proposed average is reasonable and appropriate.

VIII. PROPOSED RIDER ICR (PGL)

Introduction

Peoples Gas' Infrastructure Cost Recovery Rider ("Rider ICR") is designed to recover costs associated with Peoples Gas' replacement of CI/DI main and connecting facilities such as services, meters, and regulators. PGL Ex. VG-1.0 Rev. at 35-36. Under the rider, the recoverable costs are offset by the savings estimated to be generated by the replacement program. *Id*. Peoples Gas presented evidence supporting the rider as discussed below.

A. Peoples Gas

1. The Proposed Tariff and Agreed Modifications

Rider ICR is modeled after, but not identical to, the Commission's rules applicable to water and sewer utilities (83 Ill. Admin. Code Part 656), and it would apply to Service Classification Nos. 1, 2, 4, and 8. Each year Peoples Gas would file an information sheet stating the Rider ICR charge to be in effect for the nine-month period of April through December. The first Rider ICR charge would be effective April 1, 2011. PGL Ex. VG-1.0 Rev. at 35-36; PGL Ex. VG-1.14 (form of report). After the first effective period, by March 31 each year, Peoples Gas would file to initiate an annual reconciliation proceeding. Also, each year beginning in 2012, Peoples Gas would submit to the Commission Staff an internal audit report. PGL Ex. VG-1.0 Rev. at 36-37; Staff Ex. 15.0, Att. G. Peoples Gas agreed to several Staff-proposed modifications to Rider ICR. Those accepted modifications, shown in Staff Ex. 15.0, Att. G, are:

- clarify the wording of the cap that limits recoveries under Rider ICR (Staff Ex. 1.0 at 36-37; NS-PGL Ex. VG-2.0 Rev. at 51);
- add more specific language for the annual reconciliation proceeding, namely, a filing date and that the reconciliation will include a determination that costs incurred were prudent, just and reasonable (Staff Ex. 1.0 at 37-38; NS-PGL Ex. VG-2.0 Rev. at 51-52);
- add four specific tests that the annual internal audit would include (Staff Ex. 1.0 at 38-39; NS-PGL Ex. VG-2.0 Rev. at 52);
- update the initial percentage in the formula that calculates the Rider ICR charge to specify 90%, rather than 94%, of the Account 383 ("House Regulators") amount in the calculation (Staff Ex. 1.0 at 39; NS-PGL Ex. VG-2.0 Rev. at 52);
- remove Factor IOM (incremental operation and maintenance expenses) from the calculation because the costs would either be recoverable in other factors in the calculation or minimal (Staff Ex. 1.0 at 39-41; NS-PGL Ex. VG-2.0 Rev. at 52);
- exclude incentive compensation costs from the calculation, although Peoples Gas stated that it generally disagrees with Staff's position and agreed only for the purpose of Rider ICR in this proceeding (Staff Ex. 1.0 at 41-42; NS-PGL Ex. VG-2.0 Rev. at 52); and
- update, no less than every three years, the "actual savings" factor, which would initially be $6,000 per mile of CI/DI main abandoned during the reconciliation year (Staff Ex. 1.0 at 43-44; NS-PGL Ex. VG-2.0 Rev. at 53).

In addition, Staff withdrew two proposed tariff changes. Staff Ex. 15.0 at 33.

2. Legal Authority for Rider ICR

Peoples Gas states that in recent rate case orders, the Commission has had the opportunity to review its legal authority to authorize riders, and concluded that it has the authority to adopt a rider mechanism in proper situations and under circumstances that are lawful and reasonable. *See, e.g.*, *Peoples 2007* at 139-140. Rider ICR as proposed in this proceeding presents an appropriate situation for the Commission to use its discretion to authorize the use of a rider to facilitate the direct recovery of particular costs -- a portion of the costs of the main replacement program -- that will not upset Peoples Gas' revenue requirement because the proposed mechanism provides for the flow back of savings generated to customers. Peoples Gas states that for the same policy reasons the Commission authorized ComEd's Rider SMP and its Advanced Metering Infrastructure pilot (also known as "Smart Grid")[17] to encourage investment in the modernization of Illinois' utility infrastructure, the Commission should authorized Peoples Gas' proposed Rider ICR. In City of Chicago v. Illinois Commerce Comm'n, 13 Ill. 2d 607, 611 (1958) ("*City I*"), the Illinois Supreme Court established that the Commission has the authority to approve rate schedules that includes the power to adopt a set formula to recover costs in appropriate circumstances. The Court declared that the Commission is vested with the authority to make "pragmatic adjustments" as part of its ratemaking function. *Id*. at 618. In reliance on *City I*, Illinois courts have reviewed and affirmed rider mechanisms in a number of different circumstances. *See* City of Chicago v. Illinois Commerce Comm'n, 246 Ill. App. 3d 403, 410-412 (1st Dist. 1993) ("*City II*") (affirming Commission's approval of a rider for the recovery of the marginal cost of providing non-standard service); Central Illinois Light Co. v. Illinois Commerce Comm'n, 255 Ill. App. 3d 876, 885-886 (3rd Dist. 1993) ("*CILCO*"), *affirmed CUB* (affirming Commission's approval of rider mechanism for the recovery of coal tar remediation costs); City of Chicago v. Illinois Commerce Comm'n, 281 Ill. App. 3d 617, 627-629 (1st Dist. 1996) ("*City III*") (affirming Commission's approval of rider recovery of the utility's franchise costs); *see also* Illinois Power Co. v. Illinois Commerce Comm'n, 339 Ill. App. 3d 425, 434 (5th Dist. 2003) (recognizing that the Commission is authorized to set rates two ways: by base rates and by automatic cost recovery mechanisms such as riders). In *CUB*, the Illinois Supreme Court re-confirmed its decision in *City I* and established that the Commission has the authority to approve the direct recovery of particular costs through a rider. *CUB*, 166 Ill. 2d at 138.With respect to the rule against single issue ratemaking, Peoples Gas' position is that the Commission has concluded that Illinois law prohibits single issue ratemaking only in the context of a rate case during the phase that balances the utility's cost and allowed revenues, and is not applicable to a proposed rider that merely facilitates direct recovery of a particular cost without upsetting the utility's revenue requirement. *Peoples 2007* at 142. The rule against single issue ratemaking applies only in the context of a general rate case, such as the present proceeding. *See* Archer-Daniels-Midland Co. v. Illinois Commerce Comm'n, 184 Ill. 2d 391, 401-402 (1998); *CUB*, 166 Ill. 2d at 138. The rule is based on the principle that it would be improper to consider changes to one component of a utility's revenue requirement (operating costs plus rate base times rate of return on capital) in isolation because a change to one item of the revenue formula could be offset by a corresponding change in a different component of the formula. *BPI II*, 146 Ill. 2d at 244-245.

Based on this authority, Peoples Gas concludes that the rule against single issue ratemaking is not violated where a rider merely facilitates the direct recovery of

[17] *In re Commonwealth Edison Company*, ICC Docket No. 07-0566, at 137-143 (Order September 10, 2008).

particular costs in a manner that either has no direct impact on or accounts for any corresponding changes to the components underlying the utility's rate of return so that there is no under- or over-recovery. *BPI II*, 146 Ill. 2d at 244-245; *CUB*, 166 Ill. 2d at 138; *City III*, 281 Ill. App. 3d at 627-629; *Peoples 2007* at 159-160.

Approving Rider ICR is an appropriate exercise of the Commission's discretionary authority based on the evidence of its benefits submitted by Peoples Gas and because the rider would not violate the rule against single issue ratemaking. Peoples Gas states that unlike the version of the rider proposed in its previous rate case, Rider ICR proposed in the present proceeding includes a factor for offsetting savings generated by the accelerated program, thus preventing any overstatement of Peoples Gas' overall revenue requirements by Rider ICR. *See* PGL Ex. VG-1.1 at 90-91. Peoples Gas further relies on the fact that at the suggestion of Staff, this provision of Rider ICR has been further modified to require the re-calculation of this savings factor no less than every three years, with the Commission and other parties free to initiate proceedings to do so more frequently if necessary. Staff Ex. 1.0 at 43-44; NS-PGL Ex. VG-2.0 Rev. at 53; Staff Ex. 15.0 Att. G at 6. Peoples Gas concludes that for these reasons, Rider ICR does not violate the single issue ratemaking rule.

Peoples Gas also notes that Rider ICR proposed here corrects another legal concern raised by the Commission to the version of Rider ICR proposed in Peoples Gas' 2007 rate case. The version of the rider proposed in the 2007 rate case contained a provision that would prohibit the Commission from exercising its statutory power to initiate a proceeding under the Public Utilities Act requiring Peoples Gas to carry the burden of proving the reasonableness of Rider ICR. *Peoples 2007* at 157-158. Peoples Gas points out that the specific rider proposed in the present case does not contain any provisions of this nature. Peoples Gas further states that it submitted testimony that it believes the Commission (as well as other parties) would remain free to initiate whatever procedures are authorized under the Public Utilities Act in the future with respect to Rider ICR if it is approved. *See* NS-PGL Ex. VG-2.0 Rev. at 53.

3. Evidence of the Costs and Benefits of Accelerated System Modernization

Peoples Gas' position is that in its Order in Peoples Gas' 2007 rate case, the Commission provided specific guidance and direction pertaining to the evidence it needed to evaluate and approve Rider ICR. *Peoples 2007* at 162. Peoples Gas submitted the testimony of an expert witness, Salvatore Marano of Jacobs Consultancy which was addressed to the areas of information that the Commission specified in the 2007 rate case Order. Mr. Marano is a licensed professional engineer having 18 years of experience in the operation of gas utilities and 12 years of experience as an expert for both utilities and public utility commissions on numerous matters, including CI/DI main replacement projects. PGL Ex. SDM-1.0 Rev. at 12-13. Peoples Gas submitted the following evidence in the categories outlined by the Commission in its 2007 Peoples Gas rate case Order:

a. A detailed description and cost analysis

of the proposed system modernization

Mr. Marano provided detailed testimony describing the physical nature of the modernized system as well as the expected approaches by Peoples Gas to implement the modernization. He first describes Peoples Gas' existing system and explains how the aging CI/DI mains require a higher level of risk management and generate a larger number of main leaks requiring repair. PGL Ex. SDM-1.0 Rev. at 15-17, 21-22, 26-27. Mr. Marano explained that these materials will be replaced by polyethylene ("PE") pipe materials and, when necessary, coated cathodically protected steel, which are the state-of-the art in gas main and service materials. *Id*. at 23. The PE pipe being installed has a life expectancy of 80 plus years and is not subject to corrosion or stress-related cracking. *Id*. at 34.

Mr. Marano's testimony also explained in detail how Peoples Gas' system modernization will upgrade its distribution network from a low-pressure system to a medium-pressure system. The low-pressure system is a legacy from when customers received gas manufactured from coal and is prone to outages caused by water infiltration. *Id*. 7, 34. No low-pressure systems are installed today. *Id*. at 7, 34-35. Indeed, in the future, standard residential appliances may not be compatible with a low-pressure system. *Id*. at 38. Peoples Gas' upgraded system will provide customers with a modern medium-pressure distribution system that will provide many new functionalities and benefits. *Id*. at 7-8.

Mr. Marano's testimony also provided a detailed explanation as to the expected and recommended approaches to the accelerated main replacement program. *Id*. at 59-63. As the testimony illustrates, by accelerating and thus replacing larger amounts of main each year, Peoples Gas could add a zonal approach to the program to allow for greater economies of scale and coordination with the City and other utilities with respect to their infrastructure projects. *Id*. at 61.

Mr. Marano also prepared and submitted a detailed cost analysis on behalf of Peoples Gas to show, as best as could be projected, what the construction costs would be for replacing its CI/DI mains at the current rate, which would have the replacement completed in the year 2059, and under a nineteen-year accelerated replacement scenario which would have Peoples Gas complete its replacement program by the year 2029. PGL Ex. SDM-1.0 Rev. at 50-57, 63-65; PGL Exs. SDM-1.13 Rev., SDM-1.19. Mr. Marano's analysis concluded that the accelerated main replacement program would cost $432 million (in 2010 dollars) less in construction costs than Peoples Gas' current main replacement program over what would be its 49-year life-span. PGL Ex. SDM-1.0 Rev. at 54; PGL Exs. SDM-1.16 Rev. and SDM-1.18 Rev. After subtracting the incremental costs (termed "Incremental O&M" in the analysis) of program management and labor (such as meter installation work) associated with the accelerated program that are projected to be $159.7 million, Mr. Marano projected that the net construction cost savings from accelerating the main replacement program construction would be $272.3 million. PGL Ex. SDM-1.0 Rev. at 54; PGL Ex. SDM-1.19; NS-PGL Ex. SDM-2.0 at 12.

Mr. Marano further testified that the new distribution system would provide savings in Peoples Gas' ongoing operations and maintenance ("O&M") costs by substantially reducing the amount of leak repairs, leak surveys, leak rechecks, emergency responses, regulator station inspection and maintenance, vault survey and maintenance, lost gas and inside safety inspections. PGL Ex. SDM-1.0 Rev. at 55, 65; PGL Ex. SDM-1.17 Rev. Mr. Marano testified that compared to the scenario in which Peoples Gas continues its current main replacement plan, the accelerated scenario would generate a total of $244 million in O&M cost savings over that same time period. PGL Ex. SDM-1.0 Rev. at 54, 55; PGL Ex. SDM-1.17 Rev.

b. An identification and evaluation of the range of technology options considered and analysis and justification of the proposed technology approach

Peoples Gas provided evidence that the materials to be used in replacing its aging CI/DI mains -- PE and coated cathodically protected steel -- are the state-of-the art in gas main and service materials. PGL Ex. SDM-1.0 Rev. at 23. Likewise, the upgrade to a medium-pressure from a low-pressure distribution system will bring Peoples Gas current with the standard for natural gas distribution systems, as low-pressure systems are a legacy of a bygone era, as low-pressure systems are no longer being installed and appliances for such systems being discontinued. *Id*. 7, 34, 38. A medium-pressure system also is less costly to construct because it allows for smaller diameter pipe to be used, and can take advantage of PE pipe, which is less expensive than coated steel pipe. *Id*. at 35.

Mr. Marano's testimony discussed the technology options used and alternatives considered by Peoples Gas, explaining that the company's use of directional drilling technology reduces construction restoration costs and eliminates the need to dispose of spoil caused by open trenching. *Id*. at 58-59. Mr. Marano also described the options available for approaches to pipe replacement and explains why he recommended the use of a zonal approach to create economies of scale that may create further cost savings as well as provide benefits to the City and other utilities via the coordination of their respective infrastructure projects. *Id*. at 59-62.

Peoples Gas also provided testimony explaining how its "double decking" of mains -- that is, placing main in the parkways on each side of a street rather than a single main in the middle of the street -- would create several benefits:

- remove gas main from the congestion of utilities in the street;
- reduce future maintenance costs;
- reduce the potential for excavation damage to gas facilities from third parties;
- reduce the average length of service lines and number of long side services; and

- reduce program installation costs.

Id. at 45, 67.

c. A detailed identification and description of the functionalities of the new system, related both to system operation as well as on the customer side of the meter, and an identification and justification of functionalities foregone

Peoples Gas introduced a considerable amount of evidence as to the functionalities of the new system as to its operation and to customers and other interested parties, and the benefits provided by those functionalities. With respect to the old low-pressure system, Peoples Gas' expert Mr. Marano testified that there will not by any functionalities foregone when that system is replaced. PGL Ex. SDM-1.0 Rev. at 7, 47.

As for the new system, Mr. Marano testified that it will be simpler, more reliable and be more optimal in design. *Id*. at 44. Over 300 medium to low pressure regulator stations, along with their maintenance costs, can be eliminated and replaced with 54 new high to medium pressure regulator stations with a common design that will reduce construction costs and future maintenance costs. *Id*. at 44. Water infiltration common with low-pressure systems, which can cause outages, will be eliminated. *Id*. The moving of meter sets to outside the house will provide greater access and improved safety, and the new meters combined with the constant pressure provided by the modernized system will measure gas usage more accurately. *Id*. at 45.

From a system operation and maintenance perspective, the new regulator stations will be in the parkway, providing safe access and reduced impact on traffic. *Id*. This will also benefit the City, which will encounter fewer regulator vaults that could impede street construction. *Id*. at 46. Eliminating the medium to low pressure regulator stations will reduce the amount of training, inspection and maintenance necessary, thus also reducing the potential for human error. *Id*. at 32, 45-46. The increased use of PE pipe will reduce the risk of leaks caused by corrosion and reduce the amount of pipe required to be leak surveyed annually. *Id*. at 46.

Customers also will benefit from the functionalities of a modernized system. Customers will no longer need to install costly gas boosters and safety back-check valves to provide elevated pressures for modern energy efficient appliances and back-up generators. *Id*. at 33, 46. Service lines will have excess flow valves -- unavailable with a low-pressure system -- which will reduce the potential property damage caused by a damaged service line. *Id*. at 31, 46. Furthermore, emergency response personnel, such as the City's Fire Department, will be able to shut off gas to a building from the outside meter sets, which potentially could reduce property damage in fire and other emergency situations. *Id*. at 46.

The evidence illustrated the following additional beneficial functionalities that the modernized system will provide:

- fewer joint leaks because PE pipe is fused and steel pipe welded (*id*. at 35);
- medium-pressure meter sets will have a pressure regulator with overpressure relief and meter shutoff valve before the meter (*id*. at 32);
- meters relocated outside will eliminate the need for inside safety inspections (*id*. at 32);
- the use of PE pipes will enable crews to isolate gas leaks quickly by closing an existing valve or squeezing off the pipe upstream and downstream from the leak (*id*. at 32); and
- moving gas mains out of the streets and into parkways will result in a reduction of third-party excavation damage and accidental gas line cuts and an increase in worker safety (*id*. at 8, 32).

d. Analysis of the benefits of the system modernization, both to system operation as well as to customers, including reductions in system costs, and an analysis of the range and benefits of potential new products and services for customers made possible by the system modernization

Peoples Gas also provided evidence that the system modernization will provide additional benefits to customers, including enhanced system safety, reduced system costs, potential new products and significant environmental benefits. Furthermore, Peoples Gas submitted evidence that the acceleration of Peoples Gas' main replacement program will create additional jobs.

As Mr. Marano describes in detail in his testimony, Peoples Gas' aging CI/DI mains are comprised of materials that pose a risk of catastrophic failures, which present risk to customers and Peoples Gas' personnel that the company must manage. PGL Ex. SDM-1.0 Rev. at 21-23. While Peoples Gas does a good job managing these risks, these materials ultimately will fail and must be replaced, with the costs of managing this system continuing to increase as it ages. *Id*. at 29. Peoples Gas' proposed system modernization will eliminate the risks, along with the risk management costs they require, posed by the existence of these higher-risk materials in the company's distribution system. *Id*. at 29-30.

The evidence shows that modernizing Peoples Gas' distribution network will generate savings in Peoples Gas' O&M costs that will benefit customers. Mr. Marano's analysis projected that if Peoples Gas accelerated its main replacement program, those O&M savings would amount to $244 million between the years 2011 and 2059 because of a substantial reduction in the amount of leak repairs, leak surveys, leak rechecks, emergency responses, regulation station inspection and maintenance, vault surveys and maintenance, lost gas and inside safety inspections. *Id*. at 54, 55, 67-68. Customers would further benefit from the synergies and efficiencies in system maintenance by no longer being inconvenienced by the need to schedule inside safety inspections, suffer from water infiltration outages or the freeze-up of low-pressure risers. *Id*. at 38-39.

A medium-pressure system upgrade will enable customers to more easily use technologies and appliances, particularly high-efficiency appliances, not compatible with the low-pressure system now in place. *Id*. at 38. Currently, to operate these types of appliances and natural gas-fired back-up generators on the low-pressure system, customers are required to install and maintain electric-powered gas pressure booster systems which can cost between $20,000 and $50,000. *Id*. at 39-40. This would be important for facilities such as schools, hospitals and emergency services providers, which are required by Chicago code to have back-up generators installed. *Id*. at 40. Those facilities now located on the low-pressure system would need a pressure booster system installed to use a natural gas-powered generator (*id*.), or else use gasoline or diesel powered versions which are less environmentally friendly and potentially dangerous. *Id*. at 40-41.

A medium-pressure system would allow all customers to install high-efficiency appliances such as tankless water heaters, fan-assisted heaters, home generators and commercial-grade cooking appliances. *Id*. at 39. Not only is the availability of such high-efficiency appliances important for the environment and energy-conservation (*see id*. at 43), but they will help customers save money as well. For example, a tankless water heater is estimated to cost $265 to operate a year, as opposed to $326 for a 40-gallon gas heater and $453 for a 40-gallon electric tank. *Id*. at 39; PGL Ex. SDM-1.11.

Another financial benefit to customers of the new medium-pressure system will be that it will allow customers to use corrugated steel piping, which is more economical and will allow customers to reduce their building construction costs. *Id.* at 40.

Mr. Marano's testimony detailed other significant environmental benefits of system modernization, as well. The elimination of Peoples Gas' CI/DI mains and their replacement with PE and protected steel pipe will dramatically reduce the amount of greenhouse gas emissions from the company's mains. Based on a study by the U.S. Environmental Protection Agency, Mr. Marano estimated that by accelerating the main replacement program, Peoples Gas could further reduce the emission of greenhouse gases by approximately 10,500 Mcf per year. *Id*. at 41-42. Upgrading the system to medium-pressure also will eliminate the need for the collection, testing and disposal of water that enters the gas distribution system. *Id*. at 42-43.

Another important benefit of accelerating the main replacement program to the City would be the creation of a substantial number of jobs, as additional people will be needed to perform the construction work (both internal and external to the company), the meter installations and relights of service and the management of the work. *See Id*. at 72-74. When questioned at the hearing as to whether Peoples Gas could accelerate the main replacement program without hiring additional personnel, Mr. Marano testified: "Absolutely not." Tr. at 887-888.

Peoples Gas further relies upon the fact that even the AG-CUB witness who testified in opposition to Rider ICR agreed on cross examination that the decision on whether to implement an infrastructure investment program such as Rider ICR should not be based solely on cost, but on factors such as safety and reliability, as well. Tr. at 984. Peoples Gas argues that the evidence demonstrates that Rider ICR would generate not only financial benefits for customers in the form of construction and O&M cost savings, but additional benefits to customers such as enhanced safety, energy conservation, increased functionalities and appliance choices and reduced environmental impacts. Peoples Gas thus concludes that the evidence in the record strongly weighs in favor of authorizing Rider ICR to help bring these benefits to customers sooner than otherwise possible.

B. Staff

[Insert]

C. Other Parties

[Insert]

D. Peoples Gas' Response

1. Response to Staff

Peoples Gas explained that Staff's proposal requiring Commission approval of a plan for the accelerated replacement program is unnecessary. Consequently, there is no need for tariff revisions to implement the proposal. This subject is addressed in Section IX of this Order.

Ms. Grace explained that Staff's proposal that Rider ICR include language to provide for a more frequent update of the "actual savings" factor if demonstrated to be needed by Peoples Gas or any other party (Staff Exs. 1.0 at 44 and 15.0 at 34-35) is unnecessary. While Peoples Gas agreed to the triennial update of the factor (NS-PGL Ex. VG-2.0 Rev. at 53), Peoples Gas states that the Public Utilities Act affords the Commission, Peoples Gas and others means to address concerns with any provision in Peoples Gas' Schedule of Rates for Gas Service. Peoples Gas concludes that it is unnecessary for Rider ICR to specifically state this fact for a single tariff element.

2. Response to AG/CUB

Peoples Gas argues that Mr. Rubin's revenue requirement analysis does not accurately show what customers would pay under Rider ICR. Peoples Gas points to the following statement in Mr. Rubin's cross examination:

> My analysis is not limited to Rider ICR. My analysis is a revenue requirements analysis. The Company's proposal for Rider ICR would recover a portion of those costs through the rider and a portion of those costs through base rates.

Tr. at 992.

Peoples Gas points out that Mr. Rubin's analysis assumes customers will begin paying revenue requirements for the entire amount of capital investment made each year under the accelerated program and ignores the fact that Rider ICR contains a cap equal to 5% of base rate revenues. NS-PGL Ex. VG-3.0 at 37; Tr. at 166-171. While Mr. Rubin's revenue requirement analysis shows customers paying revenue requirements of $28.1 million, $43.6 million and $60.0 million in years 2011 through 2013, respectively (*see* AG-CUB Ex. 6.06), in reality, the revenue requirement under Rider ICR for those years would be $9.6 million, $29.8 million and $29.8 million. NS-PGL Ex. VG-3.0 at 38. On cross examination, Mr. Rubin admitted that this is how Rider ICR actually would work and that he did not perform the "interesting mathematical exercise" to determine how revenue requirements really would be determined, but rather merely assumed it would not make a difference. *See* Tr. at 993-994. Peoples Gas thus argues that although AG-CUB purports to offer this analysis to argue about the impact of Rider ICR on customers (*see* AG-CUB Ex. 6.0 at 6), it is completely divorced from the reality of how Rider ICR would work and thus, should be given little or no weight.

Peoples Gas also responds that Mr. Rubin's analysis only is able to generate larger revenue requirement numbers for the accelerated program than the current replacement program by inappropriately limiting his calculations to the 49-year period when construction would take place. Tr. at 994. Peoples Gas states that Mr. Rubin's use of this 49-year period because that is the timeframe that Mr. Marano used for his cost-benefit analysis was improper and is the source for Mr. Rubin's artificially inflated results. Peoples Gas points out that Mr. Marano's analysis was looking solely to compare the costs of construction and O&M costs that would be incurred during the timeframe of the current replacement program versus what they would be if the program was accelerated. Revenue requirements on those amounts, however, as Mr. Rubin himself testified, continue "for many years into the future" after those costs are incurred and added to the rate base. AG-CUB Ex. 6.0 at 2; Tr. at 995, 1008-1009.

Peoples Gas' position is that to fairly compare the revenue requirements associated with the accelerated main replacement program to the revenue requirements that would be generated by the current program, the overall revenue requirements generated under each scenario should be compared, not just a snapshot of time. Peoples Gas notes that Mr. Rubin, however, failed to carry his analysis past the end of the 49-year construction period even though the revenue requirements for both programs continued past that time. Tr. at 1008-1009. Mr. Rubin performed no analysis and made no assumptions as to what would occur past that 49-year period, despite the continuation of revenue requirements past that time. *See* Tr. at 1000. Indeed, Mr. Rubin was forced to admit on cross examination that if his analysis was carried out until the capital investments were completely depreciated, the current main replacement program would generate an overall larger revenue requirement than the accelerated main replacement program. Tr. at 1010-1011. Peoples Gas states that thus, even if Mr. Rubin's revenue requirement analysis were to accurately reflect the impact of Rider ICR, it would actually support the adoption of Rider ICR if performed over the proper timeframe. In addition, Peoples Gas points out that the AG-CUB's analysis also fails to account for the fact that utility revenues have a positive impact on local economies of 1.2 to 2.4 times the revenue amounts. NS-PGL Ex. SDM-3.0 at 11.

Peoples Gas thus concludes that the AG-CUB analysis of revenue requirements lacks sufficient foundation as a model of how Rider ICR would work and impact customers, and therefore, should be given no weight.

D. Commission Analysis and Conclusions

The Commission finds that it has the authority to approve riders under appropriate circumstances when legal and reasonable. The Commission finds that Rider ICR as proposed by Peoples Gas in this proceeding is legal and reasonable, and does not pose a violation of the doctrine against single issue ratemaking. The Commission finds that Peoples Gas submitted the type of information the Commission specified in its 2007 Peoples Gas rate case Order to address an infrastructure modernization proposal such as Rider ICR and concludes that the weight of the evidence submitted demonstrates benefits to customers to approving Rider ICR to help enable Peoples Gas to accelerate its main replacement program that outweigh its costs. Accordingly, the Commission agrees with Peoples Gas that this case presents a proper situation in which to exercise its legal authority to approve Rider ICR.

The Commission finds that its rules at Part 656 are a reasonable starting point for an infrastructure recovery rider such as Rider ICR. The several changes that the Staff proposed and that Peoples Gas accepted enhance the clarity of the rider and improve the Commission's ability to oversee cost recovery under the rider. The Commission finds that Rider ICR is just and reasonable. It approves the uncontested changes, as well as other uncontested portions of Rider ICR, as appropriate and reasonable. The Commission addresses Staff's proposed plan in Section IX, *infra*. For the reasons described in that section, we conclude that Staff's proposal is unnecessary and reject the requirement that Peoples Gas submit a plan to the Commission for pre-approval prior to accelerating its existing CI/DI main replacement program. Consequently, Staff's proposal to add language to Rider ICR is concerning the plan moot.

The Commission finds that interested parties have adequate rights under the Act to request that the Commission initiate a proceeding to address the "actual savings" factor in Rider ICR or any other provision. Likewise, Peoples Gas may petition the Commission to open a proceeding or the Commission may initiate a proceeding *sua sponte*. Adding language for a single clause in Peoples Gas' tariff is superfluous and unnecessary, and we do not accept Staff's proposed language.

IX. STAFF PROPOSALS REGARDING ACCELERATION OF CAST AND

DUCTILE IRON MAIN REPLACEMENT PROGRAM FOR PEOPLES GAS

A. Introduction

Staff, through its witness, Harold Stoller, has made three proposals regarding Peoples Gas' proposed acceleration of its main replacement program:

- The Commission should order Peoples Gas to conduct the accelerated main replacement program as outlined in Mr. Marano's testimony (Staff Ex. 14.0 at 6; Staff Ex. 28.0 at 6);

- The Commission should order Peoples Gas to present a fully-developed plan for carrying out the main replacement program and obtain Commission approval of that plan in a docketed proceeding, with the plan analyzed by an independent consultant to be retained by the Commission at Peoples Gas' expense (Staff Ex. 14.0 at 2); and

- The Commission should order Peoples Gas to return with an updated analysis every three years to be analyzed by an independent consultant to be retained by the Commission at Peoples Gas' expense (*id*. at 2).

The Commission addresses those Staff proposals in this Section of this Order.

1. Staff

[*Insert*]

2. Other Parties

[*Insert*]

3. Peoples Gas Response

Peoples Gas' position is that each of Staff's recommendations as to the accelerated main replacement program should be rejected because Staff failed to perform any independent analysis to support its recommendations and failed to make any showing of their necessity.

a. Ordering the Accelerated Plan

Peoples Gas notes that Mr. Stoller's recommendation that it be ordered to expedite the replacement of its CI/DI mains from the perspective of "maintaining public safety" is solely based on Mr. Marano's testimony concerning Peoples Gas' distribution system. Staff Ex. 14.0 at 5-6. Peoples Gas states that the Commission's authority to issue such an order would come from Section 8-503 of the Public Utilities Act, which provides:

> Whenever the Commission, after hearing, shall find that … repairs or improvements to, or changes in, the existing plant, equipment, apparatus, facilities or other physical property of any public utility … are necessary and ought reasonably to be made … the Commission shall make and serve an order authorizing or directing that such … repairs, improvements or changes be made … in the manner and within the time specified in said order….

220 ILCS 5/8-503. Peoples Gas' position thus is that before the Commission may enter such an order under Section 8-503, it must find that the changes to be made -- here, the acceleration of the main replacement program -- "are necessary." *Id*.

Peoples Gas states that the only "need" testified to by Mr. Stoller to justify his recommendation is "public safety." Peoples Gas states that there is no evidence in the record that the program's immediate acceleration is necessary to prevent or eliminate a public safety concern. Peoples Gas notes that Mr. Marano testified that there is no immediate danger posed by Peoples Gas' current system and that Peoples Gas does a good job managing the risks posed by the current system. PGL Ex. SDM-1.0 Rev. at 29. Staff witness Mr. Stoller agreed that there is no evidence in the record that Peoples Gas' system is not safe or not being operated safely at the present time. Tr. at 899.

Peoples Gas further argues that while Mr. Stoller testifies as to his "belief" that Peoples Gas cannot be relied upon to conduct its main replacement program appropriately without a Commission ordered timeline (Staff Ex. 14.0 at 6), Staff provides no evidence to support this belief. Peoples Gas demonstrates that although Mr. Stoller relies upon the recommendations of an original study conducted by Zinder Engineering, Inc. ("Zinder"), in 1981 to argue that Peoples Gas had not diligently pursued the recommended pace of main replacement (Staff Ex. 28.0 at 4-5), he fails to acknowledge two facts that completely undermine his conclusion. First, Mr. Stoller fails to point out that the 2030 completion date in the 1981 Zinder report was only for specific CI/DI mains buried in clay soil, not Peoples Gas' entire CI/DI main system. NS-PGL Ex. ED-3.0 at 4. Second, Mr. Stoller fails to acknowledge that a subsequent, more in-depth study by ZEI, Inc. (a successor to Zinder) concluded that the target date for replacing the CI/DI mains should be pushed back from 2030 to 2050 based on an economic (not safety) analysis. *Id*. at 4-5. When the recommendations from all of the studies performed on Peoples Gas' main replacement program prior to this proceeding are compared against the company's actual performance, the evidence proves that Peoples Gas achieved a replacement rate greater than recommended by those consultants. *Id*. at 5-6.

Peoples Gas therefore concludes that there is no evidence that acceleration of the main replacement program is necessary for public safety or that Peoples Gas cannot be relied upon to conduct its main replacement program reasonably without an order by the Commission.

b. Ordering Separate Docketed Proceeding and Consultants to Be Retained by Commission

Peoples Gas argues that Staff also failed to demonstrate the need to initiate a separate docketed proceeding to analyze and approve Peoples Gas' plan for implementing its accelerated main replacement program. Peoples Gas' position is that such micro-management of its operations is not the proper role for the Commission or Staff, especially in light of the fact that Staff has submitted no evidence demonstrating that Peoples Gas is incapable or unwilling to take the actions necessary to implement and execute an accelerated main replacement program on its own. This position is further supported by the Union, which notes that Staff submitted no evidence to support the need for additional consultants. *See* Union Init. Br. at 3-4.

Peoples Gas submitted evidence that it engaged Mr. Marano and Jacobs Consultancy and already has prepared an initial plan of action and begun working on the type of detailed implementation plan outlined by Mr. Marano in his testimony. *See* PGL Ex. SDM-1.0 Rev. at 69-74; NS-PGL Ex. SDM-2.0 at 4-8; NS-PGL Ex. SDM-3.0 at 2-6; NS-PGL Ex. SDM-3.1. Peoples Gas argues that this evidence contradicts Mr. Stoller's "beliefs" and demonstrates that Peoples Gas is capable of managing, implementing and executing an accelerated main replacement program in a reasonable and prudent manner without prior approval by Commission.

Similarly, Peoples Gas' position is that Staff has made no showing that the retention of independent consultants by the Commission at Peoples Gas' expense is necessary to ensure Peoples Gas is conducting an accelerated main replacement program properly. The Commission's authority to order such a management audit or investigation is provided by Section 8-102 of the Public Utility Act. 220 ILCS 5/8-102. Section 8-102 requires that the Commission have reasonable grounds to believe that the investigation or audit "is necessary to assure that the utility is providing adequate, efficient, reliable, safe, and least-cost service" or that it is "likely to be cost-beneficial in enhancing the quality of service or the reasonableness of rates therefor." *Id*. Peoples Gas argues that Staff has made neither a showing of necessity nor a showing that the benefits such consultants might provide would justify their cost. Peoples Gas points out that Staff has not even investigated what the costs of such consultants might be. Tr. at 900. Peoples Gas thus argues that, at this time, in light of the evidence of Peoples Gas' diligence and proactive efforts, and lack of evidence demonstrating their need or benefits, no justification exists at this time for imposing the cost of additional consultants on Peoples Gas.

Peoples Gas further argues that Staff's recommendations ignore the fact that if, at anytime in the future, there is evidence that Peoples Gas is mismanaging the accelerated main replacement program, moving too slowly or imprudently incurring costs, Staff or other parties have the ability to initiate proceedings to correct any such problems if and when such need arises. Rider ICR would require annual reporting and audits, and the costs recovered via the rider will be subject to annual reconciliation review. Cost savings will be required to be updated no less than every three years. Peoples Gas' position is that the reporting procedures required by Rider ICR would provide adequate opportunities for monitoring of program milestones and efficiency. *See* NS-PGL Ex. SDM-3.0 at 6. Moreover, Peoples Gas maintains the position that it has consistently represented throughout this proceeding that it is willing to provide additional reporting or updating on the program if the Commission requests or requires it. Peoples Gas also relies on the concession by Mr. Stoller during cross examination, nothing would prevent the Commission from taking action to initiate an investigation of the accelerated main replacement program or order the retention of consultants at some future time if it becomes necessary to do so. Tr. at 901-902.

Peoples Gas takes the further position that if the Commission decides to accept Staff's recommendations as to ordering the retention of consultants, such order should be made pursuant to its authority under Section 8-102 of the Public Utilities Act, with the costs of the consultants borne initially by Peoples Gas to "be recovered as an expense through normal ratemaking procedures" in the company's next rate case.

4. Commission Analysis and Conclusions

The Commission agrees with Peoples Gas that Staff has failed to make the required showing of necessity for the Commission to order Peoples Gas to undertake a specific program of accelerated main replacement under 220 ILCS 5/8-503. Similarly, Staff has failed to make the requisite showing of necessity or cost-benefit justification under 220 ILCS 5/8-102 for the Commission to order the retention of independent consultants by the Commission to be paid for by Peoples Gas in the first instance to review Peoples Gas' plan for acceleration in a separately docketed proceeding and/or to review periodic updates of any accelerated program. Nor does the evidence otherwise warrant Staff's proposals. The Commission therefore rejects each of Staff's recommendations as to the accelerated main replacement program.

X. OTHER NEW RIDERS

A. Rider UEA (Withdrawn)

1. The Record

The Utilities each proposed a Rider UEA, Uncollectible Expense Adjustment to recover gas cost-related Account 904 ("Uncollectible Accounts") expenses through a factor applied to customers' bills, rather than through base rates. NS Ex. VG-1.0 Rev. at 30-31; PGL Ex. VG-1.0 Rev. at 34. Subsequent to the filing, legislation (Public Act 96-0033) went into effect that allows gas utilities to file to recover certain Uncollectible Accounts expenses through an automatic adjustment mechanism. Staff Ex. 19.0 at 5; 220 ILCS 5/19-145. The Utilities therefore withdrew their proposed Rider UEA. NS-PGL Ex. VG-3.0 at 38.

2. Commission Analysis and Conclusions

The Utilities are no longer proposing Rider UEA in this proceeding, and neither Staff nor any party opposed its withdrawal. Consequently, the request to approve Rider UEA, and any proposals that were made regarding the specifics of such a rider, in this proceeding are moot.

B. Rider FCA (NS) (Uncontested)

1. The Record

North Shore proposed Rider FCA, Franchise Cost Adjustment. Ms. Grace explained that North Shore has franchise agreements with local governmental units ("local government") so that it may use public rights of way to deliver gas to customers in those areas. Under these agreements, North Shore compensates the local government. Under Rider FCA, North Shore would annually calculate a per customer charge based on the costs imposed by each local government and applicable to the customers residing in the boundaries of the local government. Ms. Grace stated that Rider FCA would recover only costs actually incurred. Effective May 1, 2010, new base rates would go into effect for North Shore to reflect the removal of franchise costs, which would then be recoverable through the rider. NS Ex. VG-1.0 Rev. at 31-33. Only Staff addressed proposed Rider FCA, and it recommended that the Commission approve it. Staff Ex. 11.0 at 22.

2. Commission Analysis and Conclusions

The Commission has approved similar mechanisms for other utilities (ComEd in Docket 05-0597; Nicor Gas in Dockets 04-0779 and 08-0363 (approving a modification to an existing rider)). Staff recommended approval of the rider and no party opposed this proposal. North Shore's proposal is consistent with cost causation principles and would recover costs from customers living in the locality causing North Shore to incur the costs. The Commission finds that Rider FCA is just and reasonable and approves it. Furthermore, the Commission directs North Shore to include in its compliance filing effective base rates that include franchise costs in its test year revenue requirements and base rates that would become effective May 1, 2010, that remove franchise costs from its test year revenue requirements.

C. Rider GCA (NS) (Uncontested)

1. The Record

North Shore proposed Rider GCA, Governmental Agency Cost Adjustment. Ms. Grace explained that local governments may impose costs on North Shore that are incremental to those included in base rates. North Shore would annually calculate a per customer charge based on the costs imposed by each local government and applicable to the customers residing in the boundaries of the local government. According to Ms. Grace, Rider GCA would recover only costs actually incurred. NS Ex. VG-1.0 Rev. at 33-34. Only Staff addressed proposed Rider GCA, and it recommended that the Commission approve it. Staff Ex. 11.0 at 22.

2. Commission Analysis and Conclusions

The Commission has approved similar mechanisms for other utilities (ComEd; Nicor Gas). Staff recommended approval of the rider and no party opposed this proposal. North Shore's proposal is consistent with cost causation principles and would recover costs from customers living in the locality causing North Shore to incur the costs. The Commission finds that Rider GCA is just and reasonable and approves it.

XI. COST OF SERVICE

A. Overview

1. North Shore and Peoples Gas

Only the Utilities prepared and submitted embedded cost of service studies ("ECOSSs"). The Utilities' witness Ms. Hoffman Malueg explained that the Utilities used these ECOSSs to develop their rate design proposals. NS Ex. JCHM-1.0 at 1 and Exs. JCHM-1.1 - 1.9; PGL Ex. JCHM-1.0 Rev. at 1 and Exs. JCHM 1.1 - 1.9. There is only one contested ECOSS issue, which is the proper classification of Account 904 costs. This issue has rate design ramifications. Additionally, there is a recommendation concerning the sales forecast that could impair preparing the ECOSSs to support final rates.

2. Other Parties

[Insert]

B. Embedded Cost of Service Study

1. Overview

a. North Shore and Peoples Gas

The Utilities' witness Ms. Hoffman Malueg prepared the ECOSSs and testified that the preparation involves three fundamental steps: (1) cost functionalization, which identifies and separates plant and expenses into categories such as production, storage, transmission, distribution and customer; (2) cost classification, which separates the functionalized plant and expenses into commodity, demand and customer; and (3) cost allocation, which allocates the functionalized and classified costs to the customer classes. She stated that the most important theoretical principle underlying a cost of service study is that cost incurrence should follow historical embedded cost causation. NS Ex. JCHM-1.0 at 7-9; PGL Ex. JCHM-1.0 Rev. at 7-9.

Ms. Hoffman Malueg's direct testimony included a detailed description of how she performed each of the three fundamental steps summarized above and, in particular, the methodologies she used to allocate various categories of costs. NS Ex. JCHM-1.0 at 8-24; PGL Ex. JCHM-1.0 Rev. at 7-25. The witness used the Utilities' revenue requirements and rate bases as sources of cost data and drew detailed information from the Utilities' systems or historical books and records. NS Ex. JCHM-1.0 at 25; PGL Ex. JCHM-1.0 Rev. at 25.

The Utilities' ECOSSs showed the following RORs under present and proposed rates:

North Shore Gas Company		
Service Classification	Present Rates	Proposed Rates

("S.C.")	(rate of return)	(rate of return)
S.C. No. 1 Small Residential Service	0.77%	9.18%
S. C. No. 2 General Service	4.30%	9.18%
S. C. No. 3 Large Volume Demand Service	No present customers	9.18%
S. C. No. 5 Standby Service	5.67%	Combined with S. C. No. 2
System average	1.84%	9.18%

NS Ex. JCHM-1.0 at 35-36. The RORs under proposed rates are consistent with North Shore's rate design proposal to set each service classification at its cost of service.

The Peoples Gas Light and Coke Company		
Service Classification	Present Rates (rate of return)	Proposed Rates (rate of return)
S.C. No. 1 Small Residential Service	(0.59%)	7.29%
S. C. No. 2 General Service	8.02%	13.27%
S. C. No. 4 Large Volume Demand Service	0.83%	9.34%
S. C. No. 6 Standby Service	18.71%	Combined with S. C. No. 2
S. C. No. 8 Compressed Natural Gas Service	7.09%	9.34%
System average	2.53%	9.34%

( ) denotes negative number

PGL Ex. JCHM-1.0 Rev. at 36-38. The RORs under proposed rates are consistent with Peoples Gas' rate design proposal to set S.C. Nos. 4 and 8 at their cost of service; S.C. No. 1 below its cost of service; and S.C. No. 2 above its cost of service.

b. Other Parties

[Insert]

2. Uncontested Issues

a. Sufficiency of ECOSS for Rate Design

i. The Record

The Utilities' witness Ms. Hoffman Malueg testified that the ECOSSs are comprehensive and theoretically sound. She stated that the ECOSSs are a reasonable estimate of revenue requirements by customer class and support the rates that the Utilities' rate design witness developed. NS Ex. JCHM-1.0 at 37; PGL Ex. JCHM-1.0 Rev. at 38. Staff reviewed the Utilities' ECOSSs and concluded that each was an acceptable guidance tool for setting rates. Staff Ex. 10.0 at 13, 36.

ii. Commission Analysis and Conclusions

Neither Staff nor any party contested the sufficiency of the Utilities' ECOSSs to develop rates in this proceeding. The Utilities' ECOSSs are complete, they systematically functionalize, classify and allocate costs, and they comport with the cost causation principles for preparing such studies that the Commission has approved in many other rate cases. The Commission finds that the Utilities' ECOSSs are sufficient and reasonable for developing rate designs in this proceeding.

3. Contested Issues

a. Classification of Uncollectible Account Expenses Account 904

i. North Shore and Peoples Gas

Account 904 includes uncollectible expenses. Ms. Hoffman Malueg stated that, in their ECOSSs, the Utilities functionalized Account 904 costs to the customer function, Customer Accounts category. The Utilities then classified these costs to the "customer" category. Finally, the Utilities allocated these costs based on the "Bad Debt allocation methodology." NS-PGL Ex. JCHM-2.0 at 8-9. Under the Bad Debt allocation methodology, Ms. Hoffman Malueg explained that the Utilities calculated the average historical bad debt net write-offs per customer by customer class as of the twelve months ended June 30, 2008, and applied that average to the customer counts by customer class for the test year. NS Ex. JCHM-1.0 at 17-18; PGL Ex. JCHM-1.0 Rev. at 18.

ii. Other Parties

[Insert]

iii. North Shore and Peoples Gas Response

The Utilities contend that their functionalization, classification and allocation are proper. Ms. Hoffman Malueg stated that, for cost classification purposes, Account 904 costs are a function of customers' unpaid bills. The bills' components (fixed or variable; customer or distribution charges) are irrelevant. If a customer does not pay his bill, the unpaid amount becomes an uncollectible account expense, irrespective of the underlying components of the unpaid bill. NS-PGL Ex. JCHM-2.0 at 9. According to the

Utilities, Staff's disagreement with the Utilities' treatment of Account 904 costs in their ECOSSs incorrectly mingles cost of service and rate design principles, by relying on the fixed and variable nature of the bill components as a reason for a cost of service study decision. Staff Ex. 24.0 at 24; Tr. at 952. Staff agreed that the underlying bill components are a function of rate design and not the ECOSSs. Tr. at 952-953. The Utilities also pointed out that Staff agreed that the ECOSSs, including cost classification, are used to develop the rate design and not *vice versa* (*id*. at 951, 953), and the Utilities' ECOSS witness would not have taken the rate design into account when preparing the ECOSSs (*id*. at 953). Consequently, when determining the proper classification of Account 904 costs, the underlying rate design would not have affected and provides no support for the proper classification. NS-PGL Ex. JCHM-2.0 at 8.

The Utilities stated that, for allocation purposes, Staff relied on language from the order in the Utilities' last rate cases to argue that the Utilities should spread these costs according "to the respective demand, customer and commodity classifications by the relative weight or percentage of revenue requirement from each customer class resulting from various categories of costs." Staff Ex. 10.0 at 3-4. The Utilities stated that this argument is flawed for several reasons.

First, Ms. Hoffman Malueg explained that Staff's recommendation is circular in nature. "Circular" means that one cannot calculate an equation without first having one of its components calculated, but one cannot calculate that component without having the answer to the equation. She gave the following example,

Equation: A = B - C

Where: B = A x D

One cannot compute the answer to A without knowing the variable B, but one needs to know A in order to compute B. In the context of the Account 904 recommendation, one component of the revenue requirement calculation is operating expenses. Account 904 costs are one piece of operating expenses. Ms. Hoffman Malueg explained that Staff's proposal requires determining the revenue requirement by class in order to spread the Account 904 costs to the classes. However, one cannot compute the revenue requirement by customer class without knowing the amount of Account 904 costs allocated to the customer classes. NS-PGL Ex. JCHM-2.0 at 3-5.

Second, Ms. Hoffman Malueg stated that the circular nature of the recommendation means that the Utilities will not be able to implement it through their ECOSSs, *i.e.*, the ECOSSs will not perform the allocation as they would under the Utilities' method. To comply with the order in the 2007 rate cases, Ms. Hoffman Malueg explained that the Utilities "forced" (hard coded) a result into the ECOSSs. NS-PGL Ex. JCHM-2.0 at 6.

Third, the Utilities stated that the Staff witness tries to avoid the circularity problem by assuming, without support, that the Order in the 2007 rate cases is using the term "revenue requirement" in this context to mean revenue requirement minus the uncollectible expense. Staff Ex. 24.0 at 23. The Staff witness agreed, however, that the Order does not include that gloss on the "revenue requirement" definition. Tr. at 958-959. Moreover, the Utilities stated that Staff has not explained why such an irregularity -- a unique definition of "revenue requirement" for the sole purpose of the Account 904 costs -- would be proper in building the ECOSSs.

Finally, there is no evidence that any Illinois utility, other than North Shore and Peoples Gas, uses this approach. Staff agreed. NS-PGL Ex. JCHM-2.0 at 7; NS-PGL Ex. JCHM-2.2; Tr. at 43. Staff witness Ms. Harden testified on cross-examination that she did not use this approach in either of two cost of service studies that she prepared as a Commission witness, nor did she recommend it in the approximately 15 other rate proceedings in which she was the Commission's main rates witness. Tr. at 959-960.

The Utilities concluded that they properly classified and allocated Account 904 costs. Staff's recommendation is inconsistent with the cost causation principles that should underlie a cost of service study, improperly mixes cost of service and rate design, and is an anomaly among Illinois utilities.

iv. Commission Analysis and Conclusions

Staff's position is largely, if not entirely, based on the fact that the Commission ordered the Utilities, in their last rate cases, to spread these costs according "to the respective demand, customer and commodity classifications by the relative weight or percentage of revenue requirement from each customer class resulting from various categories of costs." Staff is correct that the Commission required this approach in the last case. However, the Commission's decision in the Utilities' 2007 rate cases appears to be a departure from the approach it has taken on this same issue for other Illinois utilities. Also, the Utilities have provided convincing evidence in this proceeding that there are flaws with the approach. The Commission is troubled that implementing the directive required the Utilities to go outside of their ECOSSs and "force" a result. We also find convincing the Utilities' explanation that Staff's recommended approach is based on rate design considerations, namely the types of charges that customers pay, which Staff and the Utilities agree would not typically influence the preparation of the cost of service study. For these reasons, the Commission concludes that the Utilities properly functionalized Account 904 costs to the customer function, Customer Accounts category, classified these costs to the "customer" category and allocated these costs based on the "Bad Debt allocation methodology."

b. Sales Revenues Adjustments

i. Other Parties

[Insert]

ii. North Shore and Peoples Gas Response

The Utilities opposed AG-CUB witness Mr. Effron's proposed increase to therm sales for the test year, as discussed in Section V(C)(8)(a) of this Order, and also pointed out that, if the Commission accepted it, there are several effects on the ECOSSs that Mr. Effron did not address. In particular, his failure to provide a monthly breakdown of the recommended increase to sales means that there was inadequate information to quantify the impact on the ECOSSs' revenue requirements by customer class. NS-PGL Ex. JCHM-3.0 at 6. In general, Ms. Hoffman Malueg explained that his proposal would increase the S.C. Nos. 1 and 2 class revenue requirements and decrease the revenue requirements for other service classifications. *Id*. at 8.

iii. Commission Analysis and Conclusions

For the reasons discussed in Section V(C)(8)(a), *supra*, the Commission rejected Mr. Effron's proposed adjustment to therm sales and the ECOSS issues are, therefore, moot.

XII. RATE DESIGN

A. Overview

1. North Shore and Peoples Gas

The Utilities' rate design witness Ms. Grace stated that the Utilities' proposed rate designs were intended to and would accomplish the following seven objectives: (1) recover the Commission-approved revenue requirement; (2) better align revenues with underlying costs; (3) send proper price signals; (4) provide more inter- and intra-class equity; (5) maintain rate design continuity; (6) reflect gradualism; and (7) retain customers on their systems. NS Ex. VG-1.0 Rev. at 6; PGL Ex. VG-1.0 Rev. at 6.

According to the Utilities, each of North Shore's service classifications would continue to be set at its cost of service. NS Ex. VG-1.0 Rev. at 8. Peoples Gas' S.C. No. 1 would remain under its cost of service, and S.C. No. 2 would remain over its cost of service, but each by a lesser amount than in the 2007 rate cases, in the interests of a gradualism; and S.C. Nos. 4 and 8 would continue to be set at cost. PGL Ex. VG-1.0 Rev. at 8.

The Utilities stated that their rate design proposals are consistent with their existing rate designs. They proposed minor modifications to improve the extent to which the rates embody cost causation principles. The Utilities offered, as examples, their proposals to (1) add a third meter class for their general service classification (S.C. No. 2), to better reflect the costs for the larger usage customers; (2) eliminate their standby service classifications, as these customers are more logically served on S.C. No. 2; and (3) include usage-based eligibility criterion for their S.C. No. 2 and for North Shore's large volume demand service classification (S.C. No. 3). These are uncontested proposals.

2. Other Parties

[Insert]

B. General Rate Design

1. Allocation of Rate Increase

a. North Shore and Peoples Gas

The Utilities' rate design witness Ms. Grace stated that the descriptions of the Utilities' rate design, including the supporting exhibits, coupled with their ECOSSs, are detailed and specific enough that it would be straightforward to derive rates from whatever revenue requirement the Commission approves. NS-PGL Ex. VG-2.0 Rev. at 5.

b. Other Parties

[Insert]

c. North Shore and Peoples Gas Response

The Utilities stated that the AG-CUB-City tiered rate proposal, were it adopted, is only applicable to S.C. No. 1 and cannot serve as a basis for allocating the rate increase. The Utilities stated that the proposed rates and exhibits that Staff witness Ms. Harden included with her rebuttal testimony (Staff Ex. 24.0, Scheds. 24.1N (Corr.) and 24.1P (Corr.)) are problematic. Ms. Grace explained that there are several flaws with the rates, and the Staff witness testimony and exhibits would not be suitable or sufficient for developing final rates.

Ms. Grace explained that Staff's approach takes a ratio of its proposed revenue requirement to each of the Utilities' proposed revenue requirements and applies it, uniformly, to each of the Utilities' proposed rates within each service classification. According to Ms. Grace, this is flawed for several reasons, including that: it is not based upon cost of service principles; it has conceptual problems and formulaic errors; some of the formulas and outcomes are inconsistent with Staff's testimony. NS-PGL Ex. VG-3.0 at 9.

More specifically, Ms. Grace explained that Staff's method is not based upon costs or revenue requirements arising from a cost of service study. It ignores the cost differences and cost allocations between rate classes and assumes that all Staff proposed adjustments could be equally applied to customer, demand, and commodity related costs, although those adjustments were specific and not derived on an across the board basis. Adjustments affecting rate base and expense items are treated equally and grouped together in one revenue requirement number, without considering the type of costs affected by each adjustment. She also stated that Staff's proposal ignores Account specific costs, such as Account 904, and would make it impossible to render Account specific adjustments for certain rates. *Id*. at 9-10.

Also, Ms. Grace stated that Staff's method adjusts, without support: charges that the Utilities did not propose to change (*e.g.*, Rider SBO); charges based on specific cost-based revenue requirement components (*e.g.*, the Standby Service Charge); and cost-based charges based on expenses that would be unaffected by Staff's proposals (*e.g.*, transportation administrative charges). *Id*. at 10-11.

Ms. Grace reviewed the individual service classifications and pointed out multiple other errors. For example,

- Staff supported (Staff Ex. 10.0 at 36), but did not apply, Peoples Gas' proposed equal percentage of embedded cost methodology for S.C. Nos. 1 and 2.
- Staff supports (Staff Ex. 24.0 at 20), but did not accommodate, AG-CUB witness Mr. Effron's proposed sales adjustment.
- Despite its lower proposed revenue requirement, Staff's method would result in a proposed S.C. No. 2 meter class 3 customer charge that is 78% higher than Peoples Gas' proposal.
- Staff's proposed S.C. Nos. 1 and 2 rates would result in higher distribution charges arising from Staff's proposed lower customer charges. The testimony included no bill impacts for this change.
- North Shore's S.C. No. 3 and Peoples Gas' S.C. No. 4 are set at cost based upon their ECOSSs. Staff's rate adjustments do not take that into consideration and could result in these service classifications being either above or below cost, with the magnitude being determined by a mathematical exercise rather than the ECOSSs. This would affect the Utilities' next rate cases.
- For Peoples Gas, Staff's approach shifts too much gas cost-related Account 904 costs to S.C. No. 1 and not enough to S.C. No. 2.
- For North Shore, Staff's approach shifts too little gas cost-related Account 904 costs to S.C. No. 1 and too much to S.C. No. 2.
- Staff's proposed rates cannot reliably identify Account 904 costs that are included in rates. While such costs can be "backed into," as demonstrated by Ms. Grace, Account 904 costs in Staff's rates were not consistent with the costs reflected in Staff's own revenue requirement.

NS-PGL Ex. VG-3.0 at 12-19.

d. Commission Analysis and Conclusions

The Commission agrees that the Utilities proposed a reliable means of allocating the rate increases approved by this Order. The Staff's method appears fraught with inconsistencies and problems. Consequently, Staff's approach cannot be adopted. However, Staff will be able to review the Utilities' compliance rates. No intervenor proposed a rate increase allocation method that addresses all rates and services.

Accordingly, the Commission concludes that the Utilities should use their ECOSSs and rate design methodologies to allocate the rate increase and develop compliance rates based on this Order.

2. Account 904 Uncollectible Expense

a. North Shore and Peoples Gas

The Utilities proposed different customer charges for transportation and sales customers. Differentiation is proper as a matter of cost causation, *i.e.*, costs should be allocated to those who cause the utility to incur the costs. NS Ex. JCHM-1.0 at 7; PGL Ex. JCHM-1.0 Rev. at 7. Currently, this differentiation is reflected in the distribution charges. Ms. Grace stated that there are two major reasons differentiation of Account No. 904 costs in the customer charge is the most appropriate rate design. The ECOSSs properly classified Account 904 costs as “customer” costs. Consequently, the rate design developed from the ECOSSs should address Account 904 responsibility in the customer charge. Second, customer charge differentiation better addresses customer migration from sales to transportation service and *vice versa*. When a customer moves from one service to the other, the customer charge differentiation means that the gas cost-related Account 904 expense moves with the customer. NS Ex. VG-1.0 Rev. at 11-12; PGL Ex. VG-1.0 Rev. at 12-13.

b. Other Parties

[Insert]

c. North Shore and Peoples Gas Response

The Utilities explained that differentiation is appropriate. When a sales customer does not pay his bill, part of that bill includes gas purchased from the utility. When a transportation customer does not pay his bill, that is not the case. Tr. at 973. Consequently, the gas cost-related Account 904 expense associated with sales and transportation customers differs and should be recognized in rates.

The Utilities’ ECOSSs classify Account 904 costs as “customer” costs. Ms. Grace stated that this logically means that these costs should be in the customer charge and, consequently, the sales and transportation customer differentiation should be in the customer charge. NS-PGL Ex. VG-2.0 Rev. at 5. Even if the Commission accepted Staff’s ECOSS position, Ms. Grace stated that it would still be proper to differentiate for the gas cost-related Account 904 expense in the customer charge. The largely fixed revenue requirement would be the basis for the Account 904 cost allocation, so most costs would be allocated as fixed costs. Allocation to the fixed customer charge is thus reasonable. NS-PGL Ex. VG-3.0 at 7.

Ms. Grace also explained that the customer migration issue has two practical considerations that customer charge differentiation can easily address. Adjustments under the Utilities’ decoupling mechanism, Rider VBA, are based on rate case margins, which means that distribution revenues drive the calculation. Setting rates with differentiation in the distribution charges means that, when customers move between sales and transportation service, the resulting distribution revenues (actual margins) are skewed from the rate case margins, which would not occur were the differentiation in the customer charge. Consequently, Rider VBA adjustments are greater than would otherwise be the case. Also, distribution charge differentiation means that there are different Rider VBA rate case margin baselines for sales and transportation customers and, consequently, different Rider VBA adjustments for sales and transportation customers. While the Utilities stated that this has no impact on the accuracy of the Rider VBA adjustments, it does unnecessarily require four, instead of two, adjustments (S.C. No. 1 sales and transportation and S.C. No. 2 sales and transportation). NS-PGL Ex. VG-2.0 Rev. at 6-7.

d. Commission Analysis and Conclusions

First, the Commission concludes that it is proper to differentiate rates for gas cost-related Account 904 costs. Transportation customers do not purchase gas from the Utilities and should not be responsible for bad debt associated with those gas costs. This is a clear case where cost causation principles support rate differentiation. Second, we concluded that the Utilities' ECOSS proposal for Account 904 costs was correct (Section XI(B)(2)(a), *supra*) and our decision about rate design and these costs is consistent. Differentiation in the customer charges for sales and transportation customers to adjust for gas cost-related Account 904 expense is the result that properly flows from classifying the Account 904 costs as "customer" costs. This rate design best reflects cost causation principles, and it should be approved. An added benefit is eliminating the sales and transportation distinction in the Rider VBA adjustments.

[*Alternative (if Staff's proposed treatment of Account 904 in the ECOSSs is accepted)*]: First, the Commission concludes that it is proper to differentiate rates for gas cost-related Account 904 costs. Transportation customers do not purchase gas from the Utilities and should not be responsible for bad debt associated with those gas costs. This is a clear case where cost causation principles support rate differentiation. Second, differentiation in the customer charges for sales and transportation customers to adjust for gas cost-related Account 904 expense is reasonable. The largely fixed revenue requirement would be the basis for the Account 904 cost allocation under Staff's proposal, so most costs would be allocated as fixed costs. Consequently, the Commission finds that allocation to the fixed customer charge is appropriate. An added benefit is eliminating the sales and transportation distinction in the Rider VBA adjustments.]

3. Uniform Numbering of Service Classifications

a. The Record

Staff proposed that the Utilities adopt uniform numbering for their service classifications. For example, S.C. No. 1 for each company is Small Residential Service, but the Large Volume Demand Service is S.C. No. 3 for North Shore and S.C. No. 4 for Peoples Gas. Staff Ex. 10.0 at 10. The Utilities agreed to assess their customer information systems to determine if they can implement uniform numbering in their next rate cases. NS-PGL Ex. VG-3.0 at 9.

b. Commission Analysis and Conclusions

The Commission agrees with Staff that the Utilities should evaluate the feasibility of uniform numbering and address this in their next rate cases.

C. Service Classification Rate Design

1. Uncontested Issues

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

i. The Record

North Shore proposed an eligibility criterion for each of S.C. Nos. 2 (General Service) and 3 (Large Volume Demand Service). S.C. No. 2 would be available to customers who consume an average of 41,000 monthly therms or less, and S.C. No. 3 would be available to customers using more than 41,000 monthly therms. NS Ex. VG-1.0 Rev. at 10. Adding such requirements ensures that customers are served under the rate classes for which North Shore derived costs and charges. NS-PGL Ex. VG-2.0 Rev. at 42-44. Staff witness Mr. Sackett reviewed the proposal. He concluded that North Shore's arguments were reasonable and recommended that the Commission approve the proposal. Staff Ex. 26.0 at 4.

ii. Commission Analysis and Conclusions

The Commission finds that it makes sense for service classifications to specify eligibility. It is consistent with cost causation principles. Eligibility criteria help ensure that customers take service under the rates specifically designed for customers with the same usage characteristics and for which the utility derived costs and charges. North Shore supported its proposed usage criterion, and Staff concluded it was reasonable. The Commission finds that it is reasonable and approves the proposed eligibility criterion for North Shore's S.C. Nos. 2 and 3.

b. North Shore Service Classification No. 3

i. The Record

S.C. No. 3 is North Shore's Large Volume Demand Service. According to Ms. Grace, North Shore proposed setting this service classification at cost to help meet its objective of maintaining customers on the system. North Shore proposed: changing the demand charge from a declining block to a flat rate to mitigate the impact on customers who migrate to S.C. No. 3 from S.C. No. 2 and setting it at 67% of cost; increasing the customer charge to set it at cost; revising the standby service charge and removing Account 304 ("Land and Land Rights") costs; increasing the distribution charge; and eliminating the written contract requirement. NS Ex. VG-1.0 Rev. at 10, 21-22. Staff witness Ms. Harden recommended approval of the various aspects of North Shore's proposed rate design. Staff Ex. 10.0 at 25-29. Staff witness Mr. Sackett agreed that removing Account 304 costs from the standby service charge was appropriate. Staff Ex. 26.0 at 45.

ii. Commission Analysis and Conclusions

The Commission finds that North Shore's proposals are reasonable, including removing Account 304 costs from the standby service charge calculation. Only Staff addressed this service classification, and Staff had no proposed changes. The Commission agrees that it is just and reasonable to set this large volume demand service classification at cost, and it approves North Shore's proposed S.C. No. 3 rate design and its elimination of the contract requirement.

c. North Shore Service Classification No. 5

i. The Record

North Shore proposed to eliminate S.C. No. 5, Standby Service, and transfer customers to S.C. No. 2. Ms. Grace explained that, other than using gas for standby service, the customers served under S.C. No. 5 have no similar usage or cost characteristics. NS Ex. VG-1.0 Rev. at 23. Staff witness Ms. Harden concluded that the proposal was appropriate. Staff Ex. 10.0 at 32.

ii. Commission Analysis and Conclusions

The Commission finds that it is reasonable to eliminate this service classification. As we concluded in connection with the eligibility criterion for S.C. Nos. 2 and 3, it is appropriate for customers with similar usage characteristics to be served under the same rate. Only Staff addressed this proposal, and Staff agreed elimination of S.C. No. 5 was appropriate. The Commission approves North Shore's proposal to eliminate S.C. No. 5.

d. North Shore Service Classification No. 6

i. The Record

North Shore proposed no changes to S.C. No. 6, Contract Service for Electric Generation. NS Ex. VG-1.0 Rev. at 23. It is a negotiated rate service. Staff witness Ms. Harden noted that there are currently no S.C. No. 6 customers and proposed no changes. Staff Ex. 10.0 at 32-33.

ii. Commission Analysis and Conclusions

There are no proposed changes to this service classification, and the Commission finds that none are required.

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

i. The Record

Peoples Gas proposed to use the equal percentage of embedded cost method ("EPECM") to allocate the additional revenue requirement between S.C. Nos. 1 and 2. Peoples Gas stated that it used and the Commission approved the EPECM in its last three rate cases (Docket Nos. 91-0586, 95-0032 and 07-0242). The ECOSSs showed that rates for S.C. Nos. 1, 2, 4 and 8 were below cost. Peoples Gas proposed to move S.C. Nos. 4 and 8 to cost and to use the EPECM to move S.C. Nos. 1 and 2 gradually toward cost. Ms. Grace explained that, using the EPECM, Peoples Gas allocates the increase in proportion to the embedded cost of service for these two service classifications. S. C. No. 1 would be set below cost and S.C. No. 2 would be set above cost, but each less so than under rates set in the 2007 rate case. PGL Ex. VG-1.0 Rev. at 8-9. Staff agreed that using the EPECM was appropriate and helps to mitigate the bill impact on small residential customers. Staff Ex. 10.0 at 36.

ii. Commission Analysis and Conclusions

The Commission finds that, in the interest of gradualism, it is appropriate that Peoples Gas' S.C. Nos. 1 and 2 not be moved fully to cost in this proceeding. As we have found in prior proceedings, the EPECM is a reasonable way to gradually move toward cost. Only Staff addressed the EPECM, and Staff supported its use. The Commission approves Peoples Gas' proposed use of EPECM to allocate the additional revenue requirement between S.C. Nos. 1 and 2. The Commission further concludes that, in future rate cases, Peoples Gas should continue to steadily move these service classifications to embedded cost of service.

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

i. The Record

Peoples Gas proposed a maximum eligibility criterion for S.C. No. 2 (General Service) that mirrors its current minimum eligibility criterion for S.C. No. 4 (Large Volume Demand Service). S.C. No. 2 would be available to customers who consume an average of 41,000 monthly therms or less. Ms. Grace stated that S.C. No. 4 would remain available to customers who consume an average of more than 41,000 monthly therms. PGL Ex. VG-1.0 Rev. at 11. She explained that adding an eligibility requirement for S.C. No. 2 that mirrors the existing S.C. No. 4 requirement ensures that customers are served under the rate classes for which Peoples Gas derived costs and charges. NS-PGL Ex. VG-2.0 Rev. at 42-44. Staff witness Mr. Sackett reviewed the proposal. He concluded that Peoples Gas' arguments were reasonable and recommended that the Commission approve the proposal. Staff Ex. 26.0 at 4.

ii. Commission Analysis and Conclusions

As with comparable provisions for North Shore, the Commission agrees that eligibility criteria are reasonable and appropriate for service classifications. In this instance, the Commission notes that Peoples Gas already has such a criterion for its S.C. No. 4 and is proposing no change to that criterion but would mirror it in S.C. No. 2. The Commission finds that it is reasonable and approves the proposed eligibility criterion for Peoples Gas' S.C. No. 2 and no change to its existing S.C. No. 4 criterion.

g. Peoples Gas Service Classification No. 4

i. The Record

S.C. No. 4 is Peoples Gas' Large Volume Demand Service. Ms. Grace stated that Peoples Gas proposed setting this service classification at cost to help meet its objective of maintaining customers on the system. Peoples Gas proposed: changing the demand charge from a declining block to a flat rate to mitigate the impact on customers who migrate to S.C. No. 4 from S.C. No. 2 and setting it at 55% of cost; increasing the customer charge to set it at cost; revising the standby service charge and removing Account 304 costs; increasing the distribution charge; and eliminating the written contract requirement. PGL Ex. VG-1.0 Rev. at 11-12, 22-24. Staff witness Ms. Harden recommended approval of the various aspects of Peoples Gas' proposed rate design. Staff Ex. 10.0 at 48-53. Staff witness Mr. Sackett agreed that removing Account 304 costs from the standby service charge was appropriate. Staff Ex. 26.0 at 45.

ii. Commission Analysis and Conclusions

The Commission finds that Peoples Gas' proposals are reasonable, including removing Account 304 costs from the standby service charge calculation. Only Staff addressed this service classification, and Staff had no proposed changes. The Commission agrees that it is reasonable to set this large volume demand service classification at cost, and it approves Peoples Gas' proposed S.C. No. 4 rate design.

h. Peoples Gas Service Classification No. 5

i. The Record

Peoples Gas proposed no changes to S.C. No. 5, Contract Service for Electric Generation. PGL Ex. VG-1.0 Rev. at 25. It is a negotiated rate service. Staff witness Ms. Harden noted that there are currently no S.C. No. 5 customers and proposed no changes. Staff Ex. 10.0 at 53-54.

ii. Commission Analysis and Conclusions

There are no proposed changes to this service classification, and the Commission finds that none are required.

i. Peoples Gas Service Classification No. 6

i. The Record

Peoples Gas proposed to eliminate its S.C. No. 6, Standby Service, and transfer customers to S.C. No. 2. Peoples Gas explained that, other than using gas for standby service, the customers served under S.C. No. 6 have no similar usage or cost characteristics. Consequently, it is more appropriate to serve these customers under a general service rate. PGL Ex. VG-1.0 Rev. at 24. Staff witness Ms. Harden concluded that the proposal was appropriate. Staff Ex. 10.0 at 54-57.

ii. Commission Analysis and Conclusions

The Commission finds that it is reasonable to eliminate this service classification. As we concluded in connection with the eligibility criterion for S.C. Nos. 2 and 4, it is appropriate for customers with similar usage characteristics to be served under the same rate. Only Staff addressed this proposal, and Staff agreed elimination of S.C. No. 6 was appropriate. The Commission approves Peoples Gas' proposal to eliminate S.C. No. 6.

j. Peoples Gas Service Classification No. 8

i. The Record

Peoples Gas proposed to set S.C. No. 8, Compressed Natural Gas Service, at cost. The customer charge would decrease and the distribution charge would increase. PGL Ex. VG-1.0 Rev. at 25. Staff witness Ms. Harden concluded that the proposal was appropriate. Staff Ex. 10.0 at 57-58.

ii. Commission Analysis and Conclusions

The Commission agrees that it is reasonable to set this service classification at cost. The Commission notes that only Staff addressed this service classification, and it recommended no changes to Peoples Gas' proposal. The Commission finds that Peoples Gas' proposal is just and reasonable and approves it.

2. Contested Issues

a. North Shore Service Classification No. 1

i. Account 904

This issue is addressed in detail in Section XII(B)(2), *supra*.

ii. North Shore's Rate Design

This issue is addressed in Section XII(C)(2)(a)(iii), *infra*.

iii. Customer Charge

(a) North Shore

North Shore proposed to increase its customer charge. North Shore's S.C. No. 1 would be set at cost. Ms. Grace stated that the customer charge would be set to recover only 55% of fixed costs. The distribution charges would continue to be in the form of a declining two block rate with the first block (0 to 50 therms) recovering two-thirds of demand, commodity and remaining customer costs and the second block (over 50 therms) recovering the remaining costs. NS Ex. VG-1.0 Rev. at 12-14.

(b) Other Parties

[Insert]

(c) North Shore Response

North Shore stated that its proposal to increase the customer charge is consistent with prior cases in which the Commission encouraged or approved rate designs that reflect greater recovery of fixed costs in the customer charge. NS Ex. VG-1.0 Rev. at 14-15. In support, North Shore cited Peoples Gas' 1995 rate case, in which the Commission, in approving the proposed customer charge, stated that it "in fact, should be increased in future rate proceedings to move it closer to cost." *In re The Peoples Gas Light and Coke Co.*, ICC Docket No. 95-0032 (Order, Nov. 8, 1995). In the 2007 rate case, the Commission approved an increase in fixed cost recovery through the customer charge to 50% of the S. C. No. 1 revenue requirement. *Peoples 2007* at 269. For Northern Illinois Gas Company, the Commission approved recovery of 80% of fixed costs through the customer charge. The Commission stated that "[m]oving a greater percentage of fixed cost recovery to fixed charges rather than volumetric charges provides a more stable revenue stream and sends a better price signal to the consumer." *Nicor 2008* at 98.

North Shore contends that Staff's argument that there should be no increase in the amount of fixed costs recovered through the customer charge because this would be a "mid-stream alteration to the design of the [Rider VBA] program" (Staff Ex. 24.0 at 7) is flawed.

First, nothing in the 2007 rate case Order suggests that rate design could not change while Rider VBA is in effect. Indeed, Rider VBA will not change.

Second, Ms. Grace explained that the proposed customer charges for the service classifications to which Rider VBA applies (S.C. Nos. 1 and 2) remain far below embedded fixed costs. For North Shore, only about 56% of fixed costs would be recovered through fixed charges, which leaves nearly $40 million subject to Rider VBA. (For Peoples Gas, only about 48% of fixed costs would be recovered through fixed charges, which leaves nearly $300 million subject to Rider VBA.) These are large dollar amounts that the Utilities recover through variable charges and that will factor into the Rider VBA adjustments. NS-PGL Ex. VG-2.0 Rev. at 9.

Third, Rider VBA will terminate in March 2012, unless the Utilities request and the Commission approves an extension. *Peoples 2007* at 152. For the affected service classifications, Ms. Grace testified that North Shore has only about $695,000 in variable costs. (For Peoples Gas, the comparable figure is about $15 million.) If Rider VBA ends, the Utilities would still have a very large amount of fixed costs to be recovered through variable charges. Even the Utilities' proposal puts only a small dent in this mismatch. Under Staff's theory, the Utilities stated that they could take no steps to mitigate this circumstance during the four years that Rider VBA is in effect, despite the Commission's policy encouraging fixed cost recovery through fixed charges. NS-PGL Ex. VG-2.0 Rev at 9.

iv. Tiered Rates

(a) Other Parties

[Insert]

(b) North Shore Response

The Utilities' witness Ms. Grace stated that there are sound reasons tiered rates have not been used for energy companies. NS-PGL Ex. VG-2.0 Rev. at 21. The proposal in these proceedings is conceptually and practically flawed. *Id*. at 13-35.

Ms. Grace explained that conceptual flaws with the proposal include that:

- it uses historical data but does not normalize those data, which can cause the utility to under- or over-earn its revenue requirement. For example, Mr. Rubin used data that were for a colder than normal period. Consequently, relative to normalized data, the usage and volumetric revenues he used are overstated.

- it does not take changing customer usage into account. The record shows that, for several reasons, customer usage has been declining. The data that Mr. Rubin used date from mid-2007 through mid-2008 and do not take that fact into account.

- the proposed rates were based on an incomplete data set and a simplistic mathematical extrapolation for many customers. The data Mr. Rubin used for Peoples Gas included only 69% of total customers, which means that he assigned almost 239,000 customers to tiers with no usage data for those customers. For North Shore, the comparable figure is 46,000 customers.

- the number and range of the tiers is not fully explained. There are seven total tiers. Some tiers span 500 therms. Two tiers span 1,500 therms. The last tier is every customer with usage over 5,000 therms. There are no apparent rate design principles underlying the tiers.

Id. at 13-18.

Ms. Grace explained that practical problems with the proposal include that:

- it includes only one set of tiered rates for seven tiers but it would need distinct rates for sales and transportation customers to address gas cost-related Account 904 expenses, resulting in 14 tiers. Cost causation principles support rate differentiation for this reason. Mr. Rubin did not develop distinct rates, nor address the mechanics of developing and implementing distinct rates.

- it would require substantial modifications to the Utilities' customer information systems to track usage and apply the tiers to the Utilities' over 900,000 S.C. No. 1 customers. The proposed rates do not include the costs associated with these modifications, nor do they take into account any transition period needed to develop, test and implement the modifications.

- there are many challenges to placing in tiers customers with less than one year's usage, such as new customers (which may mean the same person with a new account number), customers with gas theft, or customers with other deficiencies with their historical usage.

- customer disputes about tier placement would raise novel issues for which there are no ready answers.

- sales revenue forecasting would be complicated.

Id. at 18-20.

The Utilities concluded that the tiered rate proposal should be rejected due to the many conceptual and practical problems detailed in the record and briefly summarized above.

(c) Commission Analysis and Conclusions

The Commission agrees that it is reasonable to set different rates for sales and transportation customers based on gas cost-related Account 904 costs. The extent to which transportation customers cause North Shore to incur these costs is very limited compared with sales customers. Differentiation of rates based on gas cost-related Account 904 costs is consistent with cost causation principles, and the Commission approves differentiation on this basis. The Commission also finds that the customer charge is the appropriate charge to reflect the differentiation. As we determined in Section XII(B)(2), *supra*, Account 904 costs are properly classified as customer costs. Accordingly, it is reasonable to include these costs in the customer charge.

Concerning the level of the customer charge, it is the Commission's policy to move toward greater fixed cost recovery through fixed charges, like the customer charge. North Shore's decoupling mechanism, Rider VBA, is another tool to address fixed cost recovery, but, as a matter of rate design principles, fixed cost recovery through fixed charges is appropriate. Staff is correct that Rider VBA is a pilot and the

Commission wants to be able to evaluate the pilot; however, that does not mean that there should be no changes in the percentage of fixed costs recovered through the customer charge. North Shore's proposal to recover 55% of its fixed costs through the customer charge is a modest increase that still leaves a large amount of fixed costs -- in dollars and in percentage terms -- subject to recovery through variable charges. Consequently, the decoupling pilot can still provide useful information.

Finally, the Commission does not approve the tiered rate proposal. As North Shore pointed out, there are many problems with the method underlying the specific proposed tiers and rates, not least being the facts that the proposed rates and tiers depended on incomplete data and colder than normal weather. The Commission is also concerned about the many practical problems associated with implementing this untested proposal. The incompleteness of the data set used by the witness suggests that there would be almost 300,000 Peoples Gas and North Shore customers placed in tiers based on incomplete usage data, which could easily lead to individual customers paying too much or too little in relation to the cost of serving them.

For these reasons, the Commission approves North Shore's proposed rate design, including setting the customer charge at 55% of fixed costs; setting a different customer charge for sales and transportation customers based on gas cost-related Account 904 costs; and retaining the declining two block distribution charge with the first block recovering two-thirds of demand, commodity and remaining customer costs and the second block recovering the remaining costs.

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

1. North Shore

North Shore proposed to add an additional meter class (meter class 3) to S.C. No. 2. It then proposed to increase the customer charges and move the charges for all three meter classes closer to cost. There would be a different customer charge for sales customers and for transportation customers to reflect differentiation for gas cost-related Account 904 expenses. Ms. Grace testified that for meter classes 1 and 2, North Shore would recover all customer costs and a portion of demand costs. For meter class 3, only 18% of demand costs would be recovered through the customer charge, in the interest of gradualism. This directly affects the distribution charges in the declining three block structure. Ms. Grace testified that the remaining costs would be allocated to the distribution blocks, and, for the first two blocks, this would be a decrease because of the proposed increase to the customer charge. However, because the new meter class 3 customer charge has fewer fixed costs included, the third block of the distribution charges would increase. Only 54% of the S.C. No. 2 revenue requirement would be recovered under fixed charges. NS Ex. VG-1.0 Rev. at 17-19.

2. Other Parties

[insert]

3. **North Shore Response**

North Shore contends that Staff's argument that there should be no increase in the amount of fixed costs recovered through the customer charge because this would be a "mid-stream alteration to the design of the [Rider VBA] program" (Staff Ex. 24.0 at 7) is flawed. North Shore made the same points it made in connection with a similar argument concerning the S.C. No. 1 customer charge (Section XII(C)(2)(a), *supra*).

4. Commission Analysis and Conclusions

The only issue concerning North Shore's S.C. No. 2 rate design is the amount of fixed costs to be recovered through the customer charge. (The issue of whether rate differentiation for Account 904 costs should be in the customer charge or the distribution charge was addressed in Section XII(B)(2), *supra*.) This is identical to the question raised for S.C. No. 1. As the Commission explained in connection with S.C. No. 1, it is the Commission's policy to move toward greater recovery of fixed costs through fixed charges and the Rider VBA pilot is not an impediment to continuing that movement. Accordingly, the Commission finds that North Shore's proposal is reasonable and approves it, including the establishment of a new meter class 3, retention of the declining three block distribution rate, and setting the customer charge such that it recovers 54% of the S.C. No. 2 revenue requirement, with an appropriate difference between sales and transportation customers for gas cost-related Account 904 costs.

c. Peoples Gas Service Classification No. 1

i. Account 904

(a) Peoples Gas

Like North Shore and for the same reasons, Peoples Gas proposed different S.C. No. 1 customer charges for sales and transportation customers. PGL Ex. VG-1.0 Rev. at 13-15. *See* Sections XII(B)(2) and XII(C)(2)(a) *supra*.

(b) **Other Parties**

[Insert]

(c) **Peoples Gas Response**

See Sections XII(B)(2) and XII(C)(2)(a) *supra*.

ii. Peoples Gas' Rate Design

This issue is addressed in Section XII(C)(2)(c)(iii), *infra*.

iii. Customer Charge

(a) Peoples Gas

Peoples Gas proposed to increase its customer charge. Peoples Gas' S.C. No. 1 rates would be set below cost. The customer charge would recover less than the customer costs and would be set to recover 54% of fixed costs. The distribution charges would continue to be in the form of a declining two block rate with the first block (0 to 50 therms) recovering 65% of demand, commodity and remaining customer costs and the second block (over 50 therms) recovering the remaining costs. PGL Ex. VG-1.0 Rev. at 13-15.

(b) Other Parties

[Insert]

(c) Peoples Gas Response

Like North Shore's proposal and for the same reasons, Peoples Gas stated that its proposal to increase the customer charge is consistent with prior cases in which the Commission encouraged or approved rate designs that reflect greater recovery of fixed costs in the customer charge. PGL Ex. VG-1.0 Rev. at 16-17. *See* Section XII(C)(2)(a), *supra*. Peoples Gas stated that its customer charge should be set to recover at least 54% of fixed costs.

iv. Tiered Rates

(a) Other Parties

[Insert]

(b) Peoples Gas Response

For the reasons stated in Section XII(C)(2)(a), *supra*, Peoples Gas stated that AG-CUB-City witness Mr. Rubin's tiered rate proposal is conceptually and practically flawed and should be rejected.

(c) Commission Analysis and Conclusions

The issues and arguments in connection with Peoples Gas' S.C. No. 1 are identical to those for North Shore's S.C. No. 1. For the reasons stated in Section XII(C)(2)(a), *supra*, the Commission rejects the tiered rate proposal. It finds just and reasonable and approves Peoples Gas' proposed S.C. No. 1 rate design, including setting the customer charge at 54% of fixed costs; setting a different customer charge for sales and transportation customers based on gas cost-related Account 904 costs; and retaining the declining two block distribution charge with the first block recovering 65% of demand, commodity and remaining customer costs and the second block recovering the remaining costs.

d. Peoples Gas Service Classification

No. 2, Customer Charge

1. Peoples Gas

Peoples Gas proposed to add an additional meter class (meter class 3) to S.C. No. 2. It then proposed to increase the customer charges and move the charges for all three meter classes closer to cost. There would be a different customer charge for sales customers and for transportation customers to reflect differentiation for gas cost-related Account 904 expenses. For meter classes 1 and 2, Peoples Gas would recover all customer costs and a portion (20%) of demand costs in the customer charge. For meter class 3, it would recover no demand costs in the customer charge, in the interest of gradualism. This directly affects the distribution charges in the declining three block structure. The remaining costs would be allocated to the distribution blocks. The charges for all three blocks would increase, but the increase for the third block would be larger, which results from the fact that no demand costs would be recovered through the meter class 3 customer charge. Only 35% of the S.C. No. 2 revenue requirement would be recovered under fixed charges. PGL Ex. VG-1.0 Rev. at 18-20.

2. Other Parties

[Insert]

3. Peoples Gas Response

Peoples Gas contends that Staff's argument that there should be no increase in the amount of fixed costs recovered through the customer charge because this would be a "mid-stream alteration to the design of the [Rider VBA] program" (Staff Ex. 24.0 at 7) is flawed. *See* Section XII(C)(2)(a), *supra*. Staff's position is also inconsistent with its own rate proposals which would recover 50% of costs through the customer charge. NS-PGL Ex. VG-3.0 at 14.

4. Commission Analysis and Conclusions

The only issue concerning Peoples Gas' S.C. No. 2 rate design is the amount of fixed costs to be recovered through the customer charge. This is identical to the question raised for S.C. No. 1 and for North Shore's S.C. No. 2. For the reasons stated in Section XII(C)(2)(a), *supra*, the Commission rejects Staff's arguments regarding fixed cost recovery through the customer charge. The Commission approves Peoples Gas' proposed S.C. No. 2 rate design, including the establishment of a new meter class 3, retention of the declining three block distribution rate, and setting the customer charge such that it recovers 35% of the S.C. No. 2 revenue requirement, with an appropriate difference between sales and transportation customers for gas cost-related Account 904 costs.

D. Tariffs – Other Tariff Issues

1. Uncontested Issues - North Shore and Peoples Gas

a. General Terms and Conditions

i. The Record

The Utilities each proposed several changes to their Terms and Conditions of Service. Those changes are: (1) revise the service activation and reconnection charges (discussed in subsections (b) and (c), *infra*); (2) insert a specific date for grandfathering the second pulse charge; (3) revise language related to the "Correction for Pressure, Temperature and/or Supercompressibility" to be consistent with the Utilities' practices concerning the pressure at which customers are served; (4) add a definition of "person" related to changes to Riders 4 and 5 (discussed in subsection (g), *infra*); and (5) eliminate Peoples Gas' Facilities Charge (discussed in subsection (h), *infra*). NS Ex. VG-1.0 Rev. at 28; PGL Ex. VG-1.0 Rev. at 30.

ii. Commission Analysis and Conclusions

The proposed changes to the Terms and Conditions are discussed in more detail below. The changes are fully supported in the record and neither Staff nor any party opposed them. The Commission finds the changes are just and reasonable and approves them.

b. Service Activation Charges

i. The Record

North Shore performs two types of service activation: succession turn-on when a customer moving out discontinues gas service at approximately the same time as a new applicant requests service; and a straight turn-on when there has never been service at a premises or there has been a longer time lapse between customers. North Shore performed a cost study (NS Ex. VG-1.9) showing that the cost for a succession turn-on is $16.59 and proposed, in response to a Staff proposal, to charge $16.50; for a straight turn-on is $43.91 and proposed to charge $35; and for lighting each appliance in excess of four is $8.91 and proposed no change to its current $5 charge. NS Ex. VG-1.0 Rev. at 24; NS-PGL Ex. VG-2.0 Rev. at 49.

Peoples Gas performs the same types of service activations. Its cost study (PGL Ex. VG-1.9) showed the cost for a succession turn-on is $15.52 and proposed to charge $15; for a straight turn-on is $47.78 and proposed to charge $25; and for lighting each appliance in excess of four is $10.67 and proposed no change to its current $5 charge. PGL Ex. VG-1.0 Rev. at 26.

Staff witness Mr. Boggs reviewed the proposed charges, and, with one proposed revision, he recommended their approval. He also recommended that, in future rate cases, the Utilities should move steadily to full cost recovery from the customers who cause these expenses. Staff Ex. 11.0 at 3-8, 25-28; Staff Ex. 25.0 at 2.

ii. Commission Analysis and Conclusions

The Commission finds that the proposed service activation charges are each based on a cost of service study, and, while some of the charges continue to be set below cost, the Utilities are moving the charges closer to cost. The Commission agrees with Staff that the Utilities should continue, in future rate cases, to move the charges steadily closer to cost. The Commission finds that the proposed service activation charges are just and reasonable and approves them.

c. Service Reconnection Charges

i. The Record

North Shore performs three types of service reconnection: basic reconnection requiring only a meter turn-on; reconnections requiring setting a new meter; and reconnections at the main. North Shore performed a cost study (NS Ex. VG-1.9) showing that the cost for a reconnection at the meter is $65.88 and proposed to charge $60; for a reconnection when the meter is reset is $256.04 and proposed to charge $125; and for a reconnection at the main is $1,988.89 and proposed to charge $350. The cost to light additional appliances is $8.91, and proposed no change to the current $5 per appliance in excess of four charge. NS Ex. VG-1.0 Rev. at 24-25.

Peoples Gas performs the same three types of service reconnection, and it also preformed a cost study (PGL Ex. VG-1.9) The study showed that the cost for a reconnection at the meter is $78.59 and proposed to charge $60; for a reconnection when the meter is reset is $228.91 and proposed to charge $125; and for a reconnection at the main is $2,189.49 and proposed to charge $350. The cost to light additional appliances is $10.67, and proposed no change to the current $5 per appliance in excess of four charge. PGL Ex. VG-1.0 Rev. at 26-27.

Staff witness Mr. Boggs reviewed the proposed charges, and he recommended their approval. He also recommended that, in future rate cases, the Utilities should move steadily to full cost recovery from the customers who cause these expenses. Staff Ex. 11.0 at 8-12, 28-32.

ii. Commission Analysis and Conclusions

The Commission finds that the proposed service reconnection charges are each based on a cost of service study, and, while some of the charges continue to be set below cost, the Utilities are moving the charges closer to cost. The Commission agrees with Staff that the Utilities should continue, in future rate cases, to move the charges steadily closer to cost. The Commission finds that the proposed service reconnection charges are just and reasonable and approves them.

d. Second Pulse Capability

i. The Record

The Utilities proposed no change to the $14 monthly second pulse capability charge. NS Ex. VG-1.0 Rev. at 28; NS Ex. VG-1.1 at 10; PGL Ex. VG-1.0 Rev. at 30;

PGL Ex. VG-1.1 at 12. Second pulse capability is an optional service and involves measurement devices that can provide real time usage data to customers. The charge does not apply to those who had the capability installed prior to February 14, 2008 (the effective date of the new tariffs approved in the Utilities' 2007 rate cases). Staff supported the wording change to add this date. Staff Ex. 11.0 at 12-13.

ii. Commission Analysis and Conclusions

There is no evidence for changing the existing second pulse charge. The Commission approves retention of the existing second pulse charge and addition of the specific date that determines whether a customer owes the charge.

e. Rider 1

i. The Record

The Utilities proposed editorial changes to Rider 1, Additional Charges for Taxes and Customer Charge Adjustments, to clarify the rider. NS Ex. VG-1.1 at 16; PGL Ex. VG-1.1 at 19. Staff recommended approval of the changes. Staff Ex. 11.0 at 14-15, 37.

ii. Commission Analysis and Conclusions

The Commission finds that the proposed charges are editorial in nature and will clarify the rider. The Commission approves these changes.

f. Rider 2

i. The Record

The Utilities proposed several editorial changes to Rider 2, Gas Charge, to clarify the rider. They deleted references to riders and service classifications that they propose to delete and, for Peoples Gas, eliminated a date reference that is no longer needed. NS Ex. VG-1.0 at 28; PGL Ex. VG-1.0 at 31. Staff recommended approval of the changes, if the Commission approves elimination of the referenced tariffs. Staff Ex. 11.0 at 15-16, 38. Neither Staff nor any party opposed removal of the referenced tariffs (*see* Section XIII(B)(1), *infra*).

ii. Commission Analysis and Conclusions

The Commission finds that the proposed changes are editorial in nature and will clarify the rider. The Commission approves these changes.

g. Riders 4 and 5

i. The Record

The Utilities proposed revisions to Rider 4, Extension of Mains, and Rider 5, Service Pipe, to accommodate situations where the person or group of persons requesting the main or service is developing the property for future gas service and is not the applicant for service. NS Ex. VG-1.0 at 28-29; PGL Ex. VG-1.0 at 32. Staff recommended approval of the changes. Staff Ex. 11.0 at 16-19; 38-41.

ii. Commission Analysis and Conclusions

The Commission agrees with Staff and the Utilities that it is reasonable to address situations where someone other than an applicant for service, for example, a developer, is requesting a main or service installation. Accordingly, the Commission approves the changes to Riders 4 and 5 to accommodate this circumstance.

h. Account 385 Facilities Charge

i. The Record

Peoples Gas proposed to eliminate the Facilities Charge. In its last rate case, the Commission ordered Peoples Gas to directly bill the small number of customers served by large meters that are classified under Account 385 ("Industrial Measuring and Regulating Station Equipment"). Subsequent to its last rate case, Peoples Gas stated that it changed certain accounting policies, resulting in 781 customer accounts being reclassified under Account 385, which far exceeds the number at issue in the 2007 rate case. Also, Peoples Gas explained that it is proposing a meter class 3 for its S.C. No. 2 that would better assign the Account 385 costs. PGL Ex. VG-1.0 Rev. at 31; NS-PGL Ex. VG-2.0 Rev. at 50. Staff agreed that the charge should be eliminated. Staff Ex. 11.0 at 36; Staff Ex. 25.0 at 2-3.

ii. Commission Analysis and Conclusions

The Commission agrees that the facts underlying its decision in the last rate case to require a specific Facilities Charge have changed. In particular, the introduction of a new meter class will address our concern that costs be allocated to the customers causing their incurrence.

2. Volume Balancing Adjustment (Rider VBA)

The Commission approved decoupling mechanisms (Rider VBA, Volume Balancing Adjustment) for the Utilities in their last rate cases. Rider VBA is in effect for a four-year pilot period that will end with the March 2012 filing, unless the Utilities request and receive approval to make the rider permanent. *Peoples 2007* at 152. The Utilities proposed no changes to Rider VBA in this proceeding, but the "rate case margins" components of the calculation will change. NS Ex. VG-1.0 Rev. at 14, 19-20; PGL Ex. VG-1.0 Rev. at 15, 21. At the time of the filing, for the period May 2008 through February 2009, North Shore had refunded $475,000 to S.C. No. 1 customers and $397,000 to S.C. No. 2 customers. NS Ex. VG-1.0 Rev. at 14, 20. For Peoples Gas, the refunded amounts were $1.7 million to S.C. No. 1 customers and $2.3 million to S.C. No. 2 customers. PGL Ex. VG-1.0 Rev. at 16, 21.

a. Establishment of new margins

i. The Record

When new rates are set in these proceedings, the "rate case margins" ("RCM") will change. If the Commission accepts the Utilities' proposal to differentiate for gas cost-related Account 904 costs in the customer charge, there will be a new RCM for each of S.C. Nos. 1 and 2. If the Commission requires differentiation in the distribution charge, there will be four new RCMs, namely, a sales RCM and a transportation RCM for each of S.C. Nos. 1 and 2. NS Ex. VG-1.0 Rev. at 14, 19-20; PGL Ex. VG-1.0 Rev. at 15, 21. The Utilities provided, in data responses, the revised RCM and "rate case customers," based on their direct cases (Staff Ex. 1.0 at 44 and Att. A) and their rebuttal cases (Staff Ex. 15.0 at 35 and Att. H). The Utilities stated that they will provide the Commission with final RCMs, based on the approved distribution charges, with their compliance filings. NS-PGL Ex. VG-2.0 Rev. at 5.

ii. Commission Analysis and Conclusions

The Commission agrees that there will be new Rider VBA RCMs resulting from these rate cases. The "rate case customers" component of the calculation will also change as a result of these cases. The Commission directs the Utilities to include these new RCMs with their compliance tariffs.

b. Change in Annual Report (Uncontested)

i. The Record

Staff witness Ms. Hathhorn discussed a requirement from the last rate case Order that Staff provide the Commissioners an annual report on the Utilities' rates of return and Rider VBA's effect on the return. *Peoples 2007* at 152. She recommended that the Utilities, rather than Staff, prepare this report. Staff Ex. 1.0 at 45. The Utilities agreed. NS-PGL Ex. VG-2.0 Rev. at 53-54.

ii. Commission Analysis and Conclusions

The Commission agrees that it is reasonable for the Utilities to prepare this report. The Commission directs the Utilities to prepare and submit the required report to Staff and the Commission at the time the Utilities file their petition to initiate a reconciliation proceeding.

E. Bill Impacts

1. North Shore and Peoples Gas

The Utilities prepared detailed bill impact analyses, for all service classifications affected by its rate proposals, at various usage levels under present and proposed rates. NS Exs. VG-1.0 Rev. at 23 and VG-1.8; PGL Exs. VG-1.0 Rev. at 25 and VG-1.8. The Utilities also provided additional analyses for the impact on S.C. No. 1, Small Residential Service, customers. NS Exs. VG-1.0 Rev. at 17 and VG-1.6; PGL Exs. VG-1.0 Rev. at 18 and VG-1.6. The Utilities' proposed rate designs and the resulting bill impacts are consistent with the objectives of continuity and gradualism. NS Ex. VG-1.0 Rev. at 1-2; PGL Ex. VG-1.0 Rev. at 1-2.

2. Other Parties

[Insert]

3. Commission Analysis and Conclusions

The Commission finds that the bill impact information prepared by the Utilities and discussed by the Utilities and Staff lend support to the rates that the Commission approved in this proceeding. The bill impact studies were adequate and sufficient for this purpose.

XIII. TRANSPORTATION ISSUES

A. Overview

1. North Shore and Peoples Gas

In their 2007 rate cases, the Utilities proposed extensive changes to their transportation programs. The Utilities' proposals engendered extensive testimony, and the Commission ultimately approved several major changes to the programs. *Peoples 2007* at 268-287. The Utilities implemented the substantially revised large volume transportation riders on August 1, 2008. The Utilities concluded that it would be more beneficial to gain experience under the new riders rather than to propose any new modifications at this time. NS Ex. VG-1.0 Rev. at 30; PGL Ex. VG-1.0 Rev. at 33. The Utilities also significantly revised their small volume program in the 2007 rate cases and implemented the changes in 2008. Consequently, the Utilities proposed no substantive changes in these cases. NS-PGL Ex. JM-1.0 at 15. As with the proposed changes to the large volume programs, there was considerable testimony concerning the small volume programs, and the Commission ruled on several proposals by both the Utilities and intervenors. *Peoples 2007* at 268-272, 287-307.

2. Other Parties

[Insert]

3. North Shore and Peoples Gas Response

The Utilities proposed no operational changes to their transportation programs. Staff and intervenors proposed changes, all but one uncontested, concerning the large volume programs. For the contested issue, the Utilities stated that they showed that the proposal should be rejected. An intervenor proposed changes concerning the small volume program ("Choices For You^sm^" or "CFY"), and the Utilities showed that the intervenor did not meet its burden of supporting changes to the CFY program. The

Utilities stated that the proponents of these changes bear the burden of proof on these issues. Central Illinois Public Service Co. v. Illinois Commerce Comm'n, 5 Ill. 2d. 195, 211 (1955).

The large volume program refers to customers taking service under Rider FST (Full Standby Transportation Service) or SST (Selected Standby Transportation Service). Many of these customers take service from alternative suppliers who "pool" customers under Rider P (Pooling Service). NS-PGL Ex. JM-1.0 at 6. For the large volume programs, Ms. Grace explained that the Utilities implemented new operational provisions following their 2007 rate cases. The Utilities believed it would be more beneficial to gain experience under the revised program than to propose modifications in these cases. The Utilities proposed only updating certain charges based on new cost studies; eliminating transitional riders that were in place as a bridge from the former program to the revised program that the Utilities implemented on August 1, 2008; making editorial changes; updating the number of "base rate" Allowable Bank days; and, for Peoples Gas, eliminating a rider under which customers do not take service. NS Ex. VG-1.0 Rev. at 29-30; PGL Ex. VG-1.0 Rev. at 32-33.

The CFY or small volume program refers to the customer choice program under which S.C. Nos. 1 and 2 customers may select a third party gas supplier. Rider CFY (Choices For You^{sm} Transportation Service) describes the terms and conditions of service for these customers. Rider AGG (Aggregation Service) describes the terms and conditions under which suppliers are able to aggregate CFY customers. Rider SBO (Supplier Billing Option Service) describes the terms and conditions under which a supplier may choose to issue a single bill that includes utility charges. NS-PGL Ex. JM-1.0 at 14. As with the large volume program, the Utilities implemented changes following their last rate cases and proposed no substantive changes. *Id*. at 15. The Utilities proposed updating certain charges based on new cost studies. NS Exs. 1.0 Rev. at 26 and VG-1.11; PGL Exs. VG-1.0 Rev. at 28 and VG-1.11.

B. Uncontested Issues

1. Elimination of Transportation Transition Riders

a. The Record

The Utilities implemented extensive changes to their transportation programs in their last rate cases. There was a transition period, with transition riders, before the changes took effect. Those transition riders were called Riders FST-T, SST-T, LST-T, TB-T (Peoples Gas only) and P-T. As of August 1, 2008, no customer or supplier receives service under the transition riders, and the Utilities proposed to eliminate them. NS Ex. VG-1.0 at 29; PGL Ex. VG-1.0 at 32. Neither Staff (Staff Ex. 12.0R at 4-5) nor any party opposed these proposals.

b. Commission Analysis and Conclusions

The Commission agrees that, as no customers take service under these transition riders, it is appropriate to eliminate them from the Utilities' tariffs.

2. Riders FST, SST, and P Charges

a. The Record

The Utilities prepared cost studies to support the administrative charges under their transportation programs. NS Ex. VG-1.10; PGL Ex. VG-1.10. Based on its study, North Shore proposed to reduce its Riders FST and SST Administrative Charge from $8.94 to $7.32 per account and its Rider P Pooling Charge from $4.95 to $3.44 per account. NS Ex. VG-1.0 Rev. at 26. Based on its study, Peoples Gas proposed to reduce its Riders FST and SST Administrative Charge from $11.24 to $9.87 per account and its Rider P Pooling Charge from $8.36 to $6.97 per account. PGL Ex. VG-1.0 Rev. at 28. Neither Staff (Staff Ex. 12.0R at 14) nor any party opposed these proposals.

b. Commission Analysis and Conclusions

The proposed charges are the result of a specific cost of service study. The Commission finds that the study supports the proposed charges, and it approves these charges.

3. Intra-Day Nomination Rights

a. Other Parties

[Insert]

b. North Shore and Peoples Gas Response

The Utilities witness Mr. McKendry explained that the current nomination deadline is 11:30 a.m. the day prior to the gas day (the “timely” cycle). Customers may also reallocate the nominated quantities at later times. NS-PGL Ex. JM-1.0 at 6-8. The Utilities, citing operational and administrative concerns, offered an alternative to CNE-Gas’ proposal that they offer all four nomination cycles. NS-PGL Ex. JM-1.0 at 6-12; NS-PGL Ex. RD-1.0 Rev. at 20-25.

For a four-year trial period, the Utilities would offer a late nomination (“Evening Cycle Nomination”). The customer or its supplier must make the nomination no later than 3:00 p.m. on the business day prior to the gas day on which it is to be effective. Unlike timely nominations, which are available every day, the new nomination right would only apply to nominations on business days. The Utilities, by 2:00 p.m., would post on their PEGASys™ system the aggregate volume the Evening Cycle Nomination may not exceed. Except for Critical Days, the minimum quantity available (increases and decreases) would be 100,000 therms for Peoples Gas and 20,000 therms for North Shore. On Critical Supply Surplus Days, the Utilities would allow no increases. On Critical Supply Shortage Days, the Utilities would allow no decreases. The Utilities may also post separate quantities that apply to the allowable increases and decreases, *i.e.*, increases of no more than X and decreases of no more than Y. The Utilities would reduce, *pro rata*, transportation customer Evening Cycle Nominations in excess of the posted available quantities. NS-PGL Ex. RD-1.0 Rev. at 24.

In response to CNE-Gas' proposal that the Utilities not change their current practices that allow changes to nominations when an upstream supplier cuts a transportation customers' gas (CNE-Gas Ex. 2.0 at 4-5), the Utilities' witness Mr. McKendry agreed that the current practice will continue. NS-PGL Ex. JM-2.0 at 3-4. Although the Utilities previously opposed it, they agreed in their Initial Brief (at 171) to include tariff language describing this practice of revising timely nominations to address supply cuts.

c. Commission Analysis and Conclusions

The Commission agrees that adding an additional nomination cycle may be helpful to the Utilities' transportation customers and suppliers. The Commission recognizes that it adds some complexity to the Utilities' administrative processes and its gas supply activities, and the record does not support requiring the addition of three new nomination cycles in light of that added complexity. However, the Utilities have determined that they can offer one additional nomination cycle and the potential benefits to customers make this a worthwhile service to offer for a trial period. Accordingly, the Commission approves the proposed Evening Nomination Cycle, effective for a four-year trial period, and directs the Utilities to include language in their tariffs to describe the terms and conditions of this nomination right as well as the current practice related to handling nomination changes required by upstream cuts.

4. Storage Credit

a. The Record

Staff witness Mr. Sackett questioned why CFY suppliers, but not large volume transportation customers, receive a credit based on the Utilities' savings from reduced storage inventory requirements arising from transportation customers filling their Allowable Bank inventory. Staff Ex. 12.0R at 21. The Utilities agreed that a credit for the Riders FST and SST customers would be appropriate. Ms. Grace testified that the credit for S.C. No. 2 customers would differ from the large volume demand service classifications, S.C. No. 3 (North Shore) and S.C. No. 4 (Peoples Gas) because storage costs for S.C. No. 2 are fully bundled in base rates and this is not the case for the large volume demand rates. The Utilities proposed that, for Rider FST, the credit would be per therm of Maximum Daily Quantity ("MDQ"). For Rider SST S.C. No. 2 customers, the base rate credit amount credit would be per therm of MDQ and the gas charge credit amount would be per therm of Selected Standby Quantity ("SSQ"). For the Rider SST large volume demand service classifications, the credit would be per therm of SSQ. NS-PGL Exs. VG-2.0 Rev at 55-57; VG-2.5N; VG-2.5P. Ms. Grace also stated in response to Mr. Sackett that the CFY credit would be per therm of MDQ, rather than the current method of including it as a credit against the Aggregation Charge. NS-PGL Exs. VG-2.0 Rev at 64-65.

b. Commission Analysis and Conclusions

The Commission agrees with Staff that a credit similar to what already exists for the small volume transportation program is appropriate for the large volume program. The Utilities proposed a reasonable, cost-based way to develop and implement the credit. The Commission finds that the Utilities' proposal is reasonable and approves it as well as the change in the CFY credit to a credit per therm of MDQ.

5. Diversity Factors

a. The Record

Staff witness Mr. Sackett recommended that the Utilities update their Riders FST and SST diversity factors based on the most recent four years' data. Staff Ex. 12.0R at 25. Peoples Gas agreed to reduce its diversity factor from 0.87 to 0.86, and North Shore agreed to reduce its diversity factor from 0.75 to 0.73. NS-PGL Ex. VG-2.0 Rev. at 55.

b. Commission Analysis and Conclusions

The Commission agrees with Staff that the diversity factors should be updated in this case. The Staff proposal, to which the Utilities agreed, correctly states what the new factors should be, and the Utilities should use these factors in the relevant calculations in their tariffs.

6. Standby Commodity Charge

a. The Record

Staff witness Mr. Sackett proposed that the Standby Commodity Charge ("SCC") be set at a Chicago citygate price to prevent arbitrage. He stated that the current SCC calculation allows transportation customers to "arbitrage the difference" between the SCC and the Chicago citygate price. Staff Ex. 12.0R at 42. The Utilities agreed with this proposal. The Utilities stated that Rider FST customers' usage is not daily metered, so the calculation would use an average price for the month, namely the existing definition of Average Monthly Index Price. Rider SST customers' usage is daily metered, so the calculation would use a daily price applicable to the flow date on which the imbalance occurred. An appropriate definition (Daily Index, Midpoint) is in Rider AGG. The Utilities proposed to revise Riders FST and SST to define the SCC price consistent with the existing definitions. NS-PGL Ex. RD-1.0 Rev. at 19-20. The Utilities also noted that the SCC is used in Rider P. NS-PGL Init. Br. at 173, fn. 88; NS Ex. VG-1.1 at 60; PGL Ex. VG-1.1 at 70.

b. Commission Analysis and Conclusions

The Commission agrees with Staff's recommendation. As Mr. Sackett explained, tying the SCC to a Chicago citygate price may reduce price arbitrage that could be detrimental to sales customers. The Utilities' specific proposals for the indices and definitions to use are reasonable. The Commission directs the Utilities to include the necessary language in their Riders FST, SST, and P to define the SCC consistent with their proposals.

7. Maximum Daily Quantity (MDQ) Calculation

a. The Record

RGS witness Mr. Crist disputed the Utilities' calculation of the MDQ for CFY customers. RGS Ex. 1.0 at 31. Mr. McKendry explained that the Utilities round the MDQ calculation to the nearest dekatherm but agreed to round to the nearest therm. NS-PGL Ex. JM-1.0 at 23. The Utilities noted that the changed method applies to the large volume transportation program, which has an MDQ calculation. NS-PGL Init. Br. at 173; NS Ex. VG-1.1 at 38, 48; PGL Ex. VG-1.1 at 43, 53.

b. Commission Analysis and Conclusions

The Commission agrees with RGS that, especially for small usage customers, it is more accurate to round the MDQ calculation to the nearest therm. The Commission approves this proposal for the large and small volume programs and directs the Utilities to make any necessary changes to their tariffs.

8. Rider SST Unbundled Allowable Bank

a. The Record

Staff witness Mr. Sackett proposed that the Utilities unbundle their Rider SST Allowable Bank from the standby service. Staff Ex. 12.0R at 25-42; Staff Ex. 26.0 at 7-43. The Utilities did not accept Staff's proposal to unbundle the Rider SST Allowable Bank from standby service, citing operational, administrative and rate concerns. NS-PGL Exs. RD-1.0 Rev. at 2-17; RD-2.0 at 2-13; VG-2.0 Rev. at 57-58; VG-3.0 at 30-36. In response to a data request, the Utilities agreed to work collaboratively with Staff, 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. The Utilities would file proposed tariff changes to implement any resulting mutually acceptable proposals, and, if and to the extent such proposals are not developed, to address such unbundling in their next rate case filings. Staff Cross Exs. Grace 5 and 6.

b. Commission Analysis and Conclusions

The Commission agrees that it is reasonable for the Utilities to work with Staff and develop reasonable proposals for unbundling storage service. The Commission finds that the Utilities should file any agreed upon proposals in their next rate cases, and, to the extent Staff and the Utilities do not reach agreement, the Utilities should address this matter in those rate cases.

9. Elimination of Rider TB - Transportation Balancing Service

a. The Record

Peoples Gas proposed to eliminate Rider TB, Transportation Balancing Service. Few customers have taken this service and, currently, no customers are taking it. PGL Ex. VG-1.0 Rev. at 32. Neither Staff (Staff Ex. 12.0R at 5) nor any party opposed the proposal.

b. Commission Analysis and Conclusions

The Commission agrees that Peoples Gas need not continue to offer this service. The Commission approves Peoples Gas' proposal to eliminate its Rider TB.

C. Large Volume Transportation Program

1. Super Pooling on Critical Days

a. Other Parties

[Insert]

b. North Shore and Peoples Gas Response

The Utilities pointed out that the Commission rejected "super pooling" as proposed in the Utilities' last rate case, except for a specific inventory requirement that is determined on one day each year. *Peoples 2007* at 282-283. The Utilities did not agree to implement super pooling for critical days. The Utilities note that CNE-Gas' terminology ("critical and supply surplus days") is unclear. Rider SST states that a Critical Day is either a "Supply Surplus Day" or a "Supply Shortage Day." NS Ex. VG-1.1 at 47; PGL Ex. VG-1.1 at 52. It is unclear if CNE-Gas' proposal is directed to all Critical Days or only Supply Surplus Days.

Mr. McKendry explained that the administrative burden and attendant concerns that the Utilities expressed in the 2007 rate cases have not changed or been alleviated. NS-PGL Ex. JM-1.0 at 13. He stated that, although CNE-Gas claims that its proposal in this case places the burden of the super pool determination on the supplier (CNE-Gas Ex. 2.0 at 6), this is incorrect. The Utilities would need to review the accuracy of the supplier's 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. In other words, the Utilities are ultimately responsible for implementing the process. NS-PGL Ex. JM-2.0 at 4-5. The Utilities concluded that the Commission's conclusions in their 2007 rate case Order apply to the proposal in the instant cases and, for those reasons, CNE-Gas' super pooling proposal should be rejected.

c. Commission Analysis and Conclusions

CNE-Gas has revised its proposal from the 2007 rate cases to place the initial obligation on the supplier who wishes to use super pooling on critical days. However, the Utilities are correct that, once a supplier requests to super pool, the burden on the

Utilities is substantially the same as under the proposal we reviewed and rejected in the Utilities' 2007 rate cases. The Commission agrees with the Utilities that to require super pooling for unpredictable and sporadic events like critical days would place a substantial and unnecessary burden on the Utilities. The Commission rejects CNE-Gas' proposal.

D. Small Volume Transportation Program (Choices for You[SM] or "CFY")

1. Allocation of and Access to Company-owned Assets

a. Other Parties

[Insert]

b. North Shore and Peoples Gas Response

The Utilities disputed RGS witness Mr. Crist's claim (RGS Ex. 1.0 at 10) that the Utilities recover the same amount of storage costs from sales and CFY customers but CFY customers do not receive the same rights to that storage. The Utilities stated that CFY customers and suppliers receive comparable benefits from the Utilities' storage.

First, the Utilities pointed out that the Commission addressed this same recommendation in the Utilities' last rate cases and rejected RGS' arguments. *Peoples 2007* at 288-293. RGS has raised nothing new. The Utilities proposed no changes to the CFY customers' and suppliers' storage rights and obligations. In the short period since the last rate case, sales customers have not acquired any additional or superior rights. NS-PGL Ex. RD-1.0 at 26. RGS presented no evidence that warrants the Commission reaching a different conclusion.

Second, the Utilities testified that CFY suppliers have significant flexibility to use the benefits that storage can offer, and the Utilities' decisions for their sales customers must work around the constraints caused by the CFY suppliers. For example, CFY suppliers know by 8:45 a.m. every business day, prior to making purchase decisions, the gas quantity they will need to deliver to the Utilities. This quantity includes an allocation of the storage rights that mirror those the Utilities use for sales customers. With this knowledge, CFY suppliers can then vary their deliveries within a 10% band, even on Critical Days, around the known delivery level. In contrast, the Utilities stated that they make daily purchase decisions for sales customers without knowing how CFY deliveries will vary from the projected quantity and must remain prepared to meet CFY variations that are not known until after the fact. NS-PGL Ex. RD-1.0 Rev. at 27-28. As another example, the Utilities' storage injection and withdrawal rights are constrained by limitations in the pipeline providers' tariffs or other pipeline-imposed restrictions (such as in response to *force majeure*). The Utilities testified that these limitations include injection and withdrawal ratchets and upstream source and transportation requirements. Peoples Gas' storage field (Manlove Field) also has operating limitations. Conversely, the CFY suppliers deliver gas based on projected customer requirements, without regard to storage and pipeline issues, and within a 10% tolerance band. *Id*. at 28.

Third, the Utilities stated that they use system assets to support several benefits for CFY suppliers that would not exist if the CFY suppliers were dealing with unbundled pipeline services, as the Utilities must do. These benefits include that CFY suppliers: may transport gas to the citygate using any pipeline that interconnects with the Utilities; have access to storage without having to specifically nominate injections or withdrawals; and receive a daily balancing service. NS-PGL Ex. RD-2.0 at 13-14.

Finally, RGS has not shown how Nicor Gas' allocation of storage rights and management of its version of the CFY program (Customer Select) is relevant to what the Utilities can or should adopt for their programs. Nicor Gas' system is not the same as the Utilities' systems. There is no evidence how Nicor Gas' supply personnel manage and support service for Customer Select. There is no evidence how Nicor Gas coordinates service under Customer Select with its other transportation programs. NS-PGL Ex. RD-1.0 Rev. at 26-27. There is no record support for taking a piece of another utility's transportation program and imposing it on the Utilities.

c. Commission Analysis and Conclusions

The Commission finds that RGS' contention that the CFY customers and suppliers are receiving inferior service relative to sales customers is incorrect. The CFY suppliers receive substantial benefits from the storage assets for which they are paying, and there is no evidence that those benefits are inferior to the benefits that sales customers receive from the Utilities' management of those assets on their behalf. The Commission further finds that RGS' proposal that the Utilities' program, or at least the piece of it associated with how the Utilities allocate storage capacity to CFY customers and suppliers, should be "similar to the program, in place at Nicor Gas" (RGS Ex. 1.0 at 17) is undeveloped and lacks record support. Nicor Gas and the Utilities have different assets, offer different services to their customers and have different transportation programs. There is no support for imposing on the Utilities operational service terms and conditions that another utility developed for its programs. The Commission rejects RGS' proposal that the Utilities change how storage is handled under Rider AGG.

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

a. Other Parties

[Insert]

b. North Shore and Peoples Gas Response

The Utilities disputed RGS' proposed alternative (reducing the ABGC) to its request for greater access to storage assets. The Utilities contend that reducing the ABGC would only be appropriate if the CFY customers were not receiving the benefits for which they were paying through the ABGC. The Utilities stated that this is not the case. Moreover, the Utilities stated that RGS' contention that the Utilities "recover the same amount of storage costs from both sales and Choices For You customers" (RGS Ex. 1.0 at 10) is incorrect.

The Utilities cited Mr. Crist's statement that off-system storage costs are recovered from sales customers through the Non-Commodity Gas Charge ("NCGC") and from CFY customers through the ABGC. RGS Ex. 1.0 at 10. This statement is disingenuous in the context of arguing that the Utilities recover the "same amount" of storage costs from sales and CFY customers. The Utilities pointed out that Mr. Crist acknowledged that the NCGC does not equal the ABGC. Tr. at 561. In fact, the Utilities stated that the ABGC is less than the NCGC. Specifically, the tariff defines the ABGC as "a non-commodity related, per therm, gas cost recovery mechanism applied to all therms delivered or estimated to be delivered by the Company to customers served under Rider CFY. This charge is <u>equivalent to the NCGC less any costs not associated with balancing or storage</u>. Revenues arising through the application of this charge will be credited to the Factor NCGC." (emphasis added) NS Ex. VG-1.1 at 17; PGL Ex. VG-1.1 at 20. This rate design recognizes that the Utilities provide storage and balancing services to the CFY customers and suppliers. The Utilities stated that further reducing the ABGC would result in sales customers subsidizing the CFY customers by paying for costs associated with the balancing and storage services that CFY customers and their suppliers receive.

c. Commission Analysis and Conclusions

For the reasons stated in Section XIII(D)(1), *supra*, the Commission finds that the CFY suppliers receive storage service access comparable to what sales customers receive. Consequently, RGS' alternative request is moot. The Commission also finds that the costs recovered from the CFY customers properly reflects the storage services that they and their suppliers receive, and the ABGC formula accurately captures the costs. No reduction in the ABGC is warranted.

3. Allocation of Administrative Costs and Related Charges

a. Other Parties

[Insert]

b. North Shore and Peoples Gas Response

The Utilities stated that RGS' proposal to recover CFY administrative and billing option costs from all customers is inconsistent with cost causation principles and would result in sales customers subsidizing customers who elect to take transportation service. NS-PGL Ex. VG-2.0 Rev. at 64. The Utilities' witness Ms. Grace explained that the CFY Administrative Charge recovers the Utilities' cost of administering the CFY program. She sponsored a specific cost study, identifying the activities and functions and the related costs underlying the proposed CFY Administrative Charges. NS-PGL Ex. VG-2.0 Rev. at 63; NS Ex. VG-1.10; PGL Ex. VG-1.10. She explained that the LDC Billing Option charges recover the Utilities' cost of rendering a bill with supplier specified charges, on behalf of the supplier, and remitting customer payments to the supplier. NS-PGL Ex. VG-2.0 Rev. at 63-64. The Utilities stated that the costs in question are properly assessed to CFY <u>suppliers</u> for services those suppliers receive and assessing them to all customers (sales and transportation) would be improper and should be rejected.

c. Commission Analysis and Conclusions

The administrative charges at issue are derived from a cost of service study, much as the studies for the large volume transportation programs determined the administrative charges for those programs. The billing charges were the subject of a study in a prior proceeding. No party challenged the accuracy of the studies. Instead, RGS asks that all S.C. Nos. 1 and 2 customers bear these costs. It is the Commission's policy that costs be allocated to the persons who cause the utility to incur those costs. For the CFY Administrative Charge and the LDC Billing Option charges, there is substantial evidence showing that the CFY suppliers cause the Utilities to incur these costs. The CFY costs are costs that are caused by suppliers, and sales customers receive no benefits from the services that underlie those costs. Accordingly, the CFY suppliers, and not the sales customers, should bear those costs through the cost-based charges. The Commission rejects RGS' proposal to have the CFY administrative and LDC Billing Option charges recovered from all customers.

4. Rider SBO Issues

a. Other Parties

[Insert]

b. North Shore and Peoples Gas Response

The Utilities' witness Mr. McKendry explained that Rider SBO describes the terms and conditions under which a supplier may choose to issue a single bill that includes utility charges. NS-PGL Ex. JM-1.0 at 14. Responding to RGS' request that customers in payment arrears to the Utilities should not be removed from receiving a Rider SBO bill (RGS Ex. 1.0 at 24-25), the Utilities stated that customers leaving budget billing plan when they switch to CFY seems to be a significant part of RGS' concern. Mr. McKendry stated that a customer who is participating in the Utilities' budget plan is allowed to receive a Rider SBO bill. NS-PGL Ex. JM-2.0 at 5. He explained that the alternative supplier often is the one requesting that the Utilities remove the customer from the budget plan. NS-PGL Ex. JM-1.0 at 15. The alternative supplier is, thus, in control of the situation and can remedy it, for example, by ensuring that the arrearage is paid. NS-PGL Ex. JM-2.0 at 6. The Utilities also pointed out that the origin of this requirement was that, in Docket Nos. 01-0469 and 01-0470, suppliers raised issues over collecting utility arrearages that, in their opinion, would create customer confusion and have a negative impact on competition. The suppliers argued that the Utilities needed to address receivables risk under Rider SBO. The Utilities did so by including terms in Rider SBO that insulated suppliers from receivables risk. The Commission agreed with the Utilities' proposal. *In re North Shore Gas Co.*, ICC Docket No. 01-0469, at 26 (Order, Mar. 5, 2002); *In re The Peoples Gas Light and Coke Co.*, ICC Docket No. 01-0470, at 30 (Order, Mar. 5, 2002).

Responding to RGS' request that there should be a mechanism allowing a customer's credit on its utility bill to be transferred to the supplier (RGS Ex. 1.0 at 26), the Utilities stated that Mr. Crist's request is predicated on the customer consenting to the credit transfer. Mr. McKendry explained that the Utilities have no ready way to verify if a supplier agreement includes provisions permitting such a transfer. The terms and conditions in suppliers' agreements may differ from supplier to supplier and the same supplier may have different contract forms. NS-PGL Ex. JM-1.0 at 17. When asked to provide form agreements, RGS merely provided a single example of language that it stated a supplier includes in its agreements. RGS Ex. 2.4; Tr. at 575-576. The Utilities contend that there is no evidence that all suppliers have such language in their agreements, nor that the supplier from whose agreement form(s) RGS lifted the quoted language includes that language in all its agreements. Tr. at 576. The Utilities stated that they do not review each customer's agreement to figure out what rights a supplier may have to manage a customer's account. Furthermore, Mr. McKendry stated that the customer may have legitimate reasons to have the Utilities refund that credit and not transfer it to the supplier. NS-PGL Ex. JM-1.0 at 17.

c. Commission Analysis and Conclusions

The Commission finds that RGS has not met its burden of proof on either of its requested Rider SBO changes and that the evidence does not support those changes. The Utilities are correct that the supplier is able to address both situations through its interactions with the customer. The Utilities have legitimate credit and collection concerns that are facilitated by returning to the Utilities the ability to issue their own bills when the customer has arrearages with the Utilities. Concerning the credit transfer, RGS posits that this is a case of the Utilities ignoring a customer request but, in fact, the Utilities have no reasonable way to verify that the customer has actually authorized the supplier to transfer customer credits to it. The fact that the supplier is the customer's agent does not necessarily mean that the customer has given the supplier the authority to move a credit balance to itself. The Commission rejects both of RGS' Rider SBO proposals.

5. New Customer Issues

a. Other Parties

[Insert]

b. North Shore and Peoples Gas Response

The Utilities' witness Mr. McKendry explained that the Utilities' process, applicable to all service applicants, is that an applicant starts receiving service when the gas is turned on or, if service is left on by the previous customer, when the Utilities get a meter reading. This requires scheduling a service order. Mr. McKendry explained that the account is "pending" until the gas has been turned on and becomes "active" once the service order is complete. NS-PGL Ex. JM-1.0 at 20. Mr. McKendry explained that the Utilities do not accept CFY enrollment requests that suppliers submit when customers' accounts are "pending." Circumstances can change between the service request and when service orders are scheduled. For example, a customer may cancel the service request before the scheduled turn-on date or re-schedule the turn-on date. Also, Mr. McKendry expressed concerns that activating customers' accounts immediately in supplier's pools is inconsistent with Senate Bill 171's requirement that allows customers 10 business days from the Utilities' notice to rescind contracts with their suppliers. *Id*. at 21.

c. Commission Analysis and Conclusions

The Utilities' practice concerning new customers is reasonable. In effect, RGS is seeking to have the Utilities process a request for a person to receive transportation service before the customer is actually receiving gas service. The Commission finds that RGS has not met its burden of proof to require a change in this process and that the evidence does not support that change.

6. Customer Switching Issues

a. Other Parties

[Insert]

b. North Shore and Peoples Gas Response

The Utilities stated that Mr. Crist's recommendation that the Commission require the Utilities to reduce the period from 19 to the 10 days that he states is required by Senate Bill 171 is inconsistent with Senate Bill 171 and must be rejected. First, the Utilities stated that the customer's contract rescission period is 10 business days and not calendar days, as Mr. Crist acknowledged. 220 ILCS 5/19-115(g)(6); Tr. at 573; NS-PGL Ex. JM-1.0 at 19. Second, the Utilities stated Mr. Crist appears not to recognize that the event that triggers the start of the 10-business day period is the Utilities' notice to the customer. 220 ILCS 5/19-115(g)(6); Tr. at 573; NS-PGL Ex. JM-1.0 at 19. Third, the Utilities noted that they have two business days from receiving the supplier's request to send the notice to the customer. 220 ILCS 5/19-115(g)(6); NS-PGL Ex. JM-1.0 at 19. Fourth, they pointed out that this 12-business day period necessarily includes two weekends, *i.e.*, four more calendar days. NS-PGL Ex. JM-2.0 at 7. Finally, they pointed out that many months include a State holiday. *Id*.

c. Commission Analysis and Conclusions

The Commission finds that the Utilities' 19-day period is a reasonable and, given the statutory constraints, narrow window that ensures compliance with Senate Bill 171. In contrast, Mr. Crist's comparison of 19 days to 10 calendar days to claim that the Utilities improperly extend the period by nine days is clearly incorrect, and his recommendation to reduce the window to 10 days would violate the law. The Commission rejects Mr. Crist's recommendation.

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

a. Other Parties

[Insert]

b. North Shore and Peoples Gas Response

The Utilities' witness Mr. McKendry stated that the Utilities provide the information requested by Mr. Crist through reports available to suppliers via their PEGASys™ system at any time. NS-PGL Ex. JM-1.0 at 21.

Regarding Mr. Crist's statement that the Utilities should make "improvements in their supplier billing and Pegasus (*sic*) system" (RGS Ex. 1.0 at 9), the Utilities stated that there is no explanation what PEGASys™ system improvements RGS is seeking. Consequently, there is nothing on which the Commission may act.

c. Commission Analysis and Conclusions

The Commission will not require the Utilities to make information available in a particular format. The requested information is available, at any time, on an electronic system that suppliers can access. We will not also require that the same information be presented on a monthly bill. Concerning PEGASys™, Mr. Crist offered no specific recommendation. Accordingly, the Commission will require no changes to PEGASys™.

XIV. FINDINGS AND ORDERING PARAGRAPHS

The Commission, having considered the entire record herein and being fully advised in the premises, is of the opinion and finds that:

(1) Peoples Gas is an Illinois corporation engaged in the transportation, purchase, storage, distribution and sale of natural gas to the public in Illinois and is a public utility as defined in Section 3-105 of the Public Utilities Act;

(2) North Shore is an Illinois corporation engaged in the transportation, purchase, storage, distribution and sale of natural gas to the public in Illinois and is a public utility as defined in Section 3-105 of the Public Utilities Act;

(3) the Commission has jurisdiction over the parties and the subject matter herein;

(4) the recitals of fact and conclusions of law reached in the prefatory portion of this Order are supported by the evidence of record, and are hereby adopted as findings of fact and conclusions of law; the Appendix attached hereto provides supporting calculations;

(5) the test year for the determination of the rates herein found to be just and reasonable should be the 12 months ending December 31, 2010; such test year is appropriate for purposes of this proceeding;

(6) the $2,525,147,000 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 $398,983,000 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;

(7) for the test year ending December 31, 2010, and for the purposes of this proceeding, Peoples Gas' original cost rate base with adjustments is $1,300,750,000; ***[Please note, this assumes the Utilities' proposed injuries and damages compromise];***

(8) for the test year ending December 31, 2010, and for the purposes of this proceeding, North Shore's original cost rate base with adjustments is $179,927,000; ***[Please note, this assumes the Utilities' proposed injuries and damages compromise];***

(9) a just and reasonable return which Peoples Gas should be allowed to earn on its net original cost rate base is 9.11%; this rate of return incorporates a return on common equity of 11.87% and costs of long-term debt of 5.58%, with a just and reasonable capital structure of 56% common equity and 44% long-term debt;

(10) a just and reasonable return which North Shore should be allowed to earn on its net original cost rate base is 9.06%; this rate of return incorporates a return on common equity of 11.87% and costs of long-term debt of 5.48%, with a just and reasonable capital structure of 56% common equity and 44% long-term debt;

(11) Peoples Gas' rate of return set forth in Finding (9) results in approved base rate net operating income of $ 118,498,000; ***[Please note, this assumes the Utilities' proposed injuries and damages compromise and does not correct for the uncontested merger costs adjustment]***;

(12) North Shore's rate of return set forth in Finding (10) results in approved base rate net operating income of $16,301,000; ***[Please note, this assumes the Utilities' proposed injuries and damages compromise and does not correct for the uncontested merger costs adjustment]***;

(13) Peoples Gas' rates, which are presently in effect, are insufficient to generate the operating income necessary to permit Peoples Gas the opportunity to earn a fair and reasonable return on net original cost rate base; these rates should be permanently canceled and annulled;

(14) North Shore's rates, which are presently in effect, are insufficient to generate the operating income necessary to permit North Shore the opportunity to earn a fair and reasonable return on net original cost rate base; these rates should be permanently canceled and annulled;

(15) the specific rates proposed by Peoples Gas in its initial filing do not reflect various determinations made in this Order regarding revenue requirement, cost of service allocations, and rate design; Peoples Gas' proposed rates should be permanently canceled and annulled consistent with the findings herein;

(16) the specific rates proposed by North Shore in its initial filing do not reflect various determinations made in this Order regarding revenue requirement, cost of service allocations, and rate design; North Shore's proposed rates should be permanently canceled and annulled consistent with the findings herein;

(17) Peoples Gas should be authorized to place into effect tariff sheets designed to produce annual revenues of $574,038,000, including base rate and rider revenues, which represents a gross increase of $113,178,000; such revenues will provide Peoples Gas with an opportunity to earn the rate of return set forth in Finding (9) above; based on the record in this proceeding, this return is just and reasonable; ***[Please note, this assumes the Utilities' proposed injuries and damages compromise and does not correct for the uncontested merger costs adjustment]***;

(18) North Shore should be authorized to place into effect tariff sheets designed to produce annual base rate revenues of $83,305,000, including base rate and rider revenues, which represent a gross increase of $18,105,000; such revenues will provide North Shore with an opportunity to earn the rate of return set forth in Finding (10) above; based on the record in this proceeding, this return is just and reasonable; ***[Please note, this assumes the Utilities' proposed injuries and damages compromise and does not correct for the uncontested merger costs adjustment]***;

(19) As required by Section VIII of this Order, Peoples Gas shall adopt and implement Rider ICR as proposed and with the inclusion of the recommended language changes proposed by Staff and accepted by Peoples Gas;

(20) As required by Section X(B) of this Order, North Shore should include in its compliance filing, effective base rates that include franchise costs in its test year revenue requirements and base rates that would become effective May 1, 2010, that remove franchise costs from its test year revenue requirements;

(21) As required by Section XII(B)(3) of this Order, the Utilities should evaluate the feasibility of uniform service classification numbering and address this in their next rate cases;

(22) As required by Section XII(D)(2) of this Order, the Utilities should provide with their compliance filing the Rider VBA "rate case margins" and "rate case customers" resulting from the approved revenue requirements;

(23) As required by Section XII(D)(2) of this Order, the Utilities should each annually prepare a report on the their rates of return and the effect on that return of Rider VBA and submit it to the Commission and Staff at the same time they file petitions seeking initiation of an annual reconciliation proceeding to determine the accuracy of the Rider VBA Reconciliation Adjustment;

(24) As required by Section XIII(B) of this Order, the Utilities should revise their transportation tariffs to describe the terms and conditions of the Evening Nomination Cycle; describe the current practice related to handling nomination changes required by upstream cuts; include a storage credit based on reduced storage inventory requirements arising from customers and suppliers filling transportation banks; revise the Standby Commodity Charge; and revise the Maximum Daily Quantity definition;

(25) As required by Section XIII(B)(8) of this Order, the Utilities should work collaboratively with the Commission Staff to develop proposals to unbundle their transportation storage services from their standby services;

(26) the determinations regarding cost of service and rate design contained in the prefatory portion of this Order are reasonable for purposes of this proceeding; the tariffs filed by North Shore and Peoples Gas should incorporate the rates and rate design set forth and referred to herein; and

(27) new tariff sheets authorized to be filed by this Order should reflect an effective date not less than three (3) days after the date of filing, with the tariff sheets to be corrected, if necessary, within that time period.

IT IS FURTHER ORDERED, that Rider ICR is authorized and shall be implemented by Peoples Gas.

IT IS FURTHER ORDERED, that the recommended language changes proposed by Staff and accepted by Peoples Gas shall be included in Rider ICR.

IT IS FURTHER ORDERED, that the Staff's recommendations as to the accelerated main replacement program being ordered, opening a separate docket to review and approve an implementation plan, and the retention of consultants by the Commission are denied.

IT IS THEREFORE ORDERED by the Illinois Commerce Commission that the tariff sheets presently in effect rendered by The Peoples Gas Light and Coke Company and North Shore Gas Company are hereby permanently canceled and annulled, effective at such time as the new tariff sheets approved herein become effective by virtue of this Order.

IT IS FURTHER ORDERED that the proposed tariffs seeking a general rate increase, filed by The Peoples Gas Light and Coke Company and North Shore Gas Company on February 25, 2009, are permanently canceled and annulled.

IT IS FURTHER ORDERED that The Peoples Gas Light and Coke Company and North Shore Gas Company are authorized to file new tariff sheets with supporting workpapers in accordance with Findings 17 and 18 of this Order, applicable to service furnished on and after the effective date of said tariff sheets.

IT IS FURTHER ORDERED, that North Shore shall include in its compliance filing, effective base rates that include franchise costs in its test year revenue requirements and base rates that would become effective May 1, 2010, that remove franchise costs from its test year revenue requirements.

IT IS FURTHER ORDERED, that North Shore and Peoples Gas shall evaluate the feasibility of uniform service classification numbering and address this in their next rate cases.

IT IS FURTHER ORDERED, that North Shore and Peoples Gas shall provide with their compliance filings the Rider VBA “rate case margins” and “rate case customers” resulting from the approved revenue requirements.

IT IS FURTHER ORDERED, that North Shore and Peoples Gas shall each annually prepare a report on the their rates of return and the effect on that return of Rider VBA and submit it to the Commission and Staff at the same time they file petitions seeking initiation of an annual reconciliation proceeding to determine the accuracy of the Rider VBA Reconciliation Adjustment.

IT IS FURTHER ORDERED, that North Shore and Peoples Gas shall revise their transportation tariffs to describe the terms and conditions of the Evening Nomination Cycle; describe the current practice related to handling nomination changes required by upstream cuts; include a storage credit based on reduced storage inventory requirements arising from customers and suppliers filling transportation banks; revise the Standby Commodity Charge; and revise the Maximum Daily Quantity definition.

IT IS FURTHER ORDERED, that North Shore and Peoples Gas shall work collaboratively with Staff to develop proposals to unbundle their transportation storage services from their standby services.

IT IS FURTHER ORDERED that any motions, petitions, objections, and other matters in this proceeding which remain unresolved are disposed of consistent with the conclusions herein.

IT IS FURTHER ORDERED that, subject to the provisions of Section 10-113 of the Public Utilities Act and 83 Ill. Adm. Code 200.880, this Order is final; it is not subject to the Administrative Review Law.

By order of the Commission this ___ day of __________, 20__.

(SIGNED) CHARLES E. BOX

Chairman