STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

NORTH SHORE GAS COMPANY	:	
	:	
Proposed General Increase In Rates For Gas Service.	:	No. 09-0166
	:	and
THE PEOPLES GAS LIGHT AND COKE COMPANY	:	No. 09-0167
	:	Consol.
Proposed General Increase In Rates For Gas Service.	:	

REPLY BRIEF OF NORTH SHORE GAS COMPANY AND THE PEOPLES GAS LIGHT AND COKE COMPANY

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Dated: October 9, 2009

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North Shore Gas Company ("North Shore") and The Peoples Gas Light and Coke Company ("Peoples Gas") (together the "Utilities"), by their counsel, pursuant to the Administrative Law Judges' scheduling order of April 27, 2009, submit this Reply Brief.

I. INTRODUCTION

A. Overview / Summary

Revenue Requirement Issues. The Initial Briefs of Staff, the AG, and CUB-City[1] regarding the Utilities' costs of service mix some good intentions with a lot of bad ideas. They present dozens of adjustments that are reasonable or at least acceptable and thus are uncontested, but they also propose dozens of adjustments and rates of return that are incorrect and deny reality. If they have their way, next year (2010), the Utilities' rates will fall short of their costs of service by $66 million (Staff) or $125 million (AG-CUB-City). *See* Section III, *infra*.

When one looks at Staff's and AG-CUB-City's overall revenue requirement and rate of return positions, it's almost as if the last 20 months never happened. The large cost recovery shortfalls that swiftly followed when the rates set in the Utilities' 2007 rate cases went into effect

[1] The Illinois Commerce Commission (the "Commission" or "ICC") Staff ("Staff"), the Illinois Attorney General's office ("the AG"), the Citizens Utility Board ("CUB"), and the City of Chicago (the "City").

in early 2008 seem almost irrelevant. So do the Fall financial crisis and ensuing recession that dried up the credit markets and drove up the costs of capital.

There is no dispute about the fact that, even though the Commission approved new rates for the Utilities in February 2008, the Utilities did not recover their costs of service even in 2008. NS-PGL Init. Br. at 2.[2]

In 2010, the uncontested test year in these cases, the Utilities' operating expenses will be $95 million above the level used to set their existing rates. *Id*. In 2010, under existing rates, their rates of return will be in the low single digits. *Id*.

The arbitrariness and unreality that pervade the contested Staff and AG-CUB-City positions is glaring. For example, as to the five areas involving the largest proposed reductions in the Utilities' revenue requirements:

- The Commission has shown a general trend of increasing approved rates of return on common equity ("ROEs") in the last two years. NS-PGL Init. Br. at 9. The financial crisis and recession have hit since the Utilities' 2007 rate cases. Yet, Staff and AG-CUB-City ask the Commission to approve ROEs that are significantly lower than those set in the Utilities' last rate cases and lower than any that the Commission has set for any gas utility since at least 1972. *Id*.
- Staff proposes to exclude Peoples Gas' pension asset from rate base but, inconsistently, to include North Shore's pension liability. *See* Staff Init. Br. at 36-37. Not even AG-CUB-City go that far. AG Init. Br. at 15-17; CUB-City Init. Br. at 6-7.

[2] North Shore and Peoples Gas ("NS-PGL") Initial Brief ("Init. Br.").

- Staff proposes to reduce Peoples Gas' operating expenses by nearly $5 million for incremental costs supposedly arising from untimely corrosion inspections or Pipeline Safety Act violations even though Staff's witnesses cited no outages, reliability problems, fires, explosions, leaks, or other problems, and the Utilities' head of operations testified that no such events occurred. NS-PGL Init. Br. at 65.
- Staff and AG-CUB-City propose to disallow incentive compensation costs that uncontradicted evidence shows to be prudent and reasonable and to benefit customers. *Id*. at 56-57.
- Staff wants to reduce the Utilities' cash working capital by ascribing zero lag days for pass-through taxes even though the supposed basis for doing so is different facts involving a different utility. *Id*. at 13-14.

Staff's and AG-CUB-City's arbitrariness and inconsistency are not confined to their largest proposals. For example, Staff seeks to reduce the Utilities' injuries and damages expenses while refusing to make consistent adjustments to the injuries and damages reserves in rate base (*id*. at 72); Staff theorizes about decisions on wage increases based on data that did not exist until months after the decisions were made (*id*. at 61-62); and AG-CUB-City propose the same kind of arbitrary, one-sided projection of increased sales revenues that recently was shown to have caused another utility to under-recover its costs by $5.4 million per year (*id*. at 73). The Commission should reject the contested Staff and AG-CUB-City revenue requirement proposals.

<u>Rider ICR</u>. The City and the Union support Peoples Gas' proposed infrastructure cost recover rider, Rider ICR. Neither Staff nor AG-CUB get it right on the rider. They oppose the rider based on a combination of theoretical grounds, erroneous legal arguments, and, in AG-CUB's case, a fatally flawed cost-benefit analysis. They never really come to grips with the

fact that the acceleration of cast and ductile iron main replacement in the City of Chicago is in the long-term interests of customers and the Utilities, but that, because of the large capital investments required, the rider is warranted to help decrease the disincentives for these investments. Staff even goes so far as to advocate that Peoples Gas be ordered to accelerate the main replacement program and that an expensive independent consultant be retained to oversee the program. Staff's proposed program mandate is based on an interpretation of Peoples Gas' expert witness' testimony that is not supported by what the witness actually said. The Utilities and the Union agree that Staff's proposed consultant mandate also lacks any substantial basis in the evidence.

Rate design, cost of service, and transportation issues. The Initial Briefs show that the Utilities have been reasonable both in their proposals and in the responses and counter-proposals on the subjects of rate design, cost of service, and transportation service. For the most part, Staff and the Utilities' positions on rate design and cost of service are consistent, although Staff persists in advocating an erroneous approach to the handling of uncollectible accounts expenses for cost of service study purposes.

B. Nature of Operations

1. North Shore

This subject is uncontested.

2. Peoples Gas

This subject is uncontested.

II. TEST YEAR (Uncontested)

This subject is uncontested.

III. REVENUE REQUIREMENT

The fact that the Utilities' existing rates do not allow them to recover their costs of service (their revenue requirements) is undisputed. Staff and the three intervenors that addressed revenue requirement issues (the AG, CUB, and the City) each presented testimony supporting rate increases for each utility. The problem is that, as in the 2007 cases, Staff and intervenors have gone beyond presenting reasonable or at least acceptable proposals to piling on adjustment after adjustment that is incorrect, arbitrary, and/or incomplete.

A. North Shore

North Shore's final revised revenue requirement is $83,305,000, meaning its test year cost recovery shortfall (its "revenue deficiency") under current rates would be $18,105,000. NS-PGL Init. Br. at 25.[3]

Staff's brief now seeks to reduce North Shore's revenue requirement and revenue deficiency to newly revised figures of $77,412,000 and $12,212,000, down from Staff's rebuttal figures of $78,774,000 and $13,481,000. *Compare* Staff Init. Br. at App. B, p. 1, lines 5, 27; with Hathhorn Reb., Staff Ex. 15.0 at Sched. 15.1N Corr., lines 5, 27. The Utilities infer that the decrease since rebuttal is due to Staff's reflecting certain, but not all, of the revisions and updates made in the Utilities' surrebuttal, plus a very minor error on Staff's part in applying the Gross Revenue Conversion Factor (*see* Section V(B)(11), *infra*).

AG-CUB[4] have not presented revised North Shore revenue requirement and revenue deficiency numbers. Their North Shore numbers as of rebuttal (as corrected at the evidentiary

[3] The above figures and the Peoples Gas figures in Section III(B), *infra*, assume the Utilities' more than fair proposal, made in an attempt to narrow the issues, to accept Staff's proposed adjustments to the Utilities' injuries and damages expenses if and only if the corresponding adjustments are made to the Utilities' injuries and damages reserves. NS-PGL Init. Br. at 25, fn. 29, and at 68-72. *See* Section V(C)(7)(a), *infra*. The above figures and the Peoples Gas figures in Section III(B), *infra*, also need to be corrected slightly to reflect the uncontested final revised adjustments to the Utilities' merger costs and savings. NS-PGL Init. Br. at 52 and fn. 66.

hearing) were $65,843,000 and $10,939,000. AG-CUB Ex. 4.1 Corr. at Scheds. C and A. The Utilities believe, however, that those numbers may not fully reflect some of the revised or updated adjustments in the Utilities' surrebuttal that are uncontested.

The Commission should approve North Shore's final revised revenue requirement and revenue deficiency. North Shore's figures already have been significantly reduced since its initial filing, *e.g.*, the revenue deficiency has been reduced from $21,986,000 to $18,105,000 or by nearly 18%. NS-PGL Init. Br. at 24-25. The evidence supports those figures, as discussed in Sections I, III, IV, V, and VI of the Utilities' Initial Brief and this Reply Brief. Moreover, the experience of the Utilities' 2007 cases shows that Staff and intervenors erred seriously in their proposed adjustments in those cases, as evidenced by the Utilities' large cost recovery shortfall in 2008, the increased shortfall in 2009, and the forecasted further increased shortfall in 2010.

B. Peoples Gas

Peoples Gas' final revised revenue requirement is $574,038,000, meaning its test year cost recovery shortfall (its revenue deficiency) under current rates would be $113,178,000. NS-PGL Init. Br. at 26.[5]

Staff's brief now seeks to decrease Peoples Gas' revenue requirement and revenue deficiency to newly revised figures of $514,190,000 and $53,330,000, down from Staff's rebuttal figures of $515,586,000 and $53,452,000. *Compare* Staff Init. Br. at App. A, p. 1, lines 5, 27; with Hathhorn Reb., Staff Ex. 15.0 at Sched. 15.1P Corr., lines 5, 27. The Utilities again infer

[4] The CUB-City Initial Brief addresses some but not all of the AG-CUB proposed adjustments to rate base and operating expenses, and does not address the AG-CUB proposal regarding sales revenues. To avoid an undue profusion of references, references in this Initial Brief to "AG" or "AG-CUB" positions should be understood to include the City where the CUB-City Initial Brief takes the same position.

[5] *See* fn. 3, *supra*.

that that is due to Staff's reflecting some but not all of the revisions and updates made in the Utilities' surrebuttal.

AG-CUB have not presented revised Peoples Gas revenue requirement and revenue deficiency numbers. Their Peoples Gas numbers as of rebuttal (as corrected at the evidentiary hearing) were $466,575,000 and $45,389,000. AG-CUB Ex. 4.2 Corr. at Scheds. C and A. The Utilities here, too, believe, however, that those numbers may not fully reflect some of the revised or updated adjustments that became uncontested at the surrebuttal stage.

The Commission should approve Peoples Gas' final revised revenue requirement and revenue deficiency. Peoples Gas' figures already have been significantly reduced since its initial filing, *e.g.*, the revenue deficiency has been reduced from $161,920,000 to $113,178,000 or by over 30%. NS-PGL Init. Br. at 25-26. The evidence supports those figures, as discussed in Sections I, III, IV, V, and VI of the Utilities' Initial Brief and this Reply Brief. Moreover, as noted earlier, the experience of the Utilities' 2007 cases shows that Staff and intervenors erred seriously in their proposed adjustments in those cases.

IV. <u>RATE BASE</u>

A. <u>Overview/Summary/Totals</u>

1. <u>North Shore</u>

North Shore's surrebuttal presented a final revised rate base of $179,927,000, reflecting adjustments proposed by Staff and intervenors that the utility agreed with or accepted in whole or in part, certain updates, and the correction of certain prior calculation errors. NS-PGL Init. Br. at 27. North Shore's rate base is supported by extensive, detailed evidence. *Id.*

The Commission should approve North Shore's final revised rate base. North Shore is entitled to recover its costs through rates. Staff's proposal to reduce North Shore's rate base to

$177,867,000 (Staff Init. Br. at App. B, p. 4), while it represents a relatively small reduction in a proportional sense, is erroneous, because it rests on incorrect and selective adjustments, and it should not be adopted. The same is true of AG-CUB's proposed figure as of rebuttal of $175,971,000. AG-CUB Ex. 4.1 Corr. at Sched. B.

2. <u>Peoples Gas</u>

Peoples Gas' surrebuttal presented a final revised rate base of $1,300,750,000, reflecting adjustments proposed by Staff and intervenors that the utility agreed with or accepted in whole or in part, certain updates, and the correction of certain prior calculation errors. NS-PGL Init. Br. at 28. Peoples Gas' rate base is supported by extensive, detailed evidence. *Id*.

The Commission should approve Peoples Gas' final revised rate base. Peoples Gas is entitled to recover its costs through rates. Staff's proposal to reduce Peoples Gas' rate base to $1,170,346,000 (Staff Init. Br. at App. A, p. 5) rests on incorrect and selective adjustments, and it should not be adopted. The same is true of AG-CUB's proposed figure as of rebuttal of $1,181,641,000. AG-CUB Ex. 4.2 Corr. at Sched. B.

B. <u>Uncontested Issues</u>

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

This issue is not contested.

2. <u>Plant</u>

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

Staff and the Utilities agree that the Commission should make an original cost determination of Utility plant balances as of December 31, 2007. Bridal Dir., Staff Ex. 5.0 at 8:165 – 9:184; Hengtgen Reb., NS-PGL Ex. JH-2.0 at 17:371 – 18:383. No party disagrees.

However, for the first time in its Initial Brief (at 5-6), Staff now argues that the amount of each utility's original cost plant should be decreased by $166,000 for Peoples Gas and $27,000 for North Shore relating to capitalized incentive compensation not allowed for recovery in the Utilities' 2007 rate cases. Such adjustments are inappropriate. Incentive compensation, a contested issue, is addressed in Section V(C)(1), *infra*. Furthermore, incentive compensation is an issue on appeal from the Utilities' 2007 rate cases. Hengtgen Reb., NS-PGL Ex. JH-2.0 at 16:345-346. If the Utilities prevail on appeal, the Commission would have inappropriately reduced their original cost of plant. If the Commission decides to accept Staff's new amounts for the original cost determinations, however, then the Commission's final Order should specify that if a decision in the Appellate Court or another court or a Commission decision on remand or in any other proceeding results in the plant in question being approved, then the original cost amounts should be restored to their full amounts of $2,525,147,000 original cost of plant for Peoples Gas and $398,983,000 original cost of plant for North Shore.

b. <u>Capitalized Union Wages</u>

This issue is not contested.

c. <u>Capitalized Civic, Political, and Related Activities</u>

This issue is not contested.

d. <u>Net Dismantling</u>

This issue is not contested.

e. <u>Gathering System Pigging Project (PGL)</u>

This issue is not contested.

f. <u>Cushion Gas – Recoverable (PGL)</u>

This issue is not contested.

g. <u>Cushion Gas – Non-Recoverable (PGL)</u>

This issue is not contested.

h. <u>Capitalized Savings Plan Costs</u>

This issue is not contested.

3. <u>Accumulated Reserve for Depreciation and Amortization</u>

a. <u>Inventory Reclassification</u>

This issue is not contested.

4. <u>Materials and Supplies Correction</u>

This issue is not contested.

5. <u>Gas in Storage</u>

The Utilities understand the CUB-City Initial Brief (at 2-3) to indicate, correctly, that this is an uncontested issue. All parties agree that gas in storage should be updated for the most recent price of natural gas (based on data in the August 2009 Gas Charge filings). CUB-City's brief refers, however, to the adjustment amounts in Mr. Effron's direct testimony, AG-CUB-City Ex. 1.0. The Utilities' witness updated this calculation, to which Mr. Effron agreed. Hengtgen Reb., NS-PGL Ex. JH-2.0 at 6:134-7:143; Effron Reb., AG/CUB Ex. 4.0 at 4:55-60; Hengtgen Sur., NS-PGL Ex. JH-3.0 at 5:86-6:109. Therefore, the proper amount of the adjustment appears in NS-PGL Ex. JH-3.5N and JH-3.5P.

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

In this section of its Initial Brief (at 11), Staff addressed the appropriate amortization amounts of "costs to achieve". The Utilities agree that this is an uncontested issue, which was addressed in Section V(A)(7)(n) of their Initial Brief. In this section of their Initial Brief, the Utilities addressed the change in methodology for amortizing the remaining pre-merger unamortized costs. The Utilities proposed to separately identify the remaining pre-merger net regulatory assets for pension and other welfare benefit plans and amortize those costs on a straight line amortization based on the average remaining service lives of the underlying benefit plans, effective January 1, 2010. This is an uncontested issue as well.

C. Plant

1. Forecasted Plant Additions

The Commission should approve the Utilities' revised forecasted plant additions as presented in their rebuttal testimony. Staff, based on the further documentation and information supplied by the Utilities in discovery and in their rebuttal testimony, agrees that the evidence warrants approval of the Utilities' revised forecasted plant additions. Staff Init. Br. at 12-13 (citing Everson Reb., Staff Ex. 18.0, 2:34 - 3:49). The AG and CUB-City argue for the approval of AG-CUB witness Mr. Effron's proposed adjustments (AG Init. Br. at 3-6; CUB-City Init. Br. at 3-4), but the evidence, including the cross-examination of Mr. Effron, shows that his proposal is devoid of merit.

As discussed in their Initial Brief, in March 2009, the Utilities presented updated forecasted plant additions in data request responses, but, as the Utilities refined their budgets, especially to reflect changes in public improvements projects, the forecast plant additions changed again, increasing slightly from those reduced levels. Consequently, in July 2009, in response to later data requests, the Utilities set out the final revised forecast. NS-PGL Init. Br. at 33; NS-PGL Cross Exs. Effron 26 and 28. The Utilities did more than just present new numbers. They explained why the forecasts had changed and the details of the changes, in the data request responses and also in their testimony. NS-PGL Cross Exs. Effron 27 and 29; *see also* Doerk Reb., NS-PGL Ex. ED-2.0 at 2:28-34, 3:65 - 5:103; Doerk Sur., NS-PGL Ex. 3.0 at 2:22-26, 3:46-57. The main driver of the July 2009 revisions was changes in high priority public improvements projects, as those materials show. For example, on June 17, 2009, final approval was obtained for the $8.5 million to be spent in 2010 on the U.S. Route 45 and Delaney Road public improvement projects. NS-PGL Cross Ex. Effron 27. The July 2009 revised forecasted plant additions reflected in the Utilities' rebuttal testimony have not changed and are the most accurate forecasts of the plant additions. Doerk Sur., NS-PGL Ex. ED-3.0 at 3:52-57.

The AG and CUB-City Initial Briefs can only be searched in vain for any principled reason for their adhering to the view that March 2009 forecasts should be used instead of more up to date, accurate July 2009 figures. The AG's Initial Brief relies upon two things: Mr. Effron's unsupported assertion that he "has no reason to believe" that the updated forecasts are more accurate than the forecast from four months earlier and the new assertion that the Utilities' witness never explained what were the high priority projects. *See* AG Init. Br. at 13. Neither ground has any validity. Mr. Effron's rebuttal gave no meaningful reason for his convenient unwillingness to believe. *See* Effron Reb., AG-CUB Ex. 4.0 at 3. The cross-examination of Mr. Effron showed that there is no reason. He simply has refused to take into account the detailed additional documentation and information that the Utilities had provided, even when it was provided in response to the AG's own data requests and even though it was provided before he submitted his rebuttal. Effron, Tr. at 786:12 - 789:2; NS-PGL Effron

Cross Exs. 26, 27, 28, and 29. The AG's untimely complaint about a lack of specificity rings very hollow. Mr. Effron's own rebuttal cited two of the detailed data request responses, and they in turn expressly cited two additional detailed data request responses, all four of which he admitted he received before he filed his rebuttal. Effron Reb., AG-CUB Ex. 4.0 at 3; Effron, Tr. at 786:12 - 789:2; NS-PGL Effron Cross Exs. 26, 27, 28, and 29. CUB-City's Initial Brief's discussion adds nothing to this subject. That brief stops with discussion of Mr. Effron's direct testimony, and thus it provides no basis for rejecting the updated, more accurate July 2009 forecast in favor of the outdated March 2009 forecast. *See* CUB-City Init. Br. at 3-4. The evidence in the record requires rejection of the AG-CUB-City adjustments.

2. Gathering System Phase 2 Project (PGL)

Staff's proposal to disallow the $5.7 million in 2010 costs associated with what it calls "Phase 2" of Peoples Gas' gathering system project should be rejected. Staff's Initial Brief devotes about eight pages to this subject, focusing on the claim that Peoples Gas provided insufficient evidence to support this project, and yet Staff's brief never mentions that Peoples Gas presented surrebuttal testimony from two witnesses in support of the project. *See* Staff Init. Br. at 13-20. Staff's brief offers three reasons for the proposed disallowance: (1) Peoples Gas failed to provide sufficient information that the project will be prudent and used and useful, (2) Peoples Gas failed to demonstrate that it is pursuing this project prior to the end of the test year, and (3) the misguided theory that because Peoples Gas provided an update that reduced the amount expected to be invested in the test year and thus included in its final revised rate base that somehow supported the view that the project is speculative. *Id.* at 13. None of those reasons holds up under scrutiny.

The evidence of prudence and used and usefulness is compelling. The evidence shows the project will replace existing pipes used now with new pipes that allow pigging, which serves to clean and de-water the pipes. Also, the project will address the fact that some of the existing pipes have been developing corrosion. NS-PGL Init. Br. at 34 (citing Puracchio Dir., PGL Ex. TLP-1.0 at 9:181-186; Puracchio Reb., NS-PGL Ex. TLP-2.0 at 2:28-38; Puracchio Sur., NS-PGL Ex. TLP-3.0 at 2:35 - 3:47). Staff's witness, on cross-examination, admitted the replacement pipes will have the same function as the pipes currently in use, and that they are critical to the operation of Peoples Gas' storage field. Seagle, Tr. at 911-912. (Staff cites Section 9-212 of the Act, 220 ILCS 5/9-212, but it does not apply to this type of plant.)

The real issue here, therefore, if there were to be one at all, would be whether Peoples Gas has provided sufficient support for the revised 2010 amount included in its final revised rate base. The evidence shows that this is a multi-year project that will cost tens of millions of dollars. Puracchio Dir., PGL Ex. TLP-1.0 at 8:164-168; Doerk Dir., PGL Ex. ED-1.1 at line 3. The evidence establishes that $1,500,000 is being spent in 2009 for the engineering study that will help chart which pipes will be replaced in which years. Puracchio Reb., NS-PGL Ex. TLP-2.0 at 6:113-118; Puracchio Sur., NS-PGL Ex. TLP-3.0 at 4:69-74. Staff does not contest that 2009 investment (which it called "Phase 1"). The issue is the reduced amount of $5.7 million that Peoples Gas has forecasted to be spent in 2010 (Puracchio Reb., NS-PGL Ex. TLP-2.0 at 6:120-133; NS-PGL Cross Ex. Effron 29), but which Staff has proposed to disallow. Seagle Reb., Staff Ex. 27.0 at 4:59-63.

In response to Staff's witness' rebuttal testimony, Peoples Gas presented surrebuttal testimony from both the Manager of Gas Storage and from the engineering consultant that is performing the study. The surrebuttal showed that, although the overall scope of the project –

for example, whether the project will last ten years or only eight – is not yet known, based on the analyses that have already been performed, it is clear that the forecasted 2010 work will need to proceed or be accelerated. Puracchio Sur., NS-PGL Ex. TLP-3.0 at 4:81 – 5:93; Marano Sur., NS-PGL Ex. SDM-3.0 at 15:327 – 16:346. Thus, the reduced amount of $5.7 million that Peoples Gas included in its final revised rate base is more than amply supported by the evidence in the record, and the fact that Peoples Gas provided that updated reduced amount is no reason to find that the project is speculative. Staff's proposed disallowance should not be adopted.

3. Capitalized Incentive Compensation

Please see Section V(C)(1) of this Reply Brief.

4. Capitalized Non-Union Base Wages

Please see Section V(C)(2) of this Reply Brief.

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

This issue is not contested, apart from derivative impacts of contested adjustments.

E. Cash Working Capital

1. Pass-Through Taxes

Staff continues to try to equate the cash working capital ("CWC") facts presented to the Commission in Northern Illinois Gas Company's ("Nicor") last rate case, In re Northern Illinois Gas Co., ICC Docket No. 08-0363 (Order March 25, 2009) ("*Nicor 2008*") into the different facts presented in this proceeding. However, no matter how the facts are twisted, the methodologies used by the different utilities to pay pass-through taxes simply are not the same. Therefore, the Commission must reject Staff's adjustment as it is not supported by the facts in *this* proceeding.

"In all proceedings, investigations or hearings conducted by the Commission, … , any finding, decision or order made by the Commission shall be based exclusively on the record for decision in the case … ." 220 ILCS 5/10-103. *See also* 220 ILCS 5/10-201(e)(iv)(A); *Fleming v. Illinois Commerce Comm'n*, 388 Ill. 138, 155-156 (1944) (Commission "orders are void for the further reason that they are not based upon the evidence and are predicated upon matters wholly outside the evidence offered before the commission."). The evidence presented in this proceeding is clear. As Utilities witness Mr. Hengtgen succinctly stated at hearing: "The customers pay taxes over a course of several months, and the Company pays the tax to the taxing authority … based upon an estimate of what is received, *whether or not* the taxes actually were received. Tr. at 668:18 - 669:1. (Emphasis added.) Because of the Utilities' method of remitting pass-through taxes based on estimates and not knowing if the taxes have actually been collected, the Utilities' calculations of pass-through taxes show an overall cash working capital close to zero, reflecting the lags and leads nearly cancelling each other out. Mr. Hengtgen's lead-lag study shows that for the tax payments to the City of Chicago of $171 million, the net cash working capital amount is only a negative $40,000. Hengtgen Sur., NS-PGL Ex. JH-3.0 at 10:212 – 11:215. This rebuts Staff's argument that investors somehow receive a benefit of the Utilities having pass-through taxes as cash on hand. Staff Init. Br. at 21.

Further, contrary to Staff assertions (*id.* at 23-24), there are no inconsistencies in the record with regard to pass-through taxes. Staff refers to responses to Staff data requests JMO-14.04 through JMO-14.09, which clearly indicate that payments are based on estimates and the payments are made regardless of whether or not the Utilities collect from the customers. Ostrander Reb., Staff Ex. 17.0 at 7-8 and Attachments C through N (the responses); Staff Init. Br. at 23-24. Those responses also indicate that the source of those payments is the collection of the customers' bills. This was confirmed by Mr. Hengtgen during cross-examination. The question and answer at hearing was as follows:

> Q. All right. But the source of cash for the payment is coming from customers' payment of bills right?
>
> A. Certainly. That's typically the only source of cash that the Company has except for borrowings.

Tr. at 669:2-7. This is the basis for Utilities' calculation and use of lag days in its lead lag study. NS-PGL Init. Br. at 38. Staff's argument for use of zero lag days ignores these facts.

Staff concedes that the Utilities' procedures for collecting and paying pass-through taxes have not changed since the Utilities' most recent rate cases, in which the Commission approved the lead-lag methodology the Utilities continue to use here. Ostrander, Tr. 752:18 – 753:3. There is no need for the change Staff proposes. For all the reasons stated herein and in the Utilities' Initial Brief, the Commission should reject Staff's proposal to change the cash working capital methodology for pass-through taxes.

2. <u>All Other</u> (Uncontested)

This issue is not contested.

F. <u>Accumulated Deferred Income Taxes (Uncontested Except for Derivative Adjustments from Contested Adjustments)</u>

This issue is not contested, apart from derivative impacts of contested adjustments.

G. <u>Reserve for Injuries and Damages</u>

Please see Section V(C)(7)(a) of this Reply Brief, *infra*.

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

Staff in its Initial Brief (at 27-37) continues to urge the Commission to ignore Peoples Gas' pension asset but to subtract North Shore's pension liability and the Utilities' OPEB (other post-employment benefits) liabilities from their rate bases. The AG's Initial Brief (at 14-17) and CUB-City's Initial Brief (at 4-7) take that position with respect to Peoples Gas' pension asset and the Utilities' OPEB liabilities simply by citing previous Commission Orders without even mentioning the Utilities' pension asset/liability and pension plan contributions, much less providing any grounds for disregarding them while including the OPEB liabilities. The AG and CUB-City briefs do not propose, however, to include the North Shore pension liability.

The Utilities' Initial Brief addressed why Peoples Gas' pension asset should be included in rate base, as well as why the Staff and AG-CUB-City positions are incorrect and inconsistent. NS-PGL Init. Br. at 40-45.

In its Initial Brief (at 29), Staff cites the 2008, 2004, and 1995 Northern Illinois Gas Company ("Nicor") rate cases where the Commission approved rate bases that reflected deductions for OPEB liabilities but did not incorporate pension assets. However, in those cases, the Commission found as a matter of fact that the pension assets were created by ratepayer-supplied funds. The Order in the 1995 case indicates that the pension balance had gone from negative to positive since the utility's 1987 rate case without any pension plan contributions. *In re Northern Illinois Gas Co.*, ICC Docket No. 95-0219, 1996 Ill. PUC Lexis 204 at *20 (Order April 3, 1996) ("*Nicor 1996*"). The Commission's Order in *Nicor Gas 1996* distinguished the Commission's approval of inclusion of a pension asset in rate base in *In re Central Illinois Light Co.*, ICC Docket No. 94-0040, 1994 Ill. PUC Lexis 577 (Order Dec. 12, 1994) ("*CILCO*"), on the grounds that there the utility, unlike Nicor Gas, had made pension plan contributions and the inclusion was not a contested issue. *Nicor Gas 1996* at *22. The Commission expressly noted in the 2004 case that Nicor acknowledged that it had made <u>no</u> pension plan contributions since the 1995 case. *In re Northern Illinois Gas Co.,* ICC Docket

No. 04-0779, at 22 (Order Sept. 20, 2005) ("*Nicor 2005*"). In the Order for the 2008 case, the Commission merely affirms that "the *facts* have not changed" from the previous two rate cases (emphasis added). *Nicor 2008* at 18. Thus, the *Nicor 1996, Nicor 2005,* and *Nicor 2008* Orders do not support Staff's and AG-CUB-City's proposed adjustments, because the relevant facts as relied upon by the Commission are not the same, and the 1994 *CILCO* case supports inclusion.

Staff's Initial Brief also cites the Commission's Order on Rehearing (December 20, 2006) in ICC Docket No. 05-0597, *Commonwealth Edison Company* ("*ComEd 2005 Rehearing Order*").[6] While the Commission did not include the pension asset in rate base, it allowed ComEd to recover a rate of return (based on the cost of long-term debt) on a pension plan contribution that it made shortly after the test year, that was funded by an equity contribution from the utility's ultimate parent company, and that was a major factor in a *pro forma* adjustment to reflect a lower level of pension expense in the year after the test year. *ComEd 2005 Rehearing Order*, pp. 28-29.

Staff correctly notes (Staff Init. Br. at 29) that the Commission's decision was affirmed on appeal.[7] However, in *ComEd 2005 Appeal*, the Appellate Court stated

> The additional evidence proffered by ComEd on rehearing was directed at proving the sustainability of one of three alternatives it advanced at that time. The Commission accepted ComEd's proofs with regard to the [long-term debt alternative]. The [long term debt alternative] was less expensive than the method ComEd used to fund the pension plan. The Commission disallowed recovery

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[6] While Staff (Staff Init. Br. at 29) and the AG (at 16) argue that Mr. Felsenthal stated that in the *ComEd 2005 Rehearing Order* the Commission allowed a pension asset in rate base, this mischaracterizes Mr. Felsenthal's testimony, which goes on to state:

> Interestingly, in that proceeding, the Commission was persuaded that "ComEd has incurred a cost and that customers have derived some benefit as a result of the pension contribution" (Order on Rehearing, p. 28). A return based on what would have been the utility's long term debt rate, if it had financed the contribution, was allowed on this pension contribution in the rehearing order.

Felsenthal Reb., PGL-NS Ex. AF-1.0 at 26:552-556.

[7] *Commonwealth Edison Co. v. Illinois Commerce Comm'n, et al.*, Nos. 2-06-1285 Cons. (Ill. App. Ct. 2d Dist. Sept. 17, 2009) ("*ComEd 2005 Appeal*").

> beyond what the third alternative would have cost. In essence, *ComEd initially failed to carry its burden and subsequently did carry its burden to the extent of the costs represented by the [long-term debt alternative]*. During oral argument, ComEd asserted that there was evidence that would support a finding that it was reasonable for ComEd to fund the plan in the manner it did. However, the evidence is not so compelling that the Commission was required to accept it. (Emphasis added)

ComEd 2005 Appeal at 17. (Emphasis added) While it is certainly true that the court did not "disturb" the Commission's decision, it was not because the court found that pension assets are solely funded by ratepayers or should not be recovered, but instead because ComEd failed to carry its burden in proving that the pension asset should be included in rate base and thus recovered at the utility's full rate of return (its weighted average cost of capital). Thus, as in the Nicor rate cases, it was a factual matter, and it does not stand for the proposition that no return should be allowed, which is what Staff and AG-CUB-City advocate. Here the record supports inclusion of the pension asset in rate base, as discussed in the Utilities' Initial Brief and below.

Further, Staff attempts to characterize Peoples Gas' pension asset as merely a result of a timing difference. *See* Staff Init. Br. at 30. However, Staff fails to recognize that rate base is computed with many items that are timing differences, such as deferred taxes. Felsenthal Sur., NS-PGL Ex. AF-2.0 at 3:52-55. Even the OPEB liability that Staff, AG, and CUB-City propose to deduct from rate base is a timing difference. The fact that a timing difference is involved is irrelevant. *Id.* at 3:55-57. Further, under Staff's reasoning, the Commission would have erred in its *ComEd 2005 Rehearing Order* because a debt return was allowed on a pension asset. *Id.* at 3:58-63.

Additionally, the argument that there is no evidence that the pension asset was created by contributions made by Peoples Gas is without merit. *See* Staff Init. Br. at 33. Utilities witness Mr. Felsenthal explained that Peoples Gas' pension asset is a combination of direct contributions (similar to ComEd in ICC Docket No. 05-0597) or through negative pension expense. Felsenthal

Reb., NS-PGL Ex. AF 1.0 at 27:578-583. Interestingly, Staff continues to limit its Peoples Gas comparison of total cash contributions and pension expense recorded for the last five years, which results in a net pension expense of a positive $18,394,032. Pearce Reb., Staff Ex. 16.0 at 8:189 - 9:225; Staff Init. Br. at 34. However, Staff continues to conveniently ignore that for the eight years before that (1996-2003), there was a total <u>negative</u> pension expense of $174.3 million. There simply is no real evidence that customers funded the pension asset.

The argument that Peoples Gas' pension asset is merely a result of accounting rules, namely Financial Accounting Standards ("FAS") 158 (Staff Init. Br. at 35) must be rejected as well. Contrary to Staff's arguments, the prepaid pension asset upon which Peoples Gas is seeking a return is exactly the level of the pension asset that would exist on a FAS 87 basis (without implementation of FAS 158), which is $152.5 million. Felsenthal Sur., NS-PGL Ex. AF-2.0 at 5:103-6:106. FAS 158 required that (1) the funded status, which is a liability of $70.9 million, to be put on the books as a liability; and (2) the unrecognized actuarial losses and prior service costs recorded as a regulatory asset. *Id.* at 6:106-109. Under FAS 87, these three items were each of a component of the prepaid asset. Thus, the net amount of Peoples Gas' pension asset is unaffected by FAS 158. *Id.* at 6:109-112.

In fact, the accounting rules demonstrate that customers cannot be the source of the pension asset. As Mr. Felsenthal testified, prior to FAS 87, customers were charged for pension expense in accordance with the requirements of Accounting Principles Board Opinion No. 8, which generally resulted in <u>expensing</u> <u>based</u> <u>on</u> <u>funding</u>. The actuaries would establish funding levels to provide for an accumulation of plan assets to meet the projected plan benefits – no more, no less. Therefore, prior to the adoption of FAS 87, amounts expensed were remitted to the plan to pay for plan benefits. Felsenthal Reb., NS-PGL Ex. AF-1.0 at 19:410-415. With the adoption of FAS 87, there was no longer a direct link between expensing and funding. Under FAS 87, a distinct calculation is required each year to determine pension expense under Generally Accepted Accounting Principles which takes into consideration a number of factors including service cost, expected returns, interest on projected obligations, etc. A prepaid pension asset results when there is negative pension expense or when contributions are made into the pension fund – in both cases, investor-supplied funding. Felsenthal Reb., NS-PGL Ex. AF-1.0 at 19:416-20:423.

Staff's position also is inconsistent in that Staff proposes (*see* Staff Init. Br. at 37) to include the North Shore pension liability in rate base. Staff's position is incorrect, and is inconsistent with Staff's testimony in the Utilities' 2007 rate cases. Felsenthal Reb., NS-PGL Ex. AF-1.0 at 2:36-38, 3:52-54, 20:435 - 21:447. Even AG-CUB-City and their witness Mr. Effron propose symmetrical treatment of the Peoples Gas pension asset and the North Shore pension liability. *See id.* at 21:448-449; AG Init. Br. at 15-17; CUB-City Init. Br. at 6-7.

With respect to the Utilities' OPEB liabilities, Staff, the AG, and CUB-City all cite previous Commission Orders, such as *Nicor 2005*, to support their adjustments to subtract the OPEB liabilities from rate base. *E.g.*, Staff Init. Br. at 29. The past Orders each refer to *Nicor 1996*, which differentiates between the two elements of retiree benefits by stating that "NI-GAS continues to control the ratepayer-supplied OPEB funds" implying that control is a distinguishing factor not requiring symmetrical treatment. *Nicor 1996*, 1996 Ill. PUC Lexis 204 at *23. However, control is not an appropriate standard for determining whether an asset or liability should or should not be considered in rate base as there are other elements of rate base that are not within a utility's "control". For example, Accumulated Deferred Income Taxes ("ADIT") are not controlled by the Utilities, yet such amounts are generally considered in the rate base calculation. Felsenthal Reb., NS-PGL Ex. AF-1.0 at 22:461-464. The determinant as to whether an item should or should not be considered in the rate base calculation is the source of the funds. *Id.* at 22:464-469. Because investors have supplied the funding for the pension asset and OPEB funds, they are entitled to a fair return on such funds, no different than if the investor-supplied funds were financing utility property, plant, and equipment. *Id*. at 22:471-473. There is no sound basis for asymmetrical treatment.

Accordingly, for the reasons stated herein and in the Utilities' Initial Brief, it is appropriate to include Peoples Gas' pension asset in its rate base, North Shore's pension liability in its rate base, and the Utilities' OPEB liabilities in their respective rate bases. Alternatively, if the Commission concludes that the Peoples Gas pension asset should not be included in its rate base, then North Shore's pension liability should be excluded (as the AG and CUB-City propose) and the Utilities' respective OPEB liabilities should be excluded as well.

V. <u>OPERATING EXPENSES</u>

A. <u>Overview/Summary/Totals</u>

1. <u>North Shore</u>

North Shore's surrebuttal presented final revised operating expenses and operating income figures of $67,004,000 ($59,946,000 before income taxes) and $16,301,000, reflecting adjustments proposed by Staff and intervenors that the utility agreed with or accepted in whole or in part, and certain updates. NS-PGL Init. Br. at 45; NS-PGL Ex. SM-3.1N. North Shore's operating expenses are supported by extensive, detailed evidence. NS-PGL Init. Br. at 45.

The Commission should approve North Shore's final revised operating expenses. In North Shore's 2007 rate case, the Order, which adopted a large number of contested Staff- and intervenor-proposed adjustments, approved a level of operating expenses before income taxes,

$42,895,000 that is far below North Shore's 2010 test year operating expenses before income taxes, $59,946,000. NS-PGL Init. Br. at 2. North Shore has shown, in detail, the drivers of its increased costs, the vast majority of which are increases in its operating expenses. *Id*. at 4-5. Staff's proposal to reduce North Shore's operating expenses before income taxes to $57,780,000 (Staff Init. Br. at App. B, p. 1) is the product of unwarranted and selective adjustments, and it should not be adopted. (AG-CUB did not provide an "apples to apples" figure.)

2. <u>Peoples Gas</u>

Peoples Gas' surrebuttal presented final revised operating expenses and operating income figures of $455,540,000 and $118,498,000, reflecting adjustments proposed by Staff and intervenors that the utility agreed with or accepted in whole or in part, and certain updates. NS-PGL Init. Br. at 46; NS-PGL Ex. SM-3.1P. Peoples Gas' operating expenses are supported by extensive, detailed evidence. NS-PGL Init. Br. at 46.

The Commission should approve Peoples Gas' final revised operating expenses. In Peoples Gas' 2007 rate case, the Order, which adopted a large number of contested Staff- and intervenor-proposed adjustments, approved a level of operating expenses before income taxes, $325,582,000, that is far below Peoples Gas' 2010 test year operating expenses before income taxes, $403,231,000. NS-PGL Init. Br. at 2. Peoples Gas has shown, in detail, the drivers of its increased costs, a large majority of which are increases in its operating expenses. *Id*. at 4-5. Staff's proposal to reduce Peoples Gas' operating expenses before income taxes to $386,315,000 (Staff Init. Br. at App. A, p. 1) is the result of unjustified and arbitrary adjustments, and it should not be adopted. (AG-CUB did not provide an "apples to apples" figure.)

B. Uncontested Issues

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

This issue is not contested.

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

This issue is not contested.

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

In this section in its Initial Brief, Staff correctly refers to the price used to update company use gas. *See* Staff Init. Br. at 39-40; NS-PGL Init. Br. at 47.

The inclusion of North Shore's company use gas, which originally was inadvertently omitted, is also an uncontested issue. NS-PGL Init. Br. at 48.

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

This issue is not contested.

5. Distribution

a. Gasoline and Fuel

This issue is not contested.

6. Customer Accounts

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

This issue is not contested.

7. Administrative & General Expenses

a. Account 921

This issue is not contested.

b. <u>Interest on Budget Payment Plans</u>

This issue is not contested.

c. <u>Interest on Customer Deposits</u>

This issue is not contested.

d. <u>Lobbying</u>

This issue is not contested.

e. <u>Social and Service Club Dues</u>

This issue is not contested.

f. <u>Civic, Political, and Related Activities</u>

This issue is not contested.

g. <u>Non-union Base Wages Adjustment in DLH–4.06 (PGL)</u>

This issue is not contested.

h. <u>Liberty Audit Outside Contractor Fees (PGL)</u>

This issue is not contested.

i. <u>Rate Case Expenses</u>

This issue is not contested.

j. <u>Franchise Gas Requirements (NS)</u>

This issue is not contested.

k. <u>Regulatory Asset – Welfare</u>

This issue is not contested.

l. Regulatory Asset – Pension

This issue is not contested.

m. Employee Benefits Update

This issue is not contested.

n. Merger Costs and Savings

This issue is not contested.

8. Depreciation

a. Inventory Reclassification

This issue is not contested.

b. IBS Mainframe

This issue is not contested.

9. Taxes Other Than Income Taxes

a. Real Estate Taxes

This issue is not contested.

10. Revenues

a. Accounting Charge Revenues

This issue is not contested.

11. **Gross Revenue Conversion Factor**

This issue is not contested, although the Utilities note that Staff's Initial Brief's calculations, in applying the North Shore Gross Revenue Conversion Factor, incorrectly used 1.671045 rather than the correct figure of 1.671313.[8]

C. Contested Issues

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

Staff's and AG-CUB's respective proposed disallowances of the Utilities' incentive compensation costs (*see* Staff Init. Br. at 48-66; AG Init. Br. at 10-12; CUB-City Init. Br. at 7-9) should not be adopted. They are based on many grounds, they are complicated (in Staff's case), and they rely on many citations to past Commission Orders plus a recent Appellate Court opinion. What they are not, however, is reasonable. Nor, on this evidentiary record, are they lawful, despite the Appellate Court opinion.

The Utilities' Initial Brief sets forth numerous facts relating to the Utilities' total compensation levels and their incentive compensation program designs and costs that are established by uncontradicted evidence. Those uncontested facts include, among other things, that: (1) the Utilities design their total cash compensation packages (base pay plus target incentive pay) at market median based on other energy service companies based on data from Towers Perrin, a nationally recognized compensation and benefits firm; (2) the Utilities design their total compensation programs, including their incentive compensation programs, in order to attract and retain a sufficient, qualified, and motivated work force; and (3) attracting and retaining such a work force benefits customers by making sure there are enough employees to

[8] Staff still agrees that the correct figure is 1.671313. *E.g.*, Staff Init. Br. at App. B, p. 7, line 8. However, Staff's rate increase figure before grossing up is $7,308,000 (*id*. at p. 1, sum of line 23, columns (e), (f), and (h)) and after grossing up is $12,212,000 (*id*. at line 27), which means Staff mistakenly used 1.671045.

perform needed work, by maintaining and improving the quality of work, and reducing the expenses associated with recruiting and retaining new employees.[9] NS-PGL Init. Br. at 56. The Commission must apply Illinois law regarding uncontradicted evidence. *Id*. at 58 and fn. 70.

Nothing in the Initial Briefs of Staff, the AG, or CUB-City alters those facts. Staff and AG-CUB do not claim, much less offer any evidence, that the Utilities' total compensation levels are imprudent or unreasonable, or that the incentive compensation program designs or costs are imprudent or unreasonable, apart from Staff's and AG-CUB's contentions that the designs do not warrant cost recovery under the Commission's standards.

The Initial Brief of the Utilities also contended that, under Illinois Supreme Court decisions, a utility has a well-established right to recover its prudent and reasonable costs of service; that this principle applies to employee salaries; and, that the disallowance of the Utilities' incentive compensation costs on this evidentiary record would be unlawful. NS-PGL Init. Br. at 58-60 (citing *Citizens Utility Board v. Illinois Commerce Comm'n*, 166 Ill. 2d 111, 121 (1995) ("*CUB*"); *Citizens Utilities Co. v. Illinois Commerce Comm'n*, 124 Ill. 2d 195, 200-201 (1988); *Villages of Milford v. Illinois Commerce Comm'n,* 20 Ill. 2d 556, 565 (1960) ("*Milford*"); and distinguishing *ComEd 2005 Appeal*; *DuPage Util. Co. v. Illinois Commerce Comm'n,* 47 Ill. 2d 550, 560 (1971) ("*DuPage*"); *Candlewick Lake Utilities Co. v. Illinois Commerce Comm'n*, 122 Ill. App. 3d 219, 226 (2d Dist. 1983) ("*Candlewick*")).

The questions before the Commission, therefore, are whether Staff or AG-CUB have shown reasonable grounds that warrant their proposed disallowances in the face of those facts under the Commission's standards and, if so, whether the application of those standards is lawful. The Utilities respectfully submit that the answer to both questions is no.

[9] Staff and AG-CUB dispute that the above customer benefits warrant cost recovery under the Commission's standards, but Staff and AG-CUB do not deny that these customer benefits exist.

Staff argues that its successive percentage disallowances, which end up disallowing very close to 100% of the Utilities' executive and non-executive incentive compensation program costs, are warranted on four grounds: (1) the plans include "financial" (net income) metrics that fail the Commission's cost recovery standards, (2) the 2010 targeted levels are unlikely to be achieved, (3) the plans incorporate affiliate performance metrics, and (4) the plans have an Integrys net income trigger (gate). Staff Init. Br. at 50-51, *et seq*.

As to Staff's first ground, Staff is right that the Commission in many cases has found that "financial" metrics do not fall within the Commission's standards, and that the Commission in several cases has held or stated that that reasoning applies to net income metrics. The initial question is whether the Commission should do so again here. The Commission should not do so, for three reasons. First, the Commission is required to establish rates that are just and reasonable to the utility and its shareholders as well as customers. 220 ILCS 5/9-201(c); *Business and Professional People for the Pub. Interest v. Illinois Commerce Comm'n*, 146 Ill. 2d 175, 208 (1991) ("*BPI II*"). Even assuming that financial metrics benefit shareholders, that is not a basis for disallowing them. Indeed, Staff's witness acknowledged that the fact that a metric benefits shareholders does not necessarily mean that it does not also benefit customers (Hathhorn, Tr. 714:16 - 715:17), although she did claim in her written testimony, citing past Commission Orders, that net income metrics do not benefit customers.

Second, the financial metrics at issue here, net income metrics, do in fact benefit customers. Staff's witness's testimony on this point apparently proceeds from the premise that net income metrics *a priori* do not benefit customers, because she offers only citations to past Commission Orders, not facts or reasoning, to support that conclusion. Net income metrics indisputably have both a cost side and a revenue side, however, by definition. Hoover Reb., NS-PGL Ex. JH-1.0 at 4:74-75. Even though the Commission has not approved net income metrics in prior cases, it has approved cost control metrics.[10] So, logically, the costs tied to net income metrics should be allowed. Hoover Reb., NS-PGL Ex. JH-1.0 at 4:75-80. In the alternative, they should be disallowed only by half. AG-CUB witness Mr. Effron proposed to disallow only half of the Utilities' incentive compensation costs on the grounds that the metrics are financial (except for his proposal to disallow all costs allocated from affiliates as financial). Effron Dir., AG-CUB-City Ex. 1.0 at 20:426 - 21:462. Even Staff's witness acknowledged that if a metric benefits both shareholders and customers, that that does not mean that shareholders should bear all of the costs. Hathhorn, Tr. at 714:16 - 715:17.

Finally, application of the "financial" metric disallowance standard on the facts of the instant cases is not lawful, as discussed further below.

Staff's second ground, the "unlikely to achieve" ground, is very unconvincing. The Utilities' payment of substantial incentive compensation costs was recognized in their 2007 rate cases. *See Peoples 2007* at 57-67. Moreover, Staff does not deny that the Utilities paid substantial amounts in 2007 and 2008. Furthermore, the evidence is that the targets are set each year to motivate employee behavior and are considered achievable stretch goals designed to motivate employee achievement from a competitive level to an outstanding level. Hoover Sur., NS-PGL Ex. JCH-2.0 at 4:67-69. Staff's witness appears in effect to be complaining that when employees failed to meet certain target levels in 2007 and 2008 their incentive compensation was reduced (Hathhorn Dir., Staff Ex. 1.0 at 10:213 - 11:236), but that is exactly how the programs are supposed to work. Staff's two factual examples are particularly poor choices as support for

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

Staff's position, moreover, because they involve system leak reductions and occupational safety metrics, two metrics that are operational, not financial, even under the most narrow view of the Commission's standards. Those are exactly the kinds of things that the Commission has made clear that it is desirable to encourage.

Staff's third ground is that the metrics include affiliate performance metrics, but the Utilities' witness pointed out that the Utilities and their affiliates share a team-based philosophy that encourages the sharing of best practices that benefit Illinois customers, and that affiliates share in staff support and thus in the support expense. Hoover Reb., NS-PGL Ex. JCH-2.0 at 6:121-125. Staff's brief seems to scoff at the value of sharing best practices (*see* Staff Init. Br. at 58), but, tellingly, it cites no evidence on that point.

Staff's fourth ground is the plans have an Integrys net income trigger, but the discussion of financial and affiliate-related metrics above applies to that ground.

Furthermore, Staff's Initial Brief, like its testimony, never comes to grip with the fact that Staff's application of the Commission's past standards is illogical and unreasonable. Even when the total compensation paid to employees is prudent and reasonable, Staff's application of the Commission's past decisions would result in arbitrary and illogical selective disallowances depending on the metrics of the incentive portions of the compensation. Hathhorn, Tr. at 719:22 – 727:14. That also makes no sense because, as noted above, Staff's witness admitted that the fact that a metric benefits shareholders does not necessarily mean that it is contrary to the interests of customers, and that if a metric benefits both shareholders and customers that does not mean shareholders should bear all of the costs associated with the metric.

Staff's proposed stock plans disallowance depends on similar grounds and suffers from the same flaws as the parallel grounds of its proposed executive and non-executive plan disallowances. *Compare* Staff Init. Br. at 63-64 *with* NS-PGL Init. Br. at 57.

Staff's remaining disallowances, which are based on reflecting disallowances in the Utilities' 2007 rate cases, are founded on the Order in those cases, which Staff correctly notes is still in place but on appeal. Staff Init. Br. at 65-66.

Thus, for all of the above reasons, Staff's proposed disallowances, on their merits, should not be adopted. However, even if those proposals had merit under the Commission's standards, they should not be adopted, because, on this evidentiary record, they are not lawful.

Staff argues that the *ComEd 20005 Appeal* decision defeats the Utilities' legal argument that it is improper to disallow prudent and reasonable incentive compensation costs based on the Commission's standards. Staff Init. Br. at 49-50. Staff is mistaken.[11]

The Second District, in the appeal from the 2005 ComEd rate case, noted the established law cited above on a utility's right to recovery of its prudent and reasonable costs, but added that the costs must pertain to the utility's tariffed services, citing *DuPage* and *Candlewick* and distinguishing *Milford*. *ComEd 2005 Appeal* at 10-11, 14. However, the Utilities' Initial Brief pointed out that *DuPage* and *Candlewick* are not on point. NS-PGL Init. Br at 59-60 and fn. 71. *DuPage* and *Candlewick* rely upon evidence that the employees were not performing work for the utilities and/or had excessive compensation. *Id*. There is no claim, much less any evidence, of excessive compensation on those or any other grounds in the instant cases.

[11] Staff (Init. Br. at 52) also cites the disallowance of lobbying expenses as an example of disallowing prudent and reasonable expenses, but, as Staff's witness recognized, that is based on Section 9-224 of the Public Utilities Act, 220 ILCS 5/9-224, and there is no such provision of the Act as to incentive compensation costs. Hathhorn Reb., Staff Ex. 15.0 at 13:305-307 and fn. 5; Hathhorn, Tr. at 715:19 - 716:16.

Furthermore, and critically, as the Utilities noted in their Initial Brief (at 60), the Second District, which took the unusual step of noting that if it was deciding this issue in the first instance it might agree with the utility, expressly relied on the fact that the Commission had approved half of ComEd's incentive compensation costs. *ComEd 2005 Appeal* at 14. In the 2005 ComEd rate case, the Commission allowed the utility to recover half of its incentive compensation costs, much like the Commission did (approximately) in the Utilities' 2007 rate cases. NS-PGL Init. Br. at 59. Here, however, Staff proposes to disallow almost 100% of the Utilities' incentive compensation costs, even though they include some "operational" metrics, such as metric tied to system leak reductions. Thus, the "tangential benefit" and "apportionment" reasoning of the Second District (*see ComEd 2005 Appeal* at 14) does not apply here, as pointed out in the Utilities Initial Brief (at 60). Staff's proposed disallowances, therefore, remain contrary to law.

The AG's and CUB-City's Initial Briefs, and their underlying testimony, do not identify any other ground for disallowance here. Thus, their proposed disallowances also should not be adopted.

However, in the alternative, if the Commission were to order any disallowances here, then they should be no greater than AG-CUB's proposed adjustments, which would disallow roughly half of the Utilities' incentive compensation costs. The Utilities note that, while they respectfully differ from the Second District's reasoning as well as taking the position that it is not applicable here in any event, AG-CUB's proposed adjustments, by disallowing roughly half of the costs, would move this aspect of this Docket closer to the facts on which the Second District relied in its "tangential benefit" and "apportionment" reasoning. The evidence that Staff's application here of the Commission's past standards is illogical and unreasonable, and Staff's admissions on cross-examination, also support disallowing no more than half of the costs at issue.

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

Staff's proposal for further decreases in non-union base wages, beyond the amount to which the Utilities have agreed (Staff Init. Br. at 44, 66-69; *see also* NS-PGL Init. Br. at 61-62), lacks merit and should not be adopted.

Staff proposes to further reduce the 2010 test year non-union base wages based on a two-step methodology that starts with the 2008 actual amounts and then escalates them for each of 2009 and 2010 using a 2.2% inflation rate, based on general Consumer Price Index ("CPI") inflation data that became available in May 2009. Hathhorn Reb., Staff Ex. 15.0 at 19:432 - 20:443 and Scheds. 15.8N and 15.8P.

As the Utilities' Initial Brief (at 61-62) pointed out, Staff's proposal as to the 2009 step is erroneous and unreasonable. Staff proposes to escalate the Utilities' 2009 non-union base wages from 2008 actual levels based on general CPI data that became available in May 2009, but the Utilities increased their non-union base wages for 2009 in February 2009, three months before Staff's data became available. Hoover Sur., NS-PGL Ex. JCH-2.0 at 5:91-93. That retroactive look back on the February 2009 increases based on general CPI data from May 2009 is inappropriate, and, moreover, the lower level of wage increases that Staff hypothesizes would result in non-competitive salaries. *Id*. at 5:88-98.

The evidence also shows that Staff's proposal is flawed as to both 2009 and 2010 because of its reliance on general CPI information and its rejection of labor market data. NS-PGL Init. Br. at 62. There is no valid basis for rejecting labor market data actually used by the Utilities in making human resources decisions and supported by a human resources expert in favor of general CPI information supported by a witness who is not an expert in this subject. *Id*. That the Commission, based on other evidentiary records, has relied on general CPI information in other cases in determining salaries and wages adjustments (Staff Init. Br. at 68-69) is not a reasonable basis for doing so given the evidence in the instant cases.

Finally, Mr. Hoover's testimony that the increases proposed by Staff for both 2009 and 2010 would result in non-competitive salaries (Hoover Reb., NS-PGL Ex. JCH-1.0 at 10:214-216; Hoover Sur., NS-PGL Ex. JCH-2.0 at 5:88-98) is uncontradicted.

Staff's proposal for further reductions in the Utilities' non-union base wages, beyond those accepted in the Utilities' rebuttal testimony, are not justified and should be rejected.

3. <u>Headcounts</u> (Falls in Multiple Categories of O&M)

The Commission should not adopt AG-CUB's proposed adjustments relating to the Utilities' headcounts. Staff agrees that the AG-CUB proposal should be rejected as to Peoples Gas based on the evidence, while taking no position as to North Shore. Staff Init. Br. at 69.

AG-CUB's proposal is based on extrapolation of a trend line based on 2008 and mid-2009 data (NS-PGL Init. Br. at 63; AG Init. Br. at 13-15; CUB-City Init. Br. at 9-10), but the issue is the 2010 test year, and the Utilities provided more than sufficient testimony that they would be hiring more employees, including evidence of recent hires. NS-PGL Init. Br. at 63 and fn. 72.[12] The Commission should reject AG-CUB's proposal.

[12] The AG offers speculation, nothing more, that the recent hires might have been offset by retirements or employees leaving. *See* AG Init. Br. at 15.

4. <u>Distribution Expenses</u>

a. <u>Liberty Audit-Related Expenses (PGL)</u>

Staff continues to argue for a proposed adjustment to reduce Peoples Gas' 2010 test year operating expenses by $4,961,000 on the grounds that this is warranted under the Commission's Order in *Illinois Commerce Comm'n on its Own Motion v. The Peoples Gas Light and Coke Co.*, ICC Docket No. 06-0311 (Order Dec. 20, 2006) ("*06-0311 Order*"). Staff Init. Br. at 69-85. Staff's proposed disallowance must be rejected because it is not supported by, and instead is contrary to, both the evidence and the *06-0311 Order*.

i. <u>ICC Docket No. 06-0311</u>

On April 19, 2006, the Commission initiated ICC Docket No. 06-0311 based on a Staff report dated October 19, 2005. The Staff report arose out of Pipeline Safety record audits conducted by Staff in January 2004 and March 2005 at Peoples Gas relating to 2003 and 2004, respectively, and subsequent communications and review relating to compliance with the Pipeline Safety Act and regulations thereunder. *See Illinois Commerce Comm'n on its Own Motion v. The Peoples Gas Light and Coke Co.*, ICC Docket No. 06-0311, at 1-3 (Citation Order April 19, 2006); *see also 06-0311 Order* at 3-4.

The proceedings in ICC Docket No. 06-0311 led to a final Order, the *06-0311 Order*, in which the Commission approved a proposed settlement agreement (reflected in a joint motion and a "Stipulation") among Staff, Peoples Gas, and intervenors. *06-0311 Order* at 2, 5-9.

The "Record Evidence" section of the *06-0311 Order* is based on the testimony of Staff witness Mr. Burk in that Docket, submitted by Staff and intervenors in support of the proposed settlement agreement. *Id*. at 3-4. The Record Evidence section discusses events in 2003, 2004, and 2005 (plus one reference to 2002). *Id*. The section then concludes with this paragraph:

> In January 2006, Staff conducted an analysis of the corrosion control records maintained by Peoples. The review included a historical review of corrosion control test points that were recorded as having less than adequate levels of cathodic protection and remedial actions that had been taken. All of the test points reviewed by Staff in Peoples Gas' records indicated adequate levels of protection.

Id. at 4 (citation omitted).

The Record Evidence section is followed by a section that sets forth the proposed settlement's terms as memorialized in section 9 of the Stipulation, and then by a section in which the Commission approves the proposed settlement. *Id*. at 5-7.

Staff's proposed disallowance in the instant cases is based on Findings and Ordering paragraph 11 of the *06-0311 Order*. There, using agreed language from section 9(E) of the Stipulation, the Commission ordered, in relevant part, as follows:

> pursuant to its agreement in the Stipulation, Peoples Gas shall not seek recovery, in any future rate or reconciliation proceeding before the Commission, of costs or expenses solely attributable to Peoples Gas' not performing corrosion inspections in a timely manner, as specified in paragraph 4 above, or any incremental costs caused solely by violation of the Illinois Gas Pipeline Safety Act or its implementing regulations ("the Act") discovered by the Commission's consultant retained pursuant to the Memorandum of Understanding, and which are over and above the prudent and reasonable costs necessary to comply with the Act. Peoples Gas shall operate an internal tracking mechanism to account for any such incremental costs. ****

06-0311 Order at 8 (Findings and Ordering Paragraph 11). *See also id*. at 6 (Stipulation section 9(E)). Findings and Ordering Paragraph 11, again paralleling Stipulation section 9(E), also provided in part that Peoples Gas should not recover fees paid to the consultants retained by Peoples Gas or the Commission in connection with or as a result of the Docket. *Id*. at 6, 8.

The consultant referred to in Findings and Ordering paragraph 11 was provided for in Findings and Ordering paragraph (6) and Stipulation section 9(C). *Id*. at 5, 8. The Commission subsequently retained the Liberty Consulting Group as that consultant. Liberty's investigation began in May 2007. Burk Reb., Staff Ex. 23.0 at Attachment A, p. ES-1 and p. 2. Liberty issued its final report on August 14, 2008. *Id*. at Attachment A, cover page. Peoples Gas briefly retained the Huron Consulting Group to help set up a project management office to address Liberty's recommendations. Doerk Sur., NS-PGL Ex. 3.0 at 10:204-207.

ii. The Evidence

Staff's proposed disallowance is based on the allegation that there must be costs in Peoples Gas' 2010 test year operating expenses solely attributable to not performing corrosion inspections in a timely manner or incremental costs due solely to violations of the Pipeline Safety Act discovered by Liberty. Staff Init. Br. at 76-77. However, other than pointing to fees of Liberty and Huron related to the Liberty Audit, which Peoples Gas already has agreed should not be included in, and already has removed from, its revenue requirement (*see* NS-PGL Init. Br. at 50), Staff has pointed to no instance in which costs prohibited from recovery are included in the test year costs. That is because none exist.

Utilities witness Mr. Doerk, the Vice President of Gas Operations for each of the Utilities who has been in gas operations with Peoples Energy Corporation or its subsidiaries for thirty years, testified at the hearing that Peoples Gas caught up on corrosion inspections and corrective actions in 2005 and since then has hired additional corrosion control inspectors but no more than the number that was prudent and reasonable:

> Q. You mentioned that Peoples Gas took certain actions to reduce the backlog of inspections. What did it do?
>
> A. The inspections or the corrective actions based on the inspections? We hired a contractor to reduce the backlog of corrective actions. The inspections were caught up in 2005.
>
> Q. And over this period from 2005 to the present, did Peoples Gas also hire more corrosion control inspectors?
>
> A. Yes, we did.

> Q. Would you say Peoples Gas hired more corrosion control inspectors than were necessary?
>
> A. We hired enough to do all of the inspections and do trouble shooting. We hired enough inspectors that would be able to cover all the work.
>
> …
>
> Q. Did you hire more than what you considered to be necessary? If 8 new inspectors is what was prudent and reasonable, did you hire more than 8?
>
> A. No, we hired what was required to get the work done.

Tr. at 640:14-641:16.

The uncontradicted evidence is that the only costs Peoples Gas incurred arising out of the concerns raised by the Staff audits in 2004 and 2005 and the subsequent developments through the Liberty audit and thereafter were prudent and reasonable costs of complying with the Pipeline Safety Act. *Id.*; Doerk Reb., NS-PGL Ex. ED-2.0 at 7:153-157; Doerk Sur., NS-PGL Ex. ED-3.0 at 7:135-138. Mr. Doerk, addressing the items that Staff witness Mr. Burk's rebuttal cited as violations based on the findings of the Liberty Audit, explained in detail why the actions taken by Peoples Gas to address Liberty's recommendations were not over and above prudent and reasonable costs necessary to comply with the Pipeline Safety Act. Doerk Sur., NS-PGL Ex. ED-3.0 at 7:135 - 10:203. Even Mr. Burk, with respect to each item he cited as a violation, agreed that Peoples Gas addressed those violations using reasonable means to comply with the Pipeline Safety Act. Burk, Tr. at 942:15 – 945:3. Mr. Burk and Mr. Doerk also agreed that the steps taken by Peoples Gas have improved its compliance with the Pipeline Safety Act. Burk, Tr. at 942:15 – 945:3; Doerk Sur., NS-PGL Ex. ED-3.0 at 8:155-159.

Neither of the two Staff witnesses on this subject, Mr. Burk and Staff witness Ms. Hathhorn, cited any outages, reliability problems, fires, explosions, leaks, or other similar problems caused by Pipeline Safety Act violations since the final Order in ICC Docket No. 06-0311.

Instead, Mr. Doerk, who said that such problems would definitely come to his attention as head of operations if they occurred, affirmatively stated that there were no such events. Doerk Reb., NS-PGL Ex. ED-2.0 at 7:153 – 8:163; Doerk, Tr. at 639:6 – 640:6. That evidence is uncontradicted. In fact, when Staff tried to point to corrective action that resulted in incremental costs, Mr. Doerk testified that such work was done in 2005, prior to the *06-0311 Order*. Tr. at 644:7-645:4.

Thus, the evidence shows that, under the *06-0311 Order*, no disallowance is proper. There has been no showing of incremental costs, much less that they are over and above the prudent and reasonable costs necessary to comply with the Pipeline Safety Act. The opposite has been shown.

Staff (Init. Br. at 74-76) cites the Commission's Order in *In re Central Illinois Light Company*, ICC Docket No. 94-0040, 1994 Ill. PUC Lexis 577 (Order Dec. 12, 1994) ("*CILCO 94-0040*"). However, the facts in that case are very different, and the principle that was stated and applied by both Staff and the Commission in that case supports Peoples Gas here, not Staff.

In *CILCO 94-0040*, based on the evidence in the record in that Docket, the Commission found both that the utility had been imprudent and that the utility's imprudence had caused significant incremental amounts to be spent that otherwise would not have been spent.

> The Commission has reviewed the evidence and the arguments of the parties as they relate to the manner in which CILCO maintained its Springfield cast iron system and the manner in which it responded to the discovery of its imminent failure. The Commission concludes that the weight of the evidence leads to the inexorable conclusion that CILCO, for an unspecified period of time prior to the discovery of gas in Springfield manholes by Commission personnel in the spring of 1992, had been engaged in a systematic course of conduct intended to underreport the number and severity of gas leaks occurring on its Springfield

> cast iron distribution system. The Commission further finds that this course [*25] of conduct led to the existence of a substantial threat to public safety, which necessitated the immediate and accelerated replacement of the majority of the cast iron system and the expenditure of significant sums that would not have been spent but for CILCO's imprudence.

CILCO 94-0040 at **24-25. (*See also* Staff Init. Br. at 75.) Staff there submitted evidence, and the Commission specifically found, that the utility's imprudence required the utility to spend more to fix the problems than the utility would have spent if it had acted prudently. *CILCO 94-0040* at **25, 27, 29-30. (*See also* Staff Init. Br. at 75.) Accordingly, Staff there proposed to disallow the incremental portion of the amounts spent by the utility that were due to imprudence, and the Commission agreed that that was the correct measure of the disallowance. *CILCO 94-0040* at **30-35, 40-42. (*See also* Staff Init. Br. at 75.) The Commission expressly rejected an intervenor's contention that the entire amount spent (apart from a certain amount already scheduled to be spent), rather than the incremental amount spent due to the imprudence, should be disallowed, finding not only that disallowing more than the incremental amount was unwarranted but also that it would create an incentive to put off dealing with dangerous situations. *CILCO 94-0040* at **37-41. The Commission's adoption and application of the principle that only incremental amounts due to the imprudence should be disallowed could not be clearer. For example, the Commission held: "Here, the Commission concludes that the disallowances should be imposed only to the extent that the expenses and investment exceed the levels that would have been incurred absent imprudence on the part of CILCO." *Id*. at *40.

Staff now claims (Init. Br. at 75) that "[t]he reasoning and analysis in CILCO is applicable here", but the reasoning and analysis in *CILCO 94-0040* supports the rejection of Staff's proposal here.

As stated in the Utilities' Initial Brief and discussed above -- unlike CILCO in *CILCO 94-0040* -- what Peoples Gas did not do was to ignore the problems that were discovered in a way that led to incremental costs attributable to untimely inspections or to violations of the Pipeline Safety Act over and above the level of prudent and reasonable costs. Other than the fees of Liberty and Huron that Peoples Gas already has removed from its revenue requirement, as referenced earlier, Staff can point to no incremental expense that is in Peoples Gas' revenue requirement that is due solely to untimely corrosion inspections or to violations of that statute. The evidence shows that there is none, as discussed above.

Staff's inference that there must have been incremental costs is supported by no evidence and stands in sharp contrast to the evidence of incremental costs that Staff presented in *CILCO 94-0040*. Unlike CILCO, Peoples Gas had no incremental expenses to track, and no incremental expenses to exclude from its 2010 test year operating expenses.

Finally, Staff's argument for its proposed disallowance, and its methodology for calculating the disallowance, are based upon yet another faulty premise, *i.e.*, that there were incremental costs incurred in 2008 over and above the level of costs that was prudently and reasonably incurred to comply with the Pipeline Safety Act and that those incremental costs were incorporated in the 2010 test year forecast. Staff states in part as follows:

> Much of the work associated with the audit was performed in 2008, and the [Liberty] audit report was issued in August 2008. These facts are uncontested as Mr. Doerk's testimony confirms that the Company started responding to the Liberty audit findings during the audit period. [Doerk Sur.,] NS-PGL Ex. ED-3.0, p. 8, lines 163-164 and p. 9, lines 184-186. In addition, as explained above, other actions to address the violations identified in the *06-0311 Order* occurred in 2008.

Staff Init. Br. at 80-81.

That statement only further demonstrates that Staff's proposal, and its approach to calculating its disallowance, are without merit. As that statement illustrates, Staff's proposal and the calculation of its disallowance, equate responding to Liberty's findings and recommendations with what is prohibited from recovery under the *06-0311 Order*. That is wrong. The *06-0311*

Order provides for disallowance if and only if there are incremental costs due to untimely inspections or violations of the Pipeline Safety Act discovered by Liberty above the level of prudent and reasonable costs, as discussed earlier. The evidence shows that there are no such incremental costs, as also discussed earlier. Peoples Gas would never have agreed to the settlement agreement that was the basis of the *06-0311 Order* if its intent were to disallow prudent and reasonable costs of complying with the Pipeline Safety Act as Staff's proposal now seems to suggest. Schott Reb., NS-PGL Ex. JFS-2.0 at 14:253 - 15:257.

Moreover, an examination of the testimony cited by Staff above shows that it refutes, rather than supports, the existence of any such incremental costs. Lines 163 to 164 of Mr. Doerk's surrebuttal simply state: "Peoples Gas was proactive in addressing most of the Liberty recommendations related to corrosion control before the final Liberty investigation report was issued." Doerk Sur., NS-PGL Ex. ED-3.0 at 8:163-164. The next two sentences state: "Responsibility for the corrosion control function has been centralized, and, as Mr. Burk acknowledged, the inspections and trouble shooting activities have been reassigned to dedicated, qualified technicians, and many new highly qualified technicians have been hired. Since these steps were required to comply with the [Pipeline Safety] Act, the related costs cannot be considered over and above prudent and necessary to comply with the Act." *Id*. at 8:164 - 9:169. Lines 184 to 186 of the surrebuttal do discuss that Peoples Gas hired one contractor for two months in 2008 to help address the most difficult corrosion protection cases. *Id*. at 9:184-186. The immediately following sentences of the surrebuttal once again explain, however, that this did not involve costs over and above those that were prudent and necessary to comply with the Pipeline Safety Act. *Id*. at 9:186-10:194. As noted earlier, Mr. Doerk's surrebuttal went through each of the items raised by Mr. Burk's rebuttal and explained why they did not lead to such incremental costs. *Id*. at 7:135 - 10:203.

Furthermore, nowhere in Mr. Doerk's testimony does he state that all the work pertaining the *06-0311 Order* or even the Liberty Audit was performed between January 1, 2008 and June 30, 2008 (the period of actual data for 2008 that was used in developing the 2010 forecast). The evidence demonstrates the opposite. First, the "catchup" work that resulted from the 2004 and 2005 Staff audits was completed in 2005, not 2008. As Mr. Doerk also testified:

> Q. And would you agree that in that docket the Commission found that the Company failed to perform certain corrosion inspection activities in a timely manner?
>
> A. From 2003 and 2004.
>
> Q. And using that as a basis, was there some catchup work that had to be performed subsequent to that period as a result of not timely performing those inspections?
>
> A. Those inspections were compliant in early 2005.
>
> …
>
> Q. Well, there were some corrosion inspections that were not performed when they were originally supposed to be performed that had to be performed to at least come into compliance on a going forward basis, correct?
>
> A. Those were taken care of in 2005.

Tr., 630:18 - 631:6, 634:6-11. Second, Liberty began its audit in May 2007, and Peoples Gas began responding before the Liberty's final report was issued, as noted earlier. Finally, again, Mr. Doerk's surrebuttal addressed the actions taken in 2008 and showed that they did not result in incremental costs above the level of prudent and reasonable costs.[13]

[13] Staff seems to infer that an employee's performing an action that should have been performed in a prior period somehow automatically means that there are incremental costs above the level of prudent and reasonable costs, but that simply is not correct. *E.g.*, Schott, Tr. at 151:7 - 152:9.

To be clear, the record does reflect that in 2008, in response to certain of the Liberty Audit recommendations, Peoples Gas increased its employee headcount. Gregor Dir., PGL CMG-1.0 Rev at 16:348-350. However, even Staff witness Mr. Burk recognized that these costs were reasonable and prudent. Tr. at 944:12-945:3. *See also* Section V(C)(3), *supra*, of this Reply Brief, regarding Peoples Gas' headcount.[14]

To disallow prudent and reasonable costs of coming into compliance with the Pipeline Safety Act would be contrary to the *06-0311 Order*. As Utilities witness Mr. Schott stated:

> Furthermore, Ms. Hathhorn's misreading in her direct testimony is compounded in her rebuttal testimony, where she states "If a utility violates applicable statutes or rules that result in that utility incurring more costs than it would have otherwise incurred without those violations, *even if those additional costs are to come into compliance*, then ratepayers should not bear the additional costs resulting from the utility's violations." (Hathhorn Rebuttal, ICC Staff Ex. 15.0, lines 630-634, emphasis added). Again, that flies directly in the face of the Commission's decision in ICC Docket No. 06-0311, where the Commission stated: "Peoples shall not seek recovery …of costs or expenses …and which are over and above the prudent and reasonable costs necessary to comply with the Act." Paragraph VI (11), ICC Docket No. 06-0311.

Schott Sur., NS-PGL Ex. JFS-3.0 at 7:153 - 8:162.

To disallow prudent and reasonable costs of coming into compliance with the Pipeline Safety Act also would be contrary to public policy. Schott Reb., NS-PGL Ex. JFS-2.0 at 14:249-253, 15:258-267. *See also CILCO 94-0040* at **37-41.

Finally, Staff's selection of the very large amount of 5% of total 2010 test year distribution operating and maintenance expenses, which translates to $4,961,000, as the quantification of its proposed disallowance (*see* Hathhorn Dir., Staff Ex. 1.0 at 35:830-844) is arbitrary, unreasonable, and obviously very excessive. Staff's characterization of the 5% figure

[14] To the extent that Staff's proposed disallowance here is based on disallowing a portion of Peoples Gas' distribution O&M expenses in general, and even moreso Peoples Gas' labor costs in particular, it overlaps with AG-CUB's proposed adjustment discussed in Section V(C)(3), *supra*.

as "conservative" (*id*. at 35:840) does not alter the fact that it comes out of thin air. Schott Reb., NS-PGL Ex. JFS-2.0 at 15:268-275. The assertion that the 5% figure is "reasonable" because 2008 costs were escalated by 2.0% and 1.8% for 2009 and 2010 for forecasting purposes (*id*. at 35:842-844) makes no sense. There is no logical relationship between the percentage by which total costs increased in 2009 and 2010 and any assumption about how much costs of a particular kind, if any, existed in 2008 in the first place to be escalated. Schott Reb., NS-PGL Ex. JFS-2.0 at 15:268-275. Staff's attempt to criticize Peoples Gas for not having a tracking mechanism does not justify Staff's approach. The *06-0311 Order* expressly required tracking of defined incremental costs. *06-0311 Order* at 8 (quoted earlier). There were no such costs, as the earlier discussion shows. Staff's witness admitted that Peoples Gas was not required to track non-incremental costs. Hathhorn, Tr. at 730:4 - 731:5; NS-PGL Cross Hathhorn Ex. 24.

Utilities witness Ms. Gregor, in her direct testimony, addressed the main drivers of the increases in Peoples Gas' distribution operations and maintenance from 2007 to 2010. Gregor Dir., PGL Ex. CMG-1.0 Rev. at 16:335-351. That testimony is uncontradicted. The only driver that was related to the subject at hand here was the increased headcount related to the implementation of Liberty's recommendations. The testimony of Utilities witness Mr. Doerk and Staff witness Mr. Burk supports the conclusion that the increased headcount is prudent and reasonable, as discussed earlier. *See also* Section V(C)(3) of this Reply Brief, *supra*. Accordingly, there is no factual basis for any hypothesized incremental costs that should be disallowed.

Therefore, for all the reasons stated herein and in the Utilities' Initial Brief, the Commission should reject Staff's proposed adjustment relating to the Commission's *06-0311 Order*.

5. **Customer Accounts**

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

This issue is uncontested.

6. **Customer Service and Information**

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

Staff continues to argue that the Utilities should not recover the advertising costs associated with their Safety, Reliability and Warmth Campaign ("SRW Campaign") on the theory that this advertising is primarily good will and institutional in nature. Staff Init. Br. at 85-88. In particular, Staff compares two different media forms, a poster at a bus stop and a bill insert, which are Attachments 1 and 2 to Staff's Initial Brief.[15]

Staff's argument is unreasonable. This type of creative communication strategy was used to catch the customers' attention, particularly on energy efficiency management and billing options available to fit their budget and lifestyle needs. Moy Sur., NS-PGL Ex. 3.0 Rev. at 5:105-107. This is especially important in such instances when customers are walking by a poster and not reading a bill insert. While the Utilities still use bill inserts and the corporate website, other forms of media such as radio and billboards are being utilized to promote an energy education message more strongly and reach a wider audience more effectively. *Id*. at 6:118-121. This would be applicable to expected communications about the various energy efficiency programs and customer payment plans required in Senate Bill 1918 that the Utilities will develop and implement for customers during test year 2010 and beyond. *Id*. at 121-123. Further, creative direction is subjective at every level but the copy in the ads (while not as large

[15] For clearer versions of the SRW advertising, see Attachment A of Staff Ex. 20.0.

as the "SRW words") did directly address these customer needs and benefits. *Id.* at 5:107-109. Therefore, the SRW campaign informs and educates customers regarding energy conservation and safety measures pursuant to Sections 9-225(a) and (c) of the Act. 220 ILCS 5/9-225(a), (c).

For all the reasons stated herein and in the Utilities' Initial Brief, the Commission should reject Staff's argument and allow recovery of the advertising costs associated with the SRW campaign.

7. <u>Administrative & General</u>

a. <u>Injuries and Damages Expenses</u>

Staff's efforts to rationalize its proposed injuries and damages expenses adjustments and its refusal to make consistent adjustments to the injuries and damages reserves (Staff Init. Br. at 88-90) are thoroughly unconvincing.

Staff argues that this expense can fluctuate significantly, and that using an average of five years of historical data to normalize the expense is appropriate and reasonable. Staff Init. Br. at 88-89. Staff's brief oddly does not even mention, much less address, the Commission's rejection of a similar Staff proposal in the Utilities' 2007 rate cases. NS-PGL Init. Br. at 69-70.

The Utilities' Initial Brief showed that Staff's proposal is unwarranted and should not be adopted, for four reasons. First, as in Peoples Gas' and North Shore's 2007 rate cases, Staff has failed to show that that any "normalization" of injuries and damages expenses was required in the first place. NS-PGL Init. Br. at 70. The evidence is to the contrary. *Id.*

Second, Staff's decision to base its proposal on five year averages of actual claims payments for 2004 to 2008 is arbitrary, because the selected period lacks any foundation. NS-PGL Init. Br. at 70-71. Staff's Initial Brief states that in four of the five years the figure was below the Utilities' forecasted figures for 2010 (Staff Init. Br. at 89), but Staff did not escalate its figures for inflation, which yields numbers much closer to the Utilities' figures. NS-PGL Init. Br. at 70 (showing the effects simply of escalating for 2009-2010 inflation, without even escalating the figures for inflation from 2004 to 2008).

Third, Staff's approach also is arbitrary because there is no rationale for choosing the five year period over other periods that could have been selected from the same data on which Staff relied. NS-PGL Init. Br. at 71.

Finally, Staff's proposal, even if it had merit, should not be adopted unless consistent adjustments are made to the Utilities' reserves for injuries and damages in rate base. NS-PGL Init. Br. at 72. The Utilities have presented the appropriate related adjustments to the reserves should Staff's proposal be adopted in full, and, in the interests of narrowing the issues, the Utilities remain willing to accept the Staff proposal if the consistent adjustments to the reserves are made. *Id*. Staff's attempted rationalization of its refusal to agree to the corresponding adjustments (Staff Init. Br. at 26-27) is illogical and lacks any credibility. Staff offers the contrived theory that because the Utilities' injuries and damages reserves figures are forecasted but Staff has substituted a normalization of the injuries and damages expenses based on historical data, it is somehow appropriate to reject the expenses part of the forecast while refusing to adjust the reserves part of the forecast. That makes no sense at all, and it is transparently arbitrary and results-driven. Indeed, Staff says what matters for the reserves is the estimate of future payments (*id*.), but Staff completely overlooks that its proposed adjustments do nothing other than use historical data to change the forecast of future payments.

Accordingly, the Commission should either (1) reject the Staff proposal and make no adjustments to the reserves or, alternatively, (2) adopt the Staff proposal and make the consistent adjustments to the reserves.

8. **Revenues**

a. **Sales Revenues Adjustment**

The AG's Initial Brief seeks to rehabilitate AG-CUB's proposed adjustment to the Utilities' sales revenue forecasts (*see* AG Init. Br. at 23-26), but the evidence compels rejection of AG-CUB's proposal.

The proposal lacks merit and should not be adopted, for five reasons.

- First, the Utilities' sales forecasts are the product of detailed, thorough forecasting methodologies conducted by, and that were supported in testimony by, experienced forecasters. In contrast, Mr. Effron apparently has no significant training or experience, if any, as a sales forecaster.
- Second, Mr. Effron's proposal improperly selects one factor out of the sales models to update and ignores all other factors, including the "Efficiency Improvements" group of variables, which includes the state of the economy, and which is more powerful than the price factor and drives down usage per customer. Because of timing, the economic downturn was not captured in the Utilities' sales forecasts used in their filings. Updating all of the variables, not just a single results-driven factor, likely would result in lower sales forecasts.
- Third, Mr. Effron has a record of incorrectly predicting increased natural gas utilities sales and revenues. In its Order in the 2008 Nicor Gas rate case, the Commission rejected Mr. Effron's proposal to adjust upward the utility's sales forecast. The Commission noted that evidence in the record showed that his approach was less accurate than that of the utility, and that the adoption of his approach in the 2004 Nicor Gas rate case had overstated billing units, causing the

utility to suffer an annual revenue loss of $5.4 million since the 2004 case. *Nicor 2008* at 177-190.

- Fourth, Mr. Effron overlooks that his proposal, if adopted, would be offset by necessary decreases in the test year revenues the Utilities forecast under their decoupling riders, reducing his adjustments to $28,000 as to North Shore and $489,000 as to Peoples Gas.
- Finally, Mr. Effron's proposal also overlooks that, if adopted, it would require an increase in the Utilities' uncollectibles expense.

NS-PGL Init. Br. at 73-74.

Accordingly, the Commission should reject Mr. Effron's proposal. The proposal lacks any valid basis, is wrong, and it ignores all offsets.

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

This subject is not contested, except for the derivative impacts of contested adjustments.

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

This subject is not contested, except for the derivative impacts of contested adjustments.

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

This subject is not contested, except for the derivative impacts of contested adjustments.

VI. RATE OF RETURN

A. Overview

The Commission should approve overall rates of return for Peoples Gas of 9.11% and North Shore of 9.06%. NS-PGL Init. Br. at 75-108. Staff's and AG-CUB-City's proposals for far lower rates of return depend on proposals that are incorrect and divorced from reality.

B. Capital Structure [Combined 1. Peoples Gas and 2. North Shore]

Staff's and CUB-City's positions on the Utilities' capital structure are somewhat unusual. Staff wants it both ways. On one hand, Staff agrees that the Commission should adopt the Utilities' proposed capital structure, which contains no short-term debt component, because it will result in a lower revenue requirement for Peoples Gas and make little difference in North Shore's revenue requirement. On the other hand, Staff wants the Commission to memorialize Staff's litigation position that the Utilities use short-term debt to finance rate base. Staff Init. Br. at 91.

For their part, CUB-City urge the Commission to include a short-term debt component in each utility's capital structure even though it will result in a higher revenue requirement for Peoples Gas and have virtually no impact on North Shore's revenue requirement. Completely ignoring the Utilities' substantial evidentiary showing, CUB-City assert that the Utilities "simply deny that short-term debt is used to finance rate base" and therefore appeal to "emotion." CUB-City Init. Br. at 12. Apparently, CUB-City believe that if a utility typically issues short-term debt "as a source of funds," then short-term debt should be included in its capital structure regardless of how the utility uses short-term debt. *Id.* at 13. CUB-City's position is contrary to long-standing Commission decisions as well as the overwhelming weight of the evidence that the Utilities use short-term debt only to manage cash flow and not to finance rate base.

CUB-City's position is also inconsistent with the Commission's recent decision on rehearing in *Nicor 2008*, in which the Commission adhered to longstanding decisions that it will impute a hypothetical capital structure only "when the capital structure is found to be unreasonable, imprudent, or unduly affected by circumstances such as double leverage as to unfairly burden the utility's customers." *Nicor 2008* (Order on Rehearing Oct. 7, 2009), at 12. CUB-City do not even try to muster such an evidentiary predicate for such a finding in these rate cases, and there is none to be found in the record.

The Utilities urge the Commission to find that their actual and proposed capital structures do not include short-term debt because the Utilities do not use short-term debt to finance rate base. Just two years ago, the Commission approved precisely the same capital structures that the Utilities propose in these cases. Then, as now, the Utilities' actual capital structures were similar to those included in the test year. *Peoples 2007* at 73. Then, as now, the Utilities used short-term debt only seasonally and temporarily to manage cash flow, typically at year-end when higher winter revenues have not been collected and seasonal cash requirements are at their highest, and in the late summer months when revenues are at their lowest. Johnson Reb., NS-PGL Ex. BAJ-2.0 2Rev. at 5:92 – 8:132. The tables on pages 6 and 7 of Mr. Johnson's rebuttal testimony show graphically the temporary and seasonal nature of the Utilities' historical and forecast use of short-term debt from February 2007 through December 2010.[16]

[16] The Utilities' approved capital structures in their 1995 rate cases similarly included only common equity and long-term debt. *The Peoples Gas Light and Coke Co.*, ICC Docket No. 95-0032, 1995 Ill. PUC Lexis 732, *68-70 (Order Nov. 8, 1995); *North Shore Gas Co.*, ICC Docket No. 95-0031, 1995 Ill. PUC Lexis 731, *51-53 (Order Nov. 8, 1995).

Having supported the Utilities' proposed capital structure in their last rate cases, Staff fails to identify anything that has changed factually or legally that justifies a change in the Commission's longstanding approach. Nor do CUB-City. In this regard, the Commission's decision in *Nicor 2005* is instructive. There the Commission faced an argument by Staff that the utility's capital structure should include short-term debt despite the fact that the utility's capital structure as approved in its last rate case did not. The Commission began its analysis by determining "whether there have been any material changes in circumstances since Nicor's last rate case that would lead to the inclusion of short-term debt this time around." *Id.* at 70.

The Commission found that there had been no such changes. As in *Nicor 2005*, the Utilities have:

> explained that this debt is <u>not</u> used to provide a source of capital for long term assets. No party has disputed the [the Utilities'] business, natural gas distribution, is seasonal in nature. The [Utilities'] expenses rise in the summer, the same time [their] revenue is at its lowest levels. During this time period, [the Utilities], like all businesses, [have] financial obligations [they] must meet. In order to meet these temporary and short-term cash flow requirements, [the Utilities turn to their] utilization of short-term debt.

Id. at 71.

The Commission recently determined that a utility's decision to place cash working capital in rate base constituted a sufficient change between rate cases to conclude that the utility "uses at least some of its short-term debt to finance its utility operations." *Nicor 2008*, Order on Rehearing, at 8. However, this distinction does not apply in these cases because the Utilities proposed the inclusion of cash working capital in their rate bases in their last rate cases and the Commission approved, with Staff support, capital structures with no short-term debt component. As the Commission held in the Utilities' last rate cases, "unless there are clear and distinguishable reasons for deciding a case differently, the Commission will follow in line with precedent." *Peoples 2007* at 16.

As the utility did in *Nicor 2005,* the Utilities also presented uncontroverted evidence that they use short-term debt intermittently throughout the year. *Id.* Indeed, the Utilities have no short-term debt balance for many months during the year, and are forecasted to have no short-term debt balance for 7 or 8 months in 2010. Johnson Reb., NS-PGL Ex. BAJ-2.0 2Rev. at 6:111-113. These facts further distinguish these rate cases from *Nicor 2008,* where the utility estimated that it would have a short-term debt balance for 9 months during the test year. *Nicor 2008,* Order on Rehearing, at 3.

None of Staff's new arguments to support a short-term component in the Utilities' capital structures reflect any changes in how the Utilities plan to manage their capital in 2010 compared to how they have managed their capital since their last rate cases. Rather, Staff's new arguments are simply another attempt to reduce utility revenues, and, in any event, the Utilities have thoroughly refuted the arguments.

First, consistent with its position in *Nicor 2008,* Staff claimed that the Utilities must be using short-term debt to finance rate base because their estimated rate bases exceeded the long-term capital in their proposed capital structures. Kight-Garlisch Dir., Staff Ex. 8.0 at 5:86-88. Even if a utility's rate base exceeds its permanent capital, it does not follow that the utility is using short-term debt to finance rate base. Capitalization and rate base are not measured in the same way and cannot be directly compared. As the Commission has previously held:

> On a utility's financial statements, the total dollar value of assets must equal the total dollars of liabilities and owners' equity. In a rate case, however, the total dollars of jurisdictional rate base does not necessarily equal total capitalization. This is because, for example, utilities may purchase assets that are not entirely included in rate base since some assets may be used in multiple regulatory jurisdictions. As a result, for various reasons a utility's total capitalization and rate base may not be equal in amounts. Due to the fungible nature of capital, it is generally assumed that all assets, including assets in rate

> base, are financed in proportion to total capital. However, due to certain regulatory accounting practices, short-term debt requires special attention.

In re Central Illinois Public Serv. Co. (AmerenCIPS) and Union Elec. Co. (AmerenUE), ICC Docket Nos. 02-0798, 03-0008 and 03-0009 (Cons.), at 67 (Order Oct. 22, 2003).

Moreover, even were it a valid comparison, the record voids Staff's claim that Utilities' rate bases materially exceed their permanent capitalization. In making its claim, Staff failed to consider the Utilities' adjusted rate bases. If those are considered, as they must be, Peoples Gas' permanent capital exceeds its rate base and North Shore's rate base exceeds its permanent capital by only $10.9 million. Johnson Reb., NS-PGL Ex. BAJ-2.0 2Rev. at 9:155-169. Further, the evidence shows that any difference between the financing required to support the Utilities' rate base and their permanent capital is not financed by short-term debt, but with cash. This is substantiated by the Utilities' large average net cash balances (cash minus short-term debt) over the test year. *Id.* at 9:170 – 10:193. These facts further distinguish *Nicor 2008*, in which the Commission found reasonable, <u>after</u> the inclusion of a short-term debt component, a capital structure that was only 95% of rate base. *Nicor 2008,* Order on Rehearing, at 13.

Staff's **second** argument is that there is a "strong correlation between short-term funding and net working capital," and this demonstrates that the Utilities rely on short-term debt to finance working capital, which is included their rate bases. Kight-Garlisch Dir., Staff Ex. 8.0 at 5:89-94. There is simply no relationship between working capital and net working capital. Working capital is the year-round, long-term funding necessary for day-to-day operation of the utility, the amount of which is estimated by the common method of a lead-lag study. Johnson Reb., NS-PGL Ex. BAJ-2.0 2Rev. at 11:215 – 12:224. By contrast, net working capital is generally defined as current assets net of current liabilities, and therefore has no relationship to rate base. The Utilities finance net working capital first with cash and then with short-term debt as needed. *Id.* at 12:225-231.

To paraphrase the Commission's conclusion in *Nicor 2005*, the Utilities have demonstrated by a preponderance of the evidence that they do not use short-term debt to finance rate base assets or to make long-term investments in rate base. The Utilities use short-term debt to meet seasonal, temporary needs of running their gas operations, just as they have for years. There have been no material changes, factual or legal, in circumstances since the Utilities' last rate cases that would lead to the inclusion of short-term debt this time around. The Utilities face the same need today to respond to daily and seasonal cash flow requirements, including gas costs, with revenues and other available sources of funds as they did in 2008. The record also shows that the Utilities use short-term borrowing in the same way today as they did in 2008. Therefore, the Commission should not include any short-term debt in the Utilities' capital structures. *See Nicor 2005* at 72.

C. Cost of Long-Term Debt

1. Peoples Gas

The initial briefs confirm that the only contested aspect of the Peoples Gas' cost of long-term debt is the cost of its Series OO auction rate bonds. The crux of the disagreement between the Utility and Staff is whether the cost of this debt should be based on its current cost, which is based on a formula tied to LIBOR and is near zero due to the financial crisis, or on its forecast cost. Staff argues that the current cost should be used. Staff Br. at 95.

For the reasons stated in the Utilities' Initial Brief, Peoples Gas will be refinancing this debt in 2010. NS-PGL Init. Br. at 78-79. Although Staff may believe that there is "no sound basis" for doing so, Staff Init. Br. at 95, Staff ignores the risk of high cost associated with these bonds as interest rates inevitably rise. Peoples Gas' intent to refinance these bonds is a prudent response to the anachronistic securities they have become. The cost of this debt should be set at its forecast cost during the test year, and Peoples Gas has reasonably proposed to use current indicative rates, not interest rate forecasts, to establish the cost of the refinanced debt for the second half of 2010. Johnson Reb., NS-PGL Ex. BAJ-2.0 2Rev. at 18:364-365; NS-PGL Ex. BAJ-2.2P.

For these reasons, the Commission should base the cost of Peoples Gas' Series OO auction rate bonds at a 1% cost for half the test year and a fixed rate debt cost of 7.16% for the rest of the year. This would result in an average cost of 4.08% over 2010, and an average overall cost of long-term debt for Peoples Gas of 5.58%. Johnson Sur., NS-PGL Ex. BAJ-3.0 at 5:106-108.

2. North Shore [Uncontested]

Based on the initial briefs, it is essentially uncontested that North Shore's average embedded cost of long-term debt for the test year is 5.48%. *See* Staff Br. at 96-98 (recommending a long-term debt cost of 5.49%).

D. Cost of Short-Term Debt [Combined 1. Peoples Gas and 2. North Shore]

For the reasons stated above and in the Utilities' Initial Brief, and as agreed by Staff, the Utilities' capital structure should not include short-term debt. CUB-City argue that it should, but state no position on the amount of short-term debt that should be included or its cost. *See* CUB-City Br. at 13. Before agreeing to the Utilities' proposed capital structure, Staff proposed to set the cost of short-term debt at near zero based on an annualized "spot" rate for highly-rated commercial paper as of May 14, 2009. Kight-Garlisch Dir., Staff Ex. 8.0 at 11:216 – 12:235. In the unlikely event that the Commission includes a short-term debt component in the Utilities' capital structures, setting the cost of that debt at almost zero would be punitive.

Current short-term debt rates are at historically low and unsustainable levels. NS-PGL Ex. BAJ-2.3. Current rates are not representative of the Utilities' cost of short-term debt in <u>2010</u>. As with Staff's reliance on historical spot stock prices to determine cost of equity, Staff's reliance on historical spot yields to set debt cost is arbitrary. *See* NS-PGL Init. Br. at 95-100. It makes common sense to rely on forecasts of interest rates for the forward-looking test year. Johnson Reb., NS-PGL Ex. BAJ-2.0 2Rev. at 13:257-260.

Somewhat ironically, Staff's calculation of the Utilities' credit facility fees is based on <u>historical</u> costs, not current costs. *Id.* at 13:261-262. Based on recent costs associated with a debt issuance by the Utilities' corporate parent, the Utilities' credit facility fees will be significantly higher than they have been historically. *Id.* at 13:262-265, 15:290-295.

Finally, the short-term debt rates that Staff relied on were for commercial paper for "AA"-non-financial entities, which is inappropriate for the A-2/P-1 rating associated with the Utilities' commercial paper program. *Id.* at 14:272-275. The average spread in cost between the Utilities' actual short-term debt cost and the cost of "AA"-non-financial commercial paper is about 137 basis points. NS-PGL Ex. BAJ-2.4. Applying that average spread to the forecasted cost of "AA"-non-financial commercial paper in 2010, plus the impact of likely credit facility fees, yields an average short-term debt rate of <u>5.47%</u> for Peoples Gas and <u>5.42%</u> for North Shore, compared to the sub-1% levels advocated by Staff. Johnson Reb., NS-PGL Ex. BAJ-2.0 at 14:281-288.

E. <u>Cost of Common Equity</u> [Combined 1. Peoples Gas and 2. North Shore]

1. <u>DCF Results</u>

a. <u>Financial Leverage</u>

Staff calls the Utilities' proposed financial leverage adjustment "absurd." Staff Init. Br. at 110. What is truly absurd is Staff's logic that a market-based cost of equity can be applied to a capital structure that is based on book value and, all other things held constant, that the utility will have an opportunity to earn the market-based cost of equity. The opposite is true.

Yes, the ambient temperature does not change when the measurement scale is switched from Fahrenheit to Celsius. But by the same token, 0 degrees Fahrenheit does not equal 0 degrees Celsius. The same type of measurement error is committed when a cost of equity measured by one scale (market) is applied to a capital structure measured by another scale (book). Moul Reb., NS-PGL Ex. PRM-2.0 Rev. at 28:541 – 29:553.

Staff's grossly mischaracterizes Mr. Moul's argument as follows: "when a company's book value exceeds its market value, the risk of a company increases if the capital structure is measured with book values of capital rather than market values of capital." Staff Init. Br. at 110; *see also* CUB-City Init. Br. at 42. Mr. Moul said no such thing. Rather, Mr. Moul's financial leverage adjustment accounts for the <u>error</u> that results when a market-based measure of a utility's cost of equity is applied to the utility's book value capital structure.

This is made crystal clear by Mr. McNally's own simplified example, which shows that applying a 10% market-value cost of equity to a utility's book value capital structure will prevent the utility from earning 10% on its book value capital structure. Something has to give. Either the market-value cost of equity needs to be applied to the utility's market value capital structure or the market-value cost of equity needs to be adjusted to generate sufficient revenue for the utility to earn its authorized return on its book value capital structure. NS-PGL Init. Br. at 86. If any party seeks regulation to a particular market-to-book ratio, it is CUB-City, provided the targeted ratio is 1.0: "market value in excess of book value means a utility's earnings already have exceeded its cost of equity." CUB-City Init. Br. at 42; *see* Moul Sur., NS-PGL Ex. PRM-3.0 Rev. at 14:312-315.[17]

The Commission should see CUB-City's and Staff's arguments for what they are: an attempt to obfuscate the true nature and basis for Mr. Moul's financial leverage adjustment, which is fundamentally different than the market-to-book adjustments that the Commission has previously rejected. Moul Dir., PGL Ex. PRM-1.0 Rev. at 23:483 – 26:564; Moul Reb., NS-PGL Ex. PRM-2.0 Rev. at 36:724 – 37:757. This is especially critical because, in concluding that Mr. Moul's financial leverage adjustment was essentially the same thing as a market-to-book adjustment in the Utilities' last rate cases (*Peoples 2007* at 96), the Commission seems to have relied on the same mischaracterizations. These cases provide the Commission with the opportunity to re-evaluate the issue based on an even more complete record and to determine anew whether it is proper to apply a cost of equity measured on one scale to a capital structure valued on another scale.

Although Staff opposes the financial leverage adjustment in concept, it does not challenge Mr. Moul's methodology for calculating the adjustment. No such challenge would be justified, as Mr. Moul uses well-established formulas to calculate what a utility's return on its

[17] CUB-City selectively cites testimony by Mr. Moul that "we're seeking . . . to maintain the price [of stock] as we find it" to imply that he seeks to maintain market-to-book ratios above 1.0. CUB-City Init. Br. at 42. To the contrary, as the rest of his answer (omitted by CUB-City) makes clear, Mr. Moul was simply describing the function of the financial models in deriving a cost of equity associated with whatever common stock price is assumed, "whether they're today's prices, yesterday's, whatever." Tr. at 460:10 – 461:2.

book value rate base would have to be in order to earn its market-based cost of equity. NS-PGL Init. Br. at 86.

b. Staff's Recent Conversion to the Non-Constant Growth DCF Model

Staff argues that the constant growth DCF model "is appropriate to use only if the near-term growth rate forecast for each company in the sample is expected to equal its average long-term dividend growth." Staff Init. Br. at 101. CUB-City agree, and go so far as to accuse anyone who thinks differently of "significant bias" (CUB-City Init. Br. at 25-27) – an odd position given the long history of Commission acceptance of the constant growth form of the DCF model.

As shown in the Utilities' initial brief, however, Staff's and CUB-City's position is not supported by the record. In the academic literature (see NS-PGL Init. Br. at 89), Professors Brealey, *et al*., warn against applying the constant growth form of the model "to firms having high current rates of growth. Such growth can rarely be sustained indefinitely, but the constant-growth DCF formula assumes it can." RICHARD A. BREALEY, STEWART C. MYERS AND FRANKLIN ALLEN, *Principles of Corporate Finance* at 95 (9th Ed. 2008) (emphases added). Their examples of such "high" growth rates include the railroads experiencing earnings growth of 12-15% in 2005-2006 "as they recovered from a period of low profitability," a hypothetical company earning 20% after "plowing back" 80% of its earnings, and a dot.com company that "is gradually regaining financial health after a near meltdown." *Id.* at 95-97. None of these situations even remotely represents the Utilities' financial situation.

FERC's approach, discussed at pages 89-90 of the Utilities' Initial Brief, is also consistent with the Utilities' position. FERC applies the non-constant growth form of the model when near-term growth forecasts are two to three times forecast GDP growth and dividend payout ratios are relatively low. *Southern California Edison Co.*, 92 FERC ¶61,070, at 61,261-61,262 (2000). Mr. Moul's analysis, not disputed by Staff or CUB-City, showed that natural gas utilities, like electric utilities, have relatively low growth rates and high dividend payout ratios. Moul Reb., NS-PGL Ex. PRM-2.0 Rev. at 18:369 – 19:381. Based on the FERC approach, the constant growth form of the DCF model should be applied to the Utilities.

Staff's and CUB-City's justification for switching from the constant growth form of the DCF model in the Utilities' last rate cases to the non-constant growth form in these cases is dubious at best. *See* NS-PGL Init. Br. at 90-91. Their assessment that a particular growth rate is or is not sustainable is a subjective claim based on conjecture. Moul Reb., NS-PGL Ex. PRM-2.0 Rev. at 41:839 – 42:850. That assessment, not the Utilities' analysis, is exactly the type of approach subject to "significant bias." However, even if the Commission decides to consider Staff's non-constant growth model as an appropriate basis for determining the Utilities' cost of equity, the Commission should also consider Staff's constant growth DCF model as presented by Mr. Moul because the application of that form of the model to natural gas utilities is supported by the academic literature and FERC practice. There is no valid justification for entirely casting aside the constant growth analysis; the only result that could come from doing so would be to reduce the utility's return, inappropriately and unfairly.

c. <u>Mr. Thomas' "Adjustments"</u>

CUB-City's brief documents the "adjustments" Mr. Thomas made to the DCF model supposedly as "appropriate accommodations" to current market conditions. Putting aside the fact that current market conditions as a whole call for higher, not lower, capital costs, Mr. Thomas' "adjustments" are in reality simply mathematical means of lowering his proposed cost of equity. In each case these adjustments have the impact of reducing the Utilities' cost of equity below what the financial models justify:

Adjustment	Impact on Cost of Equity
Non-constant growth DCF	Reduce growth rates in future periods, reduce ROE
Use internal growth rate	Lower than dividend/earnings growth, reduce ROE

The Utilities have discussed the improper use of the non-constant growth form of the DCF model to determine their cost of equity. Mr. Thomas' use of the internal growth rate biases the result downward. Mr. Thomas incorrectly assumes that when dividend payout ratios are expected to decline, earnings growth rates overstate the cost of equity. In reality, when dividend payout ratios decline, earnings per share growth will exceed dividend per share growth. If the dividend per share growth rate is used, the model will underestimate the return. Moul Reb., NS-PGL Ex. PRM-2.0 Rev. at 34:680-685; Moul Sur., NS-PGL Ex. PRM-3.0 Rev. at 13:298-302.

2. <u>CAPM Results</u>

a. <u>Size Adjustment</u>

Challenging Mr. Moul's size adjustment, Staff argues that he "did not provide any evidence to demonstrate that a size premium is warranted for <u>utilities</u>." Staff Init. Br. at 111 (emphasis in original). Yet in the very next sentence, Staff admits that the Ibbotson Associates study that Mr. Moul cited "is not restricted to utilities." *Id.* Studies demonstrating the size premium that include utilities certainly do constitute evidence that the premium applies to utilities.

Moreover, contrary to Staff's claim, the Ibbotson study does not constitute "the entire basis" for the adjustment. Mr. Moul cited a range of academic literature that supports the basic principle that, all other things equal, the smaller the firm the larger its risk. Moul Dir., PGL Ex. PRM-1.0 Rev. at 40:852 – 41:868. Moreover, Mr. Moul ties his adjustment to the CAPM model, which is known to understate the risk associated with smaller firms. Moul Reb., NS-PGL Ex. PRM-2.0 Rev. at 38:771-777, 39:782-798. Staff denies that the principle even exists. Staff Init. Br. at 111-113.

On this record, the need for a size adjustment to the CAPM would appear to be a question about which analysts and academics have differing opinions. There is no one right or wrong answer. Mr. Moul applied a size adjustment to his CAPM, Mr. McNally did not. This is no basis to exclude Mr. Moul's CAPM from the range of market returns the Commission considers in setting the Utilities' cost of equity.

b. <u>"Unbiased" Betas</u>

According to CUB-City, Mr. Moul's reliance on *Value Line* betas for his CAPM analysis can only be explained by bias, while Mr. Thomas' choice to use an average of *Value Line* and three other beta sources is purely objective. Based solely on how utility stocks behaved during the unprecedented stock crash that followed the financial crisis in late 2008, CUB-City declares *Value Line* betas unreliable. CUB-City Init. Br. at 22. If CUB-City were right, it would be news to the investment community, which apparently understands the extreme nature of the crash and continues to rely on *Value Line* data. Moul Reb., NS-PGL Ex. PRM-2.0 Rev. at 26:486-487. Moreover, even Mr. Bodmer did not analyze any of the other three betas that Mr. Thomas relied on, presumably because they do not publish their sources or methodology. Moul, Tr. at 449:18 – 453:6, 465:4-18. CUB-City can believe – and say – whatever they want about Mr. Moul's decision to rely on *Value Line* betas, but their accusation that he ignores the other betas purely out of bias is spurious. The Utilities could equally accuse Mr. Thomas of bias in bringing in three betas that lack reviewable foundation solely because they are generally lower than *Value Line*. Mr. Moul's reliance on *Value Line* betas for his CAPM analysis was appropriate and reasonable.

c. **<u>Mr. Thomas' "Adjustments"</u>**

As with his ROE-lowering "adjustments" to his DCF model, CUB-City's brief also lists Mr. Thomas' "adjustments" to the CAPM, all of which have the effect of reducing his CAPM results:

<u>Adjustment</u>	<u>Impact on Cost of Equity</u>
Reverse beta reversion adj.	Reduce beta, reduce ROE
Include undocumented betas	Reduce beta, reduce ROE
"Academic" EMRP	Reduce EMRP, reduce ROE

As with Mr. Thomas' DCF "adjustments," these "adjustments" are in reality simply mathematical means of lowering his proposed cost of equity.

3. **<u>Use of Historical Data</u>**

Staff's brief (at 108-109) merely summarizes in one paragraph Mr. McNally's testimony and therefore requires no further response than what the Utilities included in their Initial Brief. *See* NS-PGL Init. Br. at 95-100. Historical information has a proper role, which is reflected in Mr. Moul's analyses.

4. **<u>Staff's "Financial Risk" Adjustment</u>**

Staff's brief (at 104-105) merely summarizes in about a page the mechanics of Mr. McNally's financial risk adjustment. The arbitrariness of this adjustment is underscored by Staff's own description of the adjustment as being based on "the difference between <u>the implied forward-looking credit ratings</u> for the Companies and the <u>average credit rating</u> of the Gas

Group." *Id.* at 105. The Commission should see this adjustment for what it is: an adjustment that compares, on one hand, idealistic hypothetical "forward-looking" credit ratings that are based on assumed (i.e., assured) full recovery of test year revenues – a result that is starkly in contrast to the Utilities' recent recurring revenue deficiencies – to, on the other hand, the actual credit ratings of the proxy group that are based their actual rates and past historical financial performance. This adjustment is not only an archetypal "apples to oranges" comparison, but also one that will assuredly suppress the Utilities' cost of capital included in their rates. By using perfect revenue recovery as the benchmark, the adjustment effectively assumes zero risk to recovery, an obviously unrealistic and wholly inappropriate standard by which to establish ROE.

5. <u>Adjustments for Riders VBA and ICR</u>

Staff's brief merely recites that Mr. McNally applied a 10-basis-point adjustment to his financial model results as "authorized in the Companies' last rate case." Staff Init. Br. at 104. Staff's brief makes no attempt to square the adjustment with Staff's acknowledgment that most of the utilities in the Gas Group have decoupling mechanisms in place. *See* NS-PGL Init. Br. at 104.

Staff's brief merely summarizes Mr. McNally's testimony supporting his 163-basis point adjustment to Peoples Gas' cost of equity for the purpose of Rider ICR's ROE factor. Staff Init. Br. at 107-108. Staff did not address any of the Utilities' arguments as to why this adjustment is excessive. *See* NS-PGL Init. Br. at 104-105.

6. <u>Mr. Bodmer's Proposal</u>

CUB-City argues, with chutzpah but apparently without irony, that the Utilities "appeal to emotion ... by predicting dire consequences" if the Commission does not adopt their proposed cost of equity. CUB-City Init. Br. at 13. According to CUB-City's backwards view of the record, the Utilities' position is subjective because it ignores the results of their own "quantitative analysis" and instead rely on "signals" from a "self-interested investment community," whereas Mr. Bodmer's unprecedented approach relies on "analyses that rely on objective market indicators, the Commission's preferred estimation models, and fundamental principles of finance." *Id.* at 14. CUB-City's claims are not credible in light of Mr. Bodmer's intense reliance on what feels investors' required returns should be and their extremely and unrealistically low cost of equity results. By contrast, the Utilities and Staff freely and honestly acknowledge that the estimation of a utility's cost of equity necessarily involves no small amount of judgment. The key is to exercise that judgment fairly and consistently with the data to arrive at a reliable estimate of what investors actually require their capital to earn.

CUB-City warn the Commission against having its "attention diverted from financial fundamentals, common sense, and objective evidence of the Companies' risk-based market cost of capital" due to the current financial environment. CUB-City Init. Br. at 16. They repeat Mr. Bodmer's caution against using "the rather chaotic state of the financial markets" as a "false basis" for cost of equity. *Id.* Yet this is precisely what Mr. Bodmer advocates by declaring the traditional financial models broken and urging the Commission to set cost of equity at levels investors should be satisfied with instead of what the financial market demands. CUB-City Init. Br. at 21, 28-29; *see* Fetter Reb., NS-PGL Ex. SMF-1.0 at 8:146 – 9:165; Fetter Sur., NS-PGL Ex. SMF-2.0 at 3:46-58; Moul Sur., NS-PGL Ex. PRM-3.0 at 13:280-283.

In each of Mr. Bodmer's three recommendations that CUB-City claim constitute "principles of finance and economics that guide valid cost of equity determinations," he advocates adjustments to the types of information that investors rely on: (1) use "unbiased" betas by relying on lower ones, (2) use "sustainable," i.e., lower growth rates, and (3) "correct" bond spreads by reducing them. CUB-City Init. Br. at 28. It is no coincidence that each of Mr. Bodmer's recommendations has the effect of reducing the utility's cost of equity, and as implemented by Mr. Thomas reduced the Utilities' cost of equity to almost 8%.

CUB-City characterize the Utilities' simple, if not obvious, suggestion that the Commission consider the general context within which it makes cost of equity decisions as an "appeal[] to subjectivity and emotion." *Id.* at 17-21. In their view, the Commission need not mind that this context directly influences the investors who effectively set cost of equity. Fetter Sur., NS-PGL Ex. SMF-1.0 at 3:59 – 4:70. Never mind that Mr. Moul makes it perfectly clear that the Commission should consider this context when selecting among the financial model results that the Commission determined provide a reasonable basis for the Utilities' cost of equity. Tr. at 466:22 – 468:7. It is beyond dispute that the economy in general, investor expectations, and even investor emotions contribute powerfully to the investor behavior and, thus, the cost of capital. It is not subjective or biased to consider that data and to consider its influence as objectively as one can. What is both subjective and biased is to argue that the Commission should ignore reality and instead define what returns investors be satisfied with.[18]

Finally, in an attempt to justify a ROE recommendation that nears 8%, CUB-City portray the Utilities as essentially free of risk. The Utilities are indeed regulated monopolies (as far as gas distribution service), and therefore face no competition for such service, but as a result their prices are set by the government and their regulated cost structures do not allow them to earn any profit on their operating costs including gas commodity costs. Unlike competitive businesses, the Utilities are not free to change their prices to maximize profit in response to market shifts.

[18] Despite its position that the information is irrelevant if not suspect, CUB-City expend a considerable portion of its Initial Brief arguing over how the Commission should interpret the ROEs recently issued by other state commissions to support CUB-City's proposed ROEs. CUB-City Init. Br. at 14-15, 18-19, 30-34.

Although the Utilities are indeed guaranteed by law an opportunity to earn a fair return on their investments, the ratemaking process does not always fulfill that guarantee. CUB-City ignore another fundamental aspect of public utility service: the Utilities have an obligation to serve at all times, regardless of profit, whereas competitive firms may refuse service or withdraw from certain markets if the profit is not there.

Of all the risks listed by Mr. Fetter, CUB-City deny only one in specific: commodity risk. In doing so, CUB-City implicitly acknowledge that the Utilities retain operational risks, contract counterparty risks, regulatory risks, capital market volatility, and the risks associated with unforeseen events that create liabilities. Fetter Sur., NS-PGL Ex. SMF-2.0 at 4:81-84. How utility stocks fared in the financial crisis compared to non-utility stocks (CUB-City Init. Br. at 35-36) is neither here nor there, although Mr. Bodmer conveniently ignores the fact that utility stocks do not have the upside that non-utility stocks do in bull markets. Moul Reb., NS-PGL Ex. PRM-2.0 Rev. at 43:873-882. In these rate cases, the financial models relied on by all analysts have been applied to a proxy group of gas utilities. "In the end, how investors view these common gas company risks is best ascertained by looking at the investor demanded returns – and evidence of those demanded returns such as capital costs of other comparable companies – not by trying to rationalize the risk away or by, in effect, professing to be a better evaluator of risk than the market itself." Fetter Sur., NS-PGL Ex. 2.0 at 4:88 – 5:93.

F. Weighted Average Cost of Capital

1. Peoples Gas

For the reasons stated above and in the record, the Commission should approve an overall rate of return for Peoples Gas of 9.11%.

2. North Shore

For the reasons stated above and in the record, the Commission should approve an overall rate of return for North Shore of 9.06%.

VII. WEATHER NORMALIZATION – AVERAGING PERIOD (Uncontested)

This issue is uncontested.

VIII. PROPOSED RIDER ICR (PGL)

A. Overview

Staff's, the AG's and CUB's Initial Briefs argued against Peoples Gas' proposed Rider ICR, while the City and Union filed Initial Briefs in support of Rider ICR. Staff, AG and CUB each argue against Rider ICR based on a faulty reading and application of the legal standards for the Commission to authorize a rider. The AG goes further and makes additional arguments based on a misapplication or misunderstanding of the facts in the record and/or the analysis of its consultant that distorts how Rider ICR would actually work. For the reasons stated in the Initial Briefs of Peoples Gas, the City, and the Union, the Commission should authorize Rider ICR as proposed by Peoples Gas with the modifications agreed to by Staff and Peoples Gas.

B. Proposed Rider ICR is Appropriate and Legal

1. Peoples Gas has Established That the Circumstances Are Appropriate for the Commission to Authorize Rider ICR and that It Is Not Legally Required to Prove a "Need" for Rider Treatment

Staff, the AG and CUB each argue that Rider ICR should not be authorized because Peoples Gas has failed to show that Rider ICR is "justified." Their arguments are based on the assumption that the standard Peoples Gas must meet to obtain rider treatment is to show that it "needs" Rider ICR to raise sufficient capital to provide adequate, efficient, reliable and safe utility service at a reasonable cost. *See, e.g.*, Staff Init. Br. at 120-121; AG Init. Br. at 30-31. That, however, is <u>not</u> the standard for the Commission to authorize rider recovery.

As the Illinois Supreme Court declared in *City of Chicago v. Illinois Commerce Commission*, 13 Ill. 2d 607, 618 (1958) ("*City I*"), the Commission is vested with the authority to make "pragmatic adjustments" as part of its ratemaking function, which includes adopting a rider that allows a utility to recover certain costs directly from customers. In its Initial Brief, Peoples Gas discussed various situations in which Illinois courts have reviewed and affirmed cost recovery riders authorized by the Commission. NS-PGL Init. Br. at 111. In re-confirming its decision in *City I*, the Illinois Supreme Court concluded that the Commission may "approve direct recovery of unique costs through a rider when circumstances warrant such treatment." *CUB*, 166 Ill. 2d 111 at 138. Thus, as the Commission concluded in its Order in the Utilities' last rate cases, the Commission may approve a rider as long as it is just and reasonable. *Peoples 2007* at 139-140, 159. *See also Illinois Power Co. v Illinois Commerce Comm'n*, 339 Ill. App. 3d 425 (5th Dist. 2003) (recognizing that the ICC sets rates in two ways, by base rates or by an automatic cost recovery mechanism).

Conspicuously absent from all of the case law addressing the Commission's authority to approve a rider is the discussion of a standard that requires a utility to establish that it "needs" a rider **–** *i.e.*, that a rider is the only way that a utility service can be provided or investment funded – before the Commission can approve a rider. Nowhere in the case law or in the Commission's decisions has such a "need" standard even been addressed, let alone adopted. For example, it cannot be argued that ComEd "needed" to recover the franchise fees via a rider that were at issue in *City of Chicago v. Illinois Commerce Commission*, 281 Ill. App. 3d 617, 627-29 (1st Dist. 1996) ("*City III*"), yet the court upheld the rider in that case, holding that the Commission's finding that the rider was just and reasonable was a proper exercise of the Commission's ratemaking authority. Indeed, riders have been approved for some forty years under varying circumstances without applying any such "need" test. *See, e.g., City of Chicago v. Illinois Commerce Comm'n*, 264 Ill. App. 3d 403, 410-12 (1st Dist. 1993) (rider for recovery of the marginal cost of providing non-standard service); *Central Illinois Light Co. v. Illinois Commerce Comm'n*, 255 Ill. App. 3d 876, 885-86 (3rd Dist. 1993) (recovery of coal tar remediation costs through a rider), *aff'd in relevant part* by *CUB*, 166 Ill. 2d at 113; *City III*, 281 Ill. App. 3d at 627-29 (rider recovery of utility franchise costs).

As discussed by Peoples Gas in its Initial Brief, the Commission in its Order in Peoples Gas' last rate case specifically set out the information it needed to determine whether this would be a proper case to authorize Rider ICR. *Peoples 2007* at 162. As shown in Peoples Gas' Initial Brief (NS-PGL Init. Br. at 114-126), Peoples supplied the evidence the Commission requested and that evidence established that the circumstances here are appropriate for the authorization of Rider ICR. Two other parties to the proceeding, the City and the Union, agree as well. Indeed, even the AG in its Initial Brief concedes that Peoples Gas met the requirements outlined by the Commission in its last Peoples Gas rate case Order. *See* AG Init. Br. at 31. Rider ICR, therefore, is appropriate under the circumstances and should be authorized by the Commission.

2. **Proposed Rider ICR Does Not Violate the Prohibition Against <u>Single-Issue Ratemaking or the Commission's Test Year Rules</u>**

The AG argues that Rider ICR would violate the prohibition against single-issue ratemaking and/or the Commission's test year rules. AG Init. Br. at 47-48. As explained by Peoples Gas in its Initial Brief, Rider ICR as proposed in this proceeding does <u>not</u> violate the single-issue ratemaking rule because it accounts for any corresponding changes to the components underlying Peoples Gas' rate of return so there would be no over- or under-statement of the company's overall revenue requirement. NS-PGL Init. Br. at 112-113. Rider ICR is, thus, unlike the rider found to violate the single-issue ratemaking rule in *Finkl* which did not consider "whether other factors offset the need for additional charges." *A. Finkl & Sons v. Illinois Commerce Comm'n*, 250 Ill. App. 3d 317, 326 (1st Dist. 1993). Moreover, the rider at issue in *Finkl* was designed to recover "lost revenues" (*id.* at 321-22), not, as here, a cost incurred by the utility incremental to the costs recovered through base rates. Accordingly, as proposed, Rider ICR would not violate the single-issue ratemaking rule or the Commission's test year rules.

3. The Record Establishes That Utility Plant to Be Added to Rate Base Via Proposed Rider ICR <u>Is Used and Useful and Prudently Incurred</u>

The AG argues that there is insufficient evidence in the record for the Commission to find that the infrastructure investments to be made as part of Peoples Gas' accelerated main replacement program and added to rate base under Rider ICR would be used and useful and prudently incurred as required by 220 ILCS 5/9-211. AG Init. Br. at 48-49. This argument makes no sense in light of the fact that, as has been established throughout this proceeding, the same type of infrastructure investments to be made under Rider ICR have been ongoing since 1981. *See* Doerk Sur., NS-PGL Ex. ED-3.0 at 4:67 - 6:120. There is nothing new or controversial about the main replacements being performed; the issue in this case is the benefits to be achieved by accelerating this ongoing replacement program. The overwhelming weight of evidence presented in the testimony of Peoples Gas witness Mr. Marano, as well as Staff witness Mr. Stoller, is that this infrastructure investment is prudent and will be used and useful. *See* Marano Dir., NS-PGL Ex. SDM-1.0 Rev.; *see also* Stoller Dir., Staff Ex. 14.0. While the AG refers to the lack of a "specific implementation plan" or evaluation of which specific main locations should be replaced first, the AG offers no explanation for how or why such evidence is necessary or even relevant to a determination of whether the main replacement investments to be made under Rider ICR are used and useful and prudently incurred. Accordingly, this argument must be rejected, as well.

4. <u>Rider ICR Does Not Violate the Rule Against Retroactive Ratemaking</u>

The AG also attempts to argue that proposed Rider ICR would be a violation of the rule against retroactive ratemaking because it would allow for refunds to be made to customers if a larger amount of money is recovered than Peoples Gas actually spends on qualifying ICR-related expenses in a given year. AG Init. Br. at 49. This argument is baseless. Rider ICR specifies how the charges are to be calculated, including the determination of any refunds, if necessary. *See* PGL Ex. VG-1.1 at pp. 87-93 (Rider ICR); Hathhorn Reb., Staff Ex. 15.0 Att. G at 5. "Pass-through" cost riders that charge customers based on formulas are authorized by the Public Utilities Act and were upheld by the Illinois Supreme Court in *CUB* and *City I*. As the Commission explained in one of its previous Orders:

> Unlike rates established in a test year ratemaking proceeding, rider mechanisms contain formula rate methodologies designed to pass through costs as they are incurred. Thus, by their very nature, they will not identify specific rates or charges because those charges will not be known until the subject costs are incurred. Therefore, there is no outright prohibition on the use of "blank rates" or "formula rates" in pass-through riders.

In re Commonwealth Edison Co., ICC Docket No. 05-0159 at 52 (Order Jan. 24, 2006) (authorizing a pass-through cost recovery rider with annual reconciliation hearings requiring prudence review). Thus, Rider ICR is a proper exercise of the Commission's authority to adopt riders that pass through costs based upon set formulas and to have those costs be subjected to prudence review in an annual reconciliation proceeding.

The prudency review for Rider ICR's annual reconciliation is a modification requested by Staff to which Peoples Gas agreed; as originally proposed by Peoples Gas, the annual reconciliation for Rider ICR would be an accounting exercise comparing amounts collected under Rider ICR to qualifying investments made by Peoples Gas during the corresponding year. *See* NS-PGL Init. Br. at 127. The Commission's rules for recovery of infrastructure investments by water and sewer utilities likewise contain a prudency review component. *See* 83 Ill. Admin. Code § 656.80(a). This additional language does not create retroactive ratemaking, as again, the rider itself contains all of these provisions and thus, sets out the formula and procedures for charges, reviews and any refunds prospectively.

C. The AG and CUB Fail To Rebut the Overwhelming Evidence That Rider ICR Is Proper and Appropriate Under the Circumstances

1. The AG Incorrectly States the Scope of What Costs Will Be Recovered Under Rider ICR

In its Initial Brief, the AG incorrectly describes the scope of Rider ICR to include "*all* new investments" in the accounts related to Rider ICR. AG Init. Br. at 27 (emphasis in original). Elsewhere, the AG states that Rider ICR is "about creating a vehicle for obtaining revenue for nearly *all* infrastructure investments." *Id*. at 36 (emphasis in original). Those statements are inaccurate. Rider ICR includes three specific criteria for determining whether plant additions can be classified as Qualifying Infrastructure Plant ("QIP") for recovery under the Rider. One criteria expressly requires that before plant additions can be classified as QIP, they must be replacements of existing plant related to the company's cast iron and ductile iron main replacement program. PGL Ex. VG-1.1 at p.88 (Rider ICR, Section D(a)). The AG, therefore, exaggerates the scope of Rider ICR in its brief.

2. AG-CUB's Revenue Requirement Analysis Should Be Entitled to Little, if Any, Weight

In addition to their legal arguments, the AG and CUB also appear to argue that Rider ICR should not be adopted because the evidence does not support the conclusion that the accelerated main replacement program will provide a net financial benefit to customers. This argument is based mainly upon the revenue requirement analysis of their witness, Mr. Rubin. For the reasons Peoples Gas already demonstrated in its Initial Brief, Mr. Rubin's revenue requirement analysis is completely divorced from the reality of how Rider ICR would work and thus, should be given little or no weight, as well as the fact that the time-period examined was selectively and self-servingly chosen to generate the results that AG-CUB desired. NS-PGL Init. Br. at 117-119.

AG-CUB fail to present any of their own evidence, study or analysis of the costs of main replacement, operating and maintenance costs, safety benefits, functionalities of the new system or environmental benefits to accelerating CI/DI main replacement. Rather, they base their arguments on a simplistic and incomplete "numbers game" using the results of Peoples Gas' painstakingly-created cost model to try to apply revenue requirements to a model designed to examine construction costs. Peoples Gas' construction cost-benefit model went only through the year 2059 because there would be <u>no</u> construction costs related to the programs at issue past that time period. On the other hand, however, the revenue requirements raised by AG-CUB, as AG witness Mr. Rubin admitted on cross-examination, would do so although he chose not to calculate them:

> Q. Again, there are no construction costs for either program past the year 2059; correct?
>
> A. Correct.
>
> Q. But there are revenue requirements that go on past the year 2059 for both programs; correct?
>
> A. Yes.

Q. And you didn't calculate those, did you?

A. I did not, no.

Rubin, Tr. at 1008:20 - 1009:5. The reason Mr. Rubin and AG-CUB chose not to carry out these calculations is clear. As Mr. Rubin was forced to concede, the application of revenue requirements to the entire amount of investments to be made under Peoples Gas' current program actually would lead to larger costs for customers than the accelerated program. Rubin, Tr. 1010:17 - 1011:10. Thus, for the reasons identified and illustrated here and in Peoples Gas' Initial Brief, AG-CUB's revenue requirement analysis fails to discredit the overwhelming evidence of benefits that Rider ICR will help enable Peoples Gas to bring to customers.

Furthermore, Mr. Rubin's reliance on an argument that a utility should not replace its infrastructure quicker because it will hasten the time when that new infrastructure needs to be replaced is nonsensical and bad policy for the Commission to set in Illinois. This would be a reason for a utility to never replace or upgrade any of its infrastructure until it already had fallen apart. It also ignores the evidence submitted by Peoples Gas that if such a situation occurs in the future that requires an unplanned "reactive" acceleration of the company's CI/DI mains, that program will be significantly more expensive. *See* Marano Dir., PGL Ex. SDM-1.0 Rev. at 29:519 - 31:556. Mr. Rubin's only testimony on this point came during his cross- and re-direct examinations during the evidentiary hearing and was not supported by any study or analysis of what costs such future replacement may pose. *See* Rubin, Tr. at 1000:2-14.

As explained during the evidentiary hearing, Peoples Gas' cost-benefit model provides a conservative projection of savings that acceleration will provide, because it does not incorporate the economies of scale of which acceleration will allow the company to take advantage. Marano, Tr. at 846:10-21; Marano Dir., PGL Ex. SDM-1.0 Rev. at 61:1117-1126. Moreover, AG-CUB's focus on revenue requirements fails to consider the evidence presented by

Mr. Marano that utility revenues have a positive impact on local economies of 1.2 to 2.4 times the revenue amounts. Marano Sur., NS-PGL Ex. SDM-3.0 at 11:232-241. This is an additional public policy factor weighing in favor of Rider ICR.

Again, it is significant to note that AG-CUB witness Mr. Rubin conceded that the decision on whether to implement an infrastructure investment program such as Rider ICR should not be based solely on cost, but on factors such as safety and reliability, as well. Rubin, Tr. at 984:15-18. In fact, both the City and the Union acknowledge and cite these factors and benefits as reasons the Commission should authorize Rider ICR. Indeed, putting aside the evidence of construction costs and finances, <u>all</u> of the un-rebutted evidence concerning enhanced safety, energy conservation, increased functionalities and appliance choices and reduced environmental impacts submitted by Peoples Gas weighs heavily in favor of Rider ICR's adoption.

3. The Evidence Does Not Support the AG's Conclusion That <u>Mr. Marano's Proposed 2030 Completion Date Is Unreasonable</u>

Yet another unpersuasive argument set forth by the AG is that Mr. Marano's scenario of accelerating the main replacement program to a completion date of 2030 is not achievable because the miles of main being replaced by Peoples Gas in 2009 and 2010 decreased from what the company's annual average had been. *See* AG Init. Br. at 38. Once again, the AG plays a numbers game without reference to the real world. Mr. Marano's testimony about a 2025 completion date being not practical because it would require about a tripling of Peoples Gas' "current rate" of main replacement of 45 miles in 2008 was based on an assessment of the Company's physical resources (employees, tools, trucks, etc.) required to perform that average annual main replacement. *See* Marano Dir., PGL Ex. SDM-1.0 Rev. at 50:951-964, 73:1390 - 74:1413. The decrease in miles of main to be replaced in 2009 and 2010 was a result of a short term financial situation brought on by the general economic downturn, not a reduction in its workforce and physical resources. *See* Marano, Tr. at 884:10 - 887:6; Doerk Reb., NS-PGL Ex. ED-2.0 at 4:71-83.

Thus, Peoples Gas replacing 10 miles of main in 2010 does not mean, as implied by the AG, that the Company must increase its workforce and equipment eleven-fold to achieve an accelerated replacement rate of 110 miles per year to meet Mr. Marano's recommended 2030 completion date. Indeed, Mr. Marano submitted a detailed action plan as part of his surrebuttal testimony showing how Peoples Gas could implement his recommended accelerated main replacement program schedule. *See* NS-PGL Ex. SDM-3.1. In short, this argument fails to support the AG's position that Rider ICR should be rejected.

The Commission, therefore, for the reasons stated herein as well as in the Initial Briefs of Peoples Gas, the City and the Union should authorize Rider ICR as proposed by Peoples Gas, with the modifications of Staff agreed to by Peoples Gas.

D. Rider ICR Tariff

Only Staff addressed this section in its Initial Brief. Staff Init. Br. at 123-126. The two contested issues, addressed by Staff on pages 125-126 of its Initial Brief, are thoroughly addressed by the Utilities on pages 128-129 of their Initial Brief.

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

Staff's Initial Brief on Mr. Stoller's recommendations with respect to accelerating Peoples Gas' CI/DI main replacement program essentially mirrors Mr. Stoller's direct and rebuttal testimonies in support of those recommendations. Peoples Gas addressed these points in its Initial Brief. NS-PGL Init. Br. at 129-134.

With respect to Staff's recommendations, Peoples Gas believes it is important to reiterate that Staff has failed to make the requisite showings required by the Public Utilities Act for the Commission to order acceleration or the retention of consultants by the Commission. With respect to ordering an accelerated main replacement program, Section 8-503 of the Public Utilities Act provides:

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

220 ILCS 5/8-503. Thus, before the Commission may enter such an order under Section 8-503, it must find that the changes to be made -- here, the acceleration of the main replacement program -- "are <u>necessary</u>." *Id*. (emphasis added). That acceleration is "necessary" based on the only ground raised by Staff -- "public safety" -- is not reflected by the evidence. Indeed, there is no evidence in the record that the program's immediate acceleration is necessary to prevent or eliminate a public safety concern. Mr. Marano testified that there is <u>no</u> immediate danger posed by Peoples Gas' current system and that Peoples Gas does a good job managing the risks posed by the current system (Marano Dir., PGL Ex. SDM-1.0 Rev. at 29:510-512), and Staff witness Mr. Stoller agreed that there is no evidence in the record that Peoples Gas' system is not safe or not being operated safely at the present time. Stoller, Tr. at 899:6-13.

Likewise, with respect to ordering the retention of outside consultants, which would be governed by Section 8-102 of the Public Utilities Act, the Commission must have reasonable grounds to believe that the investigation or audit "is necessary to assure that the utility is providing adequate, efficient, reliable, safe, and least-cost service" or that it is "likely to be cost-beneficial in enhancing the quality of service or the reasonableness of rates therefor." 220 ILCS

5/8-102. Here, Staff has made neither a showing of necessity nor a showing that the benefits such consultants might provide would justify their cost. Indeed, Staff has not even investigated what the costs of such consultants might be. Stoller, Tr. at 900:2-6. Staff's position on the need for outside consultants, at best, is completely premature and speculative at this point in time. Accordingly, no justification exists for imposing the cost of additional consultants on Peoples Gas.

Staff's Initial Brief fails to acknowledge that Mr. Stoller ignored the full spectrum of recommendations Peoples Gas has received over the years regarding the replacement of its CI/DI mains in order to argue that Peoples Gas needs monitoring to avoid "backsliding" or "delays" in its main replacement program. Staff Init. Br. at 134-136. As illustrated by Peoples Gas in its Initial Brief, while Mr. Stoller relied upon the recommendations of an original study conducted by Zinder Engineering, Inc. ("Zinder"), in 1981 to argue that Peoples Gas had not diligently pursued the recommended pace of main replacement (Stoller Reb., Staff Ex. 28.0 at 4:106 - 5:123), he failed to acknowledge two facts that completely undermine his conclusion. First, Mr. Stoller fails to point out that the 2030 completion date in the 1981 Zinder report was only for specific CI/DI mains buried in clay soil, not Peoples Gas' entire CI/DI main system. Doerk Sur., NS-PGL Ex. ED-3.0 at 4:73-77. Second, Mr. Stoller fails to acknowledge that a subsequent, more in-depth study by ZEI, Inc. (a successor to Zinder) concluded that the target date for replacing the CI/DI mains should be pushed back from 2030 to 2050 based on an economic (<u>not</u> safety) analysis. *Id*. at 4:80 - 5:90. When the recommendations from all of the studies performed on Peoples Gas' main replacement program prior to this proceeding are compared against the company's actual performance, the evidence proves that Peoples Gas achieved a replacement rate <u>greater</u> than recommended by those consultants. *Id*. at 5:107 - 6:120.

The Union also has argued against the need for this micro-management by the Commission. As pointed out by the Union, Peoples Gas has exceeded the rate of main replacement that had been recommended to it by its consultants, and this has resulted in a system both Peoples Gas and Staff agree is safe and being operated safely. Union Init. Br. at 3-4.

Accordingly, for the reasons stated here as well as in the Initial Briefs of Peoples Gas and the Union, Staff's recommendations as to ordering the acceleration of Peoples Gas' main replacement program, the retention of independent consultants to review a plan and subsequent updates, as well as for Commission pre-approval of the company's implementation plan should be denied.

X. OTHER NEW RIDERS

A. Rider UEA (Withdrawn)

Neither Staff nor any party addressed this section in its Initial Brief.

B. Rider FCA (NS) (Uncontested)

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 138.

C. Rider GCA (NS) (Uncontested)

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 138-139.

XI. COST OF SERVICE

A. Overview

Only Staff addressed the two contested cost of service issues in its Initial Brief, namely the treatment of Account 904 ("Uncollectible Account") costs in the embedded cost of service studies ("ECOSSs") and the recommended increases to the sales forecast. First, the Utilities showed that they correctly functionalize, classify and allocate Account 904 costs in their ECOSSs. *See* NS-PGL Init. Br. at 138-141. Second, the Utilities showed that the recommendation related to adjusting the sales forecast should be rejected. Moreover, Staff has not sufficiently addressed the ECOSS issues arising from that recommendation. *See* NS-PGL Init. Br. at 72-74, 142.

B. Embedded Cost of Service Study

1. Uncontested Issues

a. Sufficiency of ECOSS for Rate Design

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 140.

2. Contested Issues

a. Classification of Uncollectible Account Expenses Account No. 904

Only Staff addressed this issue in its Initial Brief. Staff Init. Br. at 144-150. There is an ECOSS component and a rate design component of this issue. As it did in testimony, Staff fails to distinguish between the two distinct aspects of the Account 904 issue. The ECOSS issue, addressed in this Section XI(B)(2)(a), is the proper classification of Account 904 costs. The rate design issue is addressed in Section XII(B)(2), *infra*.

The Utilities classified Account 904 costs as customer costs. Hoffman Malueg Reb., NS-PGL Ex. JCHM-2.0 at 8:158 - 9:171. Staff's position is that Account 904 costs are comprised of fixed and variable charges and are not solely a customer cost. Staff Init. Br. at 145-147. Staff's position is flawed.

i. *Peoples 2007*

Staff's position is based almost entirely on its unsupported interpretation of the Commission's order in the 2007 rate cases.[19] That reliance is problematic for several reasons.

First, Staff's statement that the Utilities "did not follow all of the Commission's direction" from that Order (Staff Init. Br. at 145) is misleading. The Utilities' compliance filings following the 2007 rate cases were consistent with the Commission's Order. Staff has not claimed otherwise. In the instant case, the Utilities demonstrated why the method required by that Order was inappropriate. The record in this case supports a different result.

Second, despite Staff's reliance on the Order, Staff avoids the obvious circularity problem with the Order by adding words not found in the Order. Specifically, Staff's interpretation of the term "revenue requirement" in this context is that it means revenue requirement minus the uncollectible expense. Harden Reb., Staff Ex. 24.0 at 23:499-502. Staff forces the language in the 2007 Order to work by adding words. The Order does not include those words, as Ms. Harden agreed. Harden, Tr. at 958:8 - 959:8. Staff's numerical examples assume this unconventional definition of "revenue requirement" and have the same circularity problem of needing to know the variable B to answer equation A, but needing to know A in order to compute B. Harden, Tr. at 955:16 - 957:20. Moreover, Staff has no explanation for the commonly used term "revenue requirement" having a different definition for the sole purpose of the Account 904 costs. Finally, it is not apparent why a cost of service witness would use this anomalous definition in developing a cost of service model.

[19] Staff witness Ms. Harden recommends that the Utilities spread these costs according "to the respective demand, customer and commodity classifications by the relative weight or percentage of revenue requirement from each customer class resulting from various categories of costs." Harden Dir., Staff Ex. 10.0 at 3:59 - 4:65

Third, Staff ignores that its own witness has not used this approach to Account 904 in the two cost of service studies she prepared in other cases. The witness has not advocated this approach in the approximately 15 cases where she was the Commission's main rates witness. Harden, Tr. at 959:9 - 960:5. The witness agrees that no other gas utility in Illinois uses this approach. Hoffman Malueg Reb., NS-PGL Ex. JCHM-2.0 at 7:135-137; NS-PGL Ex. JCHM-2.2; Hoffman Malueg, Tr. at 43:13-18.

ii. <u>ECOSS and Rate Design</u>

Staff's disagreement with the Utilities' treatment of Account 904 costs in their ECOSSs confuses cost of service and rate design principles. Staff argues that Account 904 costs are not "customer" costs because an unpaid bill is comprised of three parts (customer charge, distribution charge and demand charge). Staff Init. Br. at 146.

First, Staff's terminology is confusing. While it is true that some rate designs include customer, distribution and demand charges, that is neither a necessity nor is it true for all the Utilities' service classifications. For example, it is apparent from Staff witness Ms. Harden's own rate exhibits that S.C. Nos. 1 and 2 for each company include a customer charge and a distribution charge but no demand charge. Harden Reb., Staff Ex. 24.0, Scheds. Staff Ex. 24.1 N (Corr.) and 24.1 P (Corr.). What is the case, however, is that classification in the ECOSS looks at commodity, demand (capacity) and customer categories. Hoffman Malueg Dir., NS Ex. JCHM-1.0 at 8:171-173; Hoffman Malueg Dir., PGL Ex. 1.0 Rev. at 8:165-167. The Utilities' ECOSS witness clarified Staff's incorrect use of terminology during cross-examination, but, in its Initial Brief, Staff persists in its erroneous use of terminology.

> Q. Okay. And given the fact that you put all those costs into the customer charge and none of them to demand charge or commodity charge, can you explain how that cost of service study is compliant with the 2007 final order?

> A. I guess I would like to clarify. I don't like using the terminology charge, to me that implies how costs are recovered through rate design. And the cost of service, I classify them to a certain bucket. It's up to the rate design witness to determine how those buckets should be recovered within rates.

Hoffman Malueg, Tr. at 46:19 - 47:8.

Second, the components of the bill are the "rate design," as Staff agreed. Harden, Tr. at 952:20 - 953:1. The ECOSS issue is how to functionalize, classify and allocate Account 904 costs. The rate design witness uses the ECOSSs to develop the rate design. Hoffman Malueg Dir., NS Ex. JCHM-1.0 at 2:33-36; Hoffman Malueg Dir., PGL Ex. 1.0 Rev. at 2:33-36; Harden, Tr. at 951:10-17. The ECOSS witness determines how to classify Account 904 without regard to whether the rate design witness will develop a rate design that includes one or more of a customer charge, distribution charge and demand charge. If the rate design witness had proposed rates that consisted completely of fixed charges or completely of variable charges, this would not have changed the ECOSS.

Finally, Staff's improper conflation of rate design and ECOSS issues is evident from the fact that Staff addressed both issues in the rate design section of the Initial Brief, rather than addressing what are two discrete analyses as such.

b. <u>Sales Revenues Adjustments</u>

Only Staff included this section in its Initial Brief. Staff Init. Br. at 140-142. Staff did not address the ECOSS issues raised by the Utilities' witness Ms. Hoffman Malueg, which are summarized in the Utilities' Initial Brief. NS-PGL Init. Br. at 142. *See* Section V(C)(8)(a) of this Reply Brief for non-ECOSS issues related to the proposed sales revenues adjustment.

XII. RATE DESIGN

A. Overview

There are four contested rate design issues, three of which Staff addressed (Staff Init. Br. at 142-150, 160-167) and one of which the AG addressed (AG Init. Br. at 56-64). First, Staff claims that its Schedules 24.1 N (Corr.) and 24.1 P (Corr.) (to Harden Reb., Staff. Ex. 24.0) can set final rates for the Utilities based on the Commission's Order. Staff's Schedules 24.1 N (Corr.) and 24.1 P (Corr.) include many errors and inconsistencies and could not accurately produce final rates. Second, Staff disagrees with the Utilities that the rate differentiation associated with gas cost-related Account 904 costs should be reflected in the customer charge. Staff's position is inconsistent with cost causation principles and, in part, flows from its improper classification of Account 904 costs in the ECOSS. Third, Staff contends that the Commission should not increase the percentage of fixed costs that the Utilities recover through their S.C. Nos. 1 and 2 customer charges. This position is contrary to Commission policy, and it is based on an unsupported conclusion that the decoupling (Rider VBA) pilot program does not permit the Utilities' proposal. Finally, the AG argues for adoption of an untested S.C. No. 1 rate design that is conceptually and practically flawed.

B. General Rate Design

1. Allocation of Rate Increase

Only Staff addressed this section in its Initial Brief. Staff Init. Br. at 142-144. In large part, Staff discusses the other contested issue related to rate design (Account 904 and fixed cost recovery through the S.C. Nos. 1 and 2 customer charges). The limited portion of the brief specifically addressing allocation of the rate increase contends that Ms. Harden's Schedules 24.1 N (Corr.) and 24.1 P (Corr.) can be "modified to quickly set final rates" (*Id*. at 142) and that whatever revenue requirement the Commission determines, it can be input into the schedule to automatically calculate final rates (*Id*. at 143). While it may be true that Staff's Schedules 24.1 N (Corr.) and 24.1 P (Corr.) could automatically calculate final rates, those rates would not be accurate and compliant with the Order. The Utilities' rate design witness Ms. Grace identified many errors with the schedules, notably that it is not based upon cost of service principles; the electronic format of the exhibits has conceptual problems and formulaic errors; and some of the formulas and outcomes are inconsistent with Staff's testimony. Grace Sur., NS-PGL Ex. VG-3.0 at 9:191 - 19:423. These problems are summarized on pages 143-146 of the Utilities' Initial Brief. Additionally, only the Utilities prepared ECOSSs, so, for example, any Account-specific adjustments required by the Order would necessarily need to be factored into final costs and rates by the Utilities. The Utilities' ECOSS and rate design models have none of the deficiencies associated with Staff's schedule and are the only viable tools for developing final rates.

Additionally, Staff, in its discussion of Account 904 rate design issues, disputes the Utilities' statement that Account 904 costs cannot be accurately identified and quantified under Staff's rate approach and cited Ms. Grace's surrebuttal testimony as support. Staff Init. Br. at 150. Staff apparently misunderstood Ms. Grace's testimony. What Ms. Grace was able to do was to derive amounts from Staff's rate schedules in a logical manner, but these amounts were inconsistent with Staff's revenue requirement schedules. Clearly, there is a problem with Staff's rates schedules. Specifically, Ms. Grace explained:

> Her [Ms. Harden's] formulaic methodology, which treats all expenses equally, is akin to a black box that would not allow the Utilities to accurately quantify nor identify the amount of total Account 904 Costs which are included in their base rates. Using Ms. Harden's gas cost related Account 904 Costs alone would cause the Utilities to incorrectly refund amounts below the artificially derived and much too high, Account 904 Costs arising from her rate design proposals. This is evidenced in Ms. Harden's Account 904 Costs shown in NS-PGL Exs. VG-3.1N and VG-3.1P, which show that Account 904 Costs from her rate proposals exceed that in Staff's proposed revenue requirements, which underlie her rates.

NS-PGL Ex. VG-3.0 at 20:438-446. For Peoples Gas, the gas cost-related Account 904 costs that could be derived from Staff witness Ms. Harden's proposed rates are $2.2 million over the amount of such costs in Staff's underlying revenue requirement and for North Shore the amount is $628,000. NS-PGL Exs. VG-3.1N and 3.1P. Staff, incorrectly, attributes the difference to the rate design difference between Staff and the Utilities. The difference has nothing to do with the Utilities' proposals, as Ms. Grace's comparison was between one Staff proposal (revenue requirement) and another Staff proposal (rates). *Id*.

Only the Utilities have presented ECOSSs and rate methodologies that are sufficient to develop final rates based on the Commission's final Order in this proceeding.

2. Account 904 Uncollectible Expense

Only Staff addressed this section in its Initial Brief. Staff Init. Br. at 144-150. As discussed in Section XI(B)(2)(a), *supra*, Staff mixed ECOSS and rate design Account 904 issues together. Staff and the Utilities agree that it is appropriate to differentiate rates for gas cost-related Account 904 costs. In particular, sales customers and transportation customers should pay different rates because the level of gas cost-related Account 904 costs differs between sales and transportation customers. The contested rate design issue is limited to whether the differentiation for gas cost-related Account 904 costs should be in the customer charge or in the distribution charges. The Utilities demonstrated that it should be in the customer charge. NS-PGL Init. Br. at 147-149.

First, as with the ECOSS issues, the Utilities' compliance filings following their 2007 rate cases were consistent with the Commission's Order. The Utilities have shown why it is appropriate to reach a different result in this proceeding. Staff agrees that the Commission should base its decision on the facts and circumstances presented to the Commission. Staff Init. Br. at 148.

Second, Staff asserts that gas usage is a cause for uncollectible costs and that these costs vary with usage. So, according to Staff, this is a reason for differentiation in the distribution charge. Staff Init. Br. at 146-147. This is a *non sequitur*. Cost causation takes into account "why" a cost occurs. The Utilities have Account No. 904 costs because customers do not pay their bills, *i.e.*, the cost causation is a function of customers not paying their bills. The bill components -- fixed or variable or some mix -- do not cause the Utilities to incur Account 904 costs. NS-PGL Ex. JCHM-2.0 at 7:138 - 8:157. Hence, the Utilities classify the costs as customer costs and propose to recover the gas cost-related differential in such costs, for sales and transportation customers, through the customer charge.

Third, Staff disputes the Utilities' assertion that Account 904 costs cannot be accurately identified and quantified under Staff's rate approach. Staff Init. Br. at 150. This argument is addressed in Section XII(B)(1), *supra*, as it is a function of the Staff's flawed rate allocation proposal and not the Account 904 proposal.

3. Uniform Numbering of Service Classifications

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 150-151.

C. Service Classification Rate Design

1. Uncontested Issues

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

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 151.

b. North Shore Service Classification No. 3

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 151-154.

c. North Shore Service Classification No. 5

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 154, 162.

d. North Shore Service Classification No. 6

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 154.

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

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 154-155. However, Staff's proposed rates and resulting rate design are inconsistent with its approval of the EPECM. *See* NS-PGL Init. Br. at 145.

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

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 155-156.

g. Peoples Gas Service Classification No. 4

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 156-158.

h. Peoples Gas Service Classification No. 5

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 158.

i. Peoples Gas Service Classification No. 6

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 158-159.

j. Peoples Gas Service Classification No. 8

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 159.

2. Contested Issues

a. North Shore Service Classification No. 1

i. Account 904

Only Staff addressed this issue in its Initial Brief. *See* Section XII(B)(2), *supra*.

ii. North Shore's Rate Design

See Section XII(C)(2)(a)(iii), *infra*.

iii. Customer Charge

Staff opposed North Shore's proposal to increase the percentage of fixed costs it recovers through its customer charge, arguing that the percentage should not increase while the decoupling (Rider VBA) pilot program is in effect.[20] Staff Init. Br. at 160-161. As the Utilities explained at pages 154-156 of their Initial Brief, an increase to recover 55% of fixed costs in the customer charge is modest, consistent with Commission policy and not contrary to Rider VBA.

[20] Staff, incorrectly, stated that the proposal is for 56%.

Staff also made the puzzling assertion that a utility should not have both a decoupling mechanism and a "high percentage fixed cost recovery through the customer charge like the other gas utilities in Illinois." Staff Init. Br. at 144. Nicor and the Ameren gas utilities have 80% fixed cost recovery through their customer charges. *Nicor 2008* at 90-91; *In re Central Illinois Light Co., Central Illinois Public Serv. Co. and Illinois Power Co.*, ICC Docket Nos. 07-0588, 07-0589 and 07-0590 (Cons.), at 237 (Order, Sept. 24, 2008). North Shore proposed to increase the recovery from 50% to 55%. This is hardly a "high percentage" and certainly not "like the other gas utilities."

iv. <u>Tiered Rates</u>

Only the AG addressed this topic in its Initial Brief. AG Init. Br. at 56-64. The Utilities demonstrated that the tiered rate proposal is deeply flawed. NS-PGL Init. Br. at 156-158. The Utilities' Initial Brief generally refuted the points raised in the AG's Initial Brief, and, therefore, this Reply Brief will address only a few discrete arguments.

First, the AG cites the difference between the proposed customer charges for sales and transportation customers but ignores the reason for this difference. AG Init. Br. at 57. The proposed customer charge for transportation customers is lower because the costs that these customers cause the Utilities to incur are lower. Specifically, the differential is attributable to gas cost-related Account 904 costs. Transportation customers cause the Utilities to incur a lesser amount of such costs and, accordingly, the Utilities proposed lower customer charges. *See* NS-PGL Init. Br. at 147.

Second, the AG asserts that the Utilities' rate design "rewards" inefficient usage. The AG relies on an example involving two customers with approximately the same usage, but different bills under the Utilities' rate design. AG Init. Br. at 57-59. It is true that these customers would pay the same amount under the tiered rates, but that is not an "efficient" result. AG-CUB-City witness Mr. Rubin described one of the customers as being the "more efficient, less costly customer." Rubin Dir., AG-CUB-City Ex. 2.0 at 9:174 - 10:175. Yet, under his proposal, which purportedly creates incentives to use gas more efficiently, this "more efficient, less costly customer" pays the same amount as the customer that he believes imposes more costs on the system. Rubin Dir., AG-CUB-City Ex. 2.0 at 8:154-157; Rubin, Tr. at 978:2-21. The major flaw with the tiered rate proposal is that it is not cost based. It is not based on sound ratemaking principles, and it selectively and improperly uses the Utilities' data as support. Grace Reb., NS-PGL Ex. 2.0 Rev. at 19:285-293, 23:516 - 27:600.

Third, the AG claims that this is not a "radical proposal" and analogizes to cable television rates. AG Init. Br. at 60. The witness had also analogized to telecommunications services. Rubin Dir., AG-CUB-City Ex. 2.0 at 29:556-573. The analogies are inapt. Even Mr. Rubin acknowledged that tiered rates have not been used for energy services. Rubin Dir., AG-CUB-City Ex. 2.0 at 29:557-558. For the industries he identified, customers are able or required to choose, usually in advance, the level of services that they desire, such as minutes, unlimited service, number of channels, premium channels, *etc*. Grace Reb., NS-PGL Ex. VG-2.0 Rev. at 21:453-457. Generally, if customers use more than their elected service, they are billed additional charges on each unit of additional service rather than automatically moved by the service provider to a higher priced plan. *Id*. at 21:457-459. There is no reconciliation, for any reason, under Mr. Rubin's proposal. Rubin, Tr. at 976:15 - 978:1. The Utilities' customers do not elect the level of gas distribution service that they desire in advance. They consume what they need or desire. Also, there is no evidence that a customer who uses 5,000 annual therms values gas service any more than the customer who uses 1,000 annual therms. Grace Reb., NS-PGL Ex. VG-2.0 Rev. at 21:464-468.

Fourth, the AG claims that tiered rates would eliminate the need for a decoupling mechanism. AG Init. Br. at 61. That is incorrect. In fact, tiered rates would result in a greater need for Rider VBA or a similar decoupling mechanism as the Utilities would be required to move customers to a tier that may differ from that for which the tiered rate and assumed revenue requirement recovery were based. Grace Reb., NS-PGL Ex. VG-2.0 Rev. at 17:379-382.

The tiered rate proposal is conceptually and practically flawed and should not be adopted.

v. Demand Rates

The AG also addressed Mr. Rubin's demand rates proposal. AG Init. Br. at 62-64. Mr. Rubin's demand-based proposal is less problematic than his tiered rate proposal but is inferior to the Utilities' proposal. Also, this proposal pushes more of the Utilities' revenues toward the end block of the distribution charges, which is the block most affected by weather variations. As a result, there is a greater need for a decoupling mechanism, such as Rider VBA, with this type of rate. As with the tiered rate proposal, he assumed that charges would not be differentiated among sales and transportation customers and did not factor in revenues or credits arising from the Utilities' transportation program when developing his rates. Grace Reb., NS-PGL Ex. VG-2.0 Rev. at 27:613 - 28:624.

The proposal would also adversely affect high use customers. For Peoples Gas, the low annual bill increase would be the same, about $60 under Peoples Gas' and Mr. Rubin's proposals. The mean annual bill increase would be similar, with Mr. Rubin's proposal resulting in a $149 annual bill increase compared to $148 arising from Peoples Gas' proposal. However, the high annual bill increase under Mr. Rubin's demand-based rates proposal would be $1,886 compared to $1,495 under Peoples Gas' proposal, or about 26% higher. For North Shore, the low annual bill increase would be similar, at about $66 under Mr. Rubin's proposal and $68 under North Shore's proposal. The mean annual bill increase would be similar, with Mr. Rubin's proposal resulting in a $123 annual bill increase compared to $120 arising from North Shore's proposal. However, the high annual bill increase under Mr. Rubin's demand-based rates proposal would be $1,862 compared to $825 under North Shore's proposal, or 126% higher. NS-PGL Ex. VG-2.0 Rev. at 29:643 - 30:661.

Finally, Mr. Rubin proposed to recover all demand-related costs on an equal cents per therm basis for both the first and second blocks. This incorrectly infers that demand-related costs are volumetrically based. The Utilities proposed an average and peak methodology to allocate demand-related costs in their ECOSSs, under which most costs are allocated to each rate class based on peak day usage and a lesser amount is allocated based on average usage. The resulting rate design should consider how underlying costs are reflected in the Utilities' supporting cost studies. Demand-related costs are fixed, and there are a few acceptable methodologies for recovering such costs. The Utilities believe that absent a fixed demand charge, such fixed costs should be recovered through a fixed charge such as the customer charge, or spread between the customer and commodity charges. *Id*. at 31:680 - 32:701.

While less problematic than the tiered rate proposal, the demand rate proposal has flaws not present in the Utilities' proposal and should be rejected.

b. <u>North Shore Service Classification No. 2, Customer Charge</u>

Only Staff addressed this issue in its Initial Brief, and the contested issue is the amount of fixed cost recovery through the customer charge. Staff Init. Br. at 161-163. The issue is identical to the customer charge issue for S.C. No. 1. *See* Section XII(C)(2)(a), *supra*. North

Shore would recover only 54% of the S.C. No. 2 revenue requirement through fixed charges. This is not a high percentage and will not interfere with the assessment of the pilot for the reasons discussed on pages 154-156 and 158-159 of the Utilities' Initial Brief.

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

i. **Account 904**

Only Staff addressed this issue in its Initial Brief. *See* Section XII(B)(2), *supra*.

ii. **Peoples Gas' Rate Design**

See Section XII(C)(2)(c)(iii), *infra*.

iii. **Customer Charge**

Only Staff addressed this issue in its Initial Brief, and the contested issue is the amount of fixed cost recovery through the customer charge. Staff Init. Br. at 163-165. The issue is identical to the customer charge issue for North Shore's S.C. No. 1. *See* Section XII(C)(2)(a), *supra*. Peoples Gas proposed to recover only 54% of its fixed costs through the customer charge. This is not a high percentage and will not interfere with the assessment of the Rider VBA pilot for the reasons discussed on pages 154-156 and 160-161 of the Utilities' Initial Brief.

iv. **Tiered Rates**

Only the AG addressed this issue in its Initial Brief. AG Init. Br. at 56-62. This issue is identical to the tiered rate proposal for North Shore. *See* Section XII(C)(2)(a)(iv), *supra*.

v. **Demand Rates**

The AG addressed AG-CUB-City witness Mr. Rubin's demand rate proposal in its Initial Brief. AG Init. Br. at 62-63. This issue is identical to the proposal for North Shore. *See* Section XII(C)(2)(a)(v), *supra*.

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

Only Staff addressed this issue in its Initial Brief, and the contested issue is the amount of fixed cost recovery through the customer charge. Staff Init. Br. at 165-167. The issue is identical to the customer charge issue for North Shore's S.C. Nos. 1 and 2 and Peoples Gas' S.C. No. 1. *See* Section XII(C)(2)(a), *supra*. Peoples Gas would recover only 35% of the S.C. No. 2 revenue requirement through fixed charges. Staff's testimony and Initial Brief are completely at odds with its proposed rates (Harden Reb., Staff Ex. 24.0, Sched. 24.1 P (Corr.)), which would increase fixed cost recovery to 50%. NS-PGL Ex. VG-3.0 at 14:300-303. While Peoples Gas certainly would not oppose this result, it seems to be simply another example of the flaws with Staff's rate proposal. Neither 35% nor 50% are high percentages and will not interfere with the assessment of the Rider VBA pilot for the reasons discussed on pages 154-156 and 160-161 of the Utilities' Initial Brief.

D. Tariffs – Other Tariff Issues

1. Uncontested Issues – North Shore and Peoples Gas

a. General Terms and Conditions

Only Staff addressed this section in its Initial Brief, and the issues are uncontested. Staff Init. Br. at 167.

b. Service Activation Charges

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 167-171.

c. **<u>Service Reconnection Charges</u>**

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 171-175.

d. **<u>Second Pulse Capability</u>**

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 176-177.

e. **<u>Rider 1</u>**

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 177.

f. **<u>Rider 2</u>**

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 178, 184.

g. **<u>Riders 4 and 5</u>**

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 178-181.

h. **<u>Account 385 Facilities Charge</u>**

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 181-182.

2. **<u>Volume Balancing Adjustment (Rider VBA)</u>**

a. **<u>Establishment of New Margins</u>**

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 182-183.

b. <u>Change in Annual Report</u> (Uncontested)

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 183.

E. <u>Bill Impacts</u>

Neither Staff nor any party addressed this section in its Initial Brief.

XIII. <u>TRANSPORTATION ISSUES</u>

A. <u>Overview</u>

Staff, CNE-Gas and RGS addressed transportation issues in their Initial Briefs. Staff addressed issues related both to the Utilities' large volume and small volume transportation programs. Staff Init. Br. at 184-206. CNE-Gas addressed only issues related to the large volume programs. RGS addressed only issues related to the small volume program ("Choices For You^sm" or "CFY").

RGS and, to a lesser degree, Staff, cite Nicor's program in their recommendations. *See, e.g.*, RGS Init. Br. at 14-16, 28-29; Staff Init. Br. at 191. RGS also cited a "Memorandum of Understanding" ("MOU") (RGS Cross Ex. Sackett 32) that it stated Nicor entered into with alternative suppliers. RGS Init. Br. at 4-5. Section 11(B) of the MOU expressly states that it "shall not have any precedential value in proceedings that address the rates or tariffs of Nicor Gas or any other utility." RGS Cross Ex. Sackett 32 at 5. The Utilities, of course, were not a party to the MOU. What Nicor may have agreed to in that MOU has no relevance to this proceeding.[21]

[21] The Utilities note that Section 11(A) of the MOU states that no party shall offer it into evidence except in connection with a proceeding related to the performance, implementation or enforcement of the MOU. RGS Cross Ex. Sackett 32 at 5.

B. Uncontested Issues

1. Elimination of Transportation Transition Riders

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 184.

2. Riders FST, SST, and P Charges

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 184.

3. Intra-Day Nomination Rights

Only Staff and CNE-Gas addressed this section in their Initial Briefs, and the issue is uncontested. Staff Init. Br. at 185; CNE-Gas Init. Br. at 5-7.

4. Storage Credit

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 185-186.

5. Diversity Factors

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 186.

6. Standby Commodity Charge

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 187.

7. Maximum Daily Quantity (MDQ) Calculation

Only Staff and RGS addressed this section in their Initial Briefs, and the issue is uncontested. Staff Init. Br. at 187; RGS Init. Br. at 41.

8. Rider SST Unbundled Allowable Bank

Only Staff and CNE-Gas addressed this section in their Initial Briefs, and the issue is uncontested. Staff Init. Br. at 187-188; CNE-Gas Init. Br. at 8.

9. Elimination of Rider TB – Transportation Balancing Service

Only Staff addressed this section in its Initial Brief, and the issue is uncontested. Staff Init. Br. at 188.

C. Large Volume Transportation Program

1. Super Pooling on Critical Days

Staff (Staff Init. Br. at 188-192) and CNE-Gas (CNE-Gas Init. Br. at 9-11) addressed this section in their Initial Briefs. CNE-Gas argues that the administrative burden identified by the Commission in rejecting the super pooling proposal in the 2007 rate cases is addressed by its alternative proposal. CNE-Gas states that the responsibility for determining and applying super pooling rests with the supplier. CNE-Gas Init. Br. at 10-11. Staff supports CNE-Gas' proposal and, like CNE-Gas, cites Nicor's agreement to implement super pooling for critical days. Staff concludes that the Utilities have not shown that they are unable to implement the proposal or that they differ from Nicor. Staff Init. Br. at 188-192.

The Commission should reject CNE-Gas' super pooling proposal. First, as described at pages 174-176 of the Utilities' Initial Brief, the proposal does not remove an administrative burden from the Utilities. If a supplier requests a waiver from what CNE-Gas called "penalty charges" based on super pooling, the Utilities will need to ascertain if the request meets the criteria for pooling the accounts or contracts and waiving the charges. Other than being triggered by a request rather than being triggered by a critical day, it is the same burden as rejected in the

2007 rate cases. *Peoples 2007* at 282-283; McKendry Reb., NS-PGL Ex. JM-1.0 at 13:268-272; McKendry Sur., NS-PGL Ex. JM-2.0 at 4:85 - 5:92.

Second, the Nicor practice, cited by both Staff and CNE-Gas, was apparently the product of a settlement. The Staff brief quotes language from the order about "compromises" between CNE-Gas and Nicor and CNE-Gas and Nicor "reaching an accord." Staff Init. Br. at 189; *Nicor 2008* at 127. In other words, this was an uncontested issue resulting from some sort of settlement. What give and take may have transpired to produce that settlement is not in the record in this proceeding, nor, apparently, in the Nicor case as the settlement occurred subsequent to when initial briefs were filed. *Nicor 2008* at 126.

Third, Staff's conclusion that the Utilities would not be entangled in the supplier/customer relationship (Staff Init. Br. at 192) is not necessarily true. One element of administering super pooling is to ensure that only the correct pools and stand alone customers are correctly accounted for in the super pool. McKendry Reb., NS-PGL Ex. JM-1.0 at 14:294-297. For example, a customer (likely a stand alone customer not in a pool) may purchase gas from more than one supplier. *See, e.g., Peoples 2007* at 282. If two suppliers seek a waiver based on including the same customer in the "super pool," that could entangle the Utilities in the supplier/customer relationship.

Fourth, the proponents of this proposal have the burden of proof. *Central Illinois Public Service Company v. Illinois Commerce Commission*, 5 Ill. 2d. 195, 211 (1955). The Utilities responded to CNE-Gas' proposal to show why it is problematic and why the rationale for the Commission's rejection of a similar proposal in the 2007 rate cases remained applicable. It is not the Utilities' burden, as posited by Staff, to show that "they are unable to implement" (Staff Init. Br. at 192) the proposal.

Fifth, it is also not the Utilities' burden to show "how they differ from Nicor Gas." *Id*. The Commission's task is to set just and reasonable rates for the Utilities based on the record in this proceeding. There is no evidence that the proposal to which Nicor agreed applies to the Utilities' programs. There is no evidence that it makes sense to apply the "compromise" that Nicor reached with CNE-Gas to the Utilities or if there are other elements of the "compromise" that should be taken into account. There is no evidence in the record about how Nicor will implement the super pooling aspect of the "compromise." For example, Staff concludes that it is "unnecessary to modify the billing system," (*Id*. at 191) but there is no evidence about whether Nicor modified its billing system or whether the Utilities would need to do so to efficiently implement the proposal.

However, if the Commission approves "super pooling," it must be clear what this entails. Staff likens it to a "billing discrepancy," (Staff Init. Br. at 191) which may suggest canceling and re-issuing the bill(s) in question and revising all quantities and charges on the bill. CNE-Gas appears to suggest it is requesting only a "credit of penalty charges" (CNE-Gas Init. Br. at 11). A cancel and rebill that affects only waiving penalties is a very different exercise from a cancel and rebill that adjusts all quantities and charges. It is not apparent from the Nicor case relied on by CNE-Gas and Staff how or if these issues were resolved. *Nicor 2008* at 127.

The Commission should reject CNE-Gas' super pooling proposal. If it approves the proposal, the Commission should clarify that it is only requiring waiver of penalty charges and it should clarify if stand alone customers (customers not in a pool) may be included in super pools.

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

1. Allocation of and Access to Company-owned Assets

Staff (Staff Init. Br. at 192-197) and RGS (RGS Init. Br. at 6-24) addressed this issue in their Initial Briefs. RGS' Initial Brief is a hodge podge of recommendations on this issue ranging from "incorporating key elements" of Nicor's Customer Select program (RGS Init. Br. at 23) to "increas[ing] the asset allocation" for CFY customers (*id*.) to reducing the amount CFY customers pay (*id*. at 24) to the occasional reference to direct assignment of upstream assets (*id*. at 8, 11). Staff compares the Utilities' Rider AGG with Nicor's Customer Select and concludes that Customer Select provides more flexibility. Staff recommends that the Utilities implement certain changes based on Nicor's program or that the Commission order workshops. Staff Init. Br. at 194-197.

The various proposals to change the program should be rejected. The Utilities refuted RGS' argument that CFY customers are receiving inferior service relative to sales customers. *See* NS-PGL Init. Br. at 176-178. Accordingly, this Reply Brief will address only a few discrete arguments.

First, RGS repeatedly claims that CFY customers pay the same amount for assets as sales customers. *See*, *e.g.*, RGS Init. Br. at 3, 6, 10, 11. This is false. Sales customers pay a Gas Charge that includes the Non-Commodity Gas Charge ("NCGC"). NS Ex. VG-1.1 at 17; PGL Ex. VG-1.1 at 20. CFY customers do not pay a Gas Charge but do pay an Aggregation Balancing Gas Charge. The NCGC and the ABGC each recovers non-commodity gas costs, which includes assets like purchased storage. The ABGC is less than the NCGC. Specifically, the ABGC is defined as "a non-commodity related, per therm, gas cost recovery mechanism applied to all therms delivered or estimated to be delivered by the Company to customers served under Rider CFY. This charge is <u>equivalent to the NCGC less any costs not associated with</u>

balancing or storage. Revenues arising through the application of this charge will be credited to the Factor NCGC." (Emphasis added) NS Ex. VG-1.1 at 17; PGL Ex. VG-1.1 at 20.

Second, Staff states that the storage flexibility that CFY suppliers receive is as though injections are directly into Manlove Field. Staff Init. Br. at 193. That statement is incorrect. For example, the "injection period" under Rider AGG is April 1 through October 31, and the withdrawal period is November 1 through March 31. However, the withdrawal period for Manlove Field typically runs from the first or second week of December through the first or second week of March. Puracchio Dir., PGL Ex. TLP-1.0 at 5:100-101.

Third, neither Staff nor RGS offers any evidence whether and to what extent Peoples Gas' and North Shore's systems are similar to Nicor's. Neither Staff nor RGS compares or contrasts the Utilities' purchased storage assets with Nicor's. Neither Staff nor RGS compares or contrasts the Utilities' company-owned storage assets with Nicor's. Indeed, it is not apparent that RGS even recognizes that North Shore does not own a storage field. RGS Init. Br. at 10 ("On-system storage (at Manlove Field) is owned by the Companies and directly connected to the Companies' distribution system."). Doerk Dir., NS Ex. ED-1.0 at 3:55-56. Yet, they propose to have the Commission impose storage operational terms and conditions from Nicor's Customer Select program on the Utilities.

Fourth, Staff and RGS each recommends that the Commission require the Utilities to adopt portions of Nicor's Customer Select tariff, but neither RGS nor Staff specifically explained how to incorporate those portions into the Utilities' tariffs or examined whether the provisions would fit with sections that, apparently, they would not change or whether any changes to other portions of the Utilities' tariffs may be necessary.

Fifth, the idea of changing CFY to provide for capacity release or direct assignment of upstream assets was not developed at all in the record. The Utilities note that, if this is RGS' true preference, it would include only pipeline assets subject to the Federal Energy Regulatory Commission's ("FERC") jurisdiction. "Capacity release" is an element of the FERC's rules (18 C.F.R. §284.8) and would not encompass company-owned assets (Peoples Gas' Manlove Field and needle peaking assets) that, otherwise, seem to be part of RGS' proposal. RGS Init. Br. at 18. *See* Dobson Reb., NS-PGL Ex. RD-2.0 at 15:320-326.

Sixth, Staff suggests a workshop process as an alternative. There is no evidence that CFY customers are not receiving the service for which they are paying. The record supporting a change to CFY was woefully underdeveloped. There is no basis for the Commission to order workshops.

Finally, RGS seeks to make much out of what it called a workpaper that it claimed the Utilities withheld. RGS Init. Br. at 17-23. This is a red herring. The Utilities explained why the document was not a workpaper and, therefore, not produced as such. Tr. at 368:17 - 372:7.

CFY customers receive access to assets that are comparable to, if not superior to, what sales customers receive. The various proposals to change the program are muddled, flawed and incomplete and should be rejected.

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

Staff (Staff Init. Br. at 197-198) and RGS (RGS Init. Br. at 24-25) address this section in their Initial Briefs. Staff does not support reducing the Aggregation Balancing Gas Charge. RGS argues that the charge should be reduced if RGS' request for greater access to storage assets is not granted. RGS' proposal should be rejected. *See* NS-PGL Init. Br. at 178-179; see Section XIII(D)(1), *supra*.

3. <u>Allocation of Administrative Costs and Related Charges</u>

Staff (Staff Init. Br. at 198-201) and RGS (RGS Init. Br. at 25-32) address this section in their Initial Briefs. Staff recommended that the Commission approve the Utilities' proposed administrative charges. Staff Init. Br. at 201. RGS argued that the administrative and LDC Billing Option charges should be assessed to all customers eligible for the CFY programs (*i.e.*, S.C. Nos. 1 and 2).

As the Utilities explained in their Initial Brief, the charges in question are cost-based. The charges are assessed against the suppliers who cause the Utilities to incur these costs. NS-PGL Init. Br. at 179-180. RGS' proposal is inconsistent with cost causation principles and would result in sales customers subsidizing customers who elect to take transportation service. Grace Reb., NS-PGL Ex. VG-2.0 Rev. at 64:1407-1417.

First, the charges at issue are assessed to suppliers. The services in question are services that the Utilities provide to suppliers. Grace, Tr. at 221:15 - 222:4. RGS' proposal is that all S.C. Nos. 1 and 2 customers pay the costs for services they do not use. The cost study showed that the administrative charge is based on, for example, costs of the Gas Transportation Services Department, a department that, for the CFY program, provides services to suppliers. It includes ITS costs that support Gas Transportation Services. It includes contract administration costs, which are services that S.C. Nos. 1 and 2 customers obviously do not require, as there are no contracts to administer. It includes PEGASys™, an internet system that suppliers use to interact with the Utilities. NS Ex. VG-1.10; PGL Ex. VG-1.10. RGS witness Mr. Crist acknowledged that sales customers do not use services such as "supplier support" and "supplier billing" and PEGASys™. Crist, Tr. at 571:13 - 573:2. The LDC Billing Option is an optional service that suppliers may use under which the Utilities issue a bill to customers that includes utility and

CFY supplier charges. RGS Init. Br. at 25. It is obvious from RGS' own description of the service that only CFY suppliers use this service. An S.C. No. 1 or 2 sales customers would not receive a bill that includes utility and CFY supplier charges.

Second, RGS' analogy to the Utilities' call center is flawed. RGS Init. Br. at 27-28. Call center costs are reasonably bundled in the customers' rates, just as other expenses such as operational and maintenance or administrative and general costs, that necessarily support utility service are bundled in the rates. There is no distinct group of customers that chooses to purchase a call center service to whom the Utilities would bill these costs. It would be imprudent and impractical to unbundle the call center and offer it as a distinct service. For example, the call center receives calls about gas leaks and other safety matters. The Utilities could not refuse to accept calls of this nature from customers who declined to take the "call center service." The Utilities could not prevent customers from calling the call center, even if they had not purchased the "call center service." Ms. Grace explained that the call center differs from Gas Transportation Services, in that the former serves all customers and the latter serves only the transportation programs. Grace, Tr. at 240:12 - 241:7. There is a distinct group of suppliers that contract for Rider AGG service (the CFY suppliers) who cause the Utilities to incur identifiable costs that the Utilities bill to those suppliers. Grace Sur., NS-PGL Ex. VG-3.0 at 36:792-801. Large volume suppliers who do not contract for Rider AGG receive no services supported by the Rider AGG administrative charge, nor do they pay any of these costs. *See* NS Ex. VG-1.10 and PGL Ex. VG-1.10 detailing the different administrative charges for CFY suppliers *versus* large volume program suppliers. CFY suppliers who do not contract with the Utilities for the Utilities to issue a bill including supplier charges do not receive services supported by the LDC Billing Option charges, nor do they pay any of these costs. *In re North Shore Gas Co.*, ICC Docket No.

01-0469, at 27-28 (Order, Mar. 5, 2002); *In re The Peoples Gas Light and Coke Co.*, ICC Docket No. 01-0470, at 31 (Order, Mar. 5, 2002).

Third, the analogy to energy efficiency programs is flawed. RGS Init. Br. at 26. The Utilities' Rider EEP, Enhanced Efficiency Program, is a funding mechanism. *Peoples 2007* at 184 ("The Commission further finds that Rider EEP is a reasonable means by which the Utilities may recover the EEP costs that they incur as a result of the programs and benefit ratepayers in that they will only be charged the amount actually spent."). Customers do not purchase "Rider EEP service." Rider EEP generates funding that is then used to support programs that are offered by others. Schott, Tr. at 101:15-21; Grace, Tr. at 260:14 - 261:2. If Rider EEP applied only to customers, who, after the fact, participate in a program funded by Rider EEP, there would be no before the fact funding to develop and implement programs.

Finally, RGS' proposal to bundle the CFY administrative and billing option costs in charges paid by all S.C. Nos. 1 and 2 customers ignores the fact that S.C. No. 2 customers are also eligible to take the Utilities' large volume transportation services.[22] Under RGS' proposal, an S.C. No. 2 customer who chose to take large volume transportation service would pay the administrative charges associated with both the CFY and the large volume programs. The cost-based administrative charges for the large volume transportation program are uncontested. *See* NS-PGL Init. Br. at 169.

The costs in question are cost-based charges that are properly assessed to CFY <u>suppliers</u> for services those suppliers receive. Assessing these costs to all <u>customers</u> (sales and transportation) would be improper and should be rejected.

[22] *See, e.g.*, NS Ex. VG-1.1 at 4 and PGL Ex. VG-1.1 at 5, defining, for purposes of S.C. No. 2, a transportation customer as "customers who take service under this Service Classification and under Rider CFY, FST or SST."

4. **Rider SBO Issues**

Staff (Staff Init. Br. at 201-203) and RGS (RGS Init. Br. at 32-37) address this section in their Initial Briefs. The two issues are: (a) should a customer with payment arrears be able to continue receiving a supplier-issued bill under Rider SBO, and both Staff and RGS support such a change; (b) should a supplier be able to direct the Utilities to transfer to it a customer's credit balance and RGS supports while Staff opposes such a change. The Utilities explained why both changes are problematic and should be rejected. NS-PGL Init. Br. at 180-182.

Concerning the arrearage issue, RGS refers to this as a "quirk" in the Utilities' systems. RGS Init. Br. at 33. It is hardly a quirk. It was the resolution of a contested issue when the Utilities proposed to offer Rider SBO. *In re North Shore Gas Co.*, ICC Docket No. 01-0469, at 26 (Order, Mar. 5, 2002); *In re The Peoples Gas Light and Coke Co.*, ICC Docket No. 01-0470, at 30 (Order, Mar. 5, 2002). A customer with arrearages to the Utilities is in danger of having service discontinued. Issuing bills and using bill messages to try to address the arrearage problem is facilitated by the Utilities controlling the production and issuance of the bill. Staff's opinion that the supplier has an incentive to collect arrearages (Staff Init. Br. at 201) is not the point. Collection is, of course, one of the Utilities' concerns, but the customer may also have a right to payment arrangements (*see, e.g.*, 83 Ill. Admin. Code §§280.110 and 280.135) or be eligible for assistance that will prevent service discontinuance ("No public utility shall disconnect service for nonpayment of a bill until the lapse of six business days after making the notification required by subsection (b)(1) of this Section so as to allow the customer an opportunity to: … 2) Contact a governmental or private agency that may provide assistance to customers for the payment of public utility bills." 83 Ill. Admin. Code §280.135(c)). The Utilities use the bill to convey some of this information.

Turning to RGS' second request concerning credit balances, RGS describes this as a matter of "complying with the customer's requests." RGS Init. Br. at 35. But, of course, it is the supplier, and not the customer, making the request. RGS was asked to offer evidence to support that it is the case that suppliers' agency authority encompasses such a request. RGS' witness provided no agreement forms and offered a single quotation from a supplier's agreement. RGS Ex. 2.4; Crist, Tr. at 579:9 - 576:1. The undefined offer that the supplier provide an affidavit (RGS Init. Br. at 36-37) offers little protection to the Utilities. In addition, the costs involved to make the system programming changes should be considered. The Utilities estimated more than 500 hours would be needed to implement system programming changes. McKendry Sur., NS-PGL Ex. JM-2.0 at 7:135-137.

For both Rider SBO issues, RGS has not met its burden of showing that a change to Rider SBO is required. The Commission should reject RGS' proposals.

5. <u>New Customer Issues</u>

Staff (Staff Init. Br. at 203-204) and RGS (RGS Init. Br. at 38-39[23]) address this issue in their Initial Briefs. Staff and RGS both argue that Senate Bill 171 does not apply to new customers and, therefore, a new customer may take transportation service immediately. In their Initial Brief, the Utilities cited Senate Bill 171 as a concern and also pointed to practical problems associated with a new customer initiating service as a transportation customer. The practical problem being the fundamental difficulty of processing a request for transportation service for a person who is not yet a customer. NS-PGL Init. Br. at 182-183. Staff's position is, apparently, that a customer may take transportation service from day 1, but the utility must still provide the customer with notice that he is taking transportation service and the customer would

[23] RGS addressed the issue of "customer switching" in this section of the brief outline and the "new customer issues" in the "customer switching" section.

then have ten business days to rescind its agreement, without penalty. Staff Init. Br. at 204. Staff's argument distinguishes subsection (g)(7) from (g)(6) of Section 19-115 of the Act. 220 ILCS 5/19-115(g). Subsection (g)(6) requires a utility to give a customer notice, within two business days of receipt of a supplier request, of a switch. The customer then has ten business days to rescind its agreement. Subsection (g)(7) does not use the term "switch" but it refers to the "gas utility notice" and the ten business day rescission period. Staff's distinction between the two subsections is confusing. Subsection (g)(6) is describing the gas utilities' obligations and subsection (g)(7) is describing the suppliers' obligations. The "gas utility notice" in subsection (g)(7) seems to be the notice described in subsection (g)(6). If subsection (g)(6) does not apply to new customers, then subsection (g)(7) does not apply to new customers. If one applies to new customers, then both apply to new customers.

Staff's interpretation also creates ambiguity. Subsection (g)(7) does not have the two business day period tied to notice from the supplier, so, while Staff is arguing that the Utilities must give notice, neither Staff nor subsection (g)(7) gives the timing for the notice. Do the Utilities give notice within two business days of receipt of a supplier request, even if there is not yet a customer to whom the Utilities may give notice because service is not yet activated? If the Utilities' notice is sent two weeks after the customer is activated on the system and is receiving transportation service, does that customer get ten business days to rescind, without penalty, the supplier contract? Staff's interpretation of Section 19-115(g) of the Act offers no guidance.

The Utilities believe their process is reasonable for the reasons stated in their Initial Briefs. However, if the Commission disagrees, the Utilities urge the Commission to clarify that neither subsection (g)(6) nor (g)(7) of Section 19-115 of the Act applies to new customers.

6. **Customer Switching Issues**

Staff (Staff Init. Br. at 205) and RGS (RGS Init. Br. at 37-38[24]) address this issue in their Initial Briefs.

The Utilities have adopted a 19-day convention to ensure compliance with Senate Bill 171. Staff and RGS both consider this "extreme." For the reasons explained in the Utilities' Initial Brief, it is a reasonable practice. NS-PGL Init. Br. at 183-184.

RGS incorrectly asserts that the Utilities picked the "most extreme example they could find - a customer enrolls the day before a four day holiday - the Wednesday before Thanksgiving." RGS Init. Br. at 38. The example did not assume a four-day holiday. It assumed that Thanksgiving was a State holiday, but it treated the day after Thanksgiving as a business day. Hence, the Utilities' example was receipt of the supplier's request on Wednesday. It sent notice two business days after that, as required by law, and one of those business days was the day after Thanksgiving. At best, the Senate Bill 171 process will take 16 days -- two business days for notice plus ten business days for the rescission period. Any twelve business day period necessarily includes two weekends. McKendry Reb., NS-PGL Ex. JM-1.0 at 19:418-422; McKendry Sur., NS-PGL Ex. JM-2.0 at 7:146-149. Any switch request received on a Thursday or Friday will encompass three weekends (six additional calendar days), even with no State holidays. A 19-day presumption is reasonable. It is likewise reasonable for Utilities that serve over 900,000 customers (NS-PGL Init. Br. at 21, 22) who are eligible for the CFY program to have an automated process to ensure that all customers receive the ten-business day window to rescind the contract before the Utilities place the customer on transportation service.

[24] RGS addressed the issue of "new customers" in this section of the brief outline and "customer switching" in the "new customer" section.

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

Staff (Staff Init. Br. at 205-206) and RGS (RGS Init. Br. at 39-40) address this issue in their Initial Briefs. For the reasons stated in the Utilities' Initial Brief, there is no support for requiring the Utilities to include additional information on bills that is readily available -- at any time -- on the PEGASys™ system that all suppliers use. McKendry Reb., NS-PGL Ex. JM-1.0 at 21:464-466.

Staff supports the request for added information on the bill. Staff Init. Br. at 206. Staff acknowledges that the information is already available to suppliers. *Id*. The Commission's bill format rules do not require this result. 83 Ill. Admin. Code §500.330. With PEGASys™, suppliers may readily get whatever information that particular supplier wants or needs and ignore what is superfluous. The request that the Utilities provide exactly the same information in the form of a new bill format, which all CFY suppliers would receive and not merely the three in this proceeding, is redundant and unnecessary and should be rejected.

XIV. CONCLUSION

Accordingly, for the reasons appearing of record and the reasons stated herein and in their Initial Brief, Peoples Gas and North Shore respectfully request that the Commission enter findings and make conclusions on all contested issues consistent with the Utilities' positions taken in testimony and/or stated herein regarding the evidence in the record and the applicable law.

Dated: October 9, 2009

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CERTIFICATE OF SERVICE

I, John P. Ratnaswamy, do hereby certify that a copy of the foregoing POST-HEARING REPLY BRIEF OF NORTH SHORE GAS COMPANY AND THE PEOPLES GAS LIGHT AND COKE COMPANY was served upon all parties on the attached Service List by electronic mail on October 9, 2009, before 5:00 p.m.

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