

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

AGL RESOURCES INC., NICOR INC., and)
NORTHERN ILLINOIS GAS COMPANY)
d/b/a NICOR GAS COMPANY)
) Docket No. 11-0046
Application for Approval of a Reorganization)
pursuant to Section 7-204 of the Illinois Public)
Utilities Act.)

PUBLIC

Surrebuttal Testimony

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On Behalf of Northern Illinois Gas Company
d/b/a Nicor Gas Company

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TABLE OF CONTENTS

	Page
I. Professional Qualifications and Summary.....	1
II. Itemized Attachments / Exhibits / Figures.....	5
III. Competition for the GLCG Product.....	5
A. Relevant Market Considerations.....	5
B. Self-Insurance is an Option that Competes with GLCG.....	9
C. Warranty Plans that Bundle Gas Lines with Other Products Compete with GLCG	16
D. Potential Competition Helps Discipline GLCG Prices.....	24
E. Nicor Services does not Possess Significant Market Power for GLCG	29
IV. Nicor Gas Inputs Provided to Nicor Services are not Essential.....	31
V. Nicor Gas is not Providing a Subsidy to Nicor Services	37
VI. Conclusion	39

1 **I. PROFESSIONAL QUALIFICATIONS & SUMMARY**

2 **Q. Please state your name and business address.**

3 A. Agustin J. Ros, 200 Clarendon Street, 11th floor, Boston, Massachusetts 02116.

4 **Q. Are you the same Agustin J. Ros who previously testified in this proceeding?**

5 A. Yes.

6 **Q. What is the subject matter of your surrebuttal testimony?**

7 A. I respond to the rebuttal testimony of three witnesses in this proceeding. Specifically, I
8 respond to the rebuttal testimony of David Sackett on behalf of the Staff (“Staff”) of the
9 Illinois Commerce Commission (“Commission”), the rebuttal testimony of
10 William Thomas on behalf of the Manchester Group LLC (“Manchester”), and the
11 rebuttal testimony of Teresa L. Ringenbach on behalf of the Retail Energy Suppliers
12 Association (“RESA”).

13 Their testimony focuses on three broad themes. The first is whether there is no
14 competition for Nicor Energy Services Company’s (“Nicor Services”) Gas Line Comfort
15 Guard (“GLCG”) product or for inside gas line warranty products. That position is best
16 articulated by Mr. Sackett, who estimates that Nicor Services has over 99 percent of the
17 relevant market for inside gas line warranty products. (Sackett Reb., Staff Ex 4.0,
18 34:606-07). As a result, and by implication, he concludes that Nicor Services has near-
19 monopoly power for the GLCG product. (*Id.*, 33:592-601). Mr. Thomas also testifies
20 that there is no “true competition” for GLCG. (Thomas Reb., Manchester Ex. 1.0, 2:23-
21 24).

22 Second, according to these witnesses, the main source of the alleged monopoly
23 power resides in the three main inputs that Nicor Gas sells to Nicor Services for the
24 provision of the GLCG product, namely: (1) repair services; (2) billing services (which
25 permit Nicor Services to bill the customer for GLCG on the Nicor Gas bill); and
26 (3) customer solicitation (which permits the solicitation of Nicor Gas customers who call
27 concerning services). (Sackett Reb., Staff Ex. 4.0, 64:1136-47; Thomas Reb.,
28 Manchester Ex. 1.0, 6:129-7:134, 16:356-60; Ringenbach Reb., RESA Ex. 1.0, 7:157-
29 62). Staff and RESA recommend that Nicor Gas make the same inputs available to Nicor
30 Services' competitors at non-discriminatory rates. (Sackett Reb., Staff Ex. 4.0, 65:1159-
31 62; Ringenbach Reb., RESA Ex. 1.0, 4:71-74). Manchester recommends the same for the
32 billing input, is silent with respect to the repair input, and recommends that Nicor
33 Services be prevented from using Nicor Gas customer solicitation. (Thomas Reb.,
34 Manchester Ex. 1.0, 19:409-22).

35 Third, Mr. Sackett continues to raise the possibility that Nicor Services is
36 receiving a cross-subsidy from Nicor Gas. (Sackett Reb., Staff Ex. 4.0, 9:163-12:200).

37 **Q. Please summarize your conclusions regarding these three themes.**

38 A. My first conclusion is that there is competition for the GLCG product and GLCG-type
39 products. Mr. Sackett defines the relevant market much too narrowly. Although not
40 stated in his testimony, his market share calculation is based on the following market
41 definition: bundled warranty/protection and repair products for homeowners' inside gas
42 lines in the Nicor Gas service territory. That is, in order to calculate a market share of 99
43 percent, he focuses only on a protection/warranty plan that provides the warranty service

44 and the repair service bundled together and that only includes inside gas lines in the
45 Nicor Gas service territory.

46 All other options available to customers should be taken into account. Consumers
47 can purchase a warranty product that includes all the homeowner's utility lines or one
48 that includes all utility lines and other important home infrastructure. I estimate that
49 there can be as many as 90,000 home warranty customers in the Nicor Gas service
50 territory and many firms offer such plans in the Nicor Gas service territory.

51 There are many more customers who protect their utility lines by self-insuring:
52 saving each year in a rainy-day fund to take account of household repairs, including
53 utility lines. I have estimated a demand model for GLCG and find that as the cost of self-
54 insurance increases, the demand for GLCG increases, providing strong evidence that self-
55 insurance options compete against GLCG and gas line warranty products.

56 Once it is recognized that the average home owner has many more choices
57 available to it for gas line protection, Nicor Services' participation in the relevant market
58 is closer to *****XX***** percent in the Nicor Gas service territory. Moreover, barriers to
59 entry are not significantly high. These facts suggest that Nicor Services does not possess
60 significant market power in the relevant product market.

61 My second conclusion is that the Nicor Gas inputs sold to Nicor Services are not
62 "essential inputs," as economists define the term. The marketplace evidence indicates
63 that firms are using a wide range of marketing/customer solicitation channels, customer
64 billing and customer repair strategies to offer warranty/protection plans and for the actual
65 repairs. Customer solicitation/marketing, customer billing and customer repair services
66 are not "essential" in the economic sense of the word. While some firms may find it

67 easier to compete were they permitted to purchase Nicor Gas' inputs, that is an
68 insufficient public policy reason to require that a firm share its inputs. Much more is
69 required; specifically, it must be shown that competition cannot exist without the inputs
70 made available to competitors. That is not the case here.

71 Competition for utility line warranty/protection products is occurring in different
72 forms and firms are experimenting with different ways to market, make repairs and bill
73 the customers. The examples include: (1) through affiliates of utility companies;
74 (2) through home warranty providers directly marketing to customers; (3) through home
75 warranty providers contracting a sales force with real estate agents; (4) through firms that
76 only sell utility line warranty/protection plans to consumers; (5) through large home
77 service firms that have developed or are developing national brands; (6) or through
78 "Mom and Pop" professionals in a discreet geographic area who are successful through
79 word of mouth and through local channels. Can a firm be successful by just selling an
80 inside gas line warranty/protection plan or will it have to offer additional services to
81 achieve economies of scope and increase its brand recognition? Time will tell what the
82 most efficient strategy and type of competition will be and whether different strategies
83 can coexist. These are questions best left to the marketplace. Mandating access to Nicor
84 Gas' inputs distorts the competition that is occurring because it favors certain competitors
85 at the expense of others. Those firms that have not invested in billing systems, invested
86 in customer solicitation/marketing channels, or contracted with reputable and licensed
87 professionals to repair utility lines will benefit at the expense of those firms (both large
88 and small) that have incurred such expenses. This distorts competition.

89 My third conclusion is that I find no evidence that Nicor Services is receiving a
 90 cross-subsidy from Nicor Gas. Indeed, Mr. Sackett admits that he has found no evidence
 91 of such a cross-subsidy. (Nicor Gas Ex. 7.6, Staff Response to NG-Staff 8.09). Instead,
 92 his discussion on cross-subsidy is based on his belief that the inputs provided by Nicor
 93 Gas to Nicor Services permit Nicor Services to exert near monopoly power. But, for the
 94 reasons discussed in my rebuttal testimony, as well as throughout this surrebuttal
 95 testimony, there is no economic basis for this allegation.

96 **II. ITEMIZED ATTACHMENTS / EXHIBITS / FIGURES**

97 **Q. Are you sponsoring any attachments / exhibits / figures?**

98 A. Yes. Attached as Exhibits to this testimony are the following:

99 Nicor Gas Ex. 7.1 Demand Model for GLCG
 100 Nicor Gas Ex. 7.2 Staff Response to Nicor Gas Request NG-Staff 8.16
 101 Nicor Gas Ex. 7.3 Manchester Response to Nicor Gas Request NG-MAN 1.06
 102 Nicor Gas Ex. 7.4 RESA Response to Nicor Gas Request NG-RESA 1.01
 103 Nicor Gas Ex. 7.5 Manchester Response to Nicor Gas Request NG-MAN 1.07
 104 Nicor Gas Ex. 7.6 Staff Response to Nicor Gas Request NG-Staff 8.09
 105 Nicor Gas Ex. 7.7 Manchester Response to Nicor Gas Request NG-MAN 1.12

106 **III. COMPETITION FOR THE GLCG PRODUCT**

107 **A. RELEVANT MARKET CONSIDERATIONS**

108 **Q. Please summarize the Staff and Intervenor rebuttal testimony regarding**
 109 **competition for the GLCG product.**

110 A. Mr. Sackett and Mr. Thomas comment on the extent of competition for the GLCG
 111 product. Mr. Sackett claims that “there is no significant competitive pressure on GLCG’s

112 price.” (Sackett Reb., Staff Ex. 4.0, 19:343-20:345). Mr. Thomas claims “true
113 competition” does not exist. (Thomas Reb., Manchester Ex. 1.0, 2:22-24).

114 **Q. What are some of the bases for Mr. Sackett’s and Mr. Thomas’ conclusions?**

115 A. Mr. Sackett believes that Nicor Services’ market share for GLCG is 99.6 percent and that
116 this demonstrates that no significant competitive pressure restrains GLCG’s price.
117 (Sackett Reb., Staff Ex. 4.0, 34:606-07). Indeed, if the market share estimate were
118 correct this implies near-monopoly power. Mr. Thomas’ support for his conclusion is
119 best summarized by his statements that “Nicor Gas has skewed the competitive market
120 for utility line protection products by denying Manchester and other competitors access to
121 the utility bill on a fair and equal basis” and that the GLCG service is protected from
122 competitive market forces. (Thomas Reb., Manchester Ex. 1.0, 1:18-2:20; *Id.*, 13:272-
123 73).

124 In this section of my surrebuttal testimony, I present evidence showing that there
125 is competition for the GLCG product and that Nicor Services does not possess significant
126 market power for this product. In a subsequent section, I respond to Mr. Thomas’
127 assertions and discuss why it is not the case that Nicor Gas billing, repairs and customer
128 solicitation are essential inputs, as economists define that term. Thus, Nicor Gas’
129 decision to provide billing and collection services only to its affiliate Nicor Services is
130 not anticompetitive.

131 **Q. Do you agree with Mr. Sackett that GLCG has 99.6 percent of the market?**

132 A. No, I do not, and this is one of the major areas of disagreement that we have.
133 Mr. Sackett’s claim that Nicor Services has a 99.6 percent market share for GLCG

134 services is a vast overestimate because he has defined the relevant product market much
135 too narrowly. Mr. Sackett's relevant market definition seems to be: bundled warranty
136 and repair products for homeowners inside gas lines in the Nicor Gas service territory.
137 He does not use this term, but by calculating market shares based upon only the sales of
138 Santanna Energy's "Gas Line Guard," Manchester's "Utility Shield" and Nicor Services'
139 GLCG, his focus is limited to bundled warranty and repair services for the customer's
140 inside gas lines.

141 **Q. What do you mean by "bundled warranty and repair products"?**

142 A. The products offered by Nicor Services, Santanna Energy and Manchester provide a
143 warranty/protection service and a repair service bundled together. A customer pays a
144 premium each month and in return the customer receives a protection policy covering the
145 cost of the repair of inside gas lines (up to a certain amount). In addition, the products
146 offered by Nicor Services, Santanna Energy and Manchester include the actual repair of
147 the inside gas lines. The customer does not need to incur the transaction costs of
148 searching for a qualified professional in the area and contracting with that professional
149 for the repair.

150 **Q. What is the difference between a bundled warranty and repair service and an**
151 **unbundled warranty and repair service?**

152 A. An unbundled warranty and repair service is an example of what I referred to in my
153 rebuttal testimony as "self-insurance." With self-insurance, customers do not pay a
154 premium each month to protect against the potential cost of gas line repairs. Instead,
155 customers pay for gas line repairs from income earned during the period that the cost is

156 incurred or through their savings. The customer incurs the transaction costs of searching
157 and contracting with the professionals for repairs.

158 **Q. Do you believe that “bundled warranty and repair products for homeowners inside**
159 **gas lines in the Nicor Gas service territory” is a relevant product market?**

160 A. No, I do not. I believe the relevant product market is broader, for reasons I explain
161 below. Thus, I disagree with Mr. Sackett’s estimate that Nicor Services has a 99 percent
162 market share and the implication that Nicor Services has near-monopoly power.

163 **Q. Please explain why you believe the relevant product market is broader than the one**
164 **Mr. Sackett has defined.**

165 A. Several factors support my opinion that there are many more competitive alternatives
166 available to actual and potential consumers of inside gas line warranty products that
167 should be included in the relevant product market and in a competitive analysis.

168 First, as discussed in my rebuttal testimony, I believe that these bundled warranty
169 and repair products compete with a consumer’s option to self-insure. If a gas line needs
170 repair, a customer can select from many local professionals who provide repairs and pay
171 from income earned in the period that the repair was done or through their savings. Thus,
172 gas line repair services offered by companies and professionals compete against GLCG,
173 Gas Line Guard and the Utility Shield. Indeed, most Nicor Gas customers do not
174 purchase gas line warranty products and instead have decided to self-insure against the
175 risk. When setting their prices, Nicor Services and other warranty providers cannot
176 ignore this option that consumers have. There is support in the economic literature for
177 the proposition that self-insurance can compete against market insurance and, as

178 discussed below, the concept has been accepted by antitrust agencies under certain
179 conditions. More importantly, as I discuss below I estimated a demand model for GLCG
180 (*see* Nicor Gas Ex. 7.1) and find empirical evidence that self-insurance competes with
181 GLCG.

182 Second, the relevant market includes bundled warranty and repair products that
183 provide protection for other inside utility lines as well as for inside gas lines. A warranty
184 and repair product that includes all inside lines (gas, water, electricity, sewer) is another
185 form of bundling/packaging, this time bundling inside gas, water, electricity and sewer
186 lines into a single warranty product. These types of bundled protection plans are offered
187 by Manchester, Santanna Energy and Nicor Services. In addition, inside gas lines are
188 typically included in home warranty/protection products that protect utility lines as well
189 as other home infrastructure (*e.g.*, water heater, heating system, ductwork, electrical
190 system, etc.). I would thus include home warranty/protection plans as part of the relevant
191 product market. There are many companies that offer home warranty/protection plans.

192 When these factors are taken into account, Nicor Services has a much lower
193 market share than what Mr. Sackett calculated and it does not possess significant market
194 power.

195 **B. SELF-INSURANCE IS AN OPTION THAT COMPETES WITH GLCG**

196 **Q. Mr. Sackett does not view self-insurance options as options that should be included**
197 **in the relevant market. (Sackett Reb., Staff Ex. 4.0, 37:659, 52:923-27, 56:993-1000).**
198 **Why do you believe that self-insurance options should be considered?**

199 A. First, GLCG and other utility line protection plans are a bundled warranty and repair
200 service. As Mr. Sackett acknowledges, plumbers and HVAC professionals can repair
201 inside gas lines. (Nicor Gas Ex. 7.2, Staff Response to NG-Staff 8.16). There are many
202 professionals that can make repairs to inside gas lines in the Nicor Gas service territory.
203 As the price of the warranty product increases, it becomes more attractive to use these
204 professionals as the need arises, rather than purchasing the warranty product.

205 Second, as discussed in my rebuttal testimony (Nicor Gas Ex. 4.0, 31:734-40),
206 there is support in the economic literature that market insurance and self-insurance
207 compete. The economic models of insurance predict the level of insurance coverage an
208 individual will purchase based on the risk outlook of the individual, the initial wealth of
209 the individual, the premium, etc. In these models, a possibility that arises is that the
210 optimal result for the individual is to not purchase insurance and instead self-insure
211 against the risk. An insurance firm needs to take this into account when setting its
212 premium: namely that if it sets its premium too high some consumers will incur the risk
213 on their own and self-insure.

214 Third, Nicor Services' marketing strategy identifies self-insurance as a
215 competitive alternative to its GLCG and other warranty products. Nicor Services'
216 rebuttal scripts identify self-insurance as an option. (Sackett Dir., Staff Ex. 2.0, Att. F).
217 Nicor Services has anticipated four responses of the potential customer, one of which is:
218 "I can do it myself/have someone else who can do it for me." This is evidence that Nicor
219 Services views self-insurance as competition.

220 Fourth, the concept that self-insurance can compete with market insurance has
221 been accepted previously by courts and regulators, as I discuss below.

222 Lastly, as I describe below, I estimated a demand model for GLCG customers.
223 (Nicor Gas Ex. 7.1). The results of the demand model show that self-insurance and
224 GLCG compete. As the price of self-insurance increases, the demand for GLCG
225 increases, holding all other factors constant.

226 **Q. What evidence have you gathered regarding customers' options to self-insure?**

227 A. As discussed in my rebuttal testimony (Nicor Gas Ex. 4.0, 27:654), there are more than
228 2,000 HVAC and plumbing firms in the Nicor Gas service territory. These are
229 professionals that are qualified to repair inside gas lines. Thus, there are many options
230 available to consumers who have decided to self-insure against the risk of gas line
231 repairs.

232 **Q. What evidence is there that some courts and regulators have accepted the concept**
233 **that self-insurance can compete with market insurance?**

234 A. There is evidence from the health care insurance industry, the workers' compensation
235 insurance industry and the medical malpractice insurance industry that courts and
236 regulators have accepted the proposition that self-insurance and market insurance can
237 compete.

238 In the health insurance industry, "self-insurers" are employers who set aside funds
239 to pay for health benefits directly rather than purchasing health insurance from an
240 insurance carrier. In 2008, 55 percent of covered employees were enrolled in self-
241 insurance plans.¹ In *Ball Memorial Hospital Inc. v. Mutual Hospital Insurance*, the U.S.
242 Court of Appeals for the Seventh Circuit recognized that the "Blues [Blue Cross Blue

¹ Congressional Research Service (Bernadette Fernandez). "Self-Insured Health Insurance Coverage." CRS Report for Congress (June 25, 2010), p. 4.

243 Shield], other insurance companies, hospitals offering PPOs, HMOs, and self-insuring
244 employers all offer methods of financing health care.”² The court further recognized the
245 district court’s observation “that firms may elect self-insurance, and HMOs may expand,
246 in response to an increase in the price of insurance,”³ and found that, in fact,
247 “[a]dministered self-insurance has been growing at the expense of other plans.”⁴ On
248 these grounds, among others, the Seventh Circuit judged the market in health care
249 financing to be competitive. In *Blue Cross & Blue Shield v. Marshfield Clinic*,⁵ the
250 Seventh Circuit rejected the argument that HMOs constituted a product market separate
251 from other forms of health insurance, finding that “[a]n HMO is basically a method of
252 pricing medical services,” not a distinctive organizational form or group of skills.⁶

253 A July 2004 report co-sponsored by the Federal Trade Commission and the
254 Department of Justice, “Improving Health Care: A Dose of Competition,” also addressed
255 this issue. In the judgment of the authors, the “issue [of] whether self-insurance should
256 be included as part of the relevant product market ... is highly fact-specific, and will turn
257 on the particulars of any given case.”⁷ The authors go on to note that “[o]ne panelist ...
258 stated his conclusion ‘that both funding types [fully-funded insurance and self-insurance]
259 are in the same market.’”⁸

² *Ball Memorial Hospital, Inc., et al v. Mutual Hospital Insurance, Inc.*, 784 F.2d 1325, 1331 (7th Cir. 1986) as quoted in “Improving Health Care: A Dose of Competition,” a Report by the Federal Trade Commission and the Department of Justice (July 2004), Chapter VI, p. 3.

³ *Ball Memorial Hospital*, 784 F.2d at 1332.

⁴ *Id.* at 1330.

⁵ *Blue Cross & Blue Shield United of Wisconsin, et al v. Marshfield Clinic*, 65 F.3d 1406 (7th Cir. 1995).

⁶ *Id.* at 1409, as quoted in “Improving Health Care: A Dose of Competition,” a Report by the Federal Trade Commission and the Department of Justice (July 2004), Chapter VI, p. 3.

⁷ Federal Trade Commission and the Department of Justice, “Improving Health Care: A Dose of Competition,” July 2004, Chapter VI, p. 5.

⁸ *Id.* The panelist quoted in the report is NERA Vice President David Monk, who consulted on the report in the public hearings leading up to its publication.

260 In the workers' compensation insurance industry, in *Temporary Services v.*
261 *American International Group*, the Supreme Court of South Carolina ruled that “[f]or
262 regulatory purposes, there are three categories of workers' compensation insurance that
263 employers can maintain: self-insurance, assigned risk insurance, and voluntary
264 insurance.”⁹ Similarly, in *Uniforce Temporary Personnel, Inc. v. National Council on*
265 *Compensation Insurance, Inc.*, the U.S. Court of Appeals for the Eleventh Circuit judged
266 that “businesses can obtain workers compensation insurance for their employees through
267 one of three markets: (1) the voluntary market, (2) the self-insurance market, and (3) the
268 ‘assigned risk’ or residual market.”¹⁰

269 Finally, in the medical malpractice insurance industry, a Congressional Research
270 Service Report for Congress also noted that the “medical malpractice insurance market
271 consists of three separate types of insurers: (1) traditional commercial multi-line
272 property-casualty insurers...; (2) hospital- and physician-owned insurers...; and (3)
273 alternative risk transfer entities that include self-insurance and pooling, captives, and risk
274 retention groups.”¹¹

275 **Q. Mr. Sackett purports to estimate the change in demand and the price elasticity of**
276 **demand for GLCG. (Sackett Reb., Staff Ex. 4.0, 38:671-39:695). Has Mr. Sackett**
277 **correctly estimated the price elasticity of demand?**

278 A. No. The price elasticity of demand is defined as the percentage change in quantity
279 demanded for a one percent change in price, holding constant all other factors that affect

⁹ *Temporary Services v. American International Group*, Opinion No. 26835 (July 19, 2010).

¹⁰ *Uniforce Temporary Personnel, Inc. v. National Council on Compensation Insurance, Inc.*, 87 F.3d 1296, 1298 (11th Cir. 1996).

¹¹ Congressional Research Service (Rawle O. King), “Medical Malpractice Liability Insurance and the McCarran-Ferguson Act,” CRS Report for Congress (March 19, 2003), p. 4.

280 the quantity demanded. Mr. Sackett incorrectly uses the loss in annual growth in
281 customers to estimate the price elasticity of demand.

282 Further, during the period Mr. Sackett analyzed other factors affecting the
283 demand curve for GLCG were also changing. These other factors include income of
284 consumers, price of substitutes, and consumers' taste and preferences. Without
285 controlling for these factors, any estimate of the price elasticity is biased.

286 **Q. Have you estimated a demand model for GLCG?**

287 A. Yes. I used the same data used by Mr. Sackett from Staff DR DAS 1.02 Confidential
288 Exhibit 1 to estimate a demand model for GLCG. Nicor Gas Exhibit 7.1 presents the data
289 used, sources, methodology and conclusions.

290 **Q. What is a demand model?**

291 A. A demand model is a statistical relationship between the quantity demanded of a product
292 and all those factors that affect how much of the product consumers purchase. These
293 other factors include the price of the good, the price of substitutes and compliments, the
294 income of the consumer and the tastes and preferences of the consumers. As these
295 factors change, the quantity demanded of the product also changes. A demand model
296 permits us to identify the strength of these relationships and to identify the products that
297 are substitutes of the products. The main purpose of my demand model is to test the
298 hypothesis that self-insurance options compete with GLCG.

299 **Q. Please describe your demand model for GLCG.**

300 A. In addition to the GLCG contract counts per month from April 2006 through September
301 2009, I had data for the nominal price of GLCG during this time period. The nominal

302 price was \$3.95 per month from April 2006 through January 2007. In February 2007 it
303 was increased to \$4.95 per month, its current price. I created a real price (inflation-
304 adjusted) of GLCG during this time period using the consumer price index for the
305 Chicago metropolitan area. I also collected data on the unemployment rate in the
306 Chicago metropolitan area, Chicago-area wages for plumbers, the yields on 10-year U.S.
307 Treasury notes, and producer price indices for plumbing, heating and air-conditioning
308 companies, and for HVAC equipment. I also created a monthly time trend to capture all
309 those unobservable factors that changed over the period.

310 Based upon the data, I estimated an econometric demand model that related the
311 number of GLCG customers per month as a function of the price of GLCG, holding
312 constant all other factors. For the reasons explained in Nicor Gas Exhibit 7.1, I estimated
313 two demand models. Model 1 uses all of the 42 months of data that are available, while
314 model 2 uses the most recent 22 months of data. (Nicor Gas Ex. 7.1).

315 **Q. Please summarize your results.**

316 A. My major finding is that self-insurance positively affects the demand for GLCG. As the
317 wages of plumbers increase, self-insurance becomes a less attractive option and, holding
318 all factors constant, the customer finds utility line warranty products more attractive. The
319 demand models confirm that this is, in fact, happening. Thus, the two compete and
320 should be included in the same relevant product market. This conclusion holds for both
321 model 1 and model 2. Specifically, in model 1, I found that a ten percent increase in the
322 wages of plumbers in the Chicago area leads to an increase of 1.7 percent in demand for
323 GLCG. In model 2, using the more recent data, I found that a ten percent increase in the
324 wages of plumbers in the Chicago area leads to an increase of five percent in demand for

325 GLCG.¹² As discussed previously, consumers who self-insure can purchase inside gas
326 line repair services from plumbers.

327 In addition, when other factors are controlled for (*e.g.*, price of substitute, income,
328 taste and preferences), the price elasticity of demand is different than that estimated by
329 Mr. Sackett.

330 **C. WARRANTY PLANS THAT BUNDLE GAS LINES WITH OTHER**
331 **PRODUCTS COMPETE WITH GLCG**

332 **Q. Why do you believe that a warranty plan that bundles gas lines with other products**
333 **competes with GLCG?**

334 A. The same type of service is provided in both cases—the warranty and repair of inside gas
335 lines. The difference is that, with GLCG, the warranty applies only to the inside gas lines
336 while with the bundled packages by paying a higher price the customer also obtains
337 protection on additional inside lines and/or other home infrastructure.

338 **Q. What evidence have you seen that companies offering utility line protection plans**
339 **compete on the basis of packages and package discounts?**

340 A. Firms' advertising and marketing materials indicate that bundling is an important element
341 of competition. For example, the response of Manchester to Data Request NG-MAN
342 1.06, Attachment 1 shows typical marketing information of Manchester for its Utility
343 Shield product. (Nicor Gas Ex. 7.3, Manchester Response to NG-MAN 1.06). The
344 marketing material shows that a customer can purchase individual utility line protection,
345 combinations of utility line protection or even a "Complete Package" covering inside gas,

¹² Both results are statistically significant at the 2.5 percent confidence level. What this means is that there is less than a 2.5% chance that the results are due to chance or coincidence.

346 plumbing and electric and outside water and sewer for \$13.95 per month. Competition
347 for bundles is common in this market.

348 **Q. Does RESA comment on the number of suppliers that offer GLCG-type services?**

349 A. Yes. Ms. Ringenbach stated that “there are many suppliers who offer these products....”
350 (Ringenbach Reb., RESA Ex. 1.0, 9:198-99). In response to data request NG-RESA
351 1.01, RESA indicated that Ms. Ringenbach was referring to GLCG-type services and
352 referring to both the protection plan and the actual repair service. (Nicor Gas Ex. 7.4,
353 RESA Response to NG-RESA 1.01). She indicated that Santanna Energy, IGS, and
354 FirstEnergy Solutions offer protection plans and “that there are home warranty
355 companies which for an additional fee will offer line coverage.” (*Id.*) In addition, in her
356 rebuttal testimony she mentions the company Clockwork Services as a potential
357 competitor for GLCG-type products. Clockwork Services is a plumbing and HVAC
358 services company.

359 **Q. What evidence have you gathered regarding home warranty products?**

360 A. The home warranty business, also known as the home service contract business, has been
361 operating since 1971 and began in response to the risk management needs of homebuyers
362 and sellers. *Warranty Week* estimated that the home warranty business was a \$1.5 billion
363 business in the U.S. in 2009.¹³ The largest firm offering home warranties is American
364 Home Shield, a division of the ServiceMaster Co., which also owns the Terminix,
365 TruGreen, and Merry Maids brands of home service providers.

¹³ See “Home Warranty Market Share,” *Warranty Week*, December 22, 2009 available at <http://www.warrantyweek.com/archive/ww20091222.html>, accessed on April 12, 2011.

366 *Warranty Week* estimates that American Home Shield receives 41 percent of the
367 gross premiums paid. The next largest companies in terms of share of gross premiums
368 are: First American (11 percent), Old Republic (8.3 percent), Cross Country Home
369 Services (6.0 percent), Home Buyers Warranty Corp. (5.3 percent), Fidelity National
370 Home Warranty Co. (4.3 percent) and Dominion Products and Services Inc.
371 (3.7 percent).¹⁴ There are many more firms that also provide some type of home
372 warranty service. Some of the home warranty companies provide service throughout
373 broad geographic areas while others operate more locally.

374 **Q. Was Nicor Services included in *Warranty Week's* market share estimates?**

375 A. Yes. *Warranty Week* listed Nicor Services as having less than one percent of the share of
376 gross premiums paid.

377 **Q. How prevalent are home warranty products?**

378 A. The number of customers nationally who have a home warranty product can be estimated
379 in a couple of ways. The average monthly price of a home warranty product is around
380 \$35. If one divides the gross premium of \$1.5 billion by the yearly cost of a home
381 warranty product one obtains approximately 3.5 million customers with a home warranty
382 product in the U.S. (\$1.5 billion divided by (\$35*12)). Alternatively, American Home
383 Shield serves 1.3 million customers nationwide and has a 41 percent share of gross
384 premiums. This implies that there are approximately 3.2 million total customers
385 (1.30/0.41).

¹⁴ *Id.*

386 There are approximately 67 million owner occupied housing units in the U.S. that
387 consist of single detached, single attached and duplex units.¹⁵ These are the homeowners
388 most likely to purchase home warranty products. Thus, approximately five percent of
389 U.S. homeowners have subscribed to a home warranty product.

390 **Q. How many housing units are in the Nicor Gas service territory?**

391 A. I have estimated that there are approximately 1.86 million housing units in the Nicor Gas
392 service territory that consist of single detached, single attached and duplex units.¹⁶ This
393 implies that there could be as many as 90,000 (1.86 million*0.05) home warranty
394 customers in the Nicor Gas service territory whose gas lines are protected by warranty
395 products other than those offered by Nicor Services.

396 **Q. What does the typical home warranty product consist of?**

397 A. As an example, America Home Shield's (American Home Warranty) Essential plan
398 covers plumbing systems (leaks and breaks of water, drain, gas, waste or vent lines),
399 stoppage coverage, water heater, heating system, ductwork, electrical system, ceiling
400 fans, dishwasher, garbage disposal, built-in microwave oven and range/oven/cooktop.
401 The enhanced plan adds air conditioning, kitchen refrigerator, garage door, clothes
402 washer and clothes dryer.

403 **Q. How do these companies market to consumers, bill customers and perform the**
404 **repair service?**

405 A. It varies quite a bit. Some firms directly market to consumers through various means
406 (telemarketing, local advertising, direct mail). Others have arrangements with local real

¹⁵ U.S. Census Bureau, 2005-2009 American Community Survey 5-Year Estimates.

¹⁶ *Id.* This estimate does not include Chicago.

407 estate agents and brokers who target potential customers moving into a new residence.
408 For example, American Home Shield’s warranty contracts are marketed by
409 approximately 180 account executives in the field who recruit local real estate brokers
410 and agents.¹⁷ These firms have contracts and make arrangements with local professionals
411 for the actual repair services and use various means to bill and receive payment from
412 customers.

413 **Q. Do real estate agencies and brokers help sell home warranty products?**

414 A. Yes. This is further evidence that different marketing and customer solicitation routes are
415 available to competitors and that Nicor Gas customer solicitation is not an essential input.
416 In fact, the arrangements between real estate agents and home warranty providers are so
417 prevalent that the Department of Housing and Urban Development issued an
418 “Interpretive rule” that clarifies that the Real Estate Settlement Procedures Act
419 (“RESPA”) also pertains to the services offered by real estate brokers and agents to home
420 warranty companies.¹⁸

421 **Q. Given that the price of home warranty products is higher than the price of utility**
422 **line protection plans, how is it possible that the two products compete?**

423 A. First, as long as a sufficient number of customers view the gas line/utility line warranty
424 product and the home warranty product as substitutes then a significant price increase is
425 not profitable. The typical or “average” customer may not in fact switch to substitute
426 products when a supplier increases its prices. The consumers who are most likely to

¹⁷ See “Home Warranties,” *Warranty Week*, October 13, 2004 available at:
<http://www.warrantyweek.com/archive/ww20041013.html>.

¹⁸ See Federal Register/Vol. 75, No. 122/Friday, June 25, 2010/Rules and Regulations, 24 CFR Part 3500 [Docket No. FR-5425-IA-01], Real Estate Settlement Procedures Act (RESPA): Home Warranty Companies’ Payments to Real Estate Brokers and Agents, Office of General Counsel, HUD; *see also* letter of Vicki Cox Golder, National Association of Realtors, July 22, 2010.

427 switch to substitute services are the “marginal customers”—those customers who were
428 already predisposed to consider other products because they view them as good
429 substitutes. If there are enough of these consumers who would switch, then the two
430 products compete.

431 Second, in general, the price of a bundled product can constrain the price of the
432 individual component within a bundle even when there are significant price differences
433 between the individual component and the bundle. As the price of an individual
434 component increases, the bundled offering becomes a more attractive option. Firms must
435 take this into account when they set their prices.

436 For example, a “triple-play” package of telecommunications services consists of
437 telephone service (monthly access, local and long distance calling), Internet access and
438 cable television services. A triple-play package can include a myriad of choices such as
439 the cable television package selected (premium channels, sports channels, foreign
440 language, etc.), broadband speed and type of calling plan. A consumer can purchase the
441 triple-play package or purchase some or all of the components individually. For a
442 customer interested in more than one of the three components, the price of the bundle
443 strongly constrains the price of the individual components. If the price of an individual
444 component increases, the triple-play package becomes more attractive. Indeed, it is often
445 the case that the price of the bundle is less than the sum of the individual components,
446 providing customers savings if they purchase the bundle. Even for a customer who
447 purchases two of the components separately (say telephone and cable television) and does
448 not subscribe to an Internet service provider, a significant increase in the price of the
449 individual components may tip the customer to finally obtain Internet access and

450 purchase the bundled product. Firms have to take these factors into account when setting
451 the price of the individual component and the bundled package.

452 **Q. Will customers who want only a gas line warranty and repair service consider a**
453 **broad utility line protection plan or a home warranty product as a substitute?**

454 A. No. Some consumers are likely not to want a utility line protection plan for all inside
455 lines or a home warranty product and will want protection only for inside gas lines.

456 **Q. Will these customers then have to pay more for inside gas warranty and repair**
457 **products?**

458 A. No. Firms offering these warranty and repair services generally charge the same price to
459 their customers for the service and do not charge customers a different price depending
460 on each customer's willingness to pay (*i.e.*, each customer's demand). While those
461 customers interested only in an inside gas line warranty product may not view a package
462 of inside line warranty or home warranty products as substitutes, other customers may
463 and, as a result, the market price set for inside gas line warranty products must take this
464 into account.

465 As discussed previously, the focus in market definition should be on the marginal
466 customer, not the average customer. There are some customers who only purchase a gas
467 line warranty product and do not purchase any other inside line warranty product
468 (electric, water, sewer) or home appliance warranty product. These customers may not
469 view a package of inside line and home appliance protection as substitutes. There are,
470 however, some customers who purchase only an inside gas line protection plan but may
471 have an interest in inside electric, water or sewer protection as well. An increase in the

472 price of the inside gas line protection plan will make a package of two or more inside line
473 protection plans more attractive. Alternatively, some customers may purchase two inside
474 line warranty products (*e.g.*, gas, electric) and may be interested in some home appliance
475 protections. These customers may view a package of inside line and home appliances
476 protections as a substitute. The important point is that there are large combinations of
477 consumer preferences for individual and packaged warranty products. An inside gas line
478 warranty provider cannot set its price without taking into account that, if the price is set
479 too high, it could encourage a customer's substitution with the package.

480 It is also important to note that those customers purchasing only the single
481 protection are self-insuring for the remaining coverage, and that also has a cost. The
482 relevant comparison is not then to the monthly price of the inside gas line warranty
483 product (say \$4.95) with the monthly price of the bundled line warranty product (say
484 \$14) or the home warranty (say \$35). Rather, the relevant comparison is the monthly
485 price of the inside gas line warranty product plus the cost a consumer incurs to self-insure
486 electric, water, sewer and home appliances compared to the monthly price of the bundled
487 product. Those customers who have not purchased a warranty product have opted for the
488 self-insurance alternative, in whole or in part.

489 **Q. How can the cost to the home owner for this self-insurance be estimated?**

490 A. The self-insurance cost to the homeowner must be imputed, as it is not directly
491 observable in the market. For example, the real estate/home industry and the warranty
492 industry suggest that homeowners should save about one percent of the value of a home

493 each year in order to deal with repair and maintenance issues that undoubtedly arise.¹⁹
494 Assuming a median home value of \$200,000, this translates into \$2,000 per year or \$166
495 per month. This can be considered a cost of self-insurance.

496 Thus, even though a customer may only be spending \$4.95 per month on a
497 warranty/protection plan for the inside gas line, the cost to the customer to self-insure
498 other utility lines and other home infrastructure is greater. At some price point, the
499 customer may decide to purchase a warranty/protection plan for more than just the inside
500 gas line and reduce the cost of self-insuring.

501 For these reasons, an inside gas line warranty provider cannot set its price without
502 taking into account that if the price is set too high it could encourage substitution with the
503 package or self-insurance.

504 **D. POTENTIAL COMPETITION HELPS DISCIPLINE GLCG PRICES**

505 **Q. Mr. Sackett characterizes your testimony on contestable markets and the GLCG**
506 **product as “conclud[ing] that the price of GLCG is set at a competitive level, due to**
507 **the market being contestable.” (Sackett Reb., Staff Ex. 4.0, 50:905-06). Is this an**
508 **accurate characterization of your testimony?**

509 A. No. In my rebuttal testimony, I stated that “potential competition also plays a role in
510 disciplining the price of the GLCG product”. (Ros Reb., Nicor Gas Ex. 4.0, 29:706-07)
511 (emphasis added). As described in my rebuttal testimony and in this surrebuttal
512 testimony, in addition to potential competition, actual competitors are disciplining the

¹⁹ Eric Tyson, as cited by Liz Pulliam Weston, “A home warranty is no guarantee,” *MSN*, January 5, 2010, available at <http://articles.moneycentral.msn.com/Banking/HomebuyingGuide/AHomeWarrantyIsNoGuarantee.aspx>, accessed on April 12, 2011.

513 price of the GLCG product. These actual competitors include other utility line protection
514 products, home warranty products and professionals that can repair utility lines.

515 The theory of contestability applies when there is one actual provider in the
516 market and potential competition is the only source that disciplines the price of the firm
517 in the market. This is not the case for the GLCG product.

518 **Q. Why then did you cite to an article that is the foundation for the economic theory of**
519 **contestability in your rebuttal testimony?**

520 A. The theory of perfect contestability is an idealized one that usually does not exist in the
521 real world in much the same way that the theory of perfect competition is an idealized
522 one that usually does not exist in the real world. Nevertheless, just as the insights from
523 the theory of perfect competition can be useful, so too can the insights of contestability be
524 appreciated and used in the real world.

525 The insights of contestability are the role of potential competition in disciplining
526 prices and the importance of examining the barriers to entering a market. Prior to the
527 theory of contestability, it was commonly accepted in the economics profession that the
528 number of participants in a market was the most important determinant of market
529 performance. An increase in the number of participants in a market would result in better
530 outcomes and a decrease in market participants would make things worse. The
531 significance of contestability is that potential competition can have just as strong an
532 impact on market outcomes as actual competition and, as potential competition increases,
533 we can expect to observe better outcomes.

534 The theory of potential competition is commonly accepted in the economics
535 profession. Indeed, in merger investigations at the Department of Justice and Federal
536 Trade Commission, a merger that increases the market share of the merged companies
537 above the “safe harbor” amount (*i.e.*, the amount that would trigger a more in-depth
538 investigation of the merger) would not be challenged if potential competition (as
539 measured through the extent of barriers to entry) were considered to be strong.

540 **Q. Please describe the role that potential competition can play in disciplining the prices**
541 **in a market.**

542 A. Potential competition is competition from a firm or firms that, although not present in the
543 relevant market, could enter and compete if there were economic profits being earned in
544 the market. Potential competition can play an important role in ensuring that firms that
545 are in the market price their services at the competitive level. Potential competition will
546 play a stronger role when barriers to entering the market are not significant.

547 **Q. What are the main types of barriers to entry?**

548 A. There are several: (1) sunk costs, which are the costs (usually investment-related) that
549 cannot be recovered upon a later exit; (2) economies of scale/scope; (3) access to
550 intellectual property such as patents, trade secrets, or other intangible assets; (4) scarce
551 inputs; (5) switching costs; and (6) legal barriers. Whenever these factors are present and
552 are significant, it may be the case that potential competition is not very strong.

553 **Q. Are the barriers to entering the relevant market to compete against gas line**
554 **warranty products significant?**

555 A. No. Competition for gas line warranty products comes from many different sources as
556 discussed above. It comes from firms selling competing utility line protection products,
557 home warranty products and from HVAC and plumbing firms. The existence of these
558 firms providing competing service indicates that, whatever barriers to entry exist, they are
559 not insurmountable.

560 The sunk costs of providing competing services are not significant. To provide
561 competing warranty products firms would need to incur many different expenses, only
562 some which fall into the category of sunk costs. The two most important ones are
563 advertising and brand promotion. Although these are examples of sunk costs, they are
564 not significant as advertising and brand promotion are required in many workably
565 competitive markets. Other costs to provide competing services include infrastructure or
566 services such as billing systems, repair networks, solicitation networks, information
567 systems, developing customer terms and conditions, call center services, and legal
568 services. These are not sunk costs as they are either investments that upon a firm's exit
569 could be used again or resold (*e.g.*, billing systems or IT systems) or are expenses that are
570 incurred and recovered in the same accounting period (*e.g.*, repair costs or sales costs).

571 Economies of scale and scope are not significant. If economies of scale and scope
572 were large, it would imply that only a few firms could survive in the marketplace.
573 Instead what we observe is that there are many firms providing competing warranty
574 services as well as many HVAC and plumbers providing competing services.

575 There are no legal barriers to entering the market. Intellectual property is not
576 relevant in this market and nor are customer switching costs. Although customer
577 contracts are for a period of 12 months, the typical contract permits a customer to cancel

578 service anytime during the 12 month period without being responsible for the remaining
579 payments.

580 Finally, there are no scarce inputs required to provide competing services.

581 **Q. Does the economic literature support the proposition that potential competition can**
582 **play an important role in constraining prices?**

583 A. Yes. In the airline industry, two articles have found support for the proposition that
584 potential competition has a strong impact on market outcomes and the mere threat of
585 entry is an important element when analyzing a market.²⁰

586 **Q. Have you recently investigated the impact of potential competition in a market?**

587 A. Yes. In a recently published article, I investigated the determinants of pricing in the
588 Mexican domestic airline industry and found that the lack of potential competition on
589 some routes is having a significant impact on airline prices in Mexico.²¹

590 **Q. Please explain.**

591 A. A major problem in the Mexican domestic airline market is that the Mexico City airport
592 is “saturated,” which means that the number of airlines using take-off and landing slots is
593 at a maximum during certain times of the day and no further flights can take-off or land.
594 Potential competitors cannot enter the Mexico City airport to compete and actual
595 operators recognize and set their prices accordingly. Thus, potential competition on those
596 routes involving Mexico City is nonexistent compared to routes where the airports are not

²⁰ See: Morrison, Steven A., and Winston, Clifford, “Empirical Implications and Tests of the Contestability Hypothesis,” *Journal of Law and Economics*, 30.1 (April 1987): 53-66; and Morrison, Steven A. “Actual, Adjacent, and Potential Competition: Estimating the Full Effect of Southwest Airlines,” *Journal of Transport Economics and Policy*, 35 (2001): 239-256.

²¹ Ros, Agustin J., “The Determinants of Pricing in the Mexican Domestic Airline Sector: The Impact of Competition and Airport Congestion,” *Review of Industrial Organization*, 38.1 (2011): 43-60.

597 saturated. I found that average domestic fares are approximately 70 percent higher at the
598 Mexico City airport because of the lack of potential competition, by far the most
599 important determinant of pricing—even more so than the number of competitors on a
600 route. This shows that potential competition can play an important role (even more
601 important than the number of firms in the market) in disciplining prices.

602 **E. NICOR SERVICES DOES NOT POSSESS SIGNIFICANT MARKET**
603 **POWER FOR GLCG**

604 **Q. How do economists determine if a firm possesses significant market power?**

605 A. All firms possess some market power due to the fact that products are usually
606 differentiated. Public policy should be focused upon firms with significant market power
607 and only if that significant market power is being used to displace competitors from the
608 market.

609 If market shares are low, it is unlikely that a firm possesses significant market
610 power. Market share is generally used as a screening device with a low market share
611 indicating no concern while higher market shares requiring additional evaluation.

612 In addition, if a firm has a high market share it may not possess significant market
613 power because barriers to entering the market are low and potential competition can
614 discipline prices.

615 **Q. Does Nicor Service possess significant market power for the GLCG product?**

616 A. No, for two reasons. First, Nicor Services does not have a high share of the relevant
617 market. For the reasons discussed previously, the relevant product market consists of gas
618 line warranty products, utility line warranty products, home warranty products and
619 customers' self-insurance option. Nicor Services' share of this market is not high. Each

620 of the approximately 1.8 million homeowners in the Nicor Gas service territory either
621 purchases a warranty product (such as a gas line warranty product or a home warranty
622 product) or self-insures against the risk of gas line repairs. Nicor Services serves
623 approximately *****XXXXXX***** customers, which represents about *****XX***** percent
624 of the homeowners. This is not a high share of the market.

625 Second, for the reasons discussed previously, the barriers to entering the market to
626 compete against gas line warranty products are not high.

627 **Q. Mr. Sackett believes that the market is not competitive because the risk premium**
628 **for GLCG is 38 times the actuarial cost. (Sackett Reb., Staff Ex. 4.0, 33:598-601). Is**
629 **there support in the economic literature for this conclusion?**

630 A. No. Mr. Sackett believes that a risk premium of 38 times the actuarial cost indicates
631 significant market power. He does not, however, provide a theory or reference to the
632 literature for support. Under this criterion, Santanna Energy also has market power in the
633 Gas Line Guard product (which, according to Mr. Sackett, also has a risk premium of 38
634 times actuarial cost).

635 A product's mark-up above marginal cost is contained in the Lerner index, an
636 index that relates the mark-up above marginal cost to the inverse of the firm's elasticity
637 of demand. It measures the extent of departure from perfect competition. Reaching
638 conclusions about the level of market power from calculating a mark-up above marginal
639 costs is prone to error when product differentiation is common or if there are substantial
640 fixed costs. Under such conditions we would not expect firms to price equal to marginal
641 cost.

642 This especially applies to insurance markets. Product differentiation is important
643 and common for insurance products and there are costs that are fixed and do not vary as
644 the number of customers served changes. Thus, it is incorrect to reach conclusions about
645 the level of competition for insurance products by simply comparing the price of
646 insurance to the cost of insurance. The demand, supply and market price for insurance is
647 determined by many factors such as: (1) the risk profile of the insured and the insurer; (2)
648 information asymmetries between the insured and the insurer; (3) the discount rate; (4)
649 the loss distribution; and (5) the initial wealth or endowment of the individuals. Because
650 these factors differ for different insurance products, companies and individuals, specific
651 insurance markets are likely to exhibit wide variances in the risk premium. This is not
652 taken into account in Mr. Sackett's analysis on the risk premium.

653 **Q. Is the actuarial cost appropriately used as a tool for the profitability of utility line**
654 **warranty/protection products?**

655 A. According to Manchester's response to NG-MAN 1.07, "[a]ctuarial cost calculations are
656 not used in warranty products or in Manchester's management of Utility Shield." (Nicor
657 Gas Ex. 7.5, Manchester Response to NG-MAN 1.07).

658 **IV. NICOR GAS INPUTS PROVIDED TO NICOR SERVICES ARE NOT**
659 **ESSENTIAL**

660 **Q. Apart from the Staff, do other Intervenors request that Nicor Gas share its inputs**
661 **with competitors?**

662 A. Yes. Ms. Ringenbach recommends that "Nicor Gas should be required to provide the
663 same services, at the same costs, to non-affiliates offering warranty products that it
664 provides to its affiliate, Nicor Services, including solicitation, billing, and repair

665 services.” (Ringenbach Reb., RESA Ex. 1.0, 4:71-74). Mr. Thomas also recommends
666 that Nicor Gas billing be shared with competitors and that Nicor Gas be prevented from
667 soliciting affiliate products in its call centers. (Thomas Reb., Manchester Ex. 1.0,
668 16:347-48; *Id.*, 18:404-05). Mr. Thomas does not mention repair services in his rebuttal
669 testimony.

670 **Q. Are the inputs requested by the Intervenor essential inputs?**

671 A. No. An essential input that should be shared with competitors is an input that must meet
672 the following requirements: (1) it must be an input controlled by a monopolist; (2) it must
673 be essential to the sustainability of competition; (3) it must neither be available from
674 another source nor capable of being duplicated; and (4) it can be feasibly (practically)
675 shared by the monopolist. If any of the four conditions are not met the input is not
676 essential.²²

677 Most importantly, the inputs in question (customer solicitation, billing and repair
678 services) are available from other sources or are capable of being duplicated. As has
679 been shown above, Nicor Gas is not the only source for these inputs in the marketplace.
680 Competition for GLCG and GLCG-type products are occurring in many different forms
681 by companies using their own marketing, billing and repair services.

682 **Q. How do you respond to Mr. Thomas’ statement that “Nicor Services’ exclusive**
683 **access to the Nicor Gas bill creates advantages and market distortions that freeze**
684 **competitors out of the market” (Thomas Reb., Manchester Ex. 1.0, 6:125-16:350)?**

²² See: Karl McDermott, Ken Gordon, William E. Taylor and Agustin J. Ros, “Essential Facilities, Economic Efficiency, and a Mandate to Share: A Policy Primer,” Edison Electric Institute, January 2000.

685 A. The evidence in this proceeding shows that competitors are using their own billing
686 systems, marketing channels and repair service networks to provide similar-type
687 products. Billing systems are not an essential input.

688 Indeed, Mr. Thomas discusses Manchester's own billing system that they are
689 currently using in some places. Manchester has invested in billing systems that "will
690 track the customer information, create an invoice, send the invoice to the customer, track
691 all aspects of the receivable from billing to cash, and address any issue with non-
692 payment." (Thomas Reb., Manchester Ex. 1.0, 15:319-25). This is evidence that
693 competitors are able to duplicate the billing input.

694 **Q. Mr. Thomas states that Manchester's costs would be lower if it were allowed to use**
695 **Nicor Gas billing. (Thomas Reb., Manchester Ex. 1.0, 15:334-16:336). Is this a**
696 **sufficient reason to require that an input be shared with competitors?**

697 A. No. Much more is needed. Under Mr. Thomas's rationale, any cost advantage a firm has
698 would need to be shared. This is the antithesis of competition.

699 **Q. Does Mr. Thomas provide additional evidence that billing is not an essential input?**

700 A. Yes. According to Mr. Thomas, he ran a utility affiliate company marketing utility line
701 protection products to both: (1) utility customers where the customer was billed on the
702 same utility bill; and (2) non-utility customers where the same products were offered with
703 only the payment of direct bill. (Thomas Reb., Manchester Ex. 1.0, 4:76-80). According
704 to Mr. Thomas, the response rate was four times higher than for direct billing. (Thomas
705 Reb., Manchester Ex. 1.0, 5:92-96). This suggests several points:

- 706 1. It is possible to sell utility line protection products without using the utility bill. It
707 is thus not an essential input. Indeed, Mr. Thomas' testimony would indicate that
708 it could compete for as many as 100,000 customers in the Nicor Gas service
709 territory.
- 710 2. The response differential could be lower if a price discount were given; that is,
711 customers might select direct billing if it came at a discount. Manchester data
712 responses indicate that the "four times higher" number given in Mr. Thomas'
713 testimony assumed that the price was the same for those customers that were billed
714 on the utility bill and those that were not. (Nicor Gas Ex. 7.7, Manchester
715 Response to NG-MAN 1.12).
- 716 3. A lower response rate for direct billing simply means that the firm would have to
717 cast a "wider net" for customers. This is not anticompetitive.
- 718 4. The firm could offer a larger bundle of services in order to make it more attractive
719 to consumers and overcome the lower value to the consumer of direct billing.
720 Indeed, non-utility warranty companies offer a broader bundle of services.
- 721 5. Mr. Thomas states that other billing remittance options (writing checks, providing
722 a credit card number) are inferior and not a good substitute for using the utility bill.
723 (Thomas Reb., Manchester Ex. 1.0, 10:222-11:231). There are, however, other
724 billing remittance options available to companies and consumers such as systems
725 like PayPal or on-line bank payment.

726 **Q. What options do companies have when it comes to billing services?**

727 A. Companies have a wide array of billing services available online. These services can be
728 categorized into two main types: (1) merchant accounts and payment gateways; and

729 (2) third party processors. The combination of a merchant account, a type of bank
730 account that allows businesses to accept payments by debit or credit cards, and a payment
731 gateway, which authorizes and facilitates the secure transfer of information between the
732 business' website and merchant account, allows a business to process its payments
733 online. Common online merchant account providers include Merchant Express,
734 Merchant Focus, and Millennium Bankcard. Common payment gateway providers
735 include Authorize.Net and Trust Commerce.

736 Merchant accounts and payment gateways can be further combined with advanced
737 billing services to allow for greater flexibility. These services are particularly suited to
738 businesses that bill their customers on a recurring basis but need additional capabilities in
739 terms of tailoring payment structures. With recurring billing services such as Chargify,
740 Recurly, and Spreedly, businesses can include multiple subscription plans per customer,
741 complimentary subscriptions, multiple subscription levels, trial periods, set-up fees, add-
742 ons, variable pricing, tiered pricing, prorated pricing, and automated communications.

743 Businesses could also elect to use an all-in-one third party processor such as
744 Amazon Simple Pay, Amazon Flexible Payments, Google Checkout, Moneybookers, or
745 PayPal. These processors combine the services of merchant accounts, payment gateways,
746 and recurring billing services to offer all the capabilities through one interface.

747 **Q. Mr. Sackett states that the inputs provided by Nicor Gas do not result from**
748 **innovation and should not be protected as I have advocated; instead they should be**
749 **shared. (Sackett Reb., Staff Ex. 4.0, 60:1072-75). Do you agree?**

750 A. No. The evidence in this proceeding indicates that firms are providing competing
751 warranty products using their own billing system, their own repair systems and their own

752 marketing resources. Home warranty providers are providing these services using their
753 own billing systems, repair networks and customer solicitation. The same applies for
754 self-insurance options.

755 The incentives to innovate would be lowered because firms would have less
756 incentive to work on and develop their own customer solicitation, billing and repair
757 services were Nicor Gas inputs made available to them. Moreover, those firms that have
758 invested to develop repair networks, billing systems and customer solicitation channels
759 would be harmed were Nicor Gas required to share its inputs with non-affiliated firms
760 because it would lower the value of their investment.

761 **Q. What other problems could occur if Nicor Gas were required to share its inputs**
762 **with competitors?**

763 A. Customer solicitation is an example. Some of the Intervenors are requesting that Nicor
764 Gas provide customers who call in with a list of companies that can provide utility line
765 warranty/protection, much in the same way that it works for the Customer Select plan.
766 (*See e.g., Ringenbach Reb., RESA Ex. 1.0, 8:164-67*). But there is a risk that some of the
767 firms that may request to be provided on such a list may not be reputable, may engage in
768 fraudulent activity or may not provide good service. The risk is that the Nicor Gas brand
769 becomes diminished based upon the conduct of some firms. Of course, a solution to this
770 is that the Commission screen all firms that want to be included on the list, much like the
771 firms providing Customer Select services need a license from the Commission to provide
772 service. But there are many firms nationwide that can provide such warranty/protection
773 service and may request to be included on the list. The Commission would need to incur
774 costs to screen all the companies requesting service.

775 **V. NICOR GAS IS NOT PROVIDING A SUBSIDY TO NICOR SERVICES**

776 **Q. What is a cross subsidy?**

777 A. In general terms, a cross subsidy is defined as the use of revenues from the sale of a
778 product to subsidize the sale of another product. A product is said to be in receipt of a
779 subsidy if the price of the product is below the cost of producing the product.
780 Incremental cost is the relevant cost standard to assess whether a product is receiving a
781 subsidy and is often used as a price floor. If the average incremental revenue contributed
782 by a product of a firm is less than the average incremental cost, then the product is in
783 receipt of a subsidy.²³

784 **Q. Has Mr. Sackett testified that Nicor Gas is subsidizing Nicor Services' products?**

785 A. No. Mr. Sackett did not testify in his direct or rebuttal testimony that Nicor Gas is, in
786 fact, subsidizing Nicor Services' products. In response to NG-Staff 8.09, Staff states
787 "Mr. Sackett has not uncovered an economic subsidy in his investigation; rather, he has
788 uncovered evidence of something much more valuable to Nicor Services: exclusive
789 solicitation, billing and repair channels." (Nicor Gas Ex. 7.6, Staff Response to NG-Staff
790 8.09).

791 Instead, Mr. Sackett states that "Nicor Gas has an incentive to subsidize Nicor
792 Services products." (Sackett Reb., Staff Ex. 4.0, 12:199-200). In this section of my
793 testimony I discuss why Nicor Gas is not providing a subsidy to Nicor Services. For the
794 reasons already discussed in this surrebuttal testimony, I disagree with Mr. Sackett's

²³ See William J. Baumol and Gregory J. Sidak, *Toward Competition in Local Telephony*, MIT Press 1994, Chapter 5.

795 statement about uncovering “evidence of something much more valuable to Nicor
796 Services: exclusive solicitation, billing and repair services.”

797 **Q. What are the inputs that Mr. Sackett alleges are being sold “below market price”?**

798 A. He refers to repair services in his discussion on Nicor Gas incentives to subsidize Nicor
799 Services. (Sackett Reb., Staff Ex. 4.0, 11:189-95).

800 **Q. Please summarize why Mr. Sackett believes that Nicor Gas has an incentive to
801 subsidize Nicor Services.**

802 A. Mr. Sackett’s allegation is that Nicor Gas has an incentive to sell an input to Nicor
803 Services at a subsidized price, thus allowing Nicor Services to earn an economic profit.
804 Specifically, his allegation is as follows: Nicor Gas sells an input to Nicor Services at a
805 price that is “below market price.” Nicor Services can then benefit by earning “an
806 economic profit” because Nicor Gas refuses to provide the input to competitors at the
807 same price. (Sackett Reb., Staff Ex. 4.0, 11:189-12:197). This will create profits for
808 GLCG even without Nicor Services having the ability to raise the price.

809 **Q. Is the allegation persuasive?**

810 A. No. Nicor Gas charges Nicor Services a flat fee of \$72 for repair services.²⁴ According
811 to the U.S. Bureau of Labor Statistics, the average hourly wage for plumbers in the
812 Chicago metropolitan area was about \$30 in 2009.²⁵

813 Moreover, the prices of the Nicor Gas inputs are based upon a fully distributed
814 costing (“FDC”) methodology, which recovers the direct costs of providing the inputs, as

²⁴ DLH 1.05 Exhibit 25, DLH 6.02 Suppl. Exhibit 1. Based on information provided by Nicor Gas, the average duration for repairs (travel time and work time) is 40 minutes.

²⁵ Bureau of Labor Statistics, National Compensation Survey, October 2009.

815 well as an assignment of costs that are indirect and common. Thus, the costs of the
816 inputs are above incremental costs—the economically relevant cost measure to determine
817 a subsidy—due to the fact that incremental costs only recover the direct costs of
818 providing the input.

819 **VI. CONCLUSION**

820 **Q. Does this conclude your surrebuttal testimony?**

821 **A.** Yes.