STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

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

REPLY BRIEF OF THE
STAFF OF THE ILLINOIS COMMERCE COMMISSION

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Staff of the Illinois Commerce Commission ("Staff"), by and through its counsel, pursuant to Section 200.800 of the Rules of Practice (83 Ill. Adm. Code 200.800) of the Illinois Commerce Commission's ("Commission"), respectfully submits its Reply Brief in the above-captioned matter regarding the filings by North Shore Gas Company ("North Shore" or the "Company") and The Peoples Gas Light And Coke Company ("Peoples Gas" or the "Company") (collectively referred to as the "Companies" or "Utilties") for proposed general increases in rates for gas service.

I. INTRODUCTION

A. Overview/Summary

The Initial Brief of the Staff of the Illinois Commerce Commission ("Staff's Initial Brief" or "Staff IB") was served on September 29, 2009. The Initial Brief Of The People Of The State Of Illinois ("AG's Initial Brief" or "AG IB"), The City of Chicago's Initial Brief

Regarding Proposed Rider ICR ("City's ICR Initial Brief" or "City ICR IB"), the Joint Initial Brief Of The Citizens Utility Board And The City Of Chicago ("CUB-City's Initial Brief" or "CUB-City IB"), the Initial Brief Of Constellation NewEnergy-Gas Division, LLC ("CNE-Gas' Initial Brief" or "CNE-Gas IB"), CUB's Initial Brief On The Issue Of Peoples Gas Light And Coke Company's Proposed Rider ICR ("CUB's ICR Initial Brief" or "CUB ICR IB"), the Initial Post-Hearing Brief Of North Shore Gas Company And The Peoples Gas Light And Coke Company ("NS-PGL's Initial Brief" or NS-PGL IB"), the Initial Brief Of The Retail Gas Suppliers ("RGS' Initial Brief" or "RGS IB"), and the Initial Post-Hearing Brief Of The Utility Workers Union Of America, AFL-CIO, Local Union No. 18007, ("UWUA's Initial Brief" or "UWUA IB"), were also filed or served on September 29, 2009.

Some of the issues raised in the parties' initial briefs were addressed in Staff's Initial Brief and, in the interest of avoiding unnecessary duplication, Staff has not repeated every argument or response previously made in Staff's Initial Brief. Thus, the omission of a response to an argument that Staff previously addressed simply means that Staff stands on the position taken in Staff's Initial Brief.

II. TEST YEAR (Uncontested)

III. REVENUE REQUIREMENT

IV. RATE BASE

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

2. Plant

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

The original cost finding the Commission makes in this proceeding should take into account any adjustments the Commission makes to the cost of plant in service at

12/31/07. In its initial brief, Staff recommends language for an Original Cost Determination to be ordered by the Commission which includes the effects of Staff's proposed adjustment for capitalized incentive compensation costs the Commission disallowed in each Company's prior rate case. Staff IB, pp. 5-6. The Companies recommend similar wording which was recommended by Staff witness Bridal in his direct testimony. NS-PGL IB, pp. 29-30. The language suggested in Staff's Initial Brief should be adopted, as it correctly reflects the adjusted cost of plant as of 12/31/07.

5. Gas in Storage

GCI witness Mr. Effron recommends additional adjustments to the Companies' gas in storage inventories. CUB-City IB, p. 3. Mr. Effron recommends a decrease for North Shore and a slight increase for Peoples Gas associated with the position of the cost attributed to their gas in storage inventory evaluations. Staff disputes GCI's request. Staff continues to support the Companies' revised calculation for their valuation of the gas in storage inventories. Tr., p. 915, August 27, 2009.

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

2. Gathering System Phase 2 Project (PGL)

Peoples Gas' discussion in its Initial Brief regarding the legitimacy of its Gathering System Phase 2 Project raised three points that Staff disputes. First, Peoples Gas misrepresented Staff's position within its arguments. Second, Peoples Gas attempts to institute a new standard for determining the used and usefulness of its project. Finally, the Company claimed information it provided is sufficient to demonstrate it will pursue the project in 2010.

Peoples Gas claims that Staff's rationale for rejecting its requested costs associated with the Gathering System Phase 2 Project only involved two areas, namely the used and usefulness of replacement pipes in serving customers and the inability to show Staff that the project would proceed in 2010. NS-PGL IB, p. 35. However, this misrepresents Staff's position. Staff's reasoning for disputing Peoples Gas' request to include the costs associated with the project was based on Peoples Gas' inability demonstrate the project would be prudently incurred and that the project would be used and useful. Staff's rationale associated with all of its arguments for disputing Peoples Gas' request were fully discussed in its initial brief, pages 14-20, and need not be repeated here.

Next, the Company claims Staff was not convinced that the replacement pipes would be used and useful in serving customers and then noted that since these replacement pipes would serve the same function as would the pipes already in use. NS-PGL IB, p. 35. In other words, it appears Peoples Gas is attempting to claim that replacement pipes are automatically used and useful. NS-PGL IB, p. 35. While Staff does not dispute the replacement of one section of pipe with another section of pipe likely does not change the pipe's function, Peoples Gas' arguments skips some mandatory steps, such as Section 9-212 of the PUA, on the road to achieve a used and useful designation. Specifically, Section 9-212 of the Public Utilities Act states:

> A generation or production facility is used and useful only if, and only to the extent that, it is necessary to meet customer demand or economically beneficial in meeting such demand. [220 ILCS 5/9-212]

In other words, Peoples Gas must demonstrate the project to replace the gathering system at its Manlove storage field is necessary or economically beneficial to meet customer demand to achieve a designation of used and useful. However, the Company itself admits that the cost benefit analysis and business case that it expects to demonstrate that the project will be prudent and used and useful will not be developed until the completion of the Phase 1 engineering study, which is currently scheduled for completion in November 2009. Peoples Gas Ex. TLP-1.0, p. 10. Without such information, Peoples Gas cannot demonstrate even if it is going to replace any of the gathering system, how it reached its decision, demonstrate a benefit, or show a need for the project. Given this, the Commission must reject Peoples Gas arguments.

The final area of dispute is Peoples Gas' claim that it provided sufficient information to demonstrate it would proceed with the project in 2010 and incur at least the $5.7 million amount it requested to include in rates. NS-PGL IB, p. 35. Staff disputes this conclusion. Staff noted that the recent issuance of the engineering study RFP (Phase 1) indicated Peoples Gas was still at the starting point in determining what, if anything, needs replaced at the Manlove storage field. ICC Staff Ex. 13.0, pp. 11-12. Further, Peoples Gas has not completed any of the necessary studies such as a cost benefit analysis or business case nor has Peoples Gas received Board approval for any expenditure associated with Phase 2 of the project. In short, Peoples Gas has provided nothing but its good intentions to support that it will incur any costs or pursue Phase 2 of this project in the 2010 test year. Therefore, Staff recommends the Commission remove all the costs associated with Phase 2 of the Gas Gathering System project from Peoples Gas' requested rates.

3. Capitalized Incentive Compensation

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

4. Capitalized Non-Union Base Wages

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

E. Cash Working Capital

1. Pass-Through Taxes

Staff maintains its proposal to reduce the amount of Cash Working Capital ("CWC") added to rate base for pass-through taxes because pass-through taxes represent funds provided by ratepayers rather than investors. The Commission should adopt revenue lag days of zero for pass-through taxes and reject the Companies' argument that revenue lag days of 40.84 for North Shore and 50.22 for Peoples Gas be included in CWC that is included in the revenue requirement. Ratepayers should not be forced to pay a return to investors on funds that the ratepayers themselves have provided. Staff IB, pp. 21-22.

The Companies contend that their process for processing pass-through taxes is significantly different than the process used by Nicor Gas in its recent rate case (Docket No. 08-0363). The Companies assert that they do not receive and hold cash receipts associated with pass-through taxes from ratepayers for a period of time until payment to taxing authorities. NS-PGL IB, pp. 38-39. However, contrary to the Companies' assertion the evidence demonstrates that the Companies do have access to the funds provided from the pass-through taxes until the funds are remitted to the taxing authorities. Staff IB, p. 25.

The Companies describe their process for pass-through taxes as amounts that are billed and paid to taxing authorities approximately as received. NS-PGL Ex. JH-3.0, pp. 9-10. In response to Staff Data Requests JMO 14.04 through JMO 14.09 (Staff Ex.

17.0, pp. 7-8), the Companies describe the process and timing of collection and payment of the various pass-through taxes as follows:

1. The taxes are included in the customer's monthly bill.
2. The Companies collect the taxes.
3. Taxes are paid on or before the due dates.
4. The payments are based on estimated amounts.
5. The payments are made regardless of whether or not the Companies collect from the customers.

However, as Staff set forth in its Initial Brief, (pp. 24-25) the cross-examination of Companies' witness Mr. Hengtgen confirmed that the Companies do in fact utilize a process for collection and payment of pass-through taxes similar to Nicor in that amounts are billed, collected, and held for a period of time, and then remitted at a later date to taxing authorities. Mr. Hengtgen described how the pass-through tax liability to the City of Chicago for August 2009 is based on the estimated gross receipts net of a provision of uncollectible accounts that are deemed collected during August 2009 and subsequently paid by one check on September 30th. Tr., pp. 667-672, August 26, 2009 and ICC Staff Cross Hengtgen Ex. No. 21 (WPG-8, page 45 of 48). The Companies are liable to remit the proper amount due on a timely basis (*In re Northern Illinois Gas Co.*, ICC Docket No. 08-0363, p. 12 (Order, Mar. 25, 2009)) whether the payment of pass-through taxes is based on actual cash receipts or estimates or any other methodology. The source of funds for such tax payments is ultimately the collection of the ratepayers' bills as confirmed by Mr. Hengtgen. Tr., pp. 668-669, August 26, 2009.

The Companies' use of lead days for pass through taxes confirms that pass-through taxes deemed collected from ratepayers (during August 2009) are held until remitted to a taxing authority at a later due date (September 30th). The length of time that the Companies have pass-through taxes available for their use has been calculated in the Companies' lead/lag study. *See* ICC Staff Cross Hengtgen Ex. 21. Staff IB, pp. 23-25. The Commission should not allow the Company to increase its rate base for revenue lag on funds for pass-through taxes because the Companies do indeed receive pass-through taxes from ratepayers, hold those funds, and later remit those funds to the taxing authorities. Staff IB, pp. 24-25.

G. Reserve for Injuries and Damages

See Section V. OPERATING EXPENSES, C. Contested Issues, 7. Administrative & General, a. Injuries and Damages Expenses, for Staff's explanation of why there is no need for corresponding adjustments with respect to the injuries and damages reserves in rate base.

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

The Companies assert that Staff and AG-CUB's proposed exclusion of Peoples Gas' pension asset is based on the faulty assumption that it was established with customer-supplied funds. NS-PGL Initial Brief, page 40. By comparison, the Companies' witness Mr. Felsenthal argued against removal of the Peoples Gas pension asset based on his assertion that the pension asset represents shareholder supplied funds and, therefore, represents an asset on which shareholders should earn a return. NS-PGL Ex. AF-2.0, page 3, lines 44 – 47.

Although the Companies provided much discussion of accounting rules and how they impact the pension asset (NS-PGL IB, pp. 41 – 42), the central question before the Commission is: what is the source of the funds that are invested in the pension plan—is it from shareholders, as Mr. Felsenthal claims, or is it from ratepayers, who provide the revenues from which the Companies obtain the cash they contribute to the pension plan? The Commission has answered this question numerous times in prior dockets, including the Companies' most recent rate case, ICC Docket No. 07-0241/-0242 (Cons.), Order February 5, 2008, at 36.

In all those cases, the Commission has consistently rejected requests to include pension assets in utility rate base. Staff IB, p. 29. The Commission has found, in those cases, that the pension asset was created by ratepayer-supplied funds, not by shareholder-supplied funds, and concluded that ratepayers should not be denied the benefits associated with the previous overpayment for pension expense which they funded. Accordingly, the Commission has consistently concluded that pension assets and pension contributions should be eliminated or excluded from rate base.

Most recently, the appellate court upheld the Commission's Order on Rehearing in Docket No. 05-0597 (*Commonwealth Edison Co. v. Ill. Commerce Comm'n*, ___Ill. App. 3d___, 2009 Ill. App. LEXIS 913 (2d Dist. Sept. 17, 2009)) in which the Commission denied rate base recovery of an $803 million pension contribution.

As the Commission is well aware, it did not allow ComEd to reflect any amount of the pension asset or contribution in its rate base. However, the Companies misinterpret the order in Docket No. 05-0597 and the related appeal, to argue that neither the Commission's decision in ComEd's 2005 rate case nor the related appeal supports denying Peoples Gas a rate of return on its pension asset. Having made this erroneous assertion, they further argue that the utility's overall cost of capital is the appropriate rate of return. In total disregard of all prior Commission orders and the appellate decision in Docket No. 05-0597, they assert it is appropriate to include the pension asset in Peoples Gas' rate base. NS-PGL IB, p. 43. Clearly, this treatment stands in absolute contradiction to the Commission's prior orders, the order in Docket No. 05-0597 and the related appeal. The Companies further argue that the question on appeal did not revolve around whether the funds used to contribute to the pension plan 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 Initial Brief, pages 43 – 44. By assuming the same fact pattern in the instant proceeding as the ComEd case (Docket No. 05-0597), the Companies artfully eliminate the question as to the source of the pension funds, and jump ahead to how much of a return the utility should earn on the pension asset. The facts of the ComEd rate case (Docket No. 05-0597) were unique to that case, in that the Company was able to demonstrate a direct link between the pension contribution and the source of funds. Even then, the Commission denied rate base recovery of the contribution and that decision was upheld on appeal. Staff reiterates the arguments put forth in Staff's Initial Brief that provide ample support for the exclusion of pension assets and related contributions from the utility's rate base.

V. OPERATING EXPENSES

B. Uncontested Issues

9. Taxes Other Than Income Taxes

a. Real Estate Taxes

Staff's proposal to decrease the expense for real estate taxes of North Shore and Peoples Gas by $45,000 and $207,000, respectively, is uncontested. NS-PGL IB, p. 53. In its Initial Brief, Staff states that Staff witness Bridal proposed adjustments to the Companies' Real Estate Taxes using the 2009 – 2013 Consumer Price Index inflation percentage of 2.2% as an escalation factor to 2008 actual real estate taxes. Staff IB, p. 48. The Companies state in their Initial Brief that Staff proposed to decrease the expense for real estate taxes to reflect actual 2008 amounts. NS-PGL IB, p. 53. Staff's proposed adjustment did, in fact, apply an escalation factor to 2008 amounts, and Staff's adjusted amount reflects 2010 dollars, not actual 2008 amounts as indicated by the Companies. ICC Staff Ex. 5.0, Schedules 5.1 N and P.

C. Contested Issues

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

The Companies argue that the testimony of Companies' witness Hoover, Director of Compensation of the Utilities, should be the determining factor regarding the cost recovery of incentive compensation in this case because Mr. Hoover is an expert on human resources ("HR") unlike the witnesses offered by Staff and AG/CUB/City. NS-PGL IB, pp. 13, 56. The Companies' reliance on their witness' expertise is misplaced. The question before the Commission concerns the application of appropriate ratemaking theory and practice to the recovery of the Companies' incentive compensation costs. With respect to this issue, the expertise of the Staff and

AG/CUB/City witnesses is much more substantial than that of the Companies' witness. Tr. p. 716, August 26, 2009. It is the appropriate ratemaking treatment of incentive compensation costs that is in question. No one has called into question whether the Companies' incentive compensation programs are appropriate from a human resources perspective. Tr., p. 713, August 26, 2009. Past Commission orders are unambiguous that the Commission weighs and often agrees with the testimony of non-HR experts in this matter of *cost recovery*.

The Companies state that the Commission cannot ignore the "uncontradicted evidence regarding the prudence and reasonableness of the incentive compensation costs or the benefits received by customers." NS-PGL IB, p. 58. However, the Companies have failed to provide the evidence of benefits to ratepayers required for cost recovery of incentive compensation by the Commission in past cases; the Companies' testimony alone is insufficient for such a finding. Staff IB, pp. 51-52; 56-58; 60-66. Staff's position is consistent with prior orders of the Commission that have repeatedly provided clear guidance that there must be evidence of ratepayer benefits for cost recovery of incentive compensation. Staff IB, pp. 53-56; 59-60; 64-65.

Staff's position is also consistent with the recent Illinois Appellate Court decision in *Commonwealth Edison Co. v. Ill. Commerce Comm'n*, ___Ill. App. 3d___, 2009 Ill. App. LEXIS 913 (2d Dist. Sept. 17, 2009) ("*ComEd 2005 Appeal*"), which concluded that "there is ample precedent making a benefit to ratepayers a condition upon which the recovery of salary-related expense depends. *Id*. at 12; *see also* Staff IB, pp. 49-50. The *ComEd 2005 Appeal* opinion nullifies the Companies' criticism of Staff's application of the Commission's past standards (NS-PGL IB, p. 58) since Staff appropriately weighs the benefits to ratepayers in analyzing each goal.

The Companies' argument that "unlike the ComEd case … Staff proposes to disallow 100% of the Utilities' incentive compensation costs, even though they include some operational metrics," reflects a misunderstanding or mischaracterization of the *ComEd 2005 Appeal*. NS-PGL IB, p. 60. The Companies incorrectly conclude that the Court's conclusion that a utility must demonstrate more than tangential benefits to receive rate recovery is inapplicable (NS-PGL IB, p. 60) since the *ComEd 2005 Appeal* considered the fact that Commonwealth Edison Company ("ComEd") received rate recovery of half of its incentive compensation based on performance-based components, and Staff's adjustment in this case disallows both operational (i.e. performance-based) and financially based goals. The Court in *ComEd 2005 Appeal* had no reason to discuss or analyze the evidence of benefits to ratepayers from ComEd's performance or operational goals since ComEd did not appeal the Commission's decision to allow recovery of performance based incentive compensation and that issue was not before the Court. The analysis and reasoning in *ComEd 2005 Appeal* in no way validates the Companies' apparent interpretation of that decision to guarantee utilities some particular percentage of rate recovery of incentive compensation. *Id.* The Companies have failed in their requirement to demonstrate any reasonable benefit to ratepayers in this case, and in fact have not proposed any apportioned option; rather they present only an all-or-nothing proposal. In short, the Companies chose to criticize the Commission's standard rather than meet it.

Staff supports the proposition that if a goal benefits both shareholders and ratepayers, that shareholders should not bear all the costs. NS-PGL IB, p. 58 and Tr., p. 714, August 26, 2009. However, Staff's position is critically conditional on the utility demonstrating in evidence some reasonable basis to allocate benefits to ratepayers. Tr., p. 715, August 26, 2009.The *ComEd 2005 Appeal* makes clear that simply arguing that certain incentive plan costs attract good employees and raise the level of service is too remote of a benefit to justify rate recovery. *ComEd 2005 Appeal* at 15; *see also* AG IB, p. 12.

The AG/CUB/City concur with Staff that the Companies have failed to meet their burden of proof that the cost of their incentive compensation programs are just and reasonable. CUB/City IB, pp. 7-8; AG IB, pp. 10-12. However, for the reasons discussed in Staff's Initial Brief, Staff recommends its adjustments over other parties' proposed adjustments. Staff IB, p. 66. Staff's adjustments are sound, legal, and should be adopted by the Commission.

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

The Companies contend that Staff's adjustments to non-union base wages are flawed due to Staff's reliance on general Consumer Price Index information over labor market data. NS-PGL IB, p. 62. The Companies conclude that "[t]here is no valid basis for rejecting labor market data actually used by the Utilities … in favor of general CPI information supported by a witness who is not an expert in this subject." *Id.* Staff challenges the labor market data relied on by the Companies because the information is out of date and overstated at 4.2% versus Staff's 2.2%. The Companies fail to acknowledge the undisputed fact that the labor market study was conducted prior to the economic downturn and that a recent study uses a wage increase of 2.2% which is exactly the same as the CPI percentage which Staff advocates. Staff IB, pp. 67-68. Thus, the data source on which the Companies themselves relied confirms Staff's analysis. The Commission is ill-advised to approve an amount for non-union wages knowing it is based on assumptions about the labor market which have changed materially since the decisions were made. *Id.*

4. Distribution Expenses

a. Liberty Audit-Related Expenses (PGL)

Peoples Gas contends that Staff's adjustment to disallow Liberty-audit related expenses must be denied because there are no disallowable incremental costs included in the test year and that Staff's disallowance is based on an arbitrary figure. NS-PGL IB, p. 64. The Company argues that no Staff witness 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.*" NS-PGL IB, p. 65 (emphasis added). The Company relies on the cross-examination testimony of Staff witness Burk to argue that 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 or excluded. NS-PGL IB, p. 65 and Tr., p. 942, August 28, 2009. What the Company omitted was Mr. Burk's testimony regarding the prudence of Peoples Gas' actions prior to corrective action, as discussed in his re-direct testimony at evidentiary hearing:

> Q. And he asked you if their actions in response to the Liberty audit were reasonable and prudent, do you recall that?
> A. Yes.

Q. Was the Company's actions prior to that time reasonable and prudent?
A. No.

Tr., p. 946, August 28, 2009. Therefore, the "architect and chief enforcer" (NS-PGL IB, p. 66) of the *06-0311 Order* agrees that the Company's conduct prior to engaging in corrective action was imprudent. Staff maintains that additional expenses incurred as a result of prior imprudent actions are not just and reasonable and should not be included in rates -- even if there is nothing imprudent in the Company's current decision to incur that expense. Staff IB, pp. 83-84. Obviously, additional imprudent acts or omissions would compound the problem. But having created a problem through imprudent acts or omissions, the fact that it is reasonable or prudent for the Company to fix that problem does not insulate it from the consequences of its prior imprudent acts or omissions. The Company's premise that incremental expenses could only result from *additional* violations of the Pipeline Safety Act *after* the *06-0311 Order* is baseless. NS-PGL IB, pp. 65-66. No such criterion exists in the *06-0311 Order or at law.* Staff IB, pp. 77-80.

The Company simply denies that past actions can have any impact on whether subsequently incurred costs constitute prudently incurred costs. Such a premise is contradicted by history. For example, the Commission excluded from Central Illinois Light Company's ("CILCO") rate base additional costs incurred to replace cast iron mains on an expedited basis because the need for expedited replacement resulted from CILCO's imprudent failure in the past to adequately maintain its Springfield cast iron distribution system. Staff IB, pp. 74-76. Similarly, Illinois courts upheld the Commission's decision in a ComEd uniform fuel adjustment clause reconciliation that while the costs of reasonably priced fuel needed to generate electricity for a utility's customers would generally be considered prudently incurred costs, such costs are not prudently incurred if an imprudent management act or omission caused or contributed to the need for such fuel. Staff IB, pp. 73-74.

The Company's claim that Staff's adjustment is arbitrary (NS-PGL IB, pp. 64-65) is unjustified. The Company does not dispute that Staff calculated its adjustment based on the test year, using distribution expenses, and that Staff in fact found one set of expenses expressly prohibited for rate recovery by the *06-0311 Order.* Staff IB, p. 44. The Company's own witness confirmed that the Company started responding to the Liberty audit findings during the audit period which directly relates to the test year. Staff IB, pp. 80-81. Staff has demonstrated that its reasonable estimate of the harm to ratepayers is sound considering the Company's failure to comply with the Commission-ordered tracking mechanism. Staff IB, pp. 80-82.

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

6. Customer Service and Information

a. Advertising (Agreed in Part)

The Companies agreed in part with Staff witness Wilcox's adjustment, only taking exception to his disallowance of the costs associated with their Safety, Reliability and Warmth Campaign ("SRW Campaign"). NS-PGL IB, p. 67; NS-PGL Ex. SM-2.0, pp. 6:140 - 7:160. Staff witness Wilcox found the focus of the SRW Campaign to be primarily promotional, goodwill, or institutional in nature. The Companies acknowledged that Section 9-225 the Public Utilities Act (220 ILCS 5/9-225) states that the Commission should not consider promotional, institutional, or goodwill advertising in a general rate increase requested by a utility. NS-PGL IB, p. 67. The evidence presented unequivocally supports Staff's position, and the Commission should accept Staff's proposed adjustment to advertising expenses.

As stated above, based on his review of the Companies' advertising material, Staff witness Wilcox proposed adjustments to disallow advertising expenses for the SRW Campaign because those advertisements were primarily promotional, goodwill, or institutional in nature. Mr. Wilcox specifically explained that the substance of the campaign is promotional even though the words "safety" and "reliability" were included in the title. ICC Staff Ex. 6.0, pp. 4-6, lines 81-117; Schedules 6.3 P and 6.3 N.

The Companies argued that the key message strategy of the campaign was to educate customers how the Companies deliver safe, clean, and reliable natural gas to improve customers' lives. The Companies asserted that the energy education advertising in the SRW Campaign focused on three main customer benefits: (1) conserving/managing home natural gas use, (2) billing and payment options, and (3) staying safe and understanding the use and maintenance of the natural gas delivery function. NS-PGL IB, p. 68; NS-PGL Ex. SM-2.0, p. 6, lines 97-113. Companies' witness Moy explained that the elements of the advertisements that Mr. Wilcox takes issue with are emphasized in the advertisements merely as a creative communication strategy used to catch the customer's attention. NS-PGL Ex. SM-2.0, p. 5, lines 144-160. Ms. Moy also argued that the costs should be recoverable because even without the SRW

Campaign the Companies would still incur costs for energy education and that forms of media other than bill inserts and the corporate website are necessary in order to reach a wider audience. NS-PGL Ex. SM-3.0, p. 6, lines 114-123.

The Companies' arguments are without merit. The Companies argue that the promotional and goodwill elements are merely the means of drawing attention to the advertisements; but they conveniently overlook the fact that those attention-getting elements are the primary focus of the advertisements.

Additionally, the targeting of the advertisements suggests the Companies are attempting to reach not just their customers, but rather to promote the image of the Companies to the general public. Neither of the two mediums utilized in the SRW Campaign – radio ads and posters – specifically target customers of the Utilities. Staff asserts that if it is someone other than the Companies' customers who make up the intended audience for these advertisements, then the Companies' customers should not pay the bill for these advertisements.

The crux of the argument is this: The Companies assert that the ads are informational because they include snippets of customer information in the fine print of the posters or in the trailers to the radio ads. Staff asserts the ads are promotional because the primary focus of the advertisements *is* promotional and because the target audience for said ads is the general public and not just the Companies customers. Staff included two Attachments to its Initial Brief to assist the Commission in arriving at its final decision.

Attachment 1 to Staff's Initial Brief is a Company-provided photograph of one of the ads from the SRW campaign on display. The only aspects of the message that are clearly perceptible are the aspects that Staff considers promotional. The fine print in the upper right corner, which according to the Companies conveys the "main message", is unreadable. Conversely, Attachment 2 to Staff's Initial Brief is an example of a monthly billing insert that is primarily informational and specifically targeted to the customers of the Companies. While Attachment 2 related costs were allowed as a test year expense, the costs associated with Attachment 1 and similar ads should not be allowed.

Based upon the above arguments and those previously stated in Staff's Initial Brief, the Commission should accept all of Staff witness Wilcox's adjustments to advertising expenses.

7. Administrative & General

a. Injuries and Damages Expenses

The Companies assert that normalization of injuries and damages expenses is not required. NS-PGL IB, p. 70. Staff's normalization proposed adjustments are based on the fact that for the most recent five year period, 2004 – 2008, the actual payments for injuries and damages claims in 4 of the 5 years were less than the amount the Companies accrued in the 2010 test year. ICC Staff Ex. 17.0, Schedules 17.2 N and P, p. 2, lines 1-5. A normalized operating expense amount should reflect the expected annual recurring level that the Companies expect to pay, apart from unusual conditions. Historical payments (experience) are a good standard against which to evaluate an expected recurring level of expense. Since the 2010 expense accruals are greater than historical experience, the Companies' injuries and damages expense accruals should be decreased to reflect a normalized level of expense in the Companies' 2010 test year operating expenses. Staff IB, p. 89.

The Companies take issue with Staff's use of a five year period of average actual claims paid; arguing that other periods could have been selected from the data that Staff relied upon. However, the Companies' use of 2 year, 3 year, and 4 year data demonstrate that the resultant adjustments do not drastically vary from Staff's proposed normalization adjustments based on the use of a five year period of actual claims paid. NS-PGL IB, p.71. Therefore, choosing different time periods for normalization does not skew the results as the Commission found was the case in the Companies prior rate case. NS-PGL IB, p. 69. The adjustments recommended by Staff to reflect a normalized level of injuries and damages operating expense for the 2010 test year are appropriate and should be adopted by the Commission.

The Companies remain willing to accept Staff's proposed normalization adjustments if in their opinion "consistent" adjustments are made to the reserves for injuries and damages in rate base. NS-PGL IB, p. 72. Staff continues to reject that proposal. The Companies continue to argue that there is a direct correlation between the amount of injuries and damages expense and the amount of the injuries and damages reserve amount which would warrant that any adjustment made to expense should also be made to the reserve. NS-PGL IB. p 72. Staff's proposed adjustments to reflect a normal level of annual operating expense or period cost are based on historical payments and have no direct corresponding impact on the estimate of the test year balance sheet liability or reserve for <u>future payments</u>. Thus, it would be inappropriate to adjust the Companies' injuries and damages reserve in rate base due to a rate making adjustment to normalize the injuries and damages operating expense in the revenue requirement.

VI. RATE OF RETURN

C. Cost of Long-Term Debt

1. Peoples Gas

b. Interest Rate on Series OO Bonds (Contested)

Staff recommends that the interest rate for Series OO bonds reflect the most recently available auction rate of 0.998% at the time of filing its direct, which was set at the April 29, 2009 auction and is the actual current cost incurred by the Company. ICC Staff Ex. 22.0, p. 5. The Series OO bonds interest rate is set at auction. The bonds have failed at auction since March 2008. Staff IB, p. 95. The Company does not expect this to change any time soon. NS-PGL IB, p.78. According to the terms of the Series OO bonds, when there is a failed auction Peoples Gas must pay the default rate which is 175% of LIBOR capped at 14%. Staff IB, p. 95. By using the rate dictated under the bonds terms, the embedded cost of long-term debt for Peoples Gas would be 5.28%. ICC Staff Ex. 22.0, Schedule 22.4P, line 26.

Rather than using the actual terms of the Series OO bonds to determine the bonds interest cost (the spot 1 month LIBOR times 175%), Peoples Gas assumes an interest rate cost of 1% for half the year and forecasts a fixed rate debt cost of 7.16% for the second half of the year. NS-PGL IB, p. 79. Those assumptions would result in the use of an interest rate of 4.08% for the Series OO bonds which would result in the overall average cost of long term debt to be 5.58%. NS-PGL IB, p. 79.

The Company's position regarding the interest cost for the Series OO bonds should be rejected for a number of reasons. Unlike Staff's recommendation which represents the actual current cost incurred by the Company on the Series OO bonds (ICC Staff Ex. 22.0, p. 5) the Company's position is not based on sound business practices. As Staff pointed out in its Initial Brief, even though investors in these bonds may not be earning a rate they originally desired, that is not a valid reason for the Company to bail out those investors by remarketing or refinancing the debt at a greater cost to the Company. The Company should be embracing those bonds since they result in a lower cost of debt for the Company, rather than remarketing or refinancing the debt. Staff IB, p. 95.

The Company also argues that "it is just a matter of time before LIBOR rises again and this will introduce an unacceptable degree of volatility in the cost of these securities due to the 175% multiplier." NS-PGL IB, p. 79. However, this argument lacks merit. First, despite "the unacceptable degree of volatility" introduced by fluctuating LIBOR rates existed at the time the Company originally issued the Series OO bonds, the Company chose to issue auction rate bonds anyway. Staff IB, p. 96. Therefore, no new volatility has been introduced. Second, the Company's own forecast shows that it does not expect LIBOR to increase to the point that the Company would pay a rate higher than their proposed 7.16% fixed rate until at least January of 2012. NS-PGL Ex. BAJ-3.5. (The LIBOR rate would have to exceed 4.09% for the default rate to be greater than the Company's proposed fixed rate.)

Finally, it is problematic trying to accurately forecast interest rates like the Company proposes. Schedule 22.5 attached to Staff witness Kight-Garlisch's rebuttal testimony demonstrates that the accuracy diminishes as the forecast period lengthens. ICC Staff Ex. 22.0, p. 7. Even though interest rates may be low on a historical basis, room still exists for those rates to further decline and no one can predict with certainty when rates will rise, how quickly they will rise, how long it will be till they fall again, how fast they will fall or whether they will rise before they fall further. Id. Accordingly, the Company's recommendation for long term debt that uses a forecasted average rate of 4.08% for Series OO bonds interest rate cost should be rejected and the Commission should adopt Staff's recommendation to use the actual interest rate for the Series OO bonds of 1.00%. ICC Staff Ex. 22.0, p. 8.

E. Cost of Common Equity

1. Overview

The Companies' IB presents several broad arguments regarding the cost of common equity ostensibly to provide the "context within which the Commission should determine [the Companies'] cost of equity." Those arguments rely largely on emotional appeal and sweeping comparisons to other authorized returns. NS-PGL IB, pp. 80-82 and 107. CUB-City already addressed those arguments well from a broad perspective. CUB-City IB, pp, 17-21. However, Staff will address certain specific arguments the Companies made in their overview.

The Companies contend that Staff's cost of common equity proposals, which are 50 and 20 basis points below the currently authorized rates of return on common equity for Peoples Gas and North Shore, respectively, imply lower risk, which is "literally incredible" given the current economic environment. NS-PGL IB. p. 76. The Companies' hyperbolic claim is erroneous. First, it wrongly implies that the level of risk is the only factor in determining the cost of common equity. However, cost of common equity is a function of both the level of risk and the price of risk. Thus, a naïve comparison to the Companies' previously authorized returns is overly simplistic and ignores a significant factor in the cost of common equity. Second, the current economic environment does not render incredible proposals that would reduce the Companies' costs of common equity. To the contrary, such results are quite consistent with the current economic climate. In fact, during challenging financial times it is quite common for investors to abandon investments in speculative companies and, instead, seek the security of stable companies, such as regulated utilities. This flight to quality increases the demand for stable companies, thus, reducing those companies' required return. Staff IB, p. 112. Moreover, the current economic environment is one of low-interest rates. For example, at the time of the last rate case, the 30-year U.S. Treasury bond yield was 4.83%. Order, Docket No. 07-0241/0242, pp. 79-80. The current the 30-year U.S. Treasury bond yield is 4.10%. Staff Ex. 7.0R, p. 13. Since, as Companies witness Moul argues, the cost of equity can be viewed as a bond yield plus an equity risk premium, all else equal, lower interest rates would produce a lower cost of common equity. Thus, the current economic environment suggests that a cost of common equity lower than that authorized in the Companies' last rate case is, in fact, warranted.

The Companies also argue that it is the Commission that reacts to the investor and not the other way around. NS-PGL IB, p.p. 81-82. Staff agrees. That is precisely why the Commission should seek not to produce or maintain a certain stock price, as Mr. Moul's arguments suggest, but merely to determine from current market data the rate of return that investors require, and apply that rate of return to the amount of capital invested in the assets serving rate payers. That is, the Commission's objective is not about *expected* return on the value of *secondary market* investments, but about *required* return on *book-value rate base*.

The Companies' overview relies heavily on data presented in the testimony of their witness, Mr. Fetter, who compared Staff's cost of common equity proposal to ROE decisions rendered by other jurisdictions and in other Commission proceedings. NS-PGL IB, pp. 80-82. Under cross-examination Mr. Fetter summarized his comparison to other authorized return runs saying, that they should not be used in a "match-type process," but rather, they should serve "as a signal that [the Commission] should look very closely at -- as they should with Mr. Moul, they should look very closely as to what Mr. McNally has done and be 100% certain before providing an authorized ROE that would make -- be historic within the State of Illinois." Tr., p. 497, 8-25-09. He further noted that the risks facing the various gas utilities in the State of Illinois were different at different periods of time and that the decisions of the Commission since 1972 that he cited were based on the facts of each case. Id., p. 487. In other words:

- The cost of common equity can change over time;
- The Commission should not rely on the findings of other jurisdictions, but should judge each case on its own merits; and
- The Commission should review the facts in this case very carefully.

Staff could not agree more. But, then again, those statements are <u>always</u> true. Thus, in light of the fact that the record is devoid of the critical facts from the ROE decisions Mr. Fetter cited that are necessary to assess comparability, (ICC Staff Ex. 21.0, p. 29) and the fact that the Commission has rejected similar comparisons to ROEs approved in previous cases by this and other commissions in previous cases, (Order, 07-0241/07-

0242 (Cons.), February 5, 2008, pp. 88-91.) Mr. Fetter's testimony added nothing of value to the record.

2. Leverage Adjustment

The Companies continue to argue for a leverage adjustment to its DCF and CAPM analyses with the rationale that the Companies' leverage differs depending on whether it is calculated using market-based data or book values under present market conditions. NS-PGL IB, pp. 85-86 and 93. That statement is unequivocally false, as a company cannot be riskier than itself. Staff witness McNally explained in great detail, including a numerical example, why a leverage adjustment is unwarranted. ICC Staff Ex. 21.0, pp. 18-22. The Companies argue, however, that Mr. McNally's example "misses the key point," and proceed to argue that the Commission's authorized return should produce the *expected* return ($11 in that example) of investors on the secondary market.[1] NS-PGL IB, pp. 86-87. However, as noted above, it is not the Commission's objective to provide investors on the *secondary market* with their *expected* return.[2] The Court explicitly confirmed this in Federal Power Com. vs. Hope Natural Gas Co. 320 U.S. 591 (1944) (1944 U.S. LEXIS 1204, p. 10) stating, "Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as

[1] The Company's initial brief does not dispute that the required rate of return (10%) and the rate base ($100) remain the same.

[2] The secondary market represents the market for transactions between investors (e.g., existing shares of stock trading on the New York Stock Exchange). Secondary market prices have no bearing on the amount of money available to the company to buy assets because the proceeds from the sale go to the previous stockholder, not to the company. In contrast, the primary market represents transactions directly between a company and its investors, such as a company's issuance of new bonds or new shares of stock. These issuances directly affect the amount of funding the company has to invest in assets to serve its customers.

invalid, even though they might produce only a meager return on the so-called 'fair value' rate base." Id. By disguising its fair value adjustment as a "leverage adjustment," the Companies are attempting an "end-run" around the Hope decision. Indeed, the Commission cannot fully control the return an investor earns on the secondary market. Rather, the Commission can only control the rate of return authorized for a utility's rate base and which assets are allowed in that rate base. Since Illinois utility rates are cost-based, that rate of return is the *required* rate of return. Mr. Moul acknowledged as much. Tr., p. 448, 8-25-09. Moreover, under original cost ratemaking, ratepayers provide a return only on the amount of capital that is invested in assets that serve ratepayers (i.e., rate base). Thus, the proper return in the example is not $11, as the Companies suggest, but $10, which reflects the investor required return of 10% multiplied by the rate base of $100.

The Companies' argument regarding Mr. McNally's example ignores the reason investors expect that company to earn $11 per year despite a required rate of return and rate base that remained the same, which, under original cost ratemaking, would produce earnings of only $10 per year. One explanation is that the investors recognize that companies often have other sources of cash flows in addition to the operating income component of the revenue requirement set by a regulatory commission. As noted above, under original cost ratemaking, ratepayers provide a return only on rate base. Inflating that return to compensate investors for capital not invested in rate base is neither fair nor appropriate; moreover, such an adjustment would effectively void the Commission's authority to establish original cost rate base.

Finally, the Commission has rejected use of the leverage adjustments many times, including Docket Nos. 01-0528/01-0628/01-0629 Consol., 99-0120/99-0134 Consol. and 94-0065. In fact, the same leverage adjustment arguments the Companies present in this proceeding were rejected by the Commission in the Companies' last rate case. ICC Staff Ex. 7.0R, p. 43. Indeed, that Order quite clearly sets forth, in great detail, the reasons such a leverage adjustment should be rejected. Order, 07-0241/07-242 Consol., February 5, 2008, pp. 95-96.

3. Non-constant DCF

The Companies acknowledge Mr. Moul's use of a <u>constant growth</u> DCF model. Nevertheless, they criticize Mr. McNally's use of a non-constant growth because it unrealistically assumes that the steady-state growth stage will remain fixed in perpetuity. NS-PGL IB, pp. 87-88. The Companies argument is absurd, since the underlying assumption of a constant growth model is the same as that of the steady-state stage of Staff's non-constant DCF, namely, that the growth rate remains stable in perpetuity. The only difference is that the constant growth model assumes that the steady-state stage begins <u>immediately</u>, rather than in 10 years.

Further, the Companies seem to argue that the constant growth model is appropriate because the Companies have been in the same regulated business for many decades, which would suggest they are in the steady-state stage of growth. However, they immediately reverse course and note that the assumption of a fixed growth rate is unrealistic because the three stages of growth can be repeated. NS-PGL IB, p. 88. The fact that the three stages of growth can be repeated does not support the use of a constant growth DCF model. In fact, it suggests that use of a non-constant growth DCF model may be warranted if it can be reasonably supported that a company is in the first or second stage of a growth cycle, in which the growth rate is atypically high.

Despite the Companies' self-defeating arguments, the assumption of a steady state growth that lasts into perpetuity does not render any model making such an assumption worthless. While it is clear that no company will grow at an absolutely fixed rate forever, that appropriate simplifying assumption is made because extremely long-term growth rates are not available. In reality, the assumption of a single long-term growth rate reflects an average growth for a relatively stable firm over the long run rather than an absolutely fixed rate of growth. That is, any cost of equity model is imperfect and will necessarily include simplifying assumptions. For example, since market-consensus expected growth rates cannot be measured directly, cost of common equity analysts assume that growth rates forecasted by securities analysts are reasonable approximations for use in their DCF models. Similarly, the CAPM assumes the estimates of the risk-free rate and the market risk premium last into perpetuity. ICC Staff Ex. 7.0R, pp. 6-8 and 11.

The question the Commission should focus on is whether or not it is reasonable to assume that the near-term growth rate forecasts for the companies in the utility sample Mr. Moul and Mr. McNally used in this proceeding ("Gas Group") are expected to equal their average long-term dividend growth. As explained in Staff's initial brief, given the large difference between the near-term growth rates for the companies in the Gas Group and long-term forecasts for the overall growth of the economy, the continuous sustainability of the near-term growth rates for the Gas Group is highly unlikely. Staff IB, pp. 101. Moreover, Mr. Moul's own data indicates that the utility companies composing the Gas

Group are, in fact, below average growth companies. Specifically, the average retention rate for the Gas Group of 37.1% is well below that of the overall market, which has a retention ratio of 63.5%. Further, one would expect utilities overall to earn well below average returns due to the below average risk reflected in their below average betas. Specifically, Mr. Moul adopted a 0.82 beta for the Gas Group, while Mr. McNally's beta estimate was 0.59. Since growth is a function of those below average earnings retention rates and the below average return on those earnings, the utilities' long-run sustainable growth <u>must</u> be below average. ICC Staff Ex. 21.0, pp. 10-11. Thus, it is even more implausible that investors expect the companies in the Gas Group to sustain a level of growth substantially above that of the overall economy.

The Companies suggest that a non-constant DCF should only be used for firms with "extraordinary" growth rates and suggest that Staff's use of a long-term GDP growth estimate as a measure by which the sustainability of company-specific growth rates can be judged is both overly stringent and subjective. Instead, the Companies propose the use of FERC's supposedly "objective" criteria of two or more times GDP growth. NS-PGL IB, pp. 89-90. Staff strongly disagrees. First, mathematically and logically the expected growth of the overall economy over the long term represents an absolute cap for the sustainable growth of any individual company over the long term. To assume otherwise would be to accept that a subset of a group can become larger than the group itself, which is obviously false. Second, Mr. McNally cited three separate financial textbooks that also suggested that a firm's growth rate will ultimately decline to a rate consistent with the rate for the overall economy. ICC Staff Ex. 21.0, pp. 8-11.

Thus, Staff's proposal to use GDP to gauge the sustainability of the Gas Group growth rates is neither overly stringent nor subjective.

In contrast, the Companies alternative criteria of two or more times GDP growth is unsupported and entirely arbitrary. In fact, distinguishing "extraordinary" growth, for which the Companies claim a non-constant DCF should be reserved, from merely above average growth is, by its very nature, subjective. The Companies suggest that the Brealey text that Staff cited in its testimony supports their argument that the use of a non-constant growth DCF should be reserved for firms with "extraordinary" growth rates. NS-PGL IB, pp. 90. However, that information is nowhere to be found in the record. Even if the content allegedly attributable to Brealey were not extra-record evidence, which it is, it does not support the Companies' contention. Rather, the example that the Companies present, purportedly taken from the Brealey text, merely highlights an extremely obvious instance for which the use of a non-constant DCF would be appropriate. Indeed, Brealey is one of the texts noted above that supports Staff's position that a firm's growth rate will ultimately decline to a rate consistent with the rate for the overall economy. It is also notable that the alleged Brealey example also demonstrates that long-established companies can experience periods of unsustainable growth, which warrants the use of a non-constant DCF model. Finally, despite labeling as "objective" FERC's selection of two or more times GDP growth as its standard, the Companies' presented no evidence whatsoever to suggest that that choice was anything other than entirely arbitrary. In fact, just as they did with the Brealey text, the Companies misrepresent the FERC decision as having pronounced a definitive standard. However, the FERC did not pronounce a standard that it would use a multi-stage DCF model only when the current growth rate estimates are two to three times greater than GDP. Rather, in its decision to use a single-stage DCF model in the Southern California Edison case (92 FERC par. 61,070 (July 27, 2000)), the difference between the current growth rate and the GDP growth rate was one of three differences in fact between that case and the Northwest Transmission case upon which the FERC presiding ALJ relied in opting for a two-stage DCF over a one-stage DCF. To appreciate those differences, one must first consider FERC's summary of the reasons it adopted a multi-stage DCF analysis in the Northwest Pipeline case:

> In Opinion No. 396-B, we gave four reasons why the long-term growth of the United States economy as a whole is a reasonable proxy for the long-term growth rate of all firms, including regulated firms in the gas business. First, the record in that case showed that as companies reach maturity over the long-term, their growth slows, and their growth rate will approach that of the economy as a whole. Second, it is reasonable to expect that, over the long-run, a regulated firm will grow at the rate of the average firm in the economy. Third, the purpose of using the DCF model approved in Opinion No. 396-B was to approximate the rate of return an investor would reasonably expect from a pipeline company, and no evidence in that record indicated that investors relied upon any of the alternative long-term growth approaches suggested by the parties in that proceeding. Fourth, each of the witnesses in Opinion No. 396-B used the long-term growth of the economy as a whole as confirmation or support for their analyses.

Significantly, the FERC did not describe a two to three times ratio of current growth to GDP growth as a condition for employing a multi-stage DCF model. In rejecting a multi-stage DCF analysis in the Southern California Edison case, the FERC describes the two-to-three times current growth to GDP ratio not as a criterion, but as only one of three distinguishing facts between the Southern California Edison case and an Ozark Transmission case:

> We find that our rationale in Opinion No. 396-B does not support the use of GDP data in developing a growth rate estimate in this proceeding. Unlike the gas pipeline industry, which was nearly through with major

> restructuring at the time we issued Opinion No. 396-B, on June 11, 1997, the electric industry is just beginning a significant new phase of its restructuring. In particular, SoCal Edison had just begun to restructure from a vertically integrated utility when it made its filing in the instant proceeding. In addition, in contrast to the growth estimates that underlay the two-step approach for gas pipelines, the current growth rate estimates for SoCal Edison are not two to three times greater than GDP.[3FN30] Moreover, the use of a two-step approach in natural gas pipeline company cases is supported by the fact that two large investment firms, Merrill Lynch and Prudential Securities, use the long-term growth of the economy as a whole in their analyses of gas pipeline companies. However, Prudential Securities indicates that it treats electric utilities differently from all of the other industrial companies when estimating growth rates.

92 FERC par. 61,070 (July 27, 2000) p.17. In its application of the DCF, FERC found that the 5.87% analyst growth estimate published by IBES, was very close to the 5.81% sustainable growth rate estimate that FERC calculated for Southern California Edison. In summary, while it was clear that a constant growth DCF analysis was inappropriate in the Ozark Transmission case, the IBES growth rate and sustainable growth rates were very close to the GDP growth rate, much closer than the Zacks growth rate and the GDP growth rate in the current proceeding.

The Companies also argue that investors “typically view investment decisions on a horizon of no more than five years and do not care about a firm’s growth compared to GDP growth into the infinite future.” NS-PGL IB, pp. 89. The Companies have presented no evidence to support that claim. Regardless, their argument is incorrect.

[3] See, e.g., Ozark Gas Transmission System, 68 FERC 61,032 at 61,104-05 (1994) (Ozark) (growth estimates ranging from 8.81 percent to 15.2 percent and GDP estimates of 5.4 percent); Williston Basin Interstate Pipeline Company, 72 FERC 61,074 at 61,387 (1995) (growth estimates ranging from 8 to 15 percent and GDP estimates of 5.37 percent and 6.33 percent); and Opinion No. 414-A, 84 FERC at 61,427-7 (growth estimates ranging from 8 percent to 15 percent and GDP estimates of 5.45 percent). By comparison, the IBES growth estimate for SoCal Edison is 5.87 percent. See trial staff's Reply Comments, Att. D-1, at p. 1. GDP estimates range from 4.41 percent to 5.2 percent. See Exh. SCE-97, at pp. 5-7.92 FERC par. 61,070 (July 27, 2000) Footnote 30, p. 18,

The assumption of an infinite horizon is a principal assumption of the DCF models Mr. Moul and I employ. In fact, the "constant-growth model" the Companies advocate is, by definition, a perpetual model. These models are based on the premise that the market value of common stock equals the cumulative value of the expected stream of all future dividends after each is discounted by the investor required rate of return. Although the individual investor has a limited investment horizon, he must sell his stake to another investor at the end of his investment horizon. The terminal value the current investor expects at the end of his/her investment horizon equals the sum of its expected discounted future dividends from that point forward, and so on for each successive investor. ICC Staff Ex. 21.0, p. 9.

The Companies argue that, for the growth rate in the steady-state stage of a non-constant DCF, the 5-10 year growth rate in the corporate profit component of GDP should be used rather than the long-term GDP growth rate. NS-PGL IB, p. 91. This argument suffers from the same fundamental defect as the Companies' argument for the use of a constant growth DCF: a component cannot sustain growth at a rate greater than the group of which it is a part. Thus, long-term corporate profit, like company-specific growth rates, is mathematically capped by GDP growth. Moreover, there is no evidence to suggest that investors expect any single component of GDP to grow to dominate GDP, which would happen if corporate profit could sustain greater growth than that of the GDP. In addition, just as the Companies note that GDP can be broken down into its components, corporate profit, too, can be broken down farther. For example, corporate profit can be broken down by industry. There is no reason to substitute corporate profit for GDP as a proxy for the long-term growth of the Gas Group when one could substitute the forecasted growth for the utility industry specifically. That is, if one accepts that corporate profit growth is better than GDP growth as a measure of overall long-term earnings growth, the utility industry growth would be a better proxy still, as utilities are generally below average growth companies. Yet, the Companies failed to address this.[4] Additionally, since earnings growth is the product of the earnings retention rate and return, if companies pay all of their earnings out as dividends (retention rate = 0%), there would be no sustainable growth regardless of the level of corporate profit. Thus, the level of corporate profit growth obviously cannot be assumed to be a reasonable estimate of earnings growth. ICC Staff Ex. 21.0, p. 12.

Finally, the Companies argue that "Mr. McNally failed to support his choice of 'the implied 20-year forward U.S. Treasury rate in ten years' for infinite GDP growth." NS-PGL IB, p. 92. Again, the Companies are wrong. In fact, Mr. McNally explained in great detail the relationship between U.S. Treasury yields and GDP growth. ICC Staff Ex. 7.0R, pp. 11-15. Mr. McNally also explained that his use of the implied 20-year forward U.S. Treasury rate in ten years is reasonable because it reflects current expectations of the long-term overall economic growth during the steady-state growth stage of his non-constant DCF model. Furthermore, Mr. McNally noted that that estimate, 4.59%, is consistent with forecasts from Global Insight, which indicate a 4.5% nominal GDP

[4] Mr. Moul did suggest company-specific analyst growth rates as a solution. NS-PGL Ex. PRM-3.0 Rev., p. 7. But Mr. Moul's suggestion misses the whole point. The company-specific growth rates that are available for the sample companies are only 3-5 year forecasts, which Mr. Moul acknowledges should be used exclusively only "when it is reasonable." NS-PGL Ex. PRM-3.0 Rev., p. 7. As explained above, those near-term growth forecasts are highly unlikely to be representative of their average long-term dividend growth. Thus, their exclusive use is not reasonable, and an estimate of the average long-term dividend growth is needed. Unfortunately, long-term company-specific growth rates are not available. ICC Staff Ex. 7.0, p. 7. If they were, this entire issue would be moot.

growth rate for the 2019-2039 period. ICC Staff Ex. 7.0R, pp. 6-7. In addition, contrary to the Companies' claims, there is no need to directly address the components of GDP growth estimates Mr. McNally used, just as Mr. Moul felt no need to directly address the components of the 3-5 year growth rates he used. That is because the components of GDP growth are already implicitly reflected in the GDP growth estimate. Consideration of the components of GDP growth, just as the components of an individual company's 3-5 year growth, is a matter for the analysts forecasting those growth rates. Mr. McNally and Mr. Moul need only be concerned with the ultimate estimate, which already comprises the basic elements of GDP growth. ICC Staff Ex. 21.0, pp. 6-7.

4. Size Premium

The Companies claim that the financial literature support Mr. Moul's addition of a size premium to his CAPM results. NS-PGL IB, p. 94. That is not true. As Mr. McNally's explained, Mr. Moul's size premium has no theoretical basis, but rather, is based solely on empirical findings that are not applicable to the Companies.[5] In fact, Mr. McNally presented almost five pages of testimony explaining why the alleged size premium is not supported for utilities and that, even for non-utilities, the existence of a true size-based risk premium is doubtful. ICC Staff 7.0R, pp. 43-47. Thus, the Fama and French finding is not clearly accepted as a "general rule," as the Companies claim. More importantly, the financial literature most certainly does not support the application of a size premium to utilities.

[5] Contrary to the Companies' implication, that there exists financial literature discussing the empirical finding regarding a particular phenomenon does not mean that that phenomenon has a theoretical basis.

The Companies also claim that Mr. Moul demonstrated that the Wong article Mr. McNally cites regarding the applicability of a size adjustment to utilities "does not address the question of additional risk for smaller sized firms that are not captured by the CAPM." NS=PGL IB, p. 94. The Companies are once again incorrect. The Companies state that it "makes sense" that there is an inverse relationship between the size of a firm and its return. However, the theory behind the CAPM is that the risk factor in the CAPM, beta, reflects <u>all</u> risk. Thus, any risk related to a firm's size should already be captured in the CAPM results. The entire purpose of the Wong study, as well as the Ibbotson and Fama and French articles that form the basis of Mr. Moul's size adjustment, was to assess whether beta <u>fully</u> captures the risk correlated with size. The Wong article could not be more clear with its findings:

> The objective of this study is to examine if the size effect exists in the utility industry. After controlling for equity values, <u>there is some weak evidence that firm size is a missing factor from the CAPM for the industrial but not for the utility stocks</u>. This implies that although the size phenomenon has been strongly documented for the industriales, the findings suggest that there is no need to adjust for the firm size in utility rate regulations.

ICC Staff Ex. 21.0, pp. 22-23.

5. Historical Data

The Companies' claim that "if by historical data we mean information from the past," Mr. McNally's stock price data as no less historical than that which Mr. Moul used, misses the point of Mr. McNally's argument regarding the use of historical data. NS-PGL IB, p. 97. That is, the Companies have assumed away the issue. Obviously, data from any given day will eventually become "historical." The problem Mr. McNally noted was that, rather than rely on the most-recently available (i.e., current) data at the time of his analysis, Mr. Moul chose to use older (i.e., historical) data. As Mr. McNally explained, the most recent data is the only data that can fully reflect all the information currently available. ICC Staff Ex. 21.0, p. 4. Thus, contrary to the Companies' claim, an analyst's use of the most-recently available data at the time of his analysis is not arbitrary. In contrast, the use of data older than the most-recently available data necessarily favors outdated information that the market no longer considers relevant over the most-recently available information. Furthermore, it requires the analyst to choose the measurement period from which the data is drawn. However, there is no "correct" measurement period. Thus, the choice of a measurement will be arbitrary, needlessly introducing additional subjectivity into the cost of common equity analysis. ICC Staff Ex. 7.0R, p. 37.

The Companies argue that the use of an historical average allows the analyst to observe "trends." NS-PGL IB, p. 97. However, the trends observed depend upon the period the analyst selects. Mr. Moul failed to demonstrate that investors determine their required rate of return on common equity using the same distinctive periods he selected. Indeed, since there is no "correct" measurement period, the choice of a measurement period will be either random or subjective, rendering the results uninformative or biased. ICC Staff Ex. 7.0, pp. 38-39. In addition, Mr. Moul combines historical averages for certain inputs in his models with data from different time periods for other inputs. That approach does not produce a cost of common equity for any single time period, but rather, an uninformative amalgam of mismatched data. ICC Staff Ex. 7.0R, p. 8.

The Companies suggest that Mr. Moul's use of historical data produces "a more accurate view" of the future than an estimate from any single day. NS-PGL IB, p. 99. While it is true that measurement error is a problem inherent in any cost of common equity analysis and should be reduced whenever possible, introducing old stock prices into an analysis simply substitutes one alleged source of measurement error, volatile stock prices, for another, irrelevant stock prices. Stock prices can be influenced by temporary imbalances in supply and demand; however, any distortions such imbalances might have on the measured cost of common equity can be reduced through the use of samples, a technique which both Mr. McNally and Mr. Moul already applied. ICC Staff Ex. 7.0R, pp. 38-39.

The Companies claim that the academic literature Mr. McNally cited refutes Staff's position that spot prices are a superior basis for determining the cost of common equity, citing a Fisher Black quotation that "Daily data hardly help at all." NS-PGL IB, p. 99. However, the quote that the Companies' argument relies on was taken out of context and mischaracterized by the Companies. Mr. Black's reference to daily data regarded the period and frequency over which an average historical return is measured (e.g., a 1-day return = daily data; a 1-year return = annual data). His argument does <u>not</u> address the use of current spot stock prices. In fact, Mr. Black's argument, when viewed in its entirety, was against the use of historical average data because, as he put it, "we need such a long period to estimate the average that we have little hope of seeing changes in expected return." ICC Staff Ex. 21.0, pp. 2-3.

6. Financial Risk Adjustment

The Companies state that "Staff's financial risk adjustment is designed to reduce the cost of equity in most cases." NS-PGL IB, p. 100. Of course, Staff's downward adjustment reduces its cost of common equity estimate; a downward adjustment will always reduce the estimate. That is, since an adjustment is a result rather than a process, an adjustment cannot be biased. In contrast, the process used to develop an adjustment can be. Thus, the Companies seem to be implying that the methodology Staff employed to develop its financial risk adjustment is purposefully biased to produce a downward adjustment "in most cases." That is absolutely false. Staff's financial risk adjustment was based on the difference between the issuer credit ratings implied by the financial ratios produced by Staff's recommendations for the Companies and the average issuer credit rating of the Gas Group. ICC Staff Ex. 7.0, pp. 22-27. Contrary to the Companies' implication, that methodology is just as likely to produce an upward adjustment as a downward adjustment.

Curiously, despite the overarching theme of the Companies' initial brief that Staff's recommendations are so woefully inadequate as to be harmful to the Companies, they argue that the financial ratios produced by those recommendations imply overly optimistic credit ratings for the Companies. The Companies lament that Staff's financial risk adjustment is based on a comparison of those "overly optimistic" implied credit ratings to the actual credit ratings of the Gas Group. NS-PGL IB, p. 100. The Companies argument is fraught with errors. First, the Companies' position is obviously self-contradictory. If Staff's recommendations would produce the inadequate degree of financial strength the Companies would have the Commission believe, they would correspondingly produced much lower implied credit ratings, which would result in either a smaller downward adjustment or a positive adjustment to the cost of common equity. The Company cannot have it both ways; either Staff's recommendations are inadequate or the financial ratios upon which Staff's financial risk adjustment is based are not overly optimistic. Second, the Companies did not show that the 2005-2007 data used to normalize the financial ratios for the Gas Sample was not representative of the norm for Gas Sample. In contrast, Staff showed that that data produces ratios consistent with the Moody's ratio guidelines used to establish their *current* ratings. Finally, the Companies' suggestion that Staff's financial risk adjustment should not be adopted because recent achieved returns deviated from the authorized return is contrary to the concept of cost-based rate making and is not just and reasonable. The Companies' superficial analysis is insufficient, as it failed to demonstrate that their earnings could not exceed their cost of capital and proposes no mechanism for returning earnings greater than their cost of capital. In addition, the past returns the Companies' argument relies on numbers that reflect the refunds that Companies were ordered to pay due to improper gas charge reconciliations. Clearly, the Companies should not receive a higher cost of capital now to compensate for reduced earnings due to those refunds. Also, the Commission should also note that the Companies' request to authorize a cost of common equity above the true cost of common equity comes at the worst possible time for rate payers: in the Companies' words, "the worst economic recession and the most volatile period of financial instability since the Great Depression." NS-PGL IB pp. 6-7.

The Companies claim that the record does not support Staff's assertion that the Companies' credit rating downgrades were due exclusively to the risk profile of their corporate parent. NS-PGL IB, p. 102. The Company is wrong. To begin with, Mr. McNally's financial risk adjustment does not depend on the Companies' credit rating downgrades owing <u>exclusively</u> to the risk of their corporate parent. Section 9-230 of the Illinois Public Utilities Act decrees that a public utility's authorized rates cannot reflect <u>any</u> incremental risk or increased cost of capital stemming the public utility's affiliation with unregulated or non-utility companies. Given that limitation, Mr. McNally noted that Moody's, itself, indicated that it downgraded North Shore and Peoples Gas as a result of their parent company's increased leverage and business risk from its diversification strategy. ICC Staff Ex. 7.0. pp. 27-28. In addition, even the Companies have acknowledged that their risk is negatively affected by the risk of their affiliates. Specifically, the Companies "agree[d] with the concept of," and accepted, Staff's proposed adjustments to the interest rates for certain bond issuances due to the effect the Companies affiliates had on the embedded rates of those bonds. NS-PGL Ex. BAJ-2.0Rev., p. 20. Thus, it is clear that the Companies risk is negatively affected to some degree, if not *exclusively*, by the risk of their affiliates. Thus, as Mr. McNally explained, his financial risk adjustment could not rely on the Companies current credit ratings, as the Companies' argument suggests; rather, it must be based on the Companies' stand-alone data. ICC Staff Ex. 7.0, pp. 27-28. Contrary to the Companies' claim, the fact that the Companies credit rating downgrades were not necessarily due <u>exclusively</u> to the risk or their affiliates in no way renders the credit ratings implied by the Companies stand-alone financial ratios overstated. To the contrary, in <u>Illinois Bell Telephone Co. v. ICC</u>, 283 Ill. App. 188, (1996), the Court concluded: "We hold that if a utility's exposure to risk is one iota greater, or it pays one dollar more for capital because of its affiliation with an unregulated or nonutility company, the Commission must take steps to ensure that such increases do not enter in its ROR calculation." Id., p. 207 Thus, the Commission is prohibited from basing its rate of return calculation on the Companies' credit ratings even if a downgrade in those credit ratings is only partially due to the risk of the Companies' affiliates.[6]

The Companies assert that it is contradictory to conclude that the Gas Group accurately reflects the Companies' operating (business) risk, but does not accurately reflect the Companies' financial risk. NS-PGL IB, p. 100. The Companies are wrong. There is nothing inconsistent with finding that the operating risk portion of the total risk for a group is reasonable approximation for that of another company, but the financial risk portion is not. In fact, Staff demonstrated that the financial risk of the Companies is lower than that of the Gas Group through a comparison of their respective financial ratios. ICC Staff Ex. 7.0R. pp. 22-.25. In contrast, Staff explained that it is reasonable to conclude that the operating risk of the Companies is similar to that of the Gas Group. In fact, Mr. Moul selected the companies in the Gas Group wholly on the basis of their business operations, which reflect their operating risk. Mr. Moul started with the Value Line gas utilities sector, which is limited to only 12 companies based solely on their line of business. He further reduced the likelihood of a significant business risk differential by eliminating three companies due to the location or the diversification of their operations. In addition to the business operations similarities upon which Mr. Moul selected his sample, the S&P business risk profiles for every company in the Gas

[6] Likewise, the Companies' claim that they have limited the financial impact of their affiliates by issuing their debt as mortgage bonds would not satisfy the requirements set forth in the Illinois Bell ruling. Regardless, that argument is irrelevant since Staff's financial risk adjustment was not based on mortgage bond ratings, but actual and implied issuer credit ratings.

Group, and both Peoples Gas and North Shore, is in the “Excellent” category, which is their lowest business risk category. ICC Staff Ex. 21.0, pp. 23-24. Mr. Moul did not use a single measure of financial risk in his sample selection process.

The Companies claim that the impact of the 2006 PGA Settlement on the Companies’ after-tax net incomes was relatively small. The Companies’ claim that even after adjusting for the 2006 PGA Settlement, the coefficient of variation of returns indicates that the operating risk of the Gas Group is lower than that of the Companies and, thus, offsets the Gas Group’s higher financial risk, making Mr. McNally’s financial risk adjustment unnecessary. NS-PGL IB. p. 103. The record is not clear how Mr. Moul calculated his coefficient of variation or his estimate of the after-tax net income impact of the refunds. It appears that he ignored the forgiveness of bad debt and other costs that, together, made up the bulk of the total PGA settlement. ICC Staff Ex. 21.0, p. 24. Nevertheless, even if one considers only the $100 million of customer refunds, it is clear that the after-tax net income effect could not reasonably be considered relatively small. Mr. Moul estimated that the after-tax net income effect for the refund would be $62 million and $2.6 million for Peoples Gas and North Shore, respectively in 2006. In comparison, Staff’s recommended net operating incomes for the 2010 test year, four years and two rate increases later, are only $90 million and $14 million for Peoples Gas and North Shore, respectively. Staff IB, Appendix A, p. 1 and Appendix B, p. 1. Thus, the 2006 after-tax effect Mr. Moul presented would represent a 68% reduction to Peoples Gas’s 2010 net operating income and an 18% reduction to North Shore’s 2010 net operating income. NS-PGL Ex. PRM-3.0, p. 9. If the Companies find a change to net income of that magnitude to be insignificant, it is not clear why they are quibbling over an adjustment for which the effect would be miniscule in comparison. Moreover, any ratio calculation that is not significantly affected by a change in income of that magnitude is not sensitive enough to be of much value in pinpointing a company's operating risk.

7. Rider VBA

The Companies suggest that Staff's proposed 10-basis point adjustment to reflect the reduction in risk associated with Rider VBA is not necessary, since that rider has been in place for two years. NS-PGL IB, p. 103. However, that Rider VBA has been in effect for two years is not relevant. Contrary to the Companies' implication, the adjustment is not intended to accommodate a one-time change in risk of the Companies. Rather, the purpose of the adjustment is to reflect the fact that the Companies have, and will continue to have, in place a risk-reducing factor that not all the companies in the sample from which the cost of equity was derived have, a fact Mr. Moul acknowledged. ICC Staff Ex. 21.00, pp. 26-27. Furthermore, the Order from the Companies' last rate case stated "we find it reasonable to reduce the return on common equity by ten (10) basis points for the duration of the pilot program." That Order also discussed the quantification of the effect of Rider VBA on the ROE in future rate cases. Order, Docket Nos. 07-0241/07-0242 (Cons.), February 5, 2008, p. 99 (emphasis added). Thus, it is clear that the Commission does not view the adjustment as a one-time only issue.

The Companies also argue that the Commission "gave no consideration to whether or to what extent the Gas Group's risk reflected the impact of revenue stabilization mechanisms" when determining the Rider VBA adjustment adopted in the

Companies last rate case. NS-PGL IB, p. 103-104. While that may be true, Staff did consider the impact of revenue stabilization mechanisms available to the Gas Group in adopting that adjustment in this proceeding. In fact, contrary to the Companies' claim, Staff's review of the revenue stabilization mechanisms available to the Gas Group provides a solid foundation for the adjustment. As Staff explained, while most of the companies in the Gas Group have in place some sort of de-coupling rider, some of those riders are only applicable to a portion of the company's service territories, and two of the companies have no de-coupling rider at all. Thus, a small cost of equity adjustment for Rider VBA is clearly warranted, and Staff concluded that the 10 basis point downward adjustment adopted in the Companies' last rate case would be appropriate in this proceeding.[7] ICC Staff Ex. 21.00, pp. 26-27. Contrary to the Companies' claim, providing facts in this proceeding that coincide with the Commission's finding in the Companies' last rate case does not constitute a revisionist interpretation of the Commission's prior decision.

8. Rider ICR

The Companies claim that Staff's proposed adjustment to reflect the reduction in risk associated with Rider ICR is overstated, given the 10 basis point adjustment for Rider VBA, which affects a greater amount of revenue.[8] NS-PGL IB, p. 104. The Companies' argument betrays a fundamental misunderstanding regarding the central

[7] As explained below, contrary to the Companies' implication, the difficulty of precisely quantifying this relatively small adjustment does not mean that no such adjustment should be made.

[8] The Companies' claim that Staff's risk adjustment to the Rider ICR cost of common equity is overstated tacitly acknowledges that the Rider does reduce the risk of Rider ICR investment vis-à-vis investment in rate base.

basis for Staff's risk adjustment. In contrast to the Rider VBA-adjusted ROE, which would apply to rate base assets, the adjusted rate of return for Rider ICR would only apply to Rider ICR assets.[9] Thus, the comparison the Companies present of the relative sizes of each rider is not relevant. Rather, the relevant comparison is the relative risk of each dollar affected. The risk reduction for each dollar affected due to Rider ICR is greater than that due to Rider VBA. While Rider VBA merely reduces the volatility and uncertainty of a portion of the Companies' revenues,[10] Rider ICR eliminates both regulatory lag and the risk of non-recovery of prudent and reasonable costs incurred in implementing ICR projects. ICC Staff Ex. 7.0, p. 28-29 and 34-35.

The Companies suggest that Staff's adjustment for Rider ICR should be rejected because, even with the adoption of Rider ICR, Peoples Gas remains at risk for non-recovery of projects found to be imprudent or unreasonable. NS-PGL IB, pp. 104-105. However, Staff's proposed adjustment accounts for that risk. As explained in Staff initial brief, if Rider ICR protected the Company against all risk of non-recovery of investments in the ICR program, a return consistent with AAA-rated long-term utility bonds would be warranted (i.e., a 326 basis point adjustment). Since the risk for non-recovery of projects found to be imprudent or unreasonable remains, Staff proposed an adjustment only half as large. Staff IB, pp. 107-108.

The Companies also suggest that Staff's adjustment for Rider ICR should be rejected because it was not quantitatively developed. NS-PGL IB, p. 105. The

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[9] Obviously, once an asset moves into rate base, it would no longer be subject to the Rider ICR-adjusted cost of common equity.

[10] Rider VBA does not true up the Companies' actual expenditures with those in their revenue requirements.

Companies' argument suggests that because the precise effect of Rider ICR cannot be observed and there is no model for precisely quantifying this adjustment, no adjustment should be made. With that logic, the Companies have a disincentive to provide an estimate of their own, and the "adjustment" would necessarily be 0%, despite a clear reduction in risk. Indeed, that is precisely the approach the Companies have taken. The Commission's acceptance of that approach would improperly turn the burden of proof from the Companies to other parties and reward the Company for presenting no evidence affirming its position that Rider ICR does not reduce the risk of investment in infrastructure. If absolute quantification is required, the cost of equity would similarly be limited to the risk-free rate, because the risk premium, too, cannot be observed and its estimate ultimately requires the analyst's judgment. For example, in his Risk Premium analysis Mr. Moul calculated an S&P Public Utilities risk premium of 6.23%, which he adjusted to 5.50% for the Gas Group because, in his opinion, non-quantifiable differences between S&P Public Utilities and the Gas Group warranted the adjustment. Peoples Gas Ex. PRM-1.0, pp. 34-35. As Staff explained, there is no established approach for precisely gauging the effect of riders such as ICR, and any adjustment will inevitably be an inexact estimate requiring the analyst's informed judgment. (ICC Staff Ex. 7.0, p. 30.) Nevertheless, as noted in the preceding paragraph, Staff provided a reasonable rationale for its proposal.

Finally, the Companies argue that Staff's adjustment for Rider ICR should be rejected because it assumes that the accelerated main replacement would be implemented to its maximum extent. NS-PGL IB, p. 105. However, nothing in the record supports the claim that Staff's adjustment assumes maximum acceleration.

Indeed, it does not. In fact, the Companies' argument is nonsensical. The adjusted rate of return for Rider ICR would only apply to, and ensure the timely recovery of prudent and reasonable investment in, Rider ICR assets; it would not apply to the Company's rate base. The rate of implementation would merely dictate the amount of assets in Rider ICR, to which that return is applied. Thus, the effect of Staff's proposal would be <u>proportional</u> to the rate of main replacement implementation. Therein lies the strength of Staff's proposal. For example, if no main replacement is undertaken, no assets would be subject to the Rider ICR-adjusted cost of common equity and Staff's proposal would have no effect. Thus, Staff's adjustment clearly makes no assumption regarding the extent of the implementation of the accelerated main replacement program.[11]

9. Conclusion

The Companies claim that their proposed cost of common equity of 11.87% is "the only proposal before the Commission that is consistent with the general trend in utility capital costs" and that Staff's proposals (9.79% for North Shore and 9.69% for Peoples Gas) are not credible under the current circumstances. NS-PGL IB, p., 107. The Companies' claims could not be more wrong. In fact, the recent trends in utility capital costs and current circumstances demonstrate the exact opposite. Indeed, the Companies' own testimony demonstrates its proposal to be drastically above the norm for recent cost of common equity decisions for gas utilities. Companies witness Fetter presents a table displaying the authorized rates of return on common equity for 30 electric and gas utilities for 2009. NS-PGL Ex. SMF-1.0, p. 7. The average of the 12

[11] In contrast, to incorporate the reduction in risk resulting from Rider ICR in the rate of return on rate base, one would have to make an assumption about the proportion of Rider ICR investment vis-à-vis rate base investment.

cost of common equity decisions rendered for gas utilities was 10.15%. That is only 36 and 46 basis points greater than Staff's recommendations for North Shore and Peoples Gas, respectively. Moreover, Staff's proposals fall within the range of those cost of common equity rulings. In contrast, the Companies' cost of equity recommendation of 11.87% is 172 basis points greater than the average. Moreover, the Companies' proposal is 112 basis points greater than the *highest* authorized rate of return on common equity for the gas utilities. Thus, the current "general trend" revealed by the authorized returns Mr. Fetter presented demonstrates the exact opposite of what the Companies suggest, namely, that Staff's recommendations are consistent with the general trend, while the Companies' proposal vastly exceeds that trend. ICC Staff Ex. 21.0, p. 29. It is no surprise, then, that the Companies have chosen not to reproduce Mr. Fetter's table in their initial brief.

Instead, the Companies' turn their focus to recent Commission decisions. NS-PGL IB, pp. 8-9. However, those, too, supports Staff's proposals and indicates that the Companies proposals are excessive. In fact, those results show Staff's proposal to be, if anything, generous. The Commission's rulings in the cost of common equity in the Companies' last rate case, and the four gas rate cases since, are presented below.

Docket No.	Company	Date	Risk-free rate	ROE	Risk premium	Equity Ratio
07-0241	North Shore Gas	2/5/08	4.83%	9.99%	5.16%	56.00%
07-0242	Peoples Gas Light and Coke	2/5/08	4.83%	10.19%	5.36%	56.00%
07-0588	Central Illinois Light.	9/24/08	4.72%	10.68%	5.96%	46.50%
07-0589	Central Illinois Public Service	9/24/08	4.72%	10.685	5.96%	47.91%
07-0590	Illinois Power	9/24/08	4.72%	10.68%	5.96%	51.76%
08-0363	Northern Illinois Gas	3/25/09	4.72%	10.17%	5.45%	46.42%
	Average		4.76%	10.40%	5.64%	50.77%
09-0166	North Shore Gas		4.10%	9.79%	5.69%	56.00%
09-0167	Peoples Gas Light and Coke		4.10%	9.69%	5.59%	56.00%

Sources: Order, Docket Nos. 07-0241/07-02742 (Cons.), February 5, 2008, pp. 79-80 and 100;
Order, Docket Nos. 07-0585/07-0586/07-0587/07-0588/07-0589/07-0590 (Cons.), September 24, 2008, pp. 193 and 216-219.

The data above reveals that the Companies costs of common equity are currently lower than they were at the time of their last rate case due, not to "undue bias" in Staff's analysis, as the Companies suggest,[12] but to current market conditions, specifically, a lower current risk-free rate. The average risk-free rate from those six cases is 4.76%, while the current risk-free rate is only 4.10%. Thus, although Staff's ROE proposals for the Companies are below the recent average ROE, the risk premiums imbedded in Staff proposals are nearly identical to the recent average risk premium.[13] Moreover, as the table above indicates, the average common equity ratios authorized in those six cases is 50.77%. In contrast, Staff is proposing a common equity ratio of 56.00% for the Companies. Thus, despite proposing an above average common equity ratio, which indicates lower risk, Staff's proposals provide the Companies common equity investors with an equity risk premium that is nearly identical to the average. Therefore, contrary

[12] NS-PGL IB, p. 107.

[13] The equity risk premium is the difference between the return on common equity and the risk-free rate. The risk-free rate of return is the theoretical rate of return on an investment with zero risk. This represents the absolute minimum return an investor demands as compensation for deferring consumption. Thus, the risk premium represents the additional return required to compensate equity investors for the risk associated with that investment. ICC Staff Ex. 7.0, p. 10.

to the Companies allegations, recent Commission decisions indicate that it is not Staff's proposals that are biased *downward*, but the Companies' proposal that is biased significantly *upward*.

For all the foregoing reasons, the Commission should reject the Companies' 11.87% cost of common equity proposal and accept Staff's cost of common equity proposals of 9.79% for North Shore and 9.69% for Peoples Gas.

VII. WEATHER NORMALIZATION – AVERAGING PERIOD (Uncontested)

VIII. PROPOSED RIDER ICR (PGL)

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

The crux of the dispute with respect to Rider ICR is that Peoples Gas apparently believes it does not need to make any real showing with respect to the need for rider recovery versus base rate recovery of the proposed accelerated investments for the replacement of cast iron and ductile iron ("CI/DI") mains and related plant. Staff supports – indeed, recommends that the Commission require – adoption of an accelerated replacement program to ensure that the Company's distribution system does not become a safety issue in future years. But whether an accelerated CI/DI main replacement program is needed or warranted is a distinct and separate issue from determination of the appropriate cost recovery mechanism for such a program. The benefits of an accelerated replacement program are the same regardless of the cost recovery mechanism utilized. Staff does not contest, and specifically supports, the need for an accelerated program to ensure the long term safety of the Company's distribution system[14], but the record is devoid of any substantive evidence demonstrating that a rider recovery mechanism is needed to enable or achieve such a program. As such, the Company has absolutely failed to meet its burden of establishing that a rider recovery mechanism is warranted or appropriate in these circumstances.

The Company contends that Rider ICR will "help enable Peoples Gas to accelerate the replacement of its aging [CI/DI] mains and low-pressure distribution system" (NS-PGL IB, p. 108), but cites to no evidence or analysis in support of this conclusory assertion. This is not surprising, as there is no such evidence in the record. Moreover, the evidence in the record indicates that when Staff requested support for the Company's claim that Rider ICR is needed to enable the accelerated program, no such support was provided. *See* Staff IB, pp. 120-121. At most, the Company's support amounts to the tautological claim that if the Commission enables the Company to recover additional funds through Rider ICR, then the Company will have additional funds through Rider ICR to spend on an accelerated program. This proves nothing with respect to the need or support for a rider recovery mechanism. The Company makes the correct initial observation that it is the proposed "acceleration" that "would bring … benefits to customers," not Rider ICR. NS-PGL IB, pp. 108-109. No support is contained in the record regarding the need for rider recovery. As the Commission noted in the Companies' last rate case, "this Commission is put to the obligation [under Illinois law] of balancing both the interests of consumers and the interests of the Utilities." *In re North Shore Gas Co. and The Peoples Gas Light and Coke Co.*, ICC Docket No. 07-

[14] Peoples Gas now maintains that such a program is not needed in response to Staff's proposal that the Commission direct the Company to implement such a program with Commission oversight. See NS-PGL IB, pp. 129-134.

0241/07-0242 (cons.), p. 152 (Order, Feb 5, 2008) (“*NS-PGL 2008*”). Absent a justification and need to impose these additional costs on ratepayers through a rider recovery mechanism, Rider ICR does not appropriately balance the interests of consumers and the utility.

Peoples Gas also attempts to characterize the Commission’s rejection of the Company’s Rider ICR proposal in its last rate case as resulting from only three specific issues. NS-PGL IB, p. 109. While those problems did exist, the Company is wrong to suggest those were the sum and substance of its problems. In rejecting Peoples Gas’ prior Rider ICR proposal, the Commission never rejected and implicitly accepted arguments that “Peoples Gas [did] not demonstrate[] the need for Rider ICR” or “the magnitude of its alleged financial detriment regarding rate base versus rider recovery of capital costs.” NS-PGL 2008 at 155-156. Those problems obviously remain with Rider ICR’s current incarnation. Another problem noted in the Company’s last rate case was that “[w]hile Rider ICR would provide recovery on new plant investments without a new rate case, ‘the offsetting depreciation and retirement of existing plant – on which the utilities are still earning a return – would be ignored.’” NS-PGL 2008 at 157. Moreover, the Commission explicitly rejected the Company’s attempt to support the need for Rider ICR based on assertions that it involved unique costs -- with the Commission agreeing that “[t]here is nothing about the costs that would be recovered under Rider ICR that are not the subject of routine, traditional Commission ratemaking.” NS-PGL 2008 at 160-161. That is true in this case as well and has been true for the past couple of decades. Costs of main replacement have been routinely recovered through the normal rate case process, and Peoples has not, simply by now calling what they plan for the future an "accelerated" program, thereby eliminated the need to provide justification and support for their rider recovery proposal.

B. Legal and Regulatory Issues – Single Issue Ratemaking

The Company appears to suggest that the rule against single-issue ratemaking has no bearing whatsoever on consideration of Rider ICR because that concept applies only in the context of a traditional rate case and not consideration of a rider. *See* NS-PGL IB, pp. 110, 111. This is a misreading or mischaracterization of the law and Commission orders.

The rule against single-issue ratemaking is based on the principle that the Commission sets rates through a revenue requirement based on aggregate costs and demands, and it would be improper to consider changes to components of the revenue requirement in isolation. See *Business & Professional People for the Public Interest v. Illinois Commerce Comm'n*, 146 Ill. 2d 175, 244-45 (1991) ("BPI II"). While the rule against single issue ratemaking does not prohibit rider recovery in all circumstances, the law is clear that the rule restricts the Commission's authority to permit rider recovery of unique costs to circumstances that warrant rider treatment. Thus, in upholding the Commission's decision to permit rider recovery of coal tar clean-up costs in *Citizens Util. Bd. v. Illinois Commerce Comm'n*, 166 Ill. 2d 111 (1995), the Illinois Supreme Court held that "[t]he rule [against single-issue ratemaking] does not circumscribe the Commission's ability to approve direct recovery *of* **unique costs** through a rider **when circumstances warrant such treatment**." Id. at 137-138 (emphasis added).

The Commission recognized in the Companies' last rate case that:

> In A. Finkl v. Illinois Commerce Commission, 250 Ill.App.3d 317(1993), the Court of Appeals overturned our ruling that Commonwealth Edison

> ("ComEd") could recover demand side management expenses through a rider, on the ground (among other grounds) that we had violated the rule against single-issue ratemaking. The Court explained the rule: "instead of considering costs and earnings in the aggregate, where potential changes in one or more items of expense or revenue may be offset by increases or decreases in other such items, single-issue ratemaking considers those changes in isolation, ignoring the totality of circumstances." Id. at 325.

NS-PGL 2008 at 158. The Commission also acknowledged that in City of Chicago v. Commerce Commission, 281 Ill.App.3d 617 (1996) ("City II"):

> The court underscored, however, that "[r]iders are closely scrutinized because of the danger of single-issue ratemaking," id. [at 628], which is "prohibited because it considers changes in isolation, thereby ignoring potentially offsetting considerations and risking understatement or overstatement of the overall revenue requirement." Id. at 627. The court concluded that the franchise fee riders under review did not constitute single-issue ratemaking because "they did not have any impact whatsoever on Edison's overall revenue requirement" and were "'without direct impact on the utility's rate of return.'" Id. at 629.

NS-PGL 2008 at 159. The Commission specifically concluded that "the courts have consistently held that when a utility's actions may affect its overall revenue needs in disparate ways, all impacts of such actions - both expenses and savings - must be considered and balanced in ratemaking." *Id*. (footnote omitted). Making absolutely clear that this conclusion applied to rider proposals and was not limited to traditional rate cases, the Commission stated, in a footnote to this sentence, that "[t]his principle has been reiterated in proceedings not involving riders as well." *Id*. at fn. 41.

Thus, even in decisions upholding rider treatment - *Citizens Utility Board* and *City II* – the courts acknowledge the importance and role of the single-issue ratemaking prohibition; and the single-issue ratemaking prohibition was the basis for reversing Commission approval of a rider in *Finkl* where appropriate justification for rider recovery was missing. While the rule against single issue ratemaking does not operate as an absolute bar to riders, it circumscribes the Commission's ability to authorize riders to those circumstances that warrant rider recovery and present either minimal or non-existent single-issue ratemaking concerns. Peoples Gas ignores this well-settled law.

The Company also argues that single issue ratemaking is not an issue for riders that have no impact on the "revenue requirement" or "rate of return" (NS-PGL IB, pp. 110, 112), and contends that is the case here. First, Peoples Gas overstates the rulings. The current circumstance in no way resembles the situations in the cases providing for recovery of localized franchise fees or additional costs imposed by local governmental entities. Those cases truly had no impact on revenue requirement or rate of return, as they simply took costs that were otherwise included in base rates and moved them to a rider to provide for localized recovery to ensure cost causers were the cost payers. No such claim can be made for Rider ICR. Rider ICR results in periodic increases to the revenue requirement between rate cases by allowing recovery of and on new plant investments, while not taking into account any other changes in plant and only one change in expenses. While Rider ICR would give the Company the benefit of immediate cost recovery for additional investments occurring between rate cases, it would deny ratepayers the benefit of immediate credit between rate cases for the ongoing depreciation of all other plant in rate base. In other words, Rider ICR presents serious and obvious single-issue ratemaking concerns. When considered with the Company's complete failure to meet its burden to make a prima facie showing that rider recovery is warranted here, its proposal clearly runs afoul of the rule against single issue ratemaking and cannot be approved on this record.

Guidance can also be obtained by reviewing the Commission's ruling regarding Rider VBA. In approving Rider VBA on a pilot basis in the Companies' last rate case, the Commission took into account that Rider VBA was "symmetrical," meaning that it tracked "both the over-recovery as well as the under-recovery of target revenues" and thus could result in credits as well as charges to ratepayers. *NS-PGL 2008 at* 139. In other words, Rider VBA was not designed to operate in a manner that always benefits the Company and burdens ratepayers. Rider ICR contains no such symmetry or evenhandedness, and is designed to always benefit the Company at the expense of ratepayers. Rather than track a unique cost that could be over or under recovered, Rider ICR tracks new investments that would otherwise not be reflected in rates absent a new rate case -- and can only operate so as to increase charges to ratepayers.[15] The Commission determined in Peoples Gas last rate case, based on the record before it, that "margin revenues will have been determined as part of the overall revenue requirement in the instant proceeding and the adjustments that occur under Rider VBA will do nothing to change the Utilities' approved revenue requirement." *NS-PGL 2008* at 142. The Commission found that Rider VBA did "not involve single issue ratemaking because the "adjustments that occur under Rider VBA will do nothing to change the Utilities' approved revenue requirement." *Id*. This is not the case with Rider ICR which will only increase the Company's revenue requirement between rate cases.

The balance of the Company's brief on Rider ICR is spent reviewing Company witness Marano's testimony regarding the benefits of an accelerated main replacement program. As explained above, this discussion contains no support for any assertion that rider recovery is warranted. Rather, Marano's testimony simply supports the need for

[15] While Rider ICR does contain a provision to credit forecasted operational savings based on miles of cast iron / ductile iron removed from service, that credit is only an offset to the increased charges to ratepayers and can never result in a net credit to ratepayers. Proposed Rider ICR, Section F, Factor SV Savings; at ICC Staff Exhibit 15.0, Attachment G.

and desirability of an accelerated program. In other words, these benefits occur regardless of whether cost recovery is implemented through base rates or a rider. They are not benefits of Rider ICR.

Staff also notes that the Company relies on guidance provided by the Commission in its last rate case by identifying "information the Commission needs, **at a minimum**, to evaluate system modernization proposals. NS-PGL 2008 at 162 (emphasis added). The Company appears to ignore and disregard the "minimum requirement" component of the Commission's guidance. The Company's whole case is premised on converting Commission guidance on recommended minimum showings into maximum requirements that somehow guaranty rider approval when met. The Commission made no such ruling, and the Company's proposal should be rejected based on the record in this case for the reasons indicated above and in Staff's Initial Brief.

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

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

Peoples, in its Initial Brief, argues 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. NS-PGL IB, p. 132. Peoples also argues in its Initial Brief that before Peoples can be ordered to undertake an accelerated main replacement program, the Commission must find the program "necessary". Id., p. 130. Peoples' argument fails to address that the courts over the years have not interpreted the phrase “necessary” or “necessity” as it is used in other sections of the PUA (most often in Section 8-406) to mean absolute necessity, but rather they have interpreted the word to mean needful and useful to the public. King v. Illinois Commerce Commission, 39 Ill. App. 3d 648 (1976).

Staff witness Stoller’s point in providing testimony for the Commission to consider was to make the Commission aware of the need to take steps to protect the future safety of the people of Chicago. Mr. Stoller’s testimony identified what he perceived, based on his experience with deteriorated utility gas and electric distribution systems, including Peoples’ own system, to be a threat to the future safety of the public in the area of Peoples’ gas distribution system, that is, the continued deterioration of Peoples’ distribution as described by Mr. Marano. Staff IB, p. 127. Mr. Stoller’s testimony also proposed a method to provide assurance to the Commission that the threat is adequately addressed over the period that the proposed acceleration program is to last. Staff IB, pp. 131-138. Mr. Stoller could not overlook the fact that Peoples Gas has been working on replacing deteriorating infrastructure for nearly thirty years of a fifty-year plan and now is asking the Commission to approve a plan that will require them to triple their recent facility replacement rate to meet the fifty-year goal. Staff IB, p. 135. Based upon the above arguments, those stated in Staff’s Initial Brief and Mr. Stoller’s testimony, Staff concludes that the accelerated main replacement program is “necessary” under Section 8-503. 220 ILCS 5/8-503.

X. OTHER NEW RIDERS

XI. COST OF SERVICE

B. Embedded Cost of Service Study

2. Contested Issues

a. Classification of Uncollectible Account Expenses Account No. 904

The Companies make several criticisms of Staff's position on the issue of the classification of Uncollectible Account Expenses. The Companies consider bill components irrelevant (NS-PGL IB, p. 139) despite the fact that the factors that cause the costs to be incurred must be identified and understood for any cost of service study as the Companies' own witness stated in Direct Testimony. NS Ex. JCHM-1.0, p. 10. A bill component that underlies the Uncollectible Account Expense should be critical in determining cost allocation. The Companies viewed these costs as a function of customers' unpaid bills rather than as the Commission found them to be in the Companies last rate cases as a function of the underlying components of those unpaid bills which are comprised of both fixed and variable charges, i.e., the customer charge, distribution charge and demand charge, as Staff asserted. ICC Docket No. 07-0241/0242, Order at 201. Adopting the Companies' proposal would mean that uncollectible costs associated with purchased gas costs would be recovered through the customer charge which is a fixed charge. That result does not make sense because purchased gas costs, which account for approximately two-thirds of a customer's bill, vary with usage and are not fixed per customer. Thus, it would be inappropriate to recover Account 904 costs solely through a non-usage based charge such as a customer charge. ICC Staff Ex. 10.0, p. 6.

The Companies argue in their Initial Brief that the cost of service and rate design principles have been mingled together incorrectly by Staff. NS-PGL IB, p. 139. The Companies' argument ignores the fact that these two issues are closely related. Mingling the two issues does not change the fact that the Companies repeat the same argument, that the Uncollectible Account Expense should be classified solely as a customer cost, which has been rejected by the Commission in Docket Nos. 07-0241/07-0242. The Companies completely disregard the previous Final Order in which the Commission determined the costs should be spread according to the respective demand, customer and commodity classifications by the relative weight or percentage of revenue requirement for each customer class resulting from various categories of costs. ICC Docket No. 07-0241/0242, Order at 201. The Companies not only disregard the previous Final Order's language, but they find fault with Staff's recommendation, which is based specifically on the Order in the Companies last rate case.

The Companies are wrong in claiming that Staff's recommendation is circular in nature (NS-PGL IB, p. 140) which was addressed in Staff's Initial Brief, as well as the fact that in surrebuttal testimony, the Companies' cost of service witness acknowledged that Ms. Harden's clarification through the discovery process demonstrated that Staff's position is not circular in nature. Staff IB, p. 147.

In response to the Companies argument that no other Illinois utility uses the same approach to Uncollectible Account Expenses (NS-PGL IB, p. 141), the Companies fail to recognize that the order for this proceeding must be based exclusively on the evidence in this record (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, 227 (1989)) and not the evidence in other Illinois utilities' proceedings. As explained in Staff's Initial Brief, no other utility has the same Uncollectible Account Expense assignment as the Companies, as well as, no other utility has Rider VBA as a decoupling rider which is also unique from the other gas utilities in Illinois. Staff IB, p. 144.

b. Sales Revenues Adjustments

As stated in Staff's Initial Brief (p. 140), Staff agreed with AG/CUB/City witness Effron's recommendation to update the sales forecasts in the test year to reflect a significantly lower current price of gas compared to that projected at the time the sales forecasts were originally prepared. Staff and the Companies were able to come to agreement on what the price of gas should be. The sales adjustment will be necessary by both the Companies and Staff if approved by the Commission.

XII. RATE DESIGN

B. General Rate Design

1. Allocation of Rate Increase

While the Companies have several criticisms of Staff's proposal for determining rates, their arguments fail to recognize that Schedules 24.1 N and 24.1 P provide a simple, easy solution to determine new rates. There are many ways that rates can be determined after the Final Order is issued in these dockets. There is, however, a limited compliance period in which the Companies and Staff must agree the rates are appropriate and in compliance with the Final Order.

2. Account 904 Uncollectible Expense

See XI. B. 2. a. Classification of Uncollectible Account Expenses Account No. 904.

XIII. TRANSPORTATION ISSUES

C. Large Volume Transportation Program

1. Super Pooling on Critical Days

CNE, Staff and the Commission have all moved on since the 2007 decision on which the Companies rely to reject CNE's current super pooling proposal. The Staff and CNE supported and the Commission accepted Nicor Gas' alternative to CNE's proposal in its rate case, Docket No. 08-0363. CNE proposed the identical solution to the critical day super pooling issue in this case. However, the Companies refuse to take a fresh look at critical day super pooling. The Companies claim, "The administrative burden and attendant concerns that the Utilities expressed in the last rate cases have not changed *or been alleviated*." NS-PGL IB, p. 175, (emphasis added). The Companies' brief is wrong on this point, ignoring the fact that CNE's proposal will not require any automation of the billing system; (CNE Ex. 2.0, p. 7) Staff concludes that this does, in fact, at least *alleviate* some of that administrative burden. Staff IB, p. 191.

Finally, the Companies provided no acknowledgement in testimony or brief that the Commission approved an identical proposal in the interim and explicitly discussed in both CNE's and Staff's testimony, (CNE Ex. 1.0, p. 26, CNE Ex. 2.0, pp. 7-8, and ICC Staff Ex. 24.0, p. 47), nor did they attempt to show that the Nicor Gas decision, Docket No. 08-0363 was not valid here. Staff concludes that CNE's proposal is consistent with the Nicor Gas decision and specifically addresses *all* of the Commission's objections from the Companies' last rate cases. Therefore, Staff recommends that the Commission order the Companies to implement this proposal.

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

1. Allocation of and Access to Company-owned Assets

While Staff continues to support RGS position that there should be revised injection and withdrawal rights that better reflect the flexibility of all storage assets, RGS is incorrect that CFY customers pay equally for Firm Transportation ("FT") assets. RGS IB, p. 3. In fact, CFY customers do not pay at all for FT. Staff witness Mr. Sackett is clear in his Revised Direct Testimony, (Staff Ex. 12.0R, p. page 36 and Attachment H, Companies' response to Staff Data Request DAS 4.02), that FT costs are excluded from the Aggregation Balancing Gas Charge. Therefore, CFY customers do not pay for FT despite RGS that repeats this statement throughout its Initial Brief.

Therefore, RGS Witness Mr. Crist was incorrect in his direct testimony this point because, while he consistently referred to off-system *storage* assets, he did state that, "*Both of these charges provide for the pass-through of interstate pipeline transportation costs as well as leased storage costs".* RGS Ex. 1.0, p. 10. Additionally, in rebuttal he switched to "capacity assets", "delivery assets" and "deliverability assets," all of which suggest he is including FT. RGS Ex. 2.0R2 , pp. 9-11. In its Initial Brief, RGS has clarified that it's comparison of what CFY customers pay for and what flexibility is reflected in Rider AGG included FT. In that brief they state,"Despite the fact that CFY customers pay essentially the same fee for storage *and upstream firm transportation* assets that is paid by sales customers of PGLS/NSG, the CFY suppliers have less access to and control over those assets than PGLS/NSG." RGS IB, p. 3. A review of the transcript shows that Mr. Crist has read Rider 2, but does not know whether FT is excluded from the Aggregation Balancing Gas Charge ("ABGC"). Tr., p. 563, August 26, 2009.

Furthermore, RGS defines the term "assets" as follows:

> The Companies use a combination of on-system and up-stream assets to meet the design or peak day needs of its system. These assets include on-system storage (Manlove Field), storage purchased from pipelines, *and firm transportation purchased from pipelines*. Collectively, these will be referred to in this brief as "assets.
> RGS IB, p. 7.

RGS also states that the costs of these "assets" are recovered through the ABGC:

> Off-system storage is leased by the Companies through contracts with third-parties. The Companies may also have contracts with interstate pipelines for firm transportation. The costs of off-system storage *and firm transportation* are recovered from residential and commercial customers whether they are on sales service, via the Non-Commodity Gas Charge ("NCG Charge"), or on CFY, via the Aggregation Balancing Gas Charge ("ABG Charge"). Both of these charges provide for the passthrough of interstate pipeline transportation costs as well as leased storage costs. (*See id*.) In other words, through a combination of base delivery charges and the ABG Charge, the Companies charge CFY customers the *same amount* for assets (on-system storage, upstream storage and upstream firm capacity) as they charge their own sales customers.
> RGS IB, p. 10.

Finally, in the chart analysis provided in its Initial Brief, (RGS IB, pp. 20-21), RGS included FT in its comparison of the relative delivery from the system for sales and CFY customers. RGS removed the citygate deliveries from RGS Ex. 2.2REV because CFY customers do not pay for those deliveries. RGS IB, p. 18. However, its comparative analysis fails to remove the additional 12% that reflects the FT that CFY customers also do not pay for.

In its IB, Staff supported RGS's position because of portions of RGS's direct testimony which stated:

> Off-system storage is connected to the interstate pipelines that serve the Companies' distribution system. Off-system storage is leased by the Companies through contracts with third-parties. The costs of off-system *storage* are recovered from residential and commercial customers whether they are on sales service, via the Non-Commodity Gas Charge, or on Choices For You, via the ABGC….Despite the fact that the Companies recover the same amount of *storage* costs from both sales and Choices For You customers, Choices For You customers have a lesser allocation of the daily and monthly injection and withdrawal rights compared to the sales customers.
>
> RGS Ex. 1.0, p. 10.

Staff agrees that off-system *storage* costs are included in both the NCGC and the ABGC and, as such, are recovered equally from sales and CFY customers. Staff continues to believe that there is merit in a comparison of these assets, excluding the FT, which RGS incorrectly includes in its analysis. Rider AGG reflects only the flexibility of on-system storage assets, while CFY customers pay for both on and off-system storage assets equally with sales customers. Furthermore, even if one removes the 12% FT from the chart analysis in RGS' Initial Brief (RGS IB, p. 20-21), this comparison still shows a 82% to 71% advantage for sales customers in deliverability from those assets which are commonly paid for.

Therefore, Staff continues to recommend that the Commission order the Companies to implement the following which are based on the Nicor program:

1. daily injection and withdrawal rights based on the methods provided in RGS Ex. 1.1 – Daily Storage Withdrawal Capacity and Daily Storage Injection Capacity.
2. monthly targets for injections and withdrawals based on the method provided in RGS Ex. 1.1 – Storage Inventory Target Levels.

3. daily delivery targets provided by the Companies based on the best estimate of the customer's daily usage with a daily tolerance of ±10% like RGS Ex. 1.1 – Daily Delivery Range.

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

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

In brief, RGS fails to provide a specific percentage for this reduction, which was based on RGS Witness Mr. Crist's Exhibit 2.2. That exhibit was modified and a new analysis is provided in RGS' Initial Brief. RGS IB, pp. 20-21. However, RGS has not advocated adopting the lesser reduction that the exhibit would have suggested. It is not clear at this point what percentage reduction is advocated by RGS. Therefore, Staff continues to recommend that this proposal be rejected. However, if the Commission orders the workshop advocated by Staff above on the issue of Allocation of and Access to Company Owned Assets, then the RGS' primary issue is being addressed and the ABGC should be considered in that context and not changed here.

3. Allocation of Administrative Costs and Related Charges

During the cross examination of Staff witness Sackett, counsel for RGS's attempted to assign the Nicor Gas Customer Select Gas Suppliers' ("CSGS") rationale to Mr. Sackett. Mr. Sackett clarified that the rationale that RGS's counsel was referring to was that of the intervenor and not his own. RGS in its Initial Brief seeks to confuse the Commission by quoting as Mr. Sackett's response what was actually a question by

RGS's counsel and that Mr. Sackett did not agree to as a correct characterization of his testimony under cross-examination. RGS IB, p. 29. Staff has explained Mr. Sackett's previous testimony on this point in its Initial Brief. Staff IB, p. 200.

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

4. Rider SBO Issues

With regard to the issue of Rider SBO and arrearages, Staff believes that its treatment of this issue in its Initial Brief is sufficient to address the objections raised by the Companies. Therefore, Staff continues to recommend that the Commission should find that the supplier under Rider SBO can continue to serve their customers in arrears under the rider. However, if the Commission orders the workshop advocated by Staff above, then the service to customers in arrears issue could be considered in that context and not addressed here.

With regard to the issue of Rider SBO and credit balances, Staff believes that its treatment of this issue in its Initial Brief is sufficient to address the objections raised by RGS. Therefore, Staff continues to recommend that the Commission order the Companies to continue their practice of returning credit balances directly to the customers.

5. New Customer Issues

With regard to the issue of the treatment of new customers under Riders CFY and AGG, Staff believes that its treatment of this issue in its Initial Brief is sufficient to address the objections raised by the Companies. Therefore, Staff continues to recommend that the Commission order the Companies to allow new customers to receive service under Rider CFY immediately without requiring that they spend a month on sales service. However, if the Commission orders the workshop advocated by Staff above, then the New Customer Issues could be considered in that context and not addressed here.

6. Customer Switching Issues

With regard to customers switching from sales to service under Rider CFY, Staff believes that its treatment of this issue in its Initial Brief is sufficient to address the objections raised by the Companies. Therefore, Staff continues to recommend that the Commission order the Companies to rewrite their policies to reflect the language in the law. However, if the Commission orders the workshop advocated by Staff above, then the Customer Switching Issues could be considered in that context and not addressed here.

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

With regard to the RGS' proposal to provide supplier information under Rider AGG, Staff believes that its treatment of this issue in its Initial Brief is sufficient to address the objections raised by the Companies. Therefore, Staff continues to recommend that the Commission direct the Companies to provide the information requested by the suppliers in the manner requested. However, if the Commission orders the workshop advocated by Staff above, then the Administrative Improvements could be considered in that context and not addressed here.

XIV. CONCLUSION

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

Respectfully submitted,

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