NS Ex. 1.0

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

NORTH SHORE GAS COMPANY	:	
	:	No. 11-____
Proposed General Increase	:	
In Rates For Gas Service	:	

Direct Testimony of

JAMES F. SCHOTT

Vice President – External Affairs,
Integrys Energy Group, Inc., and
North Shore Gas Company

On Behalf of
North Shore Gas Company

PUBLIC VERSION

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I. **INTRODUCTION AND BACKGROUND**

A. Witness Introduction

Q. Please state your name and business address.

A. My name is James F. Schott. My business address is North Shore Gas Company ("North Shore"), 130 E. Randolph Drive, Chicago, Illinois 60601.

Q. Mr. Schott, in what capacity are you employed?

A. I am the Vice President – External Affairs of the Integrys Energy Group, Inc. ("Integrys"), and of North Shore and its sister utility The Peoples Gas Light and Coke Company ("Peoples Gas"). North Shore and Peoples Gas (together, the "Utilities") each are indirect wholly-owned subsidiaries of Integrys.

Q. On whose behalf are you offering this testimony?

A. I am offering this testimony on behalf of North Shore.

B. Purpose of Testimony

Q. What are the purposes of your direct testimony?

A. The primary purposes of my direct testimony are to summarize the reasons North Shore, a natural gas local distribution company, finds it necessary to submit to the Illinois Commerce Commission (the "Commission" or "ICC") a request for a rate increase for the distribution services that North Shore provides to its customers and to identify the other witnesses submitting direct testimony on behalf of North Shore.

In addition, I will discuss the energy efficiency programs of North Shore and the alignment of the programs with North Shore's rate structure.

C. Summary of Conclusions

Q. Please summarize the conclusions of your direct testimony regarding North Shore's need for a distribution rate increase.

A. North Shore is proposing new distribution rates to go into effect in mid-January 2012 because its existing rates, which were established in Peoples Gas' and North Shore's consolidated 2009 rate cases (ICC Docket Nos. 09-0166, 09-0167 Cons.), will not allow North Shore the opportunity to recover its costs of service going forward. North Shore's existing distribution rates are insufficient largely because they do not reflect North Shore's real costs of financial and human capital.

Also, as in any rate case, North Shore proposes updates to its rate design that will better align its charges with cost drivers based on ratemaking principles as discussed in the direct testimony of Valerie Grace (North Shore Exhibit ("NS Ex.") 12.0).

Q. Please summarize your conclusions regarding the energy efficiency programs of North Shore and the alignment of the programs with North Shore's rate structure.

A. North Shore is in the process of making the transition from its joint energy efficiency program with Peoples Gas, the Chicagoland Natural Gas Savings Program, which was created pursuant to Commission Orders, to its new energy efficiency program, the North Shore Natural Gas Savings Program, which is being established under Section 8-104 of the Public Utilities Act (the "Act"). In light of the programs and the other factors affecting usage of the utility's system, including declining use per customer, North Shore is proposing that its decoupling rider, "Rider VBA", now a pilot, be made permanent. Making the rider permanent will continue to promote the accurate recovery of the portion of the utility's cost of service (of its Commission-approved revenue requirement) that is subject to the rider and continue to diminish the utility's "throughput incentive" as discussed later in my testimony.

Q. Mr. Schott, why is North Shore asking the Commission to approve an increase in distribution rates for North Shore's customers in mid-January 2012 when those customers continue to experience challenging economic times?

A. North Shore understands the difficult economic challenges our customers face. Because of the economic downturn, in 2009, Peoples Gas and North Shore (along with the other Integrys companies) undertook an extraordinary effort to reduce their current and future costs of service, and that effort was reflected in the distribution rates established by the Commission in their 2009 rate cases.

However, North Shore's existing distribution rates did not fully reflect its costs of service even as of the then-forecasted 2010 test year that was used in those cases, for a number of reasons, and its total cost of service as a distribution utility has increased since then. For a utility to experience large cost recovery shortfalls is not in the long term interests of customers, and such a situation simply is not sustainable. Moreover, large cost recovery shortfalls deny a fair return to investors and therefore will increase the utility's costs of capital over time. North Shore would not be seeking this rate relief unless it believed that it was necessary for it to continue to be able to provide adequate, reliable, and safe service over time and to do so at the least long term cost.

D. <u>Background and Experience</u>

Q. Mr. Schott, please describe your education and business experience.

A. I am a 1979 graduate of Georgetown University with a Bachelor of Science in Business Administration. I received a Master's in Business Administration from the University of

Wisconsin – Milwaukee in 1993. I was employed by Arthur Andersen & Co. from 1979 to 1990, specializing in public utility taxation and ratemaking. From 1990 through 2002, I was employed by Wisconsin Gas Company in various finance and operating responsibilities. I served as Vice President - Regulatory Affairs of Wisconsin Public Service Company ("WPSC") from January 2003 to April 2010. Upon the formation of Integrys, I became Vice President - Regulatory Affairs of Integrys, Peoples Gas, and North Shore. In April 2010, I also was promoted to Vice President – External Affairs of Integrys, Peoples Gas, and North Shore. I am a licensed Certified Public Accountant in the State of Wisconsin.

Q. Please describe your current duties and responsibilities.

A. My responsibilities include all regulatory and rate matters for all jurisdictions for the Integrys corporate family. In addition, I am responsible for Governmental Relations for Integrys. Finally, I am responsible for Internal and External Communications and Community Relations for Integrys and its subsidiaries. I also serve on the boards of directors of Integrys' operating subsidiaries. I also served as a representative of the Utilities to the Chicagoland Program from its inception until June 2010.

Q. Have you ever testified before the Commission?

A. Yes. I testified in the consolidated 2007 rate cases of Peoples Gas and North Shore (ICC Docket Nos. 07-0241, 07-0242 Cons.), the consolidated 2009 rate cases of Peoples Gas and North Shore (ICC Docket Nos. 09-0166, 09-0167 Cons.), and the consolidated Dockets involving the reconciliation of costs and revenues under Peoples Gas' and North Shore's energy efficiency program cost recovery riders, "Rider EEP – Enhanced Efficiency Program" for the reconciliation period of May 1, 2008, through June 30, 2009

(ICC Docket Nos. 09-0436, 09-0437 Cons.). I have also testified in numerous rate-related dockets before the Public Service Commission of Wisconsin.

II. SUMMARY OF NORTH SHORE'S NEED FOR RATE RELIEF

A. Overview

Q. Please give a brief description of North Shore.

A. North Shore is engaged in the business of transporting, purchasing, storing, distributing and selling natural gas at retail to approximately 159,000 residential, commercial, and industrial customers within 54 communities in Lake and Cook Counties, Illinois. This service territory covers an area of about 275 square miles. The company owns approximately 2,297 miles of gas distribution mains and approximately 95 miles of transmission lines. North Shore employs approximately 162 people. North Shore is a wholly-owned indirect subsidiary of Integrys, as I noted earlier. North Shore's system is discussed by North Shore witness Edward Doerk (NS Ex. 8.0).

B. Identification of Other Witnesses Providing Direct Testimony

Q. Please identify the witnesses presenting direct testimony in support of North Shore's filing and the main topic or topics that each witness addresses.

A. The following witnesses are providing direct testimony on behalf of North Shore:

- Lisa J. Gast, Manager, Financial Planning and Analysis for Integrys Business Support, LLC ("IBS") (NS Ex. 2.0), addresses North Shore's proposed capital structure, embedded cost of long-term debt, and overall cost of capital expressed as a rate of return on its rate base.
- Paul R. Moul, Managing Consultant, P. Moul & Associates (NS Ex. 3.0), addresses the market cost of common equity for North Shore.

- Kevin R. Kuse, Senior Load Forecaster, IBS (NS Ex. 4.0), addresses North Shore’s customer demand forecast and calculation of sales revenue based on that forecast.
- Christine M. Gregor, Director, Operations Accounting, North Shore (NS Ex. 5.0), presents the operating income statement for the forecasted 2012 test year of North Shore. She discusses the methodology used in the preparation of the operating income statement for the test year, affiliate transaction costs, depreciation expense, and income tax expense. She also discusses variances in operating expenses from 2009 to the 2012 test year. She also discusses certain recent changes in the forecast, mainly relating to recent changes in law, which are not reflected in the North Shore’s rate base and revenue requirement calculations but will be reflected in updates in its rebuttal testimony.
- Sharon Moy, Rate Case Consultant, IBS (NS Ex. 6.0), addresses the total cost of service (the “revenue requirement”) of North Shore, operating income and expenses, certain ratemaking adjustments to operating income and expenses, and the Gross Revenue Conversion Factor.
- John Hengtgen, Consultant, Stafflogix Corporation (NS Ex. 7.0), addresses the rate base of North Shore, adjustments to rate base, and the cash working capital component of rate base.
- Edward Doerk, Vice President Gas Operations, North Shore (NS Ex. 8.0), addresses certain major additions to North Shore’s rate base since its 2009 rate case (ICC Docket No. 09-0166), and presents Schedule F-4 of North Shore’s

submission under Part 285 of the ICC's rules. He also describes North Shore's forecasted capital investments.

- James C. Hoover, Assistant Vice President, Total Compensation, Integrys (NS Ex. 9.0), discusses incentive compensation costs and overall employee compensation costs.
- John P. Stabile, Tax Director, IBS (NS Ex. 10.0), discusses Medicare-related adjustments to Accumulated Deferred Income Taxes and a recent tax accounting method change.
- Christine M. Phillips, Manager, Benefits Account, IBS (NS Ex. 11.0), discusses employee benefits costs, including pension and other post-employment benefits costs and pension contributions and assets.
- Valerie H. Grace, Manager, Gas Regulatory Services, IBS (NS Ex. 12.0), addresses and supports the proposed rate design for North Shore. She also addresses and supports changes to the Schedule of Rates for Gas Service of North Shore.
- Joylyn C. Hoffman Malueg, Rate Case Consultant, IBS (NS Ex. 13.0), describes North Shore's embedded cost of service study for the 2012 test year used by Ms. Grace in the proposed changes in the North Shore rate schedules addressed in Ms. Grace's testimony.
- Thomas Connery, Supervisor, Gas Supply Trading, IBS (NS Ex. 14.0), addresses and supports changes to the transportation programs in relation to the gas supply function.

- John McKendry, Senior Leader, Gas Transportation Services, IBS (NS Ex. 15.0), discusses transportation programs in relation to the administrative function, including the proposed storage subscription process, and the cost of service study supporting the administrative costs used by Ms. Grace in developing certain charges.

C. <u>Need For Rate Relief</u>

Q. Why does North Shore need the distribution rate relief that it requests to go into effect in mid-January 2012 after having received distribution rate relief that went into effect in late January 2010?

A. As I stated earlier, North Shore is proposing new distribution rates to go into effect in mid-January 2012 because its existing rates will not allow it the opportunity to recover its costs of service going forward. North Shore's existing distribution rates are insufficient largely because they do not reflect its real costs of financial and human capital.

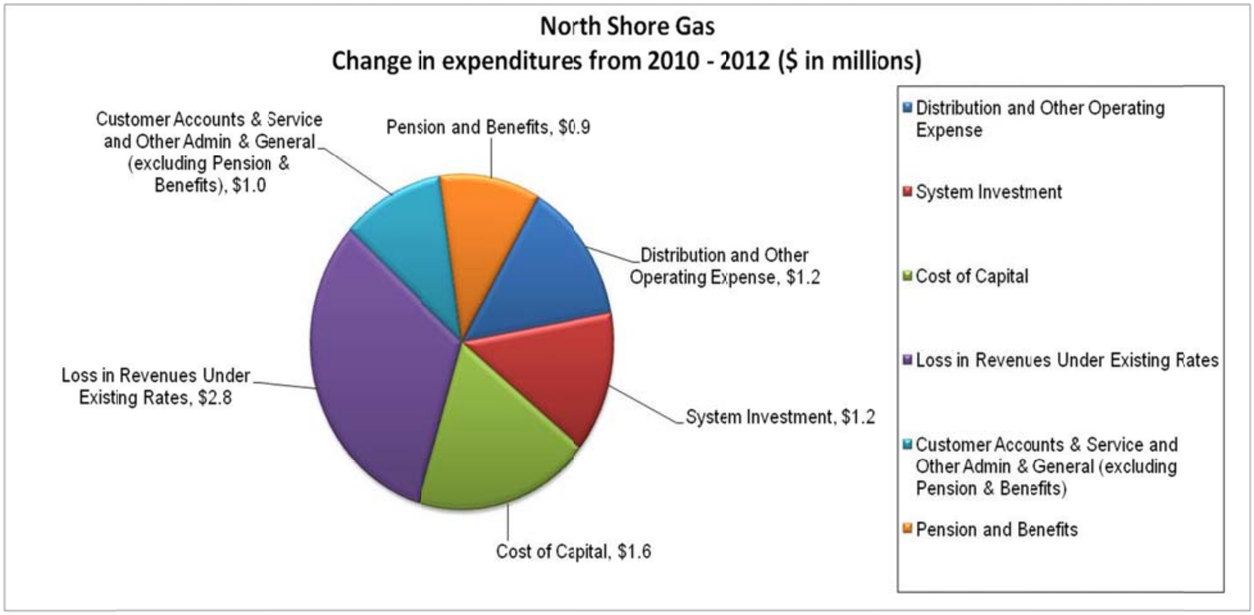
Over the long term, North Shore's ability to provide adequate, reliable, and safe distribution services and the associated customer services to its customers depends on both financial capital and human capital. A gas utility's distribution system and the other infrastructure investments that support the provision of its services are heavily capital intensive. Notwithstanding increased automation, a gas utility's operations are highly labor intensive, which mainly means the utility's own employees although it also includes the efficient use of service company personnel and outside personnel resources.

In its rate request, North Shore's costs of service have been calculated using a forward looking 2012 test year. A utility's costs of service (its revenue requirement) is the sum of (1) its operating expenses plus (2) the product of its rate base times it overall cost of capital. In its request, North Shore's operating expenses are based on its expected expenses in 2012, its rate base is determined based on the expected averages of the components of its rate base in 2012, and, its cost of capital is based on its current cost of capital applied to its expected capital structure in 2012. I have identified the witnesses for North Shore on each of those subjects. North Shore witness Ms. Gregor, as indicated above, discusses certain updates, mainly relating to recent changes in law, which will be reflected in North Shore's rebuttal testimony. The net effect of those updates will be to decrease North Shore's revenue requirement.

Based on the revenues and costs calculations contained in this filing, without the requested distribution rate relief, in 2012, North Shore would earn a return on common equity of only 7.59%, compared to the 10.33% approved in its 2009 rate case and its actual current cost of equity of 11.25% as discussed by North Shore witnesses Ms. Gast and Mr. Moul.

Q. Has North Shore prepared a summary of the drivers of its increased costs of service?

A. Yes. I refer to the pie chart below, which graphically describes the changes in our costs versus the cost levels approved in our 2009 rate case.



Q. Please describe these categories in more detail and what is driving the increases in these categories.

A. The first category, Distribution and Other Operating Expense ($1.2 million) are the non-capitalized costs we incur to operate and maintain our underground distribution system. The increase in these items is generally attributable to increased material and street restoration costs and inflation partially offset by reduced costs related to transmission pipeline digs.

The second category, System Investment ($1.2 million) represents the return on and of capital invested since the prior rate case, primarily in the underground distribution system, holding the rate of return approved in the last rate case constant. A primary driver for this category is North Shore's ongoing significant investment in its distribution system.

The third category, Cost of Capital ($1.6 million), represents the increased cost of long-term debt and common equity for North Shore since the last rate case. The overall cost of capital is the required return on the investment of North Shore (net of depreciation) in its assets, primarily distribution pipe. In order to attract capital for new investments, existing investors must receive an adequate return on their investment.

The fourth category, Loss in Revenues Under Existing Rates ($2.8 million) represents the loss in revenues under existing rates (the recovery of costs of service (revenue requirement) sometimes is referred to as "margin" or "margin revenues") as the result of lower projected customer counts and throughput volumes.

The fifth category, Customer Accounts and Service and Other Administrative and General ($1.0 million), represent increases in costs associated with "back office" operations, including billing, collection, call center, as well as support functions such as human resources, finance and accounting, information systems, etc. The increase is the result of proposed rate case amortization, higher injuries and damages and inflation offset by lower customer costs due to the outsourcing of the call center.

The sixth category, Pensions and Benefits ($0.9 million), is increasing due to changes in discount rates as well as other factors and asset losses from 2008 as Ms. Phillips explains in more detail in her testimony.

Please note that, as I indicated earlier, the testimony of Ms. Gregor discusses certain recent changes in the forecast, mainly relating to recent changes in law, which are not reflected in the North Shore's rate base and revenue requirement calculations but will be reflected in updates in its rebuttal testimony. The pie chart and discussion do not reflect those updates.

Q. **Will these increased costs prevent North Shore from earning its authorized rate of return on common equity set in its 2009 rate case?**

A. Yes. In 2010, even though the new rates went into effect on January 25, 2010, North Shore earned a return on common equity of [*** BEGIN CONF. & PROP. ***] [redacted] [*** END CONF. & PROP.***] as opposed to the rate of return on common equity of 10.33% that was approved in its 2009 rate case. Without adequate rate relief, returns on common equity will continue to fall below North Shore's actual cost of equity. As noted above, as shown in Ms. Gast's testimony, without rate relief North Shore will earn a return on equity below its actual current cost of equity, based on the financial information presented in this filing by Mr. Moul. Failure to recover costs fully, including earning an adequate return, is not sustainable and results in higher costs for future customers through a higher cost of capital.

III. ENERGY EFFICIENCY PROGRAM AND RATE STRUCTURE

Q. What is the Chicagoland Natural Gas Savings Program (the "Chicagoland Program")?

A. The Chicagoland Program is a natural gas energy efficiency program that applies to both Peoples Gas and North Shore that originally was established pursuant to the Order of the Commission in their 2007 rate cases.

Q. Please briefly summarize the activities of the Chicagoland Program to date.

A. The Chicagoland Program provides financial incentives to customers to improve the energy efficiency of their homes, businesses, and manufacturing facilities. The program is limited to Service Classification Nos. 1 and 2 customers, which are primarily residential and small business customers. Measures offered through the program include rebate programs for residential and small business customers, a multi-family low-income program that provides incentives for energy audits and retrofits, a custom program for commercial and industrial customers (co-delivered with Commonwealth Edison

Company ("ComEd"), and a retro-commissioning program for commercial and industrial customers (also co-delivered with ComEd).

The Chicagoland Program is in its third and final year. The program ends on June 30, 2011, subject to certain follow-on procedures. Upon its expiration, it will be replaced, as to North Shore, with a more comprehensive energy efficiency program, the North Shore Natural Gas Savings Program, in response to the requirements of Section 8-104 of the Act as added by Illinois Senate Bill 1918.

Q. Can you describe the North Shore Natural Gas Savings Program?

A. Some key points of the program that may be identified based on Section 8-104 of the Act are, in brief, as follows:

- The program begins on June 1, 2011.
- Section 8-104 sets forth increasing annual natural gas savings goals (based on amounts of gas delivered in calendar year 2009) beginning with the period from June 1, 2011, to May 31, 2012, and increasing each year thereafter. These accumulate to a minimum 10.1% reduction in therms for 10 years.
- Section 8-104 provides for recovery of program expenses through a rider, but it also contains limits on the recovery of expenses through the rider.
- Except for a relatively small number of exempt or self-directing customers, all customers pay into the program and can participate in the offered programs.
- Programs exist for small and large residential, commercial, and industrial customers.
- Responsibility for meeting the goals referenced above are 80% utility / 20% Department of Commerce and Economic Opportunity ("DCEO"). Associated

funding is 75% utility / 25% DCEO. DCEO will target low-income and government/municipal customers.

North Shore's proposal regarding the North Shore Natural Gas Savings Program (and of Peoples Gas' proposal regarding the Peoples Gas Natural Gas Savings Program) are pending before the Commission in ICC Docket No. 10-0564 as of the time that I am preparing this testimony.

North Shore's proposed rider under Section 8-104, pending in ICC Docket No. 10-0564, provides for specified incremental cost recovery, but it does not provide for recovery of lost revenues (lost cost recovery) due to increased energy efficiency. The decoupling rider, Rider VBA, within the limits of its specific provisions, is the only mechanism that provides North Shore an opportunity to mitigate the under-recovery of fixed costs (fixed costs of distribution service allocated to volumetric charges) that results from decreased deliveries due to increased energy efficiency.

Q. Is there a relationship between energy efficiency programs and rate structure?

A. Yes. The Commission recognized this when it approved, as a pilot, the Utilities' decoupling rider, Rider VBA, in their 2007 rate cases. The Commission's final Order (at pages 138-139) in the 2007 rate cases stated in part:

> This case presents the Commission with its first introduction to decoupling mechanisms and it is being presented here with proposed Rider VBA. In simplest form, Rider VBA would adjust customer prices under Service Classifications Nos. 1 and 2, and in a way that the Utilities revenues are held constant despite **changes in customer consumption**. Such changes in consumption are brought about by rising natural gas prices, **the call for conservation measures**, warming weather trends, **the involvement of the Utilities in gas efficiency programs**, and other events. The proposed monthly adjustments under Rider VBA are symmetrical meaning that they are based on both the over-recovery as well as the under-recovery of target revenues. Implementing Rider VBA

> imposes some additional administrative expenses and, among other things called for by Staff, there would be annual internal audits.

(Emphasis added)

Q. You referred to Rider VBA as a pilot. What is North Shore proposing with regard to Rider VBA in this case?

A. North Shore is proposing that Rider VBA be made permanent, with certain revisions, as discussed in the testimony of Ms. Grace. Otherwise, the four-year decoupling rider pilot will terminate. The Commission's final Order in the Utilities' 2007 rate case (at page 152) stated in part: "Furthermore, given the unique nature of Rider VBA, the Commission deems it appropriate to implement VBA as a four year pilot program. The Commission further accepts the Utilities' suggestion that a general rate case needs to be filed if Rider VBA is to become effective upon the conclusion of the pilot program."

Q. Has the decoupling rider benefitted North Shore's customers?

A. Yes, as Ms. Grace's testimony explains, in brief, the rider has functioned appropriately to ensure that the portion of the utility's Commission-approved costs of service (revenue requirement) that is to be recovered through the charges to which Rider VBA applies (the applicable portion of the utility's "margin", as defined in the rider) is neither over- nor under-recovered. Moreover, the utility's "throughput incentive" (financial incentive to encourage natural gas sales relative to historical levels that underlie base rates, arising from the recovery of fixed costs through volumetric charges) has been diminished.

Q. Has North Shore considered proposing a "straight fixed variable" ("SFV") rate design that would recover all all fixed costs through fixed charges?

A. Yes, as discussed in Ms. Grace's testimony, although North Shore considers an SFV rate design to be the rate design that best aligns revenue recovery with its fixed costs, North Shore, in the interests of avoiding a change in its rate structure at this time, instead is proposing to make Rider VBA permanent and to increase the recovery of fixed costs through fixed charges.

Q. Does this conclude your direct testimony?

A. Yes.