STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

NORTH SHORE GAS COMPANY	**)**	
Proposed General Increase in	**)**	**Docket No. 11-0280**
Rates for Gas Service	**)**	
	)	
THE PEOPLES GAS LIGHT AND COKE	**)**	
COMPANY	**)**	
Proposed general increase in	**)**	**Docket No. 11-0281**
Rates for Gas Service	**)**	**Consolidated**

REPLY BRIEF
OF THE PEOPLE OF THE STATE OF ILLINOIS

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I. INTRODUCTION

Early in its Brief, in the general discussion of its requested revenue requirement, the Companies cite seminal federal case law regarding the appropriate parameters and requirements of regulation. They write:

> Under long-established federal and Illinois constitutional law, and Illinois ratemaking law, a utility's rates must be set so as to allow it the opportunity to obtain full recovery of its prudent and reasonable costs of service, including its costs of capital.[1] A public utility has a constitutional right to a return that is "reasonably sufficient to assure confidence in the financial soundness of the utility and [is] adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties." *Bluefield*, 262 U.S. at 693. The authorized return on equity "should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." *Hope,* 320 U.S. at 603.

NS-PGL Brief at 9-10. The People could not agree more with the validity of these legal precepts. The U.S. Supreme Court made clear, as the Companies plainly acknowledge, that the purpose of monopoly regulation is to allow utilities the *opportunity – not the guarantee – of earning profits* "commensurate with returns on investment in other enterprises having corresponding risks." *Hope,* 320 U.S. at 603. The utilities ignore these seminal rulings, however, when it comes to their stand on residential and small commercial rate design. In the instant case, they propose a punitive residential rate design that wallops its lowest residential users of natural gas with the highest percentage increase in rates, premised on its claim that it must continue to increase the fixed portion of customer bills to ensure the recovery of its costs.

[1] *E.g., Duquesne Light Co. v. Barasch*, 488 U.S. 299, 309-310 (1989); *Federal Power Comm'n v. Hope Natural Gas Co*., 320 U.S. 591, 622 (1944); *Bluefield Water Works & Improvement Co. v. Public Service Comm'n of the State of West Virginia*, 262 U.S. 679, 693 (1923); U.S. Const., amend. V, XIV (due process and takings clauses); Ill. Const., art. I, §§ 2, 15 (same); *Commonwealth Edison Co. v. Illinois Commerce Comm'n*, 322 Ill. App. 3d 846, 849, 751 N.E.2d 196, 199 (2d Dist. 2001) ("*ComEd*") (citing *Citizens Utilities Co. v. Illinois Commerce Comm'n*, 124 Ill. 2d 195, 200, 529 N.E.2d 510, 512 (1988) ("*Citizens Utilities*"); *see also Citizens Utility Board v. Illinois Commerce Comm'n,* 166 Ill. 2d 111, 121, 651 N.E.2d 1089, 1095 (1995) ("*CUB*") (involving costs recovered under a rider).

The rate design is premised on a flawed assertion that all delivery service costs are fixed despite evidence to the contrary in their own Embedded Cost of Service Study ("ECOSS"). At the same time, the NS-PGL preferred rate design would result in rate *decreases* for the Companies' highest residential users. As the People discussed in the AG Initial Brief, that constitutes unreasonable discrimination that the Commission should reject.

The Companies' claim that approval of Rider VBA, an unlawful rider that trues up residential and small commercial customer revenues based on an annual forecast of what the Companies believe they should collect from these rate classes to *guarantee* receipt of their most recent authorized revenue requirement, is also necessary to recover their cost of service. But, as explained below and in the AG Initial Brief, there is nothing legal or necessary about guaranteeing revenues. Until the Rider VBA pilot, regulation in Illinois has always sought to permit a utility to recover its prudent and reasonably and incurred costs and the *opportunity* – not a *guarantee* – to earn a reasonable profit level. Moreover, legal issues aside, the circumstances that caused the Commission to adopt the rider no longer exist. It, too, should be rejected by the Commission.

Finally, since the filing of the Initial Briefs in this case, the Second District Appellate Court issued its opinion in the People of the State of Illinois' appeal of the Commission's approval of Rider ICR, the infrastructure cost recovery, in the last NS-PGL rate order, Docket No. 09-0166/09-0167. In its September 30, 2011 opinion, the Court held that the Commission's approval of Rider ICR constituted unlawful single-issue ratemaking. *The People ex rel. Madigan v. Illinois Commerce Comm'n,* Case Nos. 1-10-0654, 1-10-0655, 1-10-0936, 1-10-1790, 1-10-1846 and 1-10-1852 (slip op. of September 30, 2011) ("*Madigan*"). This decision is significant to this case for a few reasons. First, it is unclear what impact the ruling will have on the Companies' plans for plant investment in the remaining months of 2011 and the 2012 test year. The People filed on October 5, 2011, a Motion to Re-open the Record in light of the Court's rejection of Rider ICR. Second, the Government and Consumer Intervenors' ("GCI") proposal to reflect Accumulated Deferred Income Taxes in the Rider ICR calculations will be moot if Rider ICR is no longer available to recover a return of and on investment tied to the Accelerated Main Replacement Program ("AMRP"). Third, Commission acceptance of the Companies' invitation to approve Rider VBA on a permanent basis is even more risky than originally described in the AG Initial Brief given the appellate court's clear enunciation and affirmation[2] of the limited circumstances under which riders may be approved, as discussed later in this Reply Brief. Rider VBA fits none of the criteria outlined by the Court for lawful rider recovery of expenses.

The People urge the Commission to enter an order consistent with the arguments made in this and the AG Initial Brief.

A. Overview/Summary

B. Nature of Operations

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2. Peoples Gas

II. TEST YEAR (Uncontested)

III. REVENUE REQUIREMENT

A. North Shore

B. Peoples Gas

IV. RATE BASE

[2] The Court relied on the Second District's decision in *Commonwealth Edison Co. v. Illinois Commerce Comm'n*, Ill. App.3d (2nd Dist. 2010), which reversed the Commission's approval of Rider SMP, ComEd's smart grid pilot rider, and enunciated a clear test for when riders can be employed as lawful cost recovery mechanisms.

A. Overview/Summary/Totals

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2. Peoples Gas

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b. Use of Average Rate Assumption Method relating to Health Care Reform Legislation

c. Net Operating Loss – Tax Normalization

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

a. Forecasted Test Year Capital Additions

(i) Utility Plant in Service and (ii) Capital Additions Related to Accelerated Main Replacement – AMRP (PGL)

As discussed in the AG Initial Brief, GCI witness David Effron recommended two specific adjustments to the Companies' test year plant in service. First, based on his review of actual Peoples Gas investment data through June 30, 2011, GCI witness Effron testified that the PGL is running below 2011 forecasts on plant additions related to the accelerated main replacement program ("AMRP") in 2011 cumulative actual spending. Company data showed that through the end of June, 2011, spending was $24.7 million as compared with the Company's $62.0 million budgeted spending for the same time period. Thus, through the end of June 2011, PGL had spent *$37.3 million less* than the amount reflected in its 2011 AMRP budget. GCI Ex. 7.0 at 2.

Given these facts, Mr. Effron testified that PGL's test year level of plant in service should be modified in three ways. First, at a minimum, the test year rate base should be adjusted to recognize the actual under-spending experienced on accelerated main replacements through the end of June 2011 for PGL. This adjustment reduces the *2011* AMRP plant included in the test year rate base by $37,324,000. Mr. Effron noted that this is a relatively conservative quantification of the appropriate adjustment to 2011 AMRP plant additions because it implicitly assumes that the actual plant additions for the second half of the year will be on budget, even though that has clearly not been the case in the first six months of the year. *Id.* at 3.

Given the Company's performance in 2011, Mr. Effron testified that a second adjustment to the test year level of plant in service would also be reasonable to reflect the same reduction to the forecasted additions for 2012, the test year. In this regard, reduction of the 2012 forecast by $37,324,000 would be a conservative adjustment. It is conservative because the proposed adjustment does not extrapolate the Company's actual under-spending over the six month period in 2011 to the full year. It simply recognizes the amount under spent in 2011. Further, this proposed adjustment also recognizes a level of AMRP plant additions in 2012 that is $16.1 million higher than the adjusted level of plant additions in 2011. Accordingly, a reduction of

$37,324,000 to the forecasted 2012 AMRP plant additions should be reflected, as shown on GCI Ex. 7.2, Schedule DJE-1.1.

The effect of these adjustments to the forecasted 2011 and 2012 AMRP capital expenditures can be seen on GCI Ex. 7.2, Schedule DJE-1.1, and result in a reduction of $55,985,000 to PGL test year plant in service. (The 2012 test year depreciation expense is reduced by $1,931,000 and the average balance of accumulated depreciation in 2012 is lower by $1,610,000.) The net reduction to the 2012 test year rate base is $54,376,000. GCI Ex. 7.0 at 3-4.

Other adjustments to plant in service separate and apart from the AMRP plant adjustments are also appropriate, in light of the most recent NS-PGL data available. That data show that both companies' updates to forecasted level of test year plant are significantly overstated. As noted above, as explained in the Rebuttal phase of the docket by NS-PGL witness Doerk, PGL and North Shore increased the forecasted capital expenses in 2011 and 2012 from the amounts in the original rate case filing. *See* NS-PGL Ex. 24.0 at 7. Specifically, Mr. Doerk testified that PGL would increase capital expenditures by $10.3 million in 2011 and $56.8 million in 2012. NS-PGL Ex. 24.0 at 7. For North Shore, the increase in capital expenditures is $5.0 million for 2011 and $13.2 million for 2012. *Id.*

GCI witness Effron testified that these updates were not supported by the Companies' own data and are inappropriate. For example, in 2011 through June, North Shore's actual plant additions were $1.4 million, or 25%, below the original budget (response to Staff Data Request NS DGK 3.5, June Update, Confidential), and Peoples Gas's actual plant additions were $32.9 million, or 41%, below the original budget (response to Staff Data Request PGL DGK 3.5, June Update, Confidential). GCI Ex. 7.0 at 8. It would make little sense to adjust the rate bases for increases to the forecasted level of plant additions when the Companies aren't even keeping up with the original forecasts of plant additions. The effect of eliminating the increases to the original forecasts of plant additions is to reduce the North Shore rate base by $11,443,000 (NS Schedule DJE-1) and the Peoples Gas rate base by $38,355,000 (PGL Schedule DJE-1). *Id.*

The Companies argue in their Brief that the Commission should approve Staff's proposed adjustment and reject the GCI adjustment. They argue that Staff witness Kahle states his "analysis provides a better assessment of the Companies' performance because [his] analysis includes all of the Companies' budgeted capital expenditures rather than a single project as does [GCI witness] Mr. Effron." NS-PGL Brief at 16, citing Kahle Dir., Staff Ex. 1.0, 15:323-326. This argument misses the mark. As noted in the AG Initial Brief, this criticism was rendered moot by Mr. Effron's rebuttal analysis, which relied on total plant in service budgeted and actual numbers. When Mr. Kahle made that criticism, he had not reviewed Mr. Effron's rebuttal adjustment. As shown on AG Cross Ex. 11, Mr. Effron relied on the Company's own update to its *total* plant in service numbers. The response, the Companies' update to DGK 3.05, shows that through June of 2011, the PGL additions to plant in service were $32.9 million under budget. Tr. at 256. Mr. Kahle confirmed that those numbers reflected this under-budgeted amount. Tr. at 257. AG Cross Ex. 12, which was North Shore's update to the same discovery question, showed that North Shore's level of plant in service as of June, 2011 were $1.4 million under budget, an amount again confirmed by Mr. Kahle. Tr. at 257. The Companies' reliance on Staff witness Kahle's original criticism that Mr. Effron's plant in service adjustment related to a single project is simply wrong. Significantly, Staff's Brief indicates that it "would support Mr. Effron's proposed adjustment". Staff Brief at 9. GCI agree with Staff that should the

Commission accept the GCI-proposed adjustment, incorporation of Staff's adjustment would be double-counting.

The Companies further opine that Mr. Effron's adjustment should be rejected because (1) Peoples Gas initially treated the 2011 AMRP expenditures of $123.4 million as if they would be expended evenly over the course of 2011 and budgeted accordingly; and (2) these expenditures, however, instead reflected a bell shape curve, with fewer costs being incurred in the early and late months of the year and the peak expenditures being in the middle months, which represent the peak construction months. NS-PGL Brief at 17. The Company opines that the record demonstrates that for 2011, the first year of the 20 year AMRP, Peoples Gas has experienced the normal transition or "learning curve" that has slightly delayed the expenditures so far this year, and that expenditures can be expected to "climb dramatically for the remainder of 2011 and 2012." *Id.* This argument, too, should be rejected.

The Company never submitted any correction to the initial budget or submitted a revised budget with the supposed "bell shape curve." Tr. 791. The only budget in the record (CUB Cross Exhibit 1) is the initial budget that Peoples Gas now claims is erroneous. Whatever explanation Peoples Gas can offer, the undisputed evidence is that actual spending on the AMRP in the first six months of 2011 was $36 million below budget. There is no contrary evidence on this fact. If the Commission ignores this reality, PGL will earn a return on an investment that does not exist.

The Company also argues that "GCI's argument that any under spending in 2011 will affect 2012 spending is pure speculation and without merit." NS-PGL Brief at 18. This argument misrepresents Mr. Effron's testimony. This proposed adjustment does not extrapolate the Company's actual under-spending over the six month period in 2011 to the full year. It simply recognizes the amount under spent in 2011. *See* AG Brief at 7. The Company's arguments on this point should be rejected.

Finally, the Companies argue that should the Commission adopt GCI's adjustment, Peoples Gas cannot invest in the levels promised in its Surrebuttal testimony "if that means being denied millions of dollars of recovery of the costs of the AMRP for this period, and instead, in that event, Peoples Gas would have to limit the 2011-2012 expenditures to what the Commission allows, resulting in delay and higher costs." NS-PGL Brief at 18. This is a strawman argument that is essentially a complaint about regulatory lag. It goes without saying that a utility must (absent an infrastructure rider) finance its plant investment and wait until the next rate case to recover a return of and on that investment. This point is not a reason to inflate the Companies' rate base.

Under the Public Utilities Act, only plant that is used and useful shall be incorporated into customer rates. 220 ILCS 5/9-211. The burden of proof is on the Companies to demonstrate that forecasted levels of plant in service are supported by actual circumstances, and that plant additions sought to be included in rate base will actually be made. The evidence in the case supports Mr. Effron's conservative adjustment to forecasted plant levels. It should be adopted.

The Appellate Court Ruling in *Madigan*

As noted above, the People and CUB have filed a Motion to Re-open the Record to take evidence on how the First District Appellate Court's decision in the *Madigan* case affects Peoples Gas's infrastructure investment plans going forward. Under the decision in *Independent Voters of Illinois v. Illinois Commerce Comm'n.*, 117 Ill.2d 90, 510 N.E2d 850 (1987) ("*IVI*"), the Commission must establish a refund on Remand that would return to ratepayers the amounts collected under Rider ICR from the date of the Court's decision (September 30, 2011) through the date new rates are set in this case. *IVI,* 117 Ill.2d at 102-103. How this will affect the Companies' investment plans remains to be seen. The People reserve the right to file a supplemental brief in response to the Companies' Response to that Motion, and any testimony that might be filed as a result, should the AG-CUB Motion be granted.

b. Capitalized Incentive Compensation (see also Section V.C.1)

c. Non-Union Wages (see also Section V.C.2)

d. Original Cost Determination as to Plant Balances as of December 31, 2009

2. Materials and Supplies – Computation of Associated Accounts Payable

3. Gas in Storage – Computation of Associated Accounts Payable

4. Cash Working Capital

a. Pass-Through Taxes

b. Prepayments (Uncontested)

c. All Other (Uncontested)

5. Retirement Benefits, Net

The Companies cite a supposedly new "fact" in support of their position. They point out that GCI witness Effron agreed that "…customers' payments of their utility bills cannot be direct contributions to a utility's pension trust." NS-PGL Brief at 33. This is hardly a revelation and would have been self-evident in all prior cases. Customers' payments of their utility bills are obviously not direct contributions to a utility's pension trust. They are payments for service rendered. However, the utility can use the cash from customers' payments of their utility bills as contributions to a utility's pension trust.

The Companies' attempt to distinguish the Supreme Court's decision in *Citizens Utilities Co. of Illinois v. Illinois Commerce Comm'n.*, 124 Ill.2d 195 (1998) is not relevant to the issue before the Commission in the instant case. NS-PGL Brief at 33/34. North Shore and Peoples Gas argue that the *Citizens* Court had reversed a Commission ruling that a utility's rate base could be reduced if part of it was the product of consumer-supplied funds. *Id.* The Court found that the Commission's reduction to rate base constituted improper retroactive ratemaking. NS-PGL Brief at 34, citing *Citizens*, 124 Ill.2d at 203, 206-207. This case has nothing to do with retroactive ratemaking and it is inapposite for the Companies to raise such an argument.

Furthermore, the Appellate Court's opinion in *People ex rel Madigan v. Illinois Commerce Comm'n*., No. 1-10-0654, slip op.(2d Dist. Ill., September 30, 2011) ("*Madigan*"), the appeal of the Commission's decision in the 09-0166/09-0167 rate case, has commented on a virtually identical issue raised by North Shore and Peoples Gas in its challenge of the Commission's determination to exclude pension assets from rate base. The *Madigan* Court specifically addressed the appellants' citation of the C*itizens* decision. The Court's discussion directly undermines any comparisons that the Companies might try to make in the instant case to advance the same position on the proper treatment of pension assets:

> In this case, unlike *Citizens Utilities Co.*, the Commission's actions in determining Peoples Gas' pension asset should not be included in the rate did not constitute retroactive ratemaking. The Commission is not attempting to correct for a past error of omission by deducting the pension asset from the rate base. Instead, the Commission's decision is based solely on what impact the pension asset should have on Peoples Gas' current rate base, assuming the asset consists of customer-supplied funds. Because we are not faced with a retroactive ratemaking situation in this case, we find *Citizens Utilities Co.* provides little guidance as to how to resolve the actual issue pending before us.

Madigan, slip op. at 41-42.

It is well established that utilities are not entitled to earn a return on funds supplied by ratepayers. The Companies have offered nothing new to suggest that their pension assets were created with anything but ratepayer funds. As Staff has pointed out, the Companies' conceded on discovery that their pension contributions result from "internally generated sources," simply another way of referring to net cash from operations. Staff Brief at 17. The Commission should reject the Companies' request to include these amounts in rate base.

6. Accumulated Deferred Income Taxes –

a. 50/50 Sharing Related to Tax Accounting Method Changes

In their Brief, the Utilities argue that Mr. Effron's adjustment to reflect 100% of the benefit associated with the Overhead Change in accounting related to accumulated deferred income taxes ("ADIT") underestimates the risk associated with the change because "by definition, as a Tier 1 issue, the Overhead Change involves "'high-risk' transactions and issues that represent LB&I's highest compliance priorities.'" NS-PGL Brief at 40.

This argument is a strawman. The Companies have taken the tax deduction related to the repair change and the indirect overheads. There is no dispute that they have realized the full cash benefits (not just 50%) from these deductions. Moreover, the Companies have not reclassified the ADIT in question to FIN 48, as they are required to do, if the tax positions giving rise to the ADIT are doubtful. Tr. at 152-155.

Permitting the Companies to deduct only 50% of ADIT from rate base simply based on claims that the ADIT are based on doubtful tax deductions would establish bad precedent. As noted in the AG Initial Brief, the Companies have not established that there is any significant risk that the Internal Revenue Service will disallow the income tax deductions related to the tax accounting method change or that the risk of such disallowance is any greater than the risk of disallowance associated with any other income tax deduction. As it stands now, the income tax deductions related to the tax accounting method change increase the balance of North Shore ADIT by $2,949,000 and the balance of PGL ADIT by $7,890,000. Those increases to ADIT should be reflected in the determination of the Companies' rate bases.

On page 10 of his rebuttal testimony, Mr. Stabile responds to a question that has as its premise that you do "not believe that there is risk related to the Overhead Change" for income tax purposes. This mischaracterizes Mr. Effron's testimony. What he said was that the Companies have not established that there is any significant risk that the Internal Revenue Service will disallow the income tax deductions related to the tax accounting method change, or that the risk of such disallowance is any greater than the risk of disallowance associated with any other income tax deduction. Although Mr. Stabile discusses what he sees as the possible risk associated with the change in the tax accounting for overheads, it is difficult to see from his rebuttal testimony how significant the risk really is or if the risk approaches anything like the 50% of the ADIT that the Companies are proposing to ignore. GCI Ex. 7.0 at 9.

The full amount of the ADIT associated with the Overhead Change should be included in the balances of ADIT that are deducted from plant in service in the determination of the Companies' rate bases. As noted by Mr. Effron, the ADIT balances represent the actual cash benefits of the increased tax deductions related to the Overhead Change already taken by the Companies. The 50% offset being advocated by the Companies appears to be a purely arbitrary estimate of risk related to disallowances of these tax deductions; the Companies have not established that there is any real relationship between this 50% factor and any actual risk of disallowance of the deductions related to the Overhead Change. *See* AG Brief at 10-13.

In their Brief, Staff references Staff witness Kahle's testimony and argues that it opposed this GCI-proposed adjustment. Staff Brief at 18. During cross-examination, however, Mr. Kahle agreed that ADIT are *not* investor supplied funds. Tr. at 261. He also agreed that increases to ADIT are deducted from plant in service in the determination of rate base. *Id.* He concurred that the Companies have not actually provided anything that would establish that the 50.50 ratio is an appropriate ratio to apply, as opposed to, say, 70/30, 60/40, etc. *Id.* Mr. Kahle also stated that he has not seen from the Companies any evidence of the *likelihood* of receiving an adverse ruling from the IRS. Tr. at 261-262. He also testified that he has not seen any evidence in the Companies' testimony that would establish that there is a significant risk of a disallowance from the IRS or that such risk is any greater than the risk of disallowance associated with any other income tax deduction. Tr. at 262. Mr. Kahle could not cite any Commission decision in which it had approved a 50/50 sharing of the non-investor supplied funds associated with ADIT. *Id.*

Staff also argues in its Brief that it believes that having utilities assume all of the risk of uncertain tax positions would discourage utilities from taking tax positions that have some risk associated with them. Staff Brief at 18. This fear is unfounded. The utilities always have an incentive to take the most aggressive tax position that can reasonably be supported, in that they get to keep the benefits for shareholders until the rates in the subsequent rate case go into effect (even accepting the implicit assumption in Staff's point that utilities completely disregard the interests of ratepayers in their decision making process). What utilities should not be incentivized to do is to devise risks of disallowance as a premise for denying ratepayers the benefits of tax deductions that have already been taken.

The Commission should adopt Mr. Effron's well-supported adjustment.

Regarding Mr. Morgan's similar adjustment to reflect the full effect of the amount of the Accumulated Deferred Income Taxes related to the tax accounting associated with certain

Repairs Costs, the Companies again assert that GCI underestimates the alleged risk associated with IRS practices. NS-PGL Brief at 37-39.

Like the Companies' arguments against Mr. Effron's ADIT adjustment, the Companies' discussion misses the mark. Mr. Morgan did not testify that there are no risks related to the tax accounting change. Rather, in his direct testimony, he stated the Companies' risks are "diminished", if not eliminated. GCI Ex. 1.0 at 13-14. The question is whether the risk is so high that shareholders should receive 50 percent of the tax benefit. The answer is no because the Companies' risks are diminished. Mr. Stabile's own rebuttal testimony shows that the IRS, the American Gas Association and the Interstate Natural Gas Association of America all are working on a resolution of the methodology to be used. *See* AG Brief at 13-14.

The other fact ignored in the Companies' detailed discussion of IRS practices is that excluding 50 percent of the ADIT from rate base gives shareholders a windfall because the taxes creating the ADIT were not paid by ratepayers, not shareholders. The costs to shareholders do not change whether or not the Company prevails on the adoption of the tax accounting change. Therefore, shareholders retaining 50 percent of the ADIT does not constitute a "sharing" of any alleged risk.

Based on the foregoing, the Commission should reject the Companies' claim and flow through to ratepayers the full effect of the amount of the ADIT related to the tax accounting associated with certain repairs costs. GCI Ex. 6.0 at 4-5.

b. Derivative Adjustments from Contested Adjustments

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

V. OPERATING EXPENSES

A. Overview/Summary/Totals

1. North Shore

2. Peoples Gas

B. Uncontested Issues

1. Physical Gas Losses

a. Modify Method of Accounting for Physical Gas Losses Associated with Manlove Field (PGL)

b. Amend written procedures for treatment of physical losses of gas from underground storage fields (PGL)

2. Distribution O&M

a. Expenses for locates, leak surveys, disconnects (O&M – PGL)

b. Building Costs (PGL)

3. Distribution O&M – adjustment to reflect costs that should have been capitalized instead of expensed

4. Distribution O&M - Inflation

5. Distribution O&M - Building Lease (PGL)

6. Customer Service and Information

a. Advertising

7. Administrative & General

a. Interest Expense on Budget Payment Plan

b. Interest Expense on Customer Deposits

c. Lobbying

d. Social and Service Club Dues

e. Civic, Political, and Related

f. Charitable Contributions – Reclassification of 2012 costs

g. Inflation Factor Error-Miscellaneous Expense

h. **Employee Benefits – Adjustment to Test Year Pension and Benefits Expenses to Reflect Most Recent Actuarial Report**

i. **Integrys Business Support Benefits Billed Expense**

j. **Advertising**

8. **Depreciation Expense on Utility Plant in Service – 2010 Actual**

9. **Current Income Taxes –**

a. **Bonus Depreciation, Illinois State Income Taxes and Tax Accounting Method Changes**

b. **Reclassification of Income Taxes on Charitable Contributions**

10. **Invested Capital Tax (derivative adjustments)**

11. **Interest Synchronization (derivative adjustments)**

12. **Updated Inflation Rate**

13. **Rate 4 Revenues (NS)**

C. Contested Issues

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

The Companies persist in advocating for the recovery of incentive compensation expense, including those expenses accrued in association with the Utilities' Executive Incentive Compensation Plans and the Omnibus Incentive Compensation Plans, but they present no new perspectives on the Act or Illinois case law. Specifically, the Companies' Initial Brief alleges that the disallowance sought by both GCI and Staff of those Executive Incentive Compensation Plan costs based on an Earnings Per Share (EPS) metric is unjustified. The Companies' argue that the EPS metric "can and does incentivize the Utilities' executives to reduce operating expenses…" NS-PGL Brief at 57. Relying on testimony from NS-PGL witness Cleary, the Companies posit that because the EPS metric is derived from net income, and because net income is dependent on both revenues and costs, executive employees "…have a significant incentive to reduce costs, which will result in a higher EPS." NS-PGL Brief at 57, citing NS-PGL Ex. 25.0 at 5 and NS-PGL Ex. 43.0 at 3. This incentive to reduce costs, the Companies claim, necessarily benefits ratepayers and thus justifies including these incentive compensation costs in rates.

The connection that the Companies attempt to establish between earnings-per-share and customer benefits may exist in theory, but is not sufficiently direct enough to warrant having customers pick up the tab for an expense that is relatively detached from the provision of service. In upholding the Commission's ruling on incentive compensation cost recovery in a 2006 rate case order for Commonwealth Edison, the Appellate Court reasoned that broad correlations between incentive compensation plans and general customer satisfaction provided an inadequate nexus to define the plans as sufficiently connected to the provision of service to justify the inclusion of the plans' costs in rates. *Commonwealth Edison v. Illinois Commerce Comm'n.*, 398 Ill.App.3d 510, 519 (2d Dist., 2009) ("*ComEd*"). Similarly, the Court stated, attributing benefits that accrue to a broad group of stakeholders beyond customers cannot be used to rationalize having *only* customers bear the costs associated with these benefits. *ComEd*, 398 Ill.App.3d 519.

Furthermore, increased net income is not necessarily the result of controlling costs that would normally be included in the utility's revenue requirement or provide any customer benefits at all. As the Appellate Court explained in the *ComEd* decision, "ComEd likely incurs some nonoperating expenses that would not be included in its rate base. To the extent that an employee controlled such costs, no benefit to ratepayers would accrue." *ComEd*, 398 Ill.App.3d 519. The Companies' insistence that a higher net income and higher EPS, by definition, are signs that ratepayers have measurably benefitted from successful cost control efforts is asking the Commission to assume too much about the effects of a fluctuating cost-benefit dynamic on the quality of utility service provided to ratepayers.

Moreover, increased net income could be simply the result of higher utility rates. The Companies cannot ask the Commission to increase its rates, and then, because increased rates lead to higher revenues, which in turn will result in higher earnings, ask ratepayers to reward Company executives for having increased EPS.

Finally, the latest court pronouncement on incentive compensation endorses the "direct customer benefit standard" used by the Commission to determine whether these costs were recoverable from ratepayers. *People ex rel Madigan v. Illinois Commerce Comm'n*., No. 1-10-0654, slip op. at 35 (2d Dist. Ill., September 30, 2011) ("*Madigan*"). In again upholding a Commission decision to deny recovery of incentive compensation expenses, this time for Peoples Gas and North Shore, the Court noted that the Commission "…agreed with the People's witness that when incentive compensation seeks to achieve goals that primarily benefit shareholders, then it is reasonable to require that shareholders bear the cost of that incentive compensation." *Id.* The Commission, the Court observed, used the correct "direct customer benefit" standard in rejecting the acquisition and retention of highly qualified and motivated employees as a basis for including the costs of incentive compensation costs in rates. *Id.* Such motivations, justified as they may be as good management practice, do not qualify as the direct customer benefit which the Commission has repeatedly required, and which Illinois courts have now twice upheld, to warrant recovery of these costs in utility rates.

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

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

As noted in the AG Initial Brief, the number of employees reflected in the determination of Peoples Gas test year operation and maintenance expenses should be reduced because Peoples

Gas has failed to substantiate their forecasted number of employees. As of early 2011, the actual number of employees was about 1,089. Peoples Gas, however, forecasts 1,120 employees, which results in an overstatement of employee expense of $1,540,000 in operation and maintenance expense. GCI Ex. 2.0 at 14.

In its Brief, the Companies argue that "Mr. Effron's bare opinion, without more, cannot overcome Peoples Gas' testimony indicating it would be hiring more employees." NS-PGL Brief at 68-69. The problem with that argument is that that is precisely what the Utilities stated in the last rate case when faced with actual data demonstrating inflated forecasts. As noted in the AG Initial Brief, despite Peoples Gas' consistent forecasts of increasing numbers of employees, the actual number of employees has been relatively steady through 2009 and 2010. In the 2009 rate case (test year 2010), Peoples Gas forecasted an employee count of 1139 for every month from January through December 2010. CUB Cross Ex. 2. The proposed adjustment is not a "bare opinion". It is based on PGL's own data.

While the PGL claims that work on the AMRP will increase employee numbers, PGL witness Doerk also testified in the 2009 rate case that Peoples Gas fully expected to see their employee head count rise to the level of 1139 due to reasons such as pipeline safety enhancement work. CUB Cross Ex. 3. But as of December 2010, the actual data available for January to July of 2010 shows that the employee count never rose above 1097 in that time period and does not substantiate Peoples Gas' forecast of increased numbers of employees. CUB Cross Exhibit 4.
In the instant case, the actual number of Peoples Gas employees in early 2011 averages to 1,089. GCI Ex. 2.0 at 10, citing NS-PGL Response to AG Data Request 6.07. Contrary to what Mr. Doerk states in his Rebuttal Testimony, this employee count is not merely a snap shot in time but rather, an average of the first six months of 2011. Mr. Doerk states that Peoples Gas intends to

increase its employee force by filling 30 temporary positions but these positions are temporary. In fact, the Companies' brief cites "normal attrition" as a cause for hiring new employees. NS-PGL Brief at 69. But hiring new employees to offset "normal attrition" does not result in a net increase to the employee complement.

Accordingly, given the Peoples Gas's own evidence and past practice that the Company is unlikely to meet its forecasted employee levels, the test year employee forecast should be reduced from 1,120 to 1,089, thus decreasing the forecasted operation and maintenance expense by $1,540,000. GCI Ex. 2.0 at 14. As noted in Staff's Brief, the People agree that any adjustment to headcount should not double count any part of Staff's wage and salary adjustment.

4. Self-Constructed Property

In response to GCI witness Effron's proposed adjustment to remove $1,722,000 of costs of self-constructed property from PGL's operating expenses, the Company argues that "GCI inconsistently and unfairly did not propose to add these costs to Peoples Gas' rate base." NS-PGL Brief at 69. This argument is simply untrue. The GCI explicitly and directly stated that "The $1,722,000 expense for self-constructed property should be eliminated, and that expenditure should be treated as an addition to plant and depreciated" and "adjusted the PGL rate base to reflect the inclusion of the self constructed property, and … adjusted the test year depreciation expense to reflect the depreciation on that property." GCI Ex. 2.0 at 27.

The Companies further claim that despite the demonstration through cross-examination that "the Uniform System of Accounts permits the costs in question to be capitalized… ." NS-PGL Brief at 69. Actually, what the cross-examination showed was that the USOA *required* the costs in question to be capitalized. Tr. at 286-287. Cross-examination by the Companies' attorney also established that capitalization of these costs is the only treatment that has been approved in the Companies' published financial statements and regulatory filings. Tr. at 298-299.

The Companies' brief also complains that the section from the USOA used in cross exam of Company and Staff witnesses "had not been quoted or cited in GCI's witness' written testimony." NS-PGL Brief at 69-70. Even if this assertion were in any way relevant (which it is not), GCI Ex. 7.0, at page 13, explicitly stated that "The uniform system of accounts includes items such as general administration and insurance as components of plant construction costs."

Finally, the Companies' brief also makes much of the point that neither the Staff witness nor Companies' witness were asked if they changed their opinions on this issue during cross examination. Again, this is not a relevant criticism of Mr. Effron's proposed adjustment, let alone a requirement of trial practice. The People do not recall the Companies' attorneys asking any of the Staff or GCI witnesses whether they changed their opinions during cross examination.

In sum, Mr. Effron's proposed adjustment should be adopted.

5. Uncollectibles Expenses – Use of Net Write-Off Method

6. Administrative & General

a. Injuries and Damages Expenses

The People stand by the arguments presented in their Initial Brief on this issue.

b. Adjustment to Account 921- Office Supplies and Expenses

See Section V.C.4 above.

c. Rate Case Expenses

1. Rate Case Expenses – Docket Nos. 11-0280/0281 (cons)

As noted in the AG Initial Brief, the General Assembly amended the Public Utilities Act to require the Commission to closely review rate case expense. Specifically, Section 9-229 of the PUA provides:

> **Consideration of attorney and expert compensation as an expense**. The Commission shall specifically assess the justness and reasonableness of any amount expended by a public utility to compensate attorneys or technical experts to prepare and litigate a general rate case filing. This issue shall be addressed in the Commission's final order.

220 ILCS 5/9-229.

In this docket, the Companies argue that in planning and budgeting for the preparation and prosecution of these cases, they sought to incur only prudent and reasonable rate case expenses. They assert that "factors identified in managing and estimating these costs included: (1) efficiencies resulting from simultaneous preparation and anticipated consolidation of Peoples Gas' and North Shore's rate case filings; (2) selection of outside counsel and expert resources with extensive experience in Illinois rate cases and other proceedings and negotiations of appropriate estimated hours of work and rates; (3) cost effective use of IBS to provide rate case support services; and (4) the extensive procedures involved in prosecuting a rate case after filing … ." NS-PGL Brief at 74-75.

The problem with this argument is that record evidence shows that in nearly every category of rate case expense, including outside consultants, legal expense and intercompany (affiliate) billings, the amount requested is excessive, based on invoices received by the Companies to date that detail dollars spent as of July 31, 2011. *See* AG Cross Exhibits 4 and 5; AG Initial Brief at 28-33. When the July 31, 2011 dollar values are compared with the Companies' forecasted amounts for the test year, the ratios point to significant over-estimations of rate case expense, even assuming the conduct of additional work through the issuance of the

Commission's order in this case. Rates must reflect only reasonably incurred levels of expense under Section 9-201 of the Act. In addition to these documented over-estimations, some categories of expense are unexplained. AG Brief at 28-33. It would be unreasonable to include in customer rates levels of rate case expense that exceed reasonable estimates of that which will be actually incurred by the Companies in the various cost categories.

If "negotiation" includes flat-rate contracts, with no hourly detail provided (*see* AG Cross Ex. 7), then there is room for improvement. In sum, the Commission should disallow the Stafflogix expenses identified above that have not been adequately explained; (4) disallow 40% of the Inter-Company Affiliate billing due to the lack of reasonable support for this expense and that the allocated costs apparently cover more than a reasonable period prior to the rate case, including charges a full 12 months before the filing of tariffs; (5) disallow the SFIO Consulting expense in its entirety given the lack of billing detail provided; (6) remove expense associated with and budgeted for appeals of rate case orders[3]; and (7) reduce legal expenses charged by Foley & Lardner by 20% and R3 expenses by 25%, given the overstated budget and actual invoices received as of July 31, 2011, as discussed in the AG Initial Brief at 23-34.

2. Amortization of Rate Case Expenses associated with Docket Nos. 09-0166/0167 (cons)

As noted in the AG Initial Brief, The purpose of the rate case allowance should be to include in rates a representative and normal annual level of reasonably and prudently incurred regulatory expense, rather than to provide the utility with guaranteed dollar-for dollar cost recovery. Consistent with such normalization treatment of this expense, PGL and NS should not establish an asset for deferral of the current rate case cost and should not record amortization. Under a

[3] Staff likewise supports disallowance of rate case expense related to appeals work.

normalization approach, any remaining amortization of prior case balances would be replaced by a new representative, normalized rate case expense in each company's next rate case. *Id.*

As discussed in the AG Initial Brief, the basic premise of ratemaking is that rates set by the Commission give the utility *the opportunity* to earn its authorized return. *BPI v. Illinois Commerce Comm'n*, 136 Ill.2d 192, 209 (1989). The prohibitions against retroactive ratemaking and single issue ratemaking create an incentive to the utility to control costs between rate cases. *Citizens Utilities v. Illinois Commerce Commission,* 124 Ill.2d 195, 207 (1988). The argument that a utility might incur additional, actual costs during the amortization period is not a justification for treating an ordinary operating expense as a regulatory asset. The Commission's amortization approach to rate case expense is both unfair to consumers and inconsistent with the fundamental legal principles underlying the regulatory bargain, which is premised on the utility *controlling* costs between rate cases.

The Companies argue in response that Amortization of the 2009 rate cases expenses already was approved by the Commission's Order in the 2009 rate case, as well as other cases. NS-PGL Brief at 79. That does not mean that the Commission's past practice should be adopted here. The People have appealed the lawfulness including unamortized amounts of rate case expense in rates in the most recent Illinois American Water Company rate case, Docket No. 09-0319. *People v. Illinois Commerce Comm'n,* 1-10-1776. The Commission should reconsider this issue within the context of the prohibition against retroactive and single-issue ratemaking, and remove this amount from test year rate case expense.

3. Normalization of Rate Case Expenses

The Companies also object to GCI witness Morgan's reasonable proposal to normalize rate case expense over a two-year period rather than through amortization. NS-PGL Brief at 79-

80. They suggest that to adopt this recommendation would be premature in light of the Commission's stated intention in the last ComEd rate case order, Docket No. 10-0-467, to conduct a rulemaking related to the treatment of rate case expense. That argument against normalization rings hollow. If it is premature to normalize because of a yet-to-be-opened rulemaking, then it is likewise premature to endorse amortization of these expenses.

GCI witness Morgan explained that rate case expenses are discretionary expenditures. The decision of when to file a rate case and the level of expenditures to be incurred are under the control of management. The dollar for dollar guaranteed recovery of costs does not provide an incentive to minimize or control the level of expenditures. The normalization of costs allows the Companies to recover their costs if they do not file another rate case before the end of the normalization period. However, the amortization of rate case expenses with recovery of the unamortized balance allows the Companies to continually stack costs on top of each other and receive guaranteed recovery of those costs when it files a rate case before the end of the amortization period. That is both improper from a ratemaking perspective and inequitable to ratepayers. *See* AG Brief at 25-28.

Mr. Morgan's proposal to normalize any allowed rate case expense, consistent with the recommendations for disallowance of certain expenses identified in the AG Initial Brief, should be adopted.

d. Gas Transportation Administrative Costs

e. Solicitation Expense

The People support the arguments presented by Staff in its Brief on this issue.

7. Depreciation

a. Depreciation Expense on Forecasted Additions

b. **Derivative Adjustments from Contested Adjustments**

8. **Revenues**

a. **Repair Revenues**

The People support the arguments presented by Staff in its Brief on this issue.

b. **Other Issues Relating to PEHS and PEPP, Including Staff Request for Investigation**

The People support the arguments presented by Staff in its Brief on this issue.

c. **Warranty Products (Revenue and Non-Revenue)**

The People support the arguments presented by the Commission Staff on this issue.

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

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

F. Gross Revenue Conversion Factor

a. **Uncollectible Rate**

b. **Derivative Adjustments from Contested Adjustments**

VI. RATE OF RETURN

A. Overview

B. Capital Structure

1. **Peoples Gas**

2. **North Shore**

C. Cost of Long-Term Debt

1. **Peoples Gas**

2. **North Shore**

D. Cost of Short-Term Debt

1. **Peoples Gas**

2. North Shore

E. Cost of Common Equity

1. Peoples Gas

2. North Shore

F. Weighted Average Cost of Capital

1. Peoples Gas

2. North Shore

VII. WEATHER NORMALIZATION (Uncontested)

VIII. RIDERS – NON-TRANSPORTATION

A. Riders UEA and UEA-GC

B. Rider VBA

The Companies' proposal to permit permanent adoption of Rider VBA is nothing less than a request to guarantee revenue recovery for the Rate 1 and 2 customer classes. Modifying the arguments presented in the 2007 rate case in which Rider VBA was first approved as a pilot, the Utilities no longer stress in this case (despite testimony from NS-PGL witnesses Grace and Schott referencing these perceived issues) that high natural gas prices, warm weather trends and, in particular, the addition of an energy efficiency program, requires some regulatory response to the potential for these phenomena to depress Residential (Rate 1) and General Service (Rate 2) rate class revenues. *See* 2008 Rate Order at 150. Instead, the Companies simply assert that not adopting Rider VBA is inconsistent with their view that all delivery service costs are fixed, that the Companies "either under or over recover their Commission approved revenue requirements", and "ensures that customers will pay more or less than their share of Commission-approved distribution costs." NS-PGL Brief at 124. These arguments, again, expose the many reasons why the Commission should reject Rider VBA.

First, as discussed above in the rate design section of this brief, not all of the Companies' costs are fixed. Second, the Companies' view that revenues for these customer classes must be guaranteed ignores the test-year precepts of ratemaking. When the Commission sets a revenue requirement in a rate case, that number reflects the Commission's best estimate of a utility's reasonably and prudently incurred costs of service, including a reasonable cost of capital, and expected revenues for the test year. That number reflects the level at which rates shall be set in order to provide the utility with revenues that recover its costs and the *opportunity* to earn a reasonable profit. The revenue requirement number does *not* constitute a guarantee of receiving its cost of service, including earning the authorized return, going forward. That's because rate of return regulation recognizes that the cost of delivering utility service, *including the cost of capital*, as well as revenue flows, are dynamic and ever-changing. NS-PGL witness Schott agreed that is the case, as did Staff witness Dr. David Brightwell. Tr. at 51, 326-327. The regulatory lag between rate cases provides the Utilities the opportunity to run their business in an efficient way that maximizes profits all while providing safe, efficient, reliable and least-cost utility service. The objective of regulation is *not* to guarantee profits but to simulate the price-constraining characteristics of a competitive market place – a regulatory precept with which Staff witness Brightwell agreed. Tr. at 335-336. Businesses, utility or otherwise, are not guaranteed to receive a designated profit level. Likewise, prices vary based on changes in cost and customer demand. Rider VBA removes all incentives for the Companies to run their business in the most efficient manner because revenues are guaranteed. Such a regulatory design shifts all risk to ratepayers. This "head I win, tails you lose" paradigm should be rejected.

In addition, when the Companies assert that customers will either over or under pay without Rider VBA, they ignore that such revenue shifts are largely a function of variables that have nothing to do with the utility's delivery service. Revenues, which move with changes in natural gas demand, are a function of prices, weather, economic conditions and a range of other changes in tastes, preferences, and technology. The Companies have historically borne these business cycle risks in return for a risk-adjusted allowed rate of return on their investments. Revenue decoupling simply changes this historic risk relationship by requiring ratepayers to make the utility whole for any downside change in revenues, regardless of the source. GCI Ex. 9.0 at 5-6. Contrary to the utilities' assertion, customers are not paying more or less than the utilities' cost of service.

The Companies devote most of their Rider VBA discussion in their Brief to an explanation of why it seeks adjustments to Staff witness Ebrey's proposal to alter the rider from a partial to a full decoupling mechanism, which would operate to incorporate revenues received as a result of adding new customers into the Rider VBA adjustment calculation. NS-PGL Brief at 126-127. They argue the proposal "is flawed because the Utilities incur costs to add new customers to their systems and the proposed customer charges, except for North Shore's S.C. No. 1, would recover less than 100% of fixed customer costs." *Id.* at 126. They accept the proposal on the condition that the fixed customer charge is increased even further than their original proposal. *Id.* at 127. This complaint and the alleged solution is a strawman. NS-PGL witness Schott admits that the addition of new customers results in net revenue gains. Tr. at 51. Accordingly, the complaint that full decoupling does not account for the costs incurred in adding customers is a hollow argument.

The Companies discussion of the problems associated with the Ebrey proposal in relation to Rate Class 2 only highlights the inherent defects of Rider VBA as a whole. NS-PGL Brief at 127. The Companies point that customers transferring customer classes would affect class revenue recovery is an acknowledgement that customer needs and utility costs and revenues are dynamic. Locking in revenues in designated classes ignores these marketplace realities.

The Companies' point that Staff witness Brightwell endorsed Rider VBA is likewise unavailing. NS-PGL Brief at 125. As he explained during cross-examination, his assignment in this case was to evaluate the choice between (1) an SFV rate and (2) the Companies' proposed rate design coupled with Rider VBA implementation. Tr. at 322. He offered no view on the GCI proposals in this case.

Finally, in response to testimony submitted by GCI witness Dr. David Dismukes, the Companies argue that Rider VBA is "not conditioned on the Utilities increasing their support of energy efficiency initiatives" and that his "lost revenues" argument is a distraction because Rider VBA is not a "lost revenue" mechanism. These arguments are a mere digression. Dr. Dismukes' arguments about the effects of energy efficiency (lost revenues) are a response to both the Commission' original premise for adopting the rider, as articulated in the 2008 rate order, NS-PGL witness Schott's position that Rider VBA will reduce the utilities' "throughput incentive" and NS-PGL witness Grace's testimony that asserts that energy efficiency programs mandated under Section 8-104 will result in significant revenue losses. *See,* e.g. NS Ex. 1.0 at 15; NS-PGL Ex. 28.0 at 28-29. As discussed in the AG Initial Brief, the conditions that caused the Commission to adopt Rider VBA in 2008 no longer exist. *See* AG Brief at 37-52. Moreover, any claims that efficiency programs will diminish utilities revenues to a point that necessitates a special Commission response ignores the fact that Section 8-104, passed by the General Assembly after the Commission approved the Rider VBA pilot, does not authorize recovery of lost revenues associated with energy efficiency programs. *See* 220 ILCS 5/8-104(d). It also ignores the fact that any utility whose revenue streams are so compromised by efficiency programs can file a rate case under Section 9-201 of the Act at any time.

Outside of their fixed cost recovery argument, the Companies further point to Rider VBA as an instrument that would provide rate certainty to customers. NS-PGL Brief at 128. This argument, too, misses the mark. From the individual ratepayer's perspective, there is no rhyme or reason to the endless yo-yo of surcharges and credits that appear over nine months from April to December, which can easily move in directions opposite their individual usage patterns, based on the Companies' submission of an annual forecast of monthly average per customer class revenues. Ratepayers in any given month do not know if they will receive a credit or a surcharge because that determination is quite simply out of their control. GCI Ex. 9.0 at 8.

As thoroughly discussed in the AG Initial Brief, the Companies' request to continue and make permanent Rider VBA should be denied. The conditions that the Commission concluded justified the adoption of Rider VBA, including high natural gas prices that might induce extraordinary conservation efforts, no longer exist. In addition, the record evidence shows that potential revenue losses associated with the Companies' statutory energy efficiency programs are insignificant. The evidence shows that the Companies' usage forecasts already account for warmer weather trends, energy efficiency, and other variables. AG Brief at 59-61. In addition, Section 8-104 of the Act limits recovery from ratepayers of costs associated with a utility's energy efficiency programs to "costs for reasonably and prudently incurred expenses for cost-effective energy efficiency measures." 220 ILCS 5/8-104(a). Recovery of lost revenues associated with those programs is not included within this definition of "reasonably and prudently incurred expenses". *Id.*

Finally, since the Commission's decision in 2008, the Illinois Appellate Court has weighed in on when riders are appropriate for cost recovery in *Commonwealth Edison v. Illinois Commerce Comm'n,* 405 Ill.App.3d 389, 937 N.E.2d 685 (Second Dist. 2010) ("*ComEd").* That test was re-affirmed only last week by the First District Appellate Court in *People, ex rel. Madigan v. Illinois Commerce Commission,* Case Nos. 1-10-0654, 1-10-0655, 1-10-0936, 1-10-1790, 1-10-1846 and 1-10-1852, slip op. of September 30, 2011 at 26-28 ("*Madigan*"). Rider VBA fails to satisfy the test outlined by the *ComEd* Court as to when riders are appropriate as a cost recovery mechanism. Legal issues aside, the Companies' simply failed to show Rider VBA is necessary to recovery their costs of service, or is needed to maintain safe, reliable, least-cost service. The Commission should reject the Companies' request to make its implementation permanent.

C. Rider ICR

1. Accumulated Deferred Income Taxes

As noted earlier in this Brief, since the filing of the Initial Briefs in this case, the Second District Appellate Court issued its opinion in the People of the State of Illinois' appeal of the Commission's approval of Rider ICR, the infrastructure cost recovery, in the last NS-PGL rate order, Docket No. 09-0166/09-0167. In its September 30, 2011 opinion, the Court held that the Commission's approval of Rider ICR constituted unlawful single-issue ratemaking. *The People ex rel. Madigan v. Illinois Commerce Comm'n,* Case Nos. 1-10-0654, 1-10-0655, 1-10-0936, 1-10-1790, 1-10-1846 and 1-10-1852 *(*slip op. of September 30, 2011) ("*Madigan").*

To the extent that Rider ICR has been deemed unlawful, the issue as to whether the rider formula should account for ADIT has been rendered moot.

IX. COST OF SERVICE

A. Overview

B. Embedded Cost of Service Study

1. Uncontested Issues

a. Sufficiency of ECOSS for Rate Design

2. Contested Issues

a. Classification of Uncollectible Accounts Expenses Account No. 904

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X. Rate design

A. Overview

B. General Rate Design

1. Allocation of Rate Increase

2. Uniform Numbering of Service Classifications

C. Service Classification Rate Design

1. Uncontested Issues

a. North Shore Service Classification No. 2

b. North Shore Service Classification No. 3

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

d. Peoples Gas Service Classification No. 2

e. Peoples Gas Service Classification No. 4

f. Peoples Gas Service Classification No. 8

2. Contested Issues – North Shore and Peoples Gas

a. Service Classification No. 1 (Residential Service)

The Companies present their proposed rate design as an either/or proposition: Either the Commission should approve a fixed customer charge that recovers 62% of PGL's and 69% of North Shore' costs *and* adopt Rider VBA on a permanent basis, thereby assuring all of its Rate 1 (residential) and Rate 2 (General Service) customer revenues, *or* it should implement a straight-fixed-variable design that recovers 100% of the Companies' costs through the monthly fixed customer charge. NS-PGL Brief at 138-140. Either way, the Companies' goal is to *guarantee* a designated level of revenues from these two customer classes regardless of customer usage.

As support for this Hobson's Choice, the Companies argue that ensuring both the percentage of costs recovered through the customer charge and revenues for these classes through Rider VBA (or through a SFV rate) "is appropriate as a matter of cost causation and Commission policy." NS-PGL Brief at 139. The Companies reference a 17-year-old Commission order as well as some recent Commission orders that reference Commission interest in recovering more fixed costs through the customer charge. *Id.* But Illinois courts have held that "decisions of the Commission are not *res judicata.*" *Commonwealth Edison Company v. Illinois Commerce Comm'n,* 405 Ill.App.3d 389, 937 N.E.2d 685 (Second Dist. 2010), Rehearing Denied, Nov. 16, 2010. The concept of public regulation requires that the Commission have power to deal freely with each situation that comes before it, regardless of how it may have dealt with a similar or even the same situation in a previous proceeding. *ComEd* at 682 citing *Mississippi River Fuel Corp. v. Illinois Commerce Comm'n*, 1 Ill.2d 509 (1953). A record containing new evidence or argument that implicates a past decision compels reconsideration on the new record and may require a different result. *Id.* As noted in the AG Initial Brief, the evidence in this record of the unexplained and unsubstantiated cross-subsidization of the Companies' highest residential users of gas by their lowest users of gas constitutes unreasonable discrimination. AG Initial Brief at 75-81. This evidence supports a finding that the Companies' residential rate design is unreasonably discriminatory.

The Commission has another choice in its establishment of the rate design for the residential class: approval of the sound rate design proposed by GCI witness Scott Rubin. Conspicuously absent from the Companies' Brief is any claim that the Rubin-proposed rates would not allow the Company to recover its cost of service. The Companies claim that "there are disagreements on how to allocate and recover fixed costs." NS-PGL Brief at 140. But the evidence supplied by Mr. Rubin and the Companies own ECOSS shows that not all of the Companies' costs are fixed, but are affected by customer demand for natural gas. *See* AG Brief at 67-75.

As noted in the AG Initial Brief, unlike the Companies' proposed rate design, which assigns nearly all demand costs to the fixed customer charge (in addition to fixed customer costs), Mr. Rubin's proposed rate design recovers the demand-related costs through volume-based charges, which is fully consistent with cost causation. By doing so, it ensures that rates send an appropriate price signal to those customers who effectively cause facilities to be enlarged to meet their greater demand for gas. If rates are not set in this manner, then customers would have the mistaken belief that their increased use of gas has no effect on the costs of the distribution network. That assumption is absolutely false. GCI Ex. 8.0 at 9. When customers increase their demand for gas, it leads the Companies to install larger pipes, valves, regulators, and other facilities. Indeed, each time a facility must be replaced, the Companies must consider the likely demands to be placed on the facility in the future. If rates do not send that price signal to customers – that increased demand leads to increased costs – then an essential economic signal that customers should reduce demand (and thereby control the cost of facilities) is lost.

The GCI-proposed SC 1 rate design recognizes this fact; the Companies' rate design ignores it. GCI Ex. 8.0 at 9-10.

Just as importantly, the GCI-proposed rate design enables the Companies to recover their costs. Again, *the Companies do not assert otherwise*, but contest it only because it does not *guarantee* their requested revenue requirement, including their proposed cost of equity, as their proposals do. In their short discussion of Mr. Rubin's proposed rate design, the Companies state, "The Utilities recognize that there are disagreements on how to allocate and recover fixed costs." NS-PGL Brief at 140. The fact is that accepting either of the Companies' rate design proposals requires the Commission to adopt the Companies' view that all uncertainty associated with revenue recovery must be removed from residential rates, and that the revenue requirement must be guaranteed.

The exhibits showing the GCI/Companies' rate comparisons are located in GCI Ex. 8.2 p. 2 (PGL) and GCI Ex. 8.3 p. 2 (NS). They are attached to this Brief as Exhibit A. Demand-related costs, including storage costs, are recovered in proportion to gas consumption. Mr. Rubin's recommended rates also accommodate the particular concerns expressed by NS-PGL Grace in her rebuttal testimony. Administrative and General (A&G) costs are recovered through the first consumption block, which is unlikely to vary significantly based on weather conditions. All other costs (non-demand-related) costs are recovered through the customer charge which, again, will not vary with weather conditions. Thus, the GCI rate design is consistent with the Companies' own cost studies and their apparent goal of ensuring a relatively stable stream of revenues to the utilities. GCI Ex. 8.0 at 10.

It should be noted, too, that the utilities acknowledge that much of their plant investment is driven by customer peak usage. NS-PGL Ex. 29.0 at 15. The Companies' unorthodox view of "fixed costs", however, ignores that fact, and is best summed up by Ms. Hoffman Malueg, who presented the Companies' ECOSS. She notes in her rebuttal testimony, "Even though they have been sized to meet customers' demands, once the assets are put in place, they are essentially a fixed asset of the Utilities. Plus, once these physical assets have been put in place, their costs do not change or vary from year to year based upon customer's volumetric usage." *Id.*

This rationale, however, ignores and fails to appropriately account for *cost causation.* Instead, the Companies assert that all residential customers should be charged essentially the same for demand-related costs, regardless of the amount of gas consumed. It argues that the customer who uses the Companies' facilities for cooking gas only should be assessed the same distribution charges (via an SFV rate or the Companies' proposed discriminatory rate design coupled with Rider VBA) as the mansion-owning heating customer who uses thousands of therms per year. That approach to rate design is inequitable and discriminatory. *See* AG Brief at 75-81.

This "once it's installed, it's a fixed cost" mindset is rooted in a short-run examination of an installation time-frame, rather than a *cost-causation* analysis. The Companies' view invites the Commission to ask, as it designs rates, "Has the equipment been installed?" rather than the more appropriate question, "What *caused* the decision to make that investment?" The People assert the latter is the metric that must be applied as the Commission sets rates. This notion is not unorthodox or controversial. As noted by Mr. Rubin, the principle of cost causation applied over the long term – not the short-term examination of installation time-frames – has been the accepted rate design practice for decades. The practice of pricing based on short-run cost, as the Companies propose, is inconsistent with the long-run time horizon and function of a public utility, and the proper setting of utility rates. *See* AG Brief at 73-75.

The Companies' brief also ignores the compelling evidence in the record related to the disparate bill impacts the Companies' lowest and highest residential customers would see under the NS-PGL rate design. *See* AG Brief at 77-81. The Companies further offer a comparison of SFV rates to a budget plan, and argue that it would be "especially beneficial to high usage customers who live in energy inefficient housing, particularly those who are low income." NS-PGL Brief at 140. This argument is likewise suspect. Under the Companies' SFV proposals, customers would pay a delivery service charge of $42.10 in PGL's and $34.91 in North Shore's respective service territories. PGL Ex. 12.0 at 18-19; NS Ex. 12.0 at 16. Asking a non-heating customer to pay such rates is not likely to be viewed as "a budget plan." The reference to low-income customers is likewise unavailing. The Companies offered no data as to how many such customers (low-income persons living in inefficient housing) exist. The argument also presumes that such customers would never take advantage of, or benefit from, utility or federally-funded energy efficiency programs.

As noted in the AG Initial Brief, the stability of revenues under GCI's proposal was demonstrated by Mr. Rubin. AG Brief at 83. GCI Exhibit 8.4 provides a calculation of the actual fixed cost recovery that the Companies' rate design accomplishes. In particular, it must be recognized that revenues recovered through the first consumption block (the first 50 therms per month) are extremely constant: the Companies exhibit very little change in consumption in this first block. GCI Exhibit 8.0 at 7-9. The exhibit shows that the GCI proposed rate design would still recover in excess of 80% of the total SC 1 revenue requirements for both Companies through the customer charge and first block charge, *as is the case under present rates*.[4] Most

[4] If the Commission establishes a lower revenue requirement for each company than requested by PGL and North Shore, Mr. Rubin recommended that the customer charges he developed, which are set at the present customer charge levels, should remain the same. *See* GCI Ex. 8.2, p. 2 of 2 (PGL); GCI Ex. 8.3, p. 2 of 2 (NS). Any

importantly, GCI's rate design proposal recovers these revenues in a manner that is much fairer to low-use residential customers than the Companies' proposal. *Id.*

The evidence in the record supports their adoption by the Commission.

D. Tariffs – Other Non-Transportation Tariff Issues

1. Uncontested Issues - North Shore and Peoples Gas

a. Terms and Conditions of Service

b. Service Activation Charges

c. Service Reconnection Charges

d. Rider 2

e. Rider 9

E. Bill Impacts

XI. Transportation Issues

A. Overview

B. Uncontested Issues

1. Allowable Bank (AB) Calculation

2. Rider CFY

3. Rider AGG (except Aggregation Charge)

4. Rider SBO

C. Administrative Charges

D. Large Volume Transportation Program

1. Administrative Charges

2. Transportation Storage – Issues

reduction in the revenue requirement should be reflected by *proportionately* scaling back the block 1 and block 2 charges he recommends. GCI Ex. 3.0 at 26-27.

3. Associated Rider Modifications

a. Rider SBS/SST

b. Rider FST

c. Rider P

d. Rider SSC

e. Transition Riders

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

1. Aggregation Charge

2. Purchase of Receivables (withdrawn)

XII. CONCLUSION

For the foregoing reasons, the People request that the Commission enter an order in accordance with the arguments presented in the People's Initial Brief and this Reply Brief.

Respectfully submitted,

PEOPLE OF THE STATE OF ILLINOIS

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