STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

North Shore Gas Company	:	
	:	**Docket No. 11-0280**
Proposed General Increase in Rates for Gas Service	:	
	:	**(cons.)**
The Peoples Gas Light and Coke Company	:	
	:	**Docket No. 11-0281**
Proposed General Increase in Rates for Gas Service	:	

REPLY BRIEF OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION (COMPLETE)

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REPLY BRIEF OF THE
STAFF OF THE ILLINOIS COMMERCE COMMISSION
(COMPLETE)

Staff of the Illinois Commerce Commission ("Staff"), by and through its counsel, pursuant to Section 200.800 of the Rules of Practice (83 Ill. Adm. Code 200.800) of the Illinois Commerce Commission ("Commission"), respectfully submits its Reply Brief in the above-captioned matter.

I. INTRODUCTION

A. Overview/Summary

The Initial Brief of the Staff of the Illinois Commerce Commission ("Staff's Initial Brief" or "Staff IB") was served on September 22, 2011. The Initial Brief Of The People Of The State Of Illinois ("AG's Initial Brief" or "AG IB"), the Initial Brief Of The Citizens Utility Board And The City Of Chicago ("CUB-City's Initial Brief" or "CUB-City IB"), the Initial Brief of the Illinois Industrial Energy Consumers and Constellation NewEnergy-Gas Division, LLC ("IIEC-CNE-Gas' Initial Brief" or "IIEC-CNE-Gas IB"), the Initial Post-

Hearing Brief Of North Shore Gas Company And The Peoples Gas Light And Coke Company ("NS-PGL's Initial Brief," "NS-PGL IB," "Utilities' IB" or "Companies' IB"), the Initial Brief of Integrys Energy Services-Natural Gas, LLC ("Integrys' Initial Brief" or "Integrys IB"), and the Initial Brief Of Interstate Gas Supply of Illinois ("Interstate Gas Supply Initial Brief" or "IGS IB"), were also filed or served on September 22, 2011. An erratum to the CUB-City's Initial Brief was filed or served on September 23, 2011.

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

B. Nature of Operations

1. North Shore

2. Peoples Gas

II. TEST YEAR (Uncontested)

III. REVENUE REQUIREMENT

Staff has made no changes to its revenue requirement schedules and has not filed the schedules (attachments A and B of Staff's Initial Brief) again with its Reply Brief. The schedules are explained on page 3 of Staff's Initial Brief.

A. North Shore

Staff's recommendations for revenue are unchanged from Staff's Initial Brief. Staff IB, p. 4.

B. Peoples Gas

Staff's recommendations for revenue are unchanged from Staff's Initial Brief. Staff IB, p. 4.

IV. RATE BASE

A. Overview/Summary/Totals

1. North Shore

Staff's recommendations for rate base are unchanged from Staff's Initial Brief. Staff IB, p. 5.

2. Peoples Gas

Staff's recommendations for rate base are unchanged from Staff's Initial Brief. Staff IB, p. 5.

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

1. Natural Gas Prices – Working Capital Allowance - Gas in Storage

a. Specific Plant Investments – Warehouse at Manlove Field

b. Pigging Well-Head Separator Project #1

c. Pigging Well-Head Separator Project #2

2. Accumulated Depreciation Expense on Forecasted Additions and Utility Plant in Service – 2010 Actual

3. Accumulated Deferred Income Taxes

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

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

c. Net Operating Loss – Tax Normalization

C. Contested Issues

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

a. Forecasted Test Year Capital Additions

i. Utility Plant in Service

Staff has made no changes to its rate base schedules and has not filed the schedules again with its Reply Brief. The schedules, page 5 of the attachments to Staff's Initial Brief, are explained on page 9 of Staff's Initial Brief.

ii. Capital Additions Related to Accelerated Main Replacement – AMRP (PGL)

Staff has not changed its position on this issue. Staff IB, p. 9. Although Staff would support GCI witness Mr. Effron's proposed adjustment, the Companies accepted Staff's adjustment. NS-PGL Ex. 40.0 CORR., pp. 3 – 4. Accepting both Staff's and Mr. Effron's adjustments could result in double counting. If the Commission were to accept Mr. Effron's proposed adjustment, all or a portion of Staff's adjustment to forecasted plant additions should be removed from People Gas' revenue requirement.

Staff questions the statement made by the Companies that Peoples Gas would have to limit the 2011-2012 expenditures to what the Commission allows, resulting in delay and higher costs. NS-PGL IB, p. 7. Following this logic, one would expect Peoples Gas to never have plant additions during the period between rate cases because those plant additions would not yet be reflected in rates. This is inconsistent with the Companies' own evidence in this case which demonstrates the Company had plant additions every year regardless of when rate increases go into effect. PGL Ex. 7.1, Schedule B-5.

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

Staff has not changed its position on this issue. Staff IB, p. 10. Staff takes issue with the Companies' recommendation to include language in the final order stating that the Companies' figures should be approved if a decision in the appeals or any other proceeding results in the plant in question being approved. NS-PGL IB, p. 20. Under the PUA, the pendency of an appeal does not of itself stay or suspend a decision of the Commission. 220 ILCS 5/10-204. Therefore, the Commission should adjust original costs in accordance with its orders in the previous dockets 07-0241/0242 and 09-0166/0167 (Staff Ex. 1.0 and 10.0, pp. 19 – 20) and should not include alternative language in the event those prior Commission orders are found reversed. In fact as discussed elsewhere in this reply brief the Commission's order in the Companies 2009 rate cases was upheld on appeal with the exception of Rider ICR. People v. Illinois Commerce Comm'n, Nos. 1-10-0654, 1-10-0655, 1-10-0936, 1-10-179-, 1-10-1846 and

1-10-1852, Consolidated, Appellate Court (First District-Fifth Division) September 30, 2011, Slip Opinion, p. 28.

During Staff's review of this issue in preparation of its reply brief, it came to Staff's attention that rate base had not been reduced by the prior disallowances. If the Commission accepts Staff's proposed reductions to Original Cost as discussed in Staff witness Kahle's direct testimony, Staff Ex. 1.0, p. 20, adjustments should be made to each Company's rate base as well. North Shore's plant would be reduced by $122,000 and accumulated depreciation would be reduced by $15,000. Peoples Gas' plant would be reduced by $649,000 and accumulated depreciation would be reduced by $99,000. Depreciation expense would be reduced by $2,000 for North Shore and $14,000 for Peoples Gas. Final Order for Docket Nos. 09-0166/09-0167 (cons), Appendix A, p. 9, lines 19, 25, 28 and Appendix B, p. 11, lines 22, 28, 31.

2. Materials and Supplies – Computation of Associated Accounts Payable

Staff's proposal for Accounts Payable with materials and supplies inventory is based on an actual analysis provided by the Companies rather than the GCI estimate. Staff's proposal should be approved by the Commission. The Companies argue that a lead-lag study can be used only for the determination of a CWC requirement in rate base and nothing else. NSPGL IB, pp. 20-21. The Companies are incorrect. By definition, a lead lag study determines the time lag between the receipt of items purchased and the payment for those purchases. As discussed in the direct testimony of Company witness Hengtgen, "An expense lead represents the time between when a good is received or service is provided and when Peoples Gas pays for that good or service." PGL Ex. 7.0, p. 27 and NS Ex. 7.0, p. 24. This timing difference is consistent with the amount of time the cost of an item is included in Accounts Payable. As discussed in Staff's Initial Brief, the proposal made by GCI witness Morgan (and accepted by the Companies) assumes 30 days for payment of Materials and Supplies purchases while Staff's proposal, based on the results of the lead lag study uses 42.44 days and 46.62 days for NS and PGL, respectively. Staff IB, p. 11. The dispute here between Staff and the Companies is about the timing of purchases and payments and the lead lag study addresses this directly. Staff's proposal provides a more reasonable derivation based on record evidence and should be approved.

3. Gas in Storage – Computation of Associated Accounts Payable

Staff's proposal for accounts payable associated with gas in storage should be approved because it more accurately reflects the reality of the accounts payable actually recorded by the Companies. The Companies argue that the accounts payable associated with the cost of gas is somehow tied to the methodology used for accounting for its stored gas inventory. NSPGL IB, pp. 21-22. Company witness Hengtgen explained in detail the timing of payments for the purchases of gas. PGL Ex. 7.0, pp. 28-29 and NS Ex. 7.0, pp. 24-26. Company Schedule F-8 clearly shows purchases are made every month of the year; therefore accounts payable associated with those purchases would also be reflected on the Companies books monthly, not just during those months in which a net increase in gas in storage occurs. Staff IB, p. 12. While Staff did consider the Companies arguments concerning LIFO inventory valuation, Staff believes its proposal for accounts payable is a more accurate representation than the alternative considered. Id., pp. 12-13.

Staff's counter to the Companies' argument concerning the use of lead lag study information for the determination of accounts payable is included under C.2. above.

4. Cash Working Capital

a. Pass-Through Taxes

Staff continues to support using revenue lag days of zero for pass-through taxes. Staff IB, p. 13. The Companies' response to Staff's position in their Initial Brief contains a series of true statements about revenue lag, but those statements are irrelevant to the analysis and do not address Staff's argument. For example, the Companies state that pass-through taxes and energy assistance charges are included in ratepayers' monthly bills and payments. NS-PGL IB, p. 25. While this is true, the Companies confuse form with substance. The method by which the Companies collect the pass-through taxes does not change the substance of pass-through taxes, and the method by which pass-through taxes are transferred from ratepayers to taxing authorities does not change their substance. In arguing that Staff's proposal should not be adopted, the Companies define revenue lag as the number of days from the date service was rendered by the utilities until the date payment was received from customers and such funds become available to the utilities. NS Ex. 7.0, p. 19; PGL Ex. 7.0, p. 22. By the Companies' definition, pass-through taxes cannot have revenue lag since there is no date on which service was rendered by the utilities. Additionally, the Companies support their argument by stating that they are required to collect and transmit pass-through taxes. NS-PGL IB, p. 26. This is also true, but again, provides no evidence or valid basis for the argument that pass-through taxes should be considered as revenue.

The Companies put stock in prior Commission decisions on this issue that favor the Companies' treatment of pass-through taxes. NS-PGL IB, p. 25. Staff asserts that while consistency is desirable, the Commission is not bound by prior decisions. The Commission's conclusion in this proceeding should stand on the facts presented in this proceeding and the facts in this proceeding support a finding of zero revenue lag days for pass-through taxes.

The Companies wish to ignore recent rate cases in which the Commission has determined that pass-through taxes should have zero revenue lag days. NS-PGL IB, p. 27. These recent rate cases are described in Staff's Initial Brief. Staff IB, p. 14. In particular, while the Companies note that they are dissimilar from Commonwealth Edison Company (Docket No. 10-0467) ("ComEd") in that ComEd is an electric utility while Peoples Gas and North Shore are gas utilities, the Companies fail to acknowledge the many aspects in which ComEd is similar to the Companies. ComEd also operates in the Chicago metropolitan area and has Energy Assistance Charges and Gross Receipts/Municipal Utility Taxes included in its CWC calculation with zero revenue lag days and zero expense lead days. 10-0467 Order at 17.

The Companies point out that Energy Assistance Charges are described in statute as a charge for utility service. NS-PGL IB, p. 26. Staff agrees with that statement but would point out that Energy Assistance Charges have been treated as pass-through taxes by the Commission in the prior rate proceedings of the Companies. Additionally, the treatment of Energy Assistance Charges as pass-through taxes is consistent with the Companies' inclusion of Energy Assistance Charges with all other pass-through taxes in their initial filing of Schedule C-25. For ratemaking purposes, there is no precedent for Energy Assistance Charges to be considered a charge for utility service.

The Companies suppose that if pass-through taxes are not recorded as expense in the revenue requirement, that pass-through taxes could not have an expense lead. NS-PGL IB, p. 26. This logic is flawed because it ignores the Companies ability to collect ratepayer funds and hold those funds until they are remitted to taxing authorities. Some pass-through taxes are remitted to the taxing agencies prior to collection from ratepayers and some pass-through taxes are remitted after collection from ratepayers. This effect on CWC is taken into account in Staff's CWC calculation. Staff IB Appendix A, p. 11, lines 16 – 19; Staff IB Appendix B, p. 11, lines 17 – 21.

The Companies clearly lay out the number of days they could hold ratepayer funds before remitting those funds to taxing authorities. These calculations, according to Mr. Hengtgen's testimony, are based upon when the taxes are collected from ratepayers and when they are due to taxing authorities. NS-PGL Ex. 23.0 CORRECTED, p. 21. Staff incorporated these calculations in its rebuttal position. Staff Ex. 10.0, p. 8.

Cash Working Capital is included in rate base to allow investors to recover the cost of financing operating expenses until operating revenue is collected. The collection of pass-through taxes is not the recovery of a cost of providing service; therefore, pass-through taxes are not included in the revenue requirement. Because ratepayers provide the financing for pass-through taxes, the Commission should not allow a revenue lag for pass-through taxes which would allow investors to earn a return on ratepayer provided funds.

The Commission should accept the Cash Working Capital levels recommended by Staff on page 11 of Appendices A and B to Staff's Initial Brief.

b. Prepayments (Uncontested)

c. All Other (Uncontested)

5. Retirement Benefits, Net

a. Pension Asset

The Companies argue that exclusion of the so called pension asset from rate base would be contrary to the law. In support of their argument the Companies state the "Supreme Court of Illinois previously has rejected a claim that a utility's rate base should be reduced on the theory that part of it was the product of customers supplied funds." (citing Citizens Utilities, 124 Ill.2d at 201-203, 204-205) NS-PGL IB, pp. 33-34. The Companies argument is simply wrong and therefore should be rejected. Under Illinois law, for ratemaking purposes, a public utility may not receive a return on investment from ratepayers for ratepayer-supplied funds. City of Alton v. Illinois Commerce Commission, 19 Ill. 2d 76, 85-6 and 91 (1960); DuPage Utility Co. v. Illinois Commerce Commission, 47 Ill. 2d 550, 554 and 558 (1971); and Central Illinois Light Co. v. Illinois Commerce Commission, 252 Ill. App. 3d 577, 583-3 (3rd Dist., 1993). See also Business and Professional People for the Public Interest v. Illinois Commerce Commission ("BPI II"), 146 Ill. 2d 175, 258 (1991). Staff Witness Ebrey testified that "[t]he pension asset should not be included in rate base because it was not created with funds supplied by shareholders. Rather, the pension asset has been funded from normal operating revenues collected from utility ratepayers and represents funds supplied by ratepayers, as evidenced by the Companies' responses to Staff data requests ("DR") TEE 9.01 and TEE 9.02 (Attachments A and B). The only source of funds provided in those responses is "cash provided by operating activities" or cash provided by ratepayers. Since the pension asset was funded by normal operations, rather than provided by shareholders, shareholders should not earn a return on it." Staff Ex. 3.0 Corrected, pp. 3-4.

The Commission has consistently rejected the attempts by utilities to get a return on these ratepayer-supplied funds whether OPEB or more generally the pension asset. Central Illinois Light Co. d/b/a AmerenCILCO, et al., Ill.C.C. Docket Nos. 06-0070, 06-0071, and 06-0072, (cons.), Order of November 21, 2006, pp. 27-28, Comm. App., pp. A50-A51; Northern Illinois Gas Company d/b/a Nicor Gas Company, Ill.C.C. Docket No. 04-0779, Order of September 20, 2005, p. 26, 2005 Ill. PUC LEXIS 475, *56-*58, 245 P.U.R.4th 194, --, Comm. App., pp. A52-A53; Northern Illinois Gas Co. ("Nigas"), Ill.C.C. Docket No. 95-0219, Order of April 3, 1996, pp. 9-10, 1996 Ill. PUC LEXIS 204, *19-*23, Comm. App., pp. A43-A44, *affd. sub nom*. Nigas, et al. v. Illinois Commerce Commission, Order of June 23, 1997, Appeal Nos. 3-96-0473, etc. (cons.); and GTE North Inc., Ill.C.C. Docket Nos. 93-0301 and 94-0041 (cons.), Order of October 11, 1994, pp. 8-13, 1994 Ill. PUC LEXIS 436, *16-*26, Comm. App., pp. A 39-A42, *affd. sub nom.* Citizens Utility Board, et al. v. Illinois Commerce Commission, Order of July 12, 1995, Appellate Court Docket Nos. 4-94-1103, 4-94-1104 and 4-94-1122 (cons.), *cert den*. December 6, 1995, Sup. Ct. Docket No. 79931, Petition of GTE North. See also Citizens Utility Board v. Illinois Commerce Commission, 166 Ill. 2d 111, 132 (1995) [Commission is unauthorized to depart drastically from practices established in earlier orders] and Mississippi River Fuel

Corp. v. Illinois Commerce Commission, 1 Ill. 2d 509, 514 (1953) [long-term consistent actions by the Commission can constitute a binding statutory construction].

On September 30, 2011, the First District Appellate Court issued its opinion regarding the appeal of the Companies' 2009 rate cases (ICC Docket No. 09-0166/0167) and one of the issues on appeal concerned the Companies Pension Asset. People v. Illinois Commerce Comm'n, Nos. 1-10-0654, 1-10-0655, 1-10-0936, 1-10-179-, 1-10-1846 and 1-10-1852, Consolidated, Appellate Court (First District-Fifth Division) September 30, 2011, Slip Opinion, pp. 36-43. In that appeal, like in this proceeding, the Companies argued with respect to the pension asset issue that in Citizens Utilities Co. of Illinois v. Illinois Commerce Commission the Supreme Court rejected a claim that a utility's rate base should be reduced on the theory that part of it was the product of consumer-supplied funds. Id., p. 39. The Appellate Court in response to that argument stated that because it was not faced with the issue of retroactive ratemaking "we find Citizen's Utilities Co. provides little guidance as to how the resolve the actual issue pending … ." Id. p. 42. The Appellate Court then went on to uphold the Commission's decision to exclude the pension asset from ratebase on the basis that it consisted of consumer-supplied funds. Id., pp. 42-43.

The Companies make much of their novel argument that, a portion of what ratepayers pay through a rate is a return on investment and that contributes to retained earnings, as if it is an important fact that has not been addressed by courts in prior cases. NS-PGL IB, p. 32. This argument ignores the simple fact that the source of that cash was from ratepayers and under the law a public utility may not receive a return on investment from ratepayers for ratepayer-supplied funds. Based upon all of the arguments made above and those set forth in Staff's IB and Ms. Ebrey's direct and rebuttal testimonies the Companies' position should be rejected.

6. Accumulated Deferred Income Taxes –

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

Staff has not changed its position on this issue. Staff IB, p. 18. Staff believes that the Commission should not discourage utilities from taking tax positions that have some risk associated with them when such positions are appropriate and could benefit ratepayers. The Companies may benefit from ratepayer provided "free" or low cost capital in the short term, but if the Companies prevail, ratepayers will receive 100% of the benefit of reduced rate base in succeeding rate cases. Staff Ex. 10.0, pp. 23-24.

b. Derivative Adjustments from Contested Adjustments

Staff's position is that once a decision is made on the contested adjustments any derivative adjustments fall out of the formulae. Staff is not aware of any dispute over those formulae used to make the derivative adjustments. Staff IB, p. 18.

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

Staff's position is that once a decision is made on the contested adjustments any derivative adjustments fall out of the formulae. Staff is not aware of any dispute over those formulae used to make the derivative adjustments. Staff IB, p. 18.

V. OPERATING EXPENSES

A. Overview/Summary/Totals

1. North Shore

Staff's recommendations for operating expenses are unchanged from Staff's Initial Brief. Staff IB, p. 19.

2. Peoples Gas

Staff's recommendations for operating expenses are unchanged from Staff's Initial Brief. Staff IB, p. 19.

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

i. Inflation Rate Update

ii. Inflation Factor Error

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

The Companies argue that:

> The Commission cannot ignore the uncontradicted evidence regarding the prudence and reasonableness of the incentive compensation costs or the benefits received by customers. The Commission must apply Illinois law governing uncontradicted evidence. "Where the testimony of a witness is neither contradicted, either by positive testimony or by circumstances, nor inherently improbable, and the witness has not been impeached, that testimony cannot be disregarded by the trier of fact." *Bazydlo v. Volant*, 164 Ill. 2d 207, 215, 647 N.E.2d 273, 277 (1995).

NS-PGL IB, p. 62. The Companies' view is flatly inconsistent with the court's decision in Commonwealth Edison Co. v. Ill. Commerce Comm'n, 398 Ill. App. 3d 510, 516-17 (2nd

Dist. 2009). Thus whether or not "uncontradicted" evidence showed that the costs were reasonably and prudently incurred is irrelevant to the issue of recoverability. Long ago, in Illinois Bell Telephone Co. v. Illinois Commerce Comm'n, 55 Ill.2d 461, 481 (1973), the Illinois Supreme Court affirmed a Commission decision which disallowed cost for recovery for expenditures for dues to civic, social and athletic clubs as they were held not to be "operating expenses to be considered in the fixing of rates." There, as here and in Commonwealth Edison, those expenditures were properly denied recovery even though such expenditures "[u]ndoubtedly . . . would be the sort of perk that would help an employer recruit employees." Commonwealth Edison Co. v. Ill. Commerce Comm'n, 398 Ill. App. 3d 519 (Emphasis added). Put simply, in the absence of a demonstrated direct benefit to ratepayers, even otherwise just and reasonable cost cannot be recovered.

The Companies also argue that "[i]t is settled law, moreover, that employee salaries are operating expenses and, as such, are recoverable in full so long as they are prudent and reasonable. See, e.g. *Villages of Milford v. Illinois Commerce Comm'n*, 20 Ill.2d 556, 565, 170 N.E.2d 576, 581 (1960) ("*Milford*")." The Companies also argue that "the present case is distinguishable from *Commonwealth Edison Co. v. Illinois Commerce Comm'n*, 398 Ill. App. 3d 510." NS-PGL IB, p. 63, stating that the courts "reliance in ComEd 2009 [i.e. *Commonwealth Edison Co. v. Illinois Commerce Comm'n*, 398 Ill. App. 3d 510] on *DuPage Util. Co. v. Illinois Commerce Commission*, 47 Ill. 2d 550, 560 ("*DuPage*"), which distinguished *Milford*, is inapplicable here." NS-PGL IB, p. 63. The Companies continue by arguing that in "*DuPage,* the Court distinguished *Mileford*, basing its decision on evidentiary supported findings that the salaries of three officers of a company serving 840 customers were excessive rather than reasonable, including evidence that the officers only worked-part time and maintained only a minimal contact with the utility's day to day operations, and the salaries were disproportionately high compared to comparable utilities." Id. The Companies go onto argue that "[t]here is no claim, much less any evidence, of excessive compensation on those or any other grounds in the instant cases." Id.

Despite the Companies' claim, this proceeding is not distinguishable from Commonwealth Edison Co. v. Illinois Commerce Comm'n, 398 Ill. App. 3d 510. The Companies attempt to undercut the Commonwealth Edison decision by reference to the Supreme Court's decision in Du Page Utility Co. v. Illinois Commerce Comm'n, 47 Ill. 2d 550, 560-61 (1971) should be disregarded. In DuPage the Commission disallowed the recovery of certain annual employee salaries on the basis that they were excessive and out of proportion to the extent and nature of the services performed. Whether or not the Commission in that case determined that the salaries were "excessive" in part and therefore disallowed in part does not undermine, and in fact supports, the conclusion that expenses which are not shown to benefit ratepayers are not to be included in rates.

Whether the Commission made a finding that the salaries were excessive and therefore unrecoverable or it made a finding that costs, though otherwise reasonable expenses for an ordinary corporation, did not provide direct benefits to ratepayers is of little import when the result is the same. Without a direct benefit to ratepayers, incentive compensation costs can and should be disallowed. In this proceeding, like the Commonwealth Edison proceeding, there has been a failure by a utility to show a direct benefit to rate payers for certain incentive compensation expenses. See, Staff Ex. 12.0

Corrected, pp. 5-12. Accordingly, without a direct benefit to ratepayers those incentive compensation costs must be disallowed.

On September 30, 2011, the First District Appellate Court issued its opinion regarding the appeal of the Companies' 2009 rate cases (ICC Docket No. 09-0166/0167) and one of the issues on appeal concerned the Companies Incentive Compensation Costs. People v. Illinois Commerce Comm'n, Nos. 1-10-0654, 1-10-0655, 1-10-0936, 1-10-179-, 1-10-1846 and 1-10-1852, Consolidated, Appellate Court (First District-Fifth Division) September 30, 2011, Slip Opinion, pp. 29-36. The Court upheld the Commission's order on the issue of incentive compensation costs. The Court held that "Illinois law supports the Commission's use of a direct benefit standard" in denying [ ] incentive compensation costs." Id., p. 32. In addition, the Court rejected arguments similar to those made by the Companies in their IB in this proceeding that tried to distinguish Commonwealth Edison Co. v. Illinois Commerce Comm'n, 398 Ill. App. 3d 510. The court stated "[c]ontrary to Peoples Gas' contentions on appeal, both the Act and Illinois case law clearly reflect the direct customer benefit standard was an appropriate standard for the Commission to apply… . People v. Illinois Commerce Comm'n, Nos. 1-10-0654, 1-10-0655, 1-10-0936, 1-10-179-, 1-10-1846 and 1-10-1852, Consolidated, Appellate Court (First District-Fifth Division) September 30, 2011, Slip Opinion, p. 35.

2. Non-union Base Wages

The Companies mischaracterize Staff's observation regarding the 3.9% wage increase. Staff does not assume that all employees will be elevated to "top-performer" status (NSPGL IB, p. 66) but rather that the highest performers for the utilities would be receiving increases even higher than the cited survey[1] would indicate. Staff IB, p. 30. The Companies did not provide any explanation of why their "top-performers" would receive increases well above the average for top-performers in the survey used as support for their position for why the increases budgeted for 2011 and 2012 would be almost double the increase granted in 2010. Id. Staff's analysis, as well as the historic data presented by Staff, support the recommendation to limit the non-union wage increases to those presented in the IB revenue requirements.

3. Headcounts

4. Self-Constructed Property

GCI Witness Effron continues to recommend a reduction of $1.722 million of Peoples Gas' test year operating expenses for self-constructed property costs and advocates that such amount be added to rate base. CUB-City IB, pp. 18-19. Staff's and People Gas' witnesses acknowledged, via cross-examination by GCI, that the Uniform System of Accounts permits the subject costs to be capitalized. Tr., August 30, 2011, 284:6-287:11 (Ostrander) and Tr., September 2, 2011, 922:12-925:9 (Gregor). However, GCI failed to demonstrate that capitalizing self-constructed property costs is the only proper treatment allowed by the Uniform System of Accounts. NS-PGL IB, pp. 69-70. None of the other Integrys regulated utilities capitalize indirect overhead costs of self-constructed property. The policy of capitalizing the subject indirect overhead costs was implemented mainly to assist the Companies' tax department in meeting requirements under the Tax Reform Act of 1986. The tax department has now filed with

[1] The Companies offered the World at Work Salary Budget Survey. Staff's analysis of the July 2010 and July 2011 surveys provided the basis for Staff's conclusions regarding the level of increase for top performers.

the Internal Revenue Service for a different means of calculating such indirect costs. Staff IB, p. 32. Based upon the above arguments and those previously stated in Staff's Initial Brief, Staff continues to believe that Mr. Effron's proposed adjustment for self constructed property is not necessary.

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

Staff continues to recommend that the Commission establish uncollectibles expense percentages of 0.5936% for North Shore Gas and as 2.7927% for Peoples Gas. Staff Ex. 1.0, p. 23. Staff also continues to recommend that the Commission order the Companies to switch to the net write-off method in Rider UEA.

The Companies attempt to promote the percentage of revenues method because the method is easier to calculate. NS-PGL IB, 71. The argument that the percentage of revenues method is easier to calculate has no merit. The percentage of revenues method produces an amount of uncollectible expense that represents an estimate of future uncollectible expense on the revenues billed but not yet collected for the current period and prior periods. In comparison, the net write-off method uses actual amounts written off during the period and does not have to be calculated or estimated. The amounts written off are an accurate measure of the amount of lost revenue the Companies should be allowed to recover. In addition, actual information is preferable to estimates since it is more accurate, and should be used whenever available. Staff IB, p. 90. The Companies also argue that the net write-off method creates a mismatch issue. NS-PGL IB, p. 71. The Companies' method, however, is dependent on estimates and write-offs from prior years in its calculation. If there is a problem with multiple years and writing-off combined purchased gas adjustment charges and base rate charges, the problem already exists and would not be created by adopting Staff's proposal to use the net write-off method. Staff Ex. 10.0, p. 19.

6. Administrative & General

a. Injuries and Damages Expenses

GCI Witness Effron continues to recommend the disallowance of $3.077 million of Peoples Gas' test year operating expenses for injuries and damages expenses. Mr. Effron continues to posit that Peoples Gas has failed to adequately support the increase in allocated expenses from IBS. AG IB, pp. 20-21. In surrebuttal testimony, Peoples Gas reduced its 2012 test year expenses by $1.433 million based on an updated 2012 forecast. NS-PGL IB, p. 72. The adjusted 2012 amount of injuries and damages expenses of $12.142 million represents a 5.97% reduction from historical 2009 injuries and damages expenses of $12.913 million. Staff continues to believe that Mr. Effron's proposed adjustment is not necessary since the Companies have adequately supported the increase in injuries and damages expenses. Staff IB, pp. 33-34.

b. Adjustment to Account 921- Office Supplies and Expenses

The only contested issue pertaining to Adjustment to Account 921 – Office Supplies and Expenses concerns self constructed property. Please refer to Section V.C.4 of Staff's Reply Brief.

c. Rate Case Expenses

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

The Companies agree that if the Commission approves Staff's disallowance of incentive compensation expenses as documented in Section V.C.1 of Staff's Initial Brief, then the rate case expenses related to Non-Executive Incentive plan costs should also be disallowed. In addition, subject to the Commission's approval of Staff's adjustments, the Companies agree with Staff's recommended conclusion in the Commission's Order as documented in Staff Exhibit 11.0 Corrected, p. 7, with the inclusion of "and updated in the Utilities' surrebuttal" following "adjusted by staff". NS-PGL IB, p. 76. Staff agrees with the inclusion of the Companies' proposed addition to the recommended conclusion in the Commission's Order.

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

The Companies agree that the calculation of the amount of 2009 rate case expenses to be amortized should be based on actual costs up to the amount approved by the Commission. The Companies continue to contest Staff's proposed adjustments to exclude costs related to rehearing and appeals for the 2009 rate cases claiming that the excluded costs are a common part of litigation of a general rate case. NS-PGL IB, p. 78. The Companies' proposal for the amortization of the prior rate case expenses includes items and amounts which were not previously approved by the Commission. ICC Staff Exhibit 11.0, pp. 8-9. The adjustments recommended by Staff to amortize the remaining actual costs incurred, excluding any rehearing costs, for Docket Nos. 09-0166/0167 are appropriate and should be adopted by the Commission.

iii. Normalization of Rate Case Expenses

GCI Witness Morgan continues to recommend the normalization of rate case expenses instead of the regulatory asset treatment. CUB-City IB, p. 25. Staff and the Companies remain opposed to Mr. Morgan's normalization proposal. As was stated in Staff's Initial Brief, the Commission ordered the initiation of a rulemaking regarding rate case expense in Docket No. 10-0467 and it is possible that this general practice may be an issue in that proceeding. It would not be appropriate to revise the general practice before the Commission has the opportunity to consider various alternatives in the rulemaking. Staff IB, pp. 36-37.

d. Gas Transportation Administrative Costs

e. Solicitation Expense

The Commission should accept Staff witness Sackett's proposed adjustment to the expenses billed to the Companies from their affiliated service company Integrys Business Support ("IBS"). In its initial brief, Staff explained why such an adjustment was appropriate. Staff IB, pp. 37-47.

In their brief, the Companies object to any adjustment stating, "The Utilities have reflected appropriate and reasonable cost-based figures for those IBS solicitation revenues in their forecasts for the 2012 test year, a total of $16,572, so no adjustment is proper or necessary. Gregor Sur., NS-PGL Ex. 38.0, 7:142 – 8:164,9:171-183." NS-PGL IB, p. 80.

The Companies' attempt to prove these expenses are already included in rates by citing their witness' assertion that, "…the 2012 test year expenses for IBS include an appropriate amount of costs billed to PEHS for customer relations activities including solicitation and the handling of PEHS customer inquiries. Therefore, Mr. Sackett's proposed adjustment is unnecessary….the current test year reflects an appropriate level of billings to PEHS." NS-PGL Ex. 38.0, pp. 7-9. However, as Staff pointed out in its Initial Brief, Ms. Gregor states that the inclusion cannot be verified. Indeed, the Companies assert that such proof is not available, because it does "not show up as an identifiable amount on any … schedules." Staff Cross Ex. 15, p. 9; Companies response to Staff DR DAS 13.03e. The Commission should not consider such unreliable information, especially when, as shown in Staff's brief, there is evidence that this amount is provided below the Fully Distributed Cost ("FDC"). The Companies appeared to alter this position in surrebuttal, and thus Staff was unable to conduct a thorough discovery on the inclusion of this amount. This new estimate from surrebuttal is one-fourth of the estimate presented in rebuttal testimony. Their shifting position creates more than enough uncertainty about the Companies' current estimate's validity to require the Commission to reject it.

The Companies also claim that, "Any errors made by IBS in prior years by not billing PEHS the right amounts do not alter the correctness of the 2012 test year figures." Id. at 9:184-190." NS-PGL IB, p. 80. This point is moot. The Companies simply provided no proof that they included these charges in the test year.

The Companies appear to have violated both of the relevant agreements, not only for solicitation but also for billing and repairs. The Companies, via their affiliate PEHS, have a clear motive to profit from PPP. Staff IB, at 50-51 (Commission should investigate to prevent "ratepayers from continuing to subsidize the affiliates."). The Commission should not blindly trust the Companies on this issue, but instead rely upon the record developed in this docket.

Lastly, the Companies argue that "the correct calculation is cost-based under the Master Non-Regulated Affiliated Interest Agreement. Gregor Sur., NS-PGL Ex. 38.0, 7:138-141, 8:165-170." NS-PGL IB, pp. 80-81. As Staff pointed out, there is sufficient evidence that the credits in the test year for services to be provided to PEHS are not "cost-based" as required but rather *below* Fully Distributed Costs, Staff IB, pp. 44-45, thus the agreement cannot have been the guiding standard for determining the credit to ratepayers. If the Companies' affiliate IBS fails to charge PEHS or if they choose to charge them less than the FDC for these services, then Staff recommends that the Commission credit the ratepayers directly. Due to the fact that the evidence demonstrates that these costs were not correctly assigned to the affiliates, there is no good estimate of what those FDC are. Staff believes that the most reasonable credit is what that solicitation is *worth* to PEHS. IGS provides in its Initial Brief a discussion of the value of the "unique and impossible-to-duplicate nature of some of the solicitation opportunities the Companies provide to PEHS." IGS IB, p.7-8. The margin that PEHS makes on PPP is a good measure of the market value of those exclusive solicitation channels. Staff witness Sackett calculated an unrefuted estimate of that margin in his rebuttal testimony and the Companies did not object to that amount. Staff believes that this estimate provides the Commission with the most reasonable credit to ratepayers.

Staff continues to recommend that the Commission draw four conclusions from this evidence: (1) there is no evidence of any credit in the original test year expenses for customers relations services provided by IBS for PEHS; (2) the estimates provided by the Companies are not the full costs of providing these services as required under the governing agreement; (3) since there is no established estimate of FDC, another adjustment should be used; and (4) the adjustment should be based on the market value of these services. The Commission should utilize the estimate of this market value provided by Staff Witness Sackett, which is based on the margin of $656,267 and $116,361 that PEHS makes on PPP for Peoples Gas and North Shore respectively.

Staff Ex. 18.0, p. 23. This margin was never refuted by the Companies. Only Staff's proposal ensures that ratepayers receive the full benefit for all value of these services to PEHS.

In the alternative, if the Commission determines that Staff's proposed amount is not warranted, Staff continues to recommend that the adjustment of $70,000 contained in the Companies rebuttal testimony is more appropriate than their surrebuttal testimony recommendation of no adjustment.

7. Depreciation

a. Depreciation Expense on Forecasted Additions

The argument for Depreciation Expense on Forecasted Additions is contained in Section C. 1. A. (i).

b. Derivative Adjustments from Contested Adjustments

Staff's position is that once a decision is made on the contested adjustments any derivative adjustments fall out of the formulae. Staff is not aware of any dispute over those formulae used to make the derivative adjustments.

8. Revenues

a. Repair Revenues

In Staff's Initial Brief, it recommended that the Commission should approve an alternate "pricing mechanism" where the affiliate must pay the ratepayer rate. Staff's position is based on the fact that the Companies have admitted that they do not charge their affiliates the FDC of providing repair services. Staff IB, pp. 47-49.

The Companies continue to claim that, "Under the Commission-approved Services and Transfers Agreement, which applies here, the Utilities are to bill PEHS at the FDC of providing the service. Gregor Sur., NS-PGL Ex. 38.0, 10:197-204." NS-PGL IB, p. 82. This is incorrect. As noted in Staff's Initial Brief, the STA instead requires that the default, primary charge is a "pricing mechanism approved by the Commission." Staff Ex. 9.0, Attachment F, p. 6. The Companies acknowledge that they have been charging below FDC from 2008-2010 and the amount that the Companies added to its test year revenues in its surrebuttal testimony is significantly less than the amount charged historically. Further, it is also less than the amount estimated by the Companies in their rebuttal testimony.

The Companies object to Staff's contention that they have not supported their FDC calculation. Id*.* at 10:201-204; NS-PGL IB. p. 82. The Companies' support is based on time records provided to Staff in discovery - Staff Ex. 18.0, Attachment B – Companies responses to Staff DR DAS 7.02h. While the data does show where the Companies derived the amounts charged to PEHS, there is no evidence that the time billed to PEHS was the total amount of time spent on these repairs. This can be seen by noting that the average charges for non-PPP ratepayers for the exact same service as PPP is almost twice as high as the average charges that PEHS pays for PPP. As noted, the Companies themselves claim that the only difference in the costs between the repair services is the profit margin. Staff Ex. 18.0, Attachment H – Companies responses to Staff DR DAS 9.08. However, as Staff demonstrated, in order for the Companies' charges to PEHS to really be at FDC the profit margin on non-PPP repairs charged to ratepayers must be 70 -115%. Staff IB, pp. 48-49. The Commission should not allow the Companies to charge a profit margin on a service to ratepayers without requiring the same margin to be charged to an affiliate.

The Companies again claim that the revised revenue requirements presented in their surrebuttal testimony are the correct amounts. NS-PGL IB, p. 82. The amounts in surrebuttal testimony are based on an average of the amount charged to PEHS from 2005-2010. NS-PGL Ex. 38.0, p. 10. If it significantly discounted those amounts during this period as Staff maintains, then the test year amount is significantly below FDC.

Once again the Companies misread the STA by claiming, "The Utilities are required to charge PEHS the FDC, and are not required to charge the same amount charged to customers [citation omitted]." NS-PGL IB, p. 82. Regardless, the Companies are required to charge a Commission-approved amount. The Commission should exercise its authority and require that PEHS be charged for repairs at the same rates it charges non-PPP customers. It is unreasonable for the Companies to charge their affiliate half of what they charge their ratepayers for the same services, without permitting ratepayers to benefit from this same margin in establishing test year revenues.

Staff continues to believe that the Commission should order the Companies to charge PEHS the same rate that they charge ratepayers. The full amount of those charges of $17,313 for Peoples Gas and $2,456 for North Shore should be included in the test year instead of the difference between them and the test year amounts.

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

Staff recommended that the Commission order an investigation into the Companies dealings with their affiliates and the support for PPP in general to establish that the interactions between the utilities and their affiliates are in the public interest. Staff IB, pp. 50-51.

The Companies object that "The amounts involved do not justify the burdens and costs of such steps. The impact of the 2012 test year solicitation revenues, properly calculated, on the Utilities' forecasts are just $16,572, as noted above. The missed billings for repairs in 2008 to 2010 were just a total of $7,174 for Peoples Gas and $910 for North Shore, as noted above." NS-PGL IB, p. 82.

An entire rate case was insufficient to determine the full extent of the Companies' interactions with its affiliates. Thus, Staff believes that an investigation is still warranted. The "burdens and costs" of an investigation is small compared to the potential harm done to ratepayers over time. Staff estimates the margin on PPP is around $700,000 per year, which is not insignificant. "Larger amounts potentially would be at stake if the solicitation and repairs amounts were to be calculated as Staff proposes, but, as discussed earlier, Staff's proposals are incorrect." NS-PGL IB, p. 82.

If the Companies are willing to stop facilitating solicitation of their ratepayers by affiliates for affiliate products, to stop performing repairs for their affiliates, and to allow alternative suppliers to bill on the utility bill for competitive products, then Staff would recommend that those steps are sufficient to avert this process.

c. Warranty Products (Revenue and Non Revenue)

IGS recommends that the Commission require the Companies to provide other warranty suppliers with equal access to the bill. IGS IB, p. 8. Staff supports this requirement.

IGS recommends that the Commission require the Companies to provide other warranty suppliers with equal access to the solicitation channels used by PEHS. IGS IB, pp. 8-9. Staff does not support this recommendation. At present, the impact of this on ratepayers is unclear. Staff generally does not support the solicitation of ratepayers for any non-utility service provided by any party. There is insufficient evidence in this case of how IGS' recommendation would be implemented. This matter could be better considered in the recommended investigation proceeding.

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

1. Uncollectible Rate

Staff has not changed its position on this issue. Staff IB, p. 51.

2. Derivative Adjustments from Contested Adjustments

VI. RATE OF RETURN

A. Overview

B. Capital Structure

1. Peoples Gas

Staff's proposed capital structure is fair and reasonable, supported by the record evidence, and consistent with applicable law. The Utilities' proposed capital structure is not.

In support of their unlawful and unreasonable capital structure, the Utilities have developed a practice of making unsupported and unfounded statement and allegations. In the colloquial, they just "say stuff." When they do try to support the stuff they say, the alleged support is rife with misrepresentations. For instance, the utilities subtly mix "apples with oranges," and then claim that it is Staff that is making inappropriate comparisons, as if such a transparent tactic will immunize them. Such tactics are born of desperation.

The old lawyers' adage explains: When the law is on your side, argue the law; when only the facts are on your side, argue the facts; when neither the law nor the facts are on your side, jump up and down to do something to distract the decision makers from the real issues. The Utilities have neither facts nor law on their side so they are forced to reach down to the distraction tactic. There are some issues, moreover, where the utilities appear to have calculated that even the distraction tactic will be of no help. On these issues the Utilities simply ignore the issue, like they have steadfastly ignored the Section 9-230 issue.

a. Section 9-230

In their Initial Brief, the Utilities argue at considerable length, Utilities IB, at 97-103, that their proposed capital structure is reasonable. The Utilities also argue that Staff has failed to "justify" its proposed capital structure. Utilities IB, at 92-95. This unsupported allegation is wrong. Staff, like it did in the last NS/PGL rate case,[2] made adjustments to the Utilities' proposals to address the inherent flaws contained it their proposals. The fatal flaw in the Utilities' proposed capital structure is that it is unlawful.

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[2] See *Order*, NS-PGL Rate Case 09-0166/0167 (cons.) (Jan. 21, 2010, at 94 ('In determining a reasonable rate of return for establishing rates, Staff points out, Section 9-230 of the PUA prohibits the inclusion of any incremental risk or increased cost of capital, which is the direct or indirect result of the public utility's affiliation with unregulated or non-utility companies.").

Staff's proposal addresses this flaw and corrects it. The Utilities entirely ignore the unlawfulness of their proposal, even though Staff raised the issue in its direct testimony. See Staff Ex. 4.0, at 7. The threshold question is whether the Utilities' proposed capital structure is lawful in light of Section 9-230 of the Public Utilities Act.

As the Staff noted in its Initial Brief, Staff IB, at 55-57, Section 9-230 provides in relevant part that:

> In determining a reasonable rate of return upon investment for any public utility in any proceeding to establish rates or charges, the Commission *shall not* include *any* (i) incremental risk, [or] (ii) increased cost of capital … which is the direct or indirect result of the public utility's affiliation with unregulated or nonutility companies.
>
> 220 ILCS 5/9-230 (emphasis added).

Illinois courts have interpreted this provision strictly against the inclusion of any incremental risk or increased cost of capital in a utility's rate of return, if such incremental risk or increased cost of capital results from association with unregulated affiliates. In *Illinois Bell Telephone Co. v. Commerce Comm'n*, 283 Ill. App. 3d 188, 669 N.E.2d 919 (2nd Dist. 1996) (*IBT*), the Appellate Court for the Second District ruled that:

> *Section 9-230 does not allow the Commission to consider what portion of a utility's increased risk or cost of capital caused by affiliation is "reasonable" and therefore should be born by the utility's ratepayers; the legislature has determined that any increase whatsoever must be excluded from the ROR determination*. It is impermissible for the Commission to substitute its reasonableness standard for the legislature's absolute standard. The Commission may not define a portion of the Act in a way that conflicts with a specific directive contained in the Act. [citation] *We hold that if a utility's exposure to risk is one iota greater, or it pays one dollar more for capital because of its affiliation with an unregulated or nonutility company, the Commission must take steps to ensure that such increases do not enter in its ROR calculation*.
>
> *IBT*, 283 Ill. App. 3d at 207, 669 N.E.2d at 933 (emphasis added; citation omitted).

Two things are apparent from this holding. *First*, the Commission cannot consider the reasonableness of a proposed capital structure until it makes a threshold determination that the capital structure in question satisfies the requirements of Section 9-230. *Second*, Section 9-230 absolutely bars, as a matter of law, the adoption of a capital structure which, as a result of affiliation, results in increased risk or increased cost of capital.

These findings are fatal to the Utilities' proposal. Since equity is generally a more expensive form of capital than debt, a greater percentage of equity in a utility's capital structure equates to a higher rate of return. *IBT*, 283 Ill. App. 3d at 204, 669 N.E.2d at 931. As Staff witness Sheena Kight-Garlisch demonstrated, the Utilities are considered by ratings agencies to be better credit risks and otherwise less financially risky than their parent company, Integrys. Staff Ex. 4.0 at 5-8; Staff Ex. 13.0C at 4-8. This means, logically, that the Utilities' capital structures should be weighted more heavily towards debt than that of Integrys. This is not, however what the Utilities propose; instead, they advance the counterintuitive, and in this case unlawful, argument that, notwithstanding the fact that their riskier parent's capital structure contains 47.8% equity, theirs should contain 56% equity. *See* Staff Ex. 13.0C, Schedule 13.4 (47.8% equity); Initial Brief at 94 (56% equity). The Commission cannot even consider the reasonableness of this proposal.

On the other hand, Staff's proposed capital structure is not only lawful but reasonable.

b. The Utilities' Proposed Capital Structure Is Not Reasonable

The Utilities primarily argue that their proposed capital structure is reasonable because it is similar to their past capital structures. Other than this argument, the Utilities attack Staff's proposal as unreasonable while providing no more justification for their proposed capital structure. Of course, the Utilities carry the burden of proof, not Staff. 220 ILCS 5/9-201(c). Moreover, the Utilities' implication that that their proposed capital structure is reasonable because it is similar to their past capital structures ignores the clear legal precedent discussed above that Commission orders are not *res judicata* because "'[t]he concept of public regulation includes of necessity the philosophy that the commission shall have power to deal freely with each situation as it comes before it, regardless of how it may have dealt with a similar or even the same situation in the past.'" *Metro Util. Co. v. Illinois Commerce Comm'n*, 262 Ill. App. 3d 266, 271 (2nd Dist. 1994), *quoting Mississippi River Fuel Corp. v. Illinois Commerce Comm'n*, 1 Ill. 2d 509, 513 (1953).

Finally, the Utilities' incessant use of the word "actual" in reference to their proposal, while using "hypothetical" and similar words in referencing Staff's proposal, is just another instance of the distraction tactic. As Staff pointed out, neither the Utilities' nor Staff's proposals are the "actual" capital structure nor the forecasted capital structure, for that matter. Staff IB, at 52-53. Rather, the Utilities impute a capital structure that is allegedly similar to the Utilities' historical capital structures. In contrast, Staff's imputed capital structure correct the fatal flaws in the Utilities' proposed capital structure. Either way, both use an imputed capital structure because neither uses the actual or forecasted capital structures. *Id*.

Moreover, beyond the Utilities' misrepresentations of actual or imputed, there is nothing sacrosanct in actual costs themselves. The Utilities have the burden of not only demonstrating that they incur costs but that these costs are just and reasonable and prudently incurred. *See also Citizens Util. Bd. v. Illinois Commerce Comm'n*, 166 Ill. 2d 111, 121 (1995) ("In setting rates, *the* Commission *must determine that the rates accurately reflect the cost of service delivery and must allow the utility to recover costs prudently and reasonably incurred,*" *citing* 220 ILCS 5/1-102(a)(iv)).

Of course, the Utilities cannot show that their costs are prudently and reasonably incurred because their capital structure contains an excessive amount of equity capital (56% for both PGL and NS), which results in a needlessly high cost of capital. The Illinois courts have clearly explained, "equity is a more expensive form of capital than debt." *IBT*, 283 Ill. App. 3d at 204. Consequently, the "more equity in a utility's capital structure, the higher the ROR must be to recover the cost of capital." *Id*. *See also Citizens Utility Board v. Illinois Commerce Comm'n*, 276 Ill. App. 3d 730, 744 (First Dist. 1995)("*CUB*")("[S]ince equity always costs more than debt, as a corporation increases its proportion of equity, its total cost of capital generally increases, although the cost of debt and the cost of equity both decrease.").

The Utilities' proposed capital structure is needlessly expensive due to an excessive amount of equity. As Staff noted in its Initial Brief, the Court in *CUB* acknowledged the natural incentive for a utility to avoid an "optimal, lowest cost capital structure" in a holding company context:

> When a larger corporation owns a utility, the corporation is generally motivated not to establish an optimal, lowest cost capital structure for the utility, but to use instead a structure with a greater percentage of equity than is optimal, thereby allowing the corporation to realize a greater return.

> The assured profits from the regulated utility can then bolster the security of the corporation, allowing it to sell its own debt instruments at lower cost and use the debt capital to finance riskier, unregulated and competitive ventures. Thus, the corporation maintains an overall capital structure with a higher proportion of low-cost debt, while reporting the capital structure of the owned utility with a higher proportion of high-cost equity. The Commission acknowledged the evidence showing that corporations which own utilities have this incentive to overstate the effective equity in the capital structures of the utilities, saying: "There is no question that a capital structure may be manipulated."

CUB., 276 Ill. App. 3d 730 at 745. Moreover, the Court recognized the Commission's duty to consider whether it was presented with such an "optimal, lowest cost capital structure," and the related burden on a utility to address the possibility of meeting its capital needs at lower cost in demonstrating the reasonableness of its capital structure:

> [T]he Commission should disallow recovery of any cost of capital in excess of that reasonably necessary for the provision of services. If a utility has included excessive equity in its capital structure, it has inflated the rate of return and its capital cost. While the Commission here found that Centel's reported capital structure was reasonable, it also ordered Centel to perform studies to determine whether a different capital structure could reduce capital costs. As Centel conceded at oral argument, *the order shows that the Commission found a reasonable likelihood that a different capital structure would permit Centel to meet its capital needs at lower cost. But this means Centel did not meet its burden of proving that the reported capital structure reflects capital costs reasonably necessary for the provision of services. The order contradicts the finding that Centel proved its proposed capital costs reasonable.*
>
> The order shows that the Commission based its approval of the capital structure primarily on its rejection of the evidence of manipulation CUB presented. Again, the Commission apparently acted as an impartial arbiter deciding which party presented the stronger argument. "Requiring intervenors to establish unreasonableness is *** no substitute for requiring proof of reasonableness." CUB's failure to prove manipulation of the capital structure is not sufficient to show that the reported capital structure provides an adequate basis for assessing Centel's cost of capital.
>
> *Id*., at 746-47 (emphasis added, citations omitted).

Accordingly, not only are the Utilities' proposed capital structure unjust and unreasonable because they are unlawful in violate Section 9-230, they are also unjust and unreasonable because they contain an excessive amount of equity, which results in a needlessly high cost of capital.

c. Short Term Debt Funds Rate Base

The Utilities next argue that that they have shown that their short-term debt does not support rate base because Staff has not shown that short-term debt does not support rate base or that Staff has not proven that the Utilities' use short-term debt differently than previously. Utilities IB, at 96-97. At the same time the Utilities, in a footnote, allege that Staff Witness Ms. Kight-Garlisch statement, based on the Utilities' DR response (NS-PGL Ex. 35.1N and 35.1P), that "the Utilities have stated that they fund the difference between rate base and "permanent capital" with short-term debt" is wrong and misleading. Utilities IB, at 97, fnt. 61. They explain that their response to Staff "was referring to only a single point time and that generally the Utilities fund differences between rate base and permanent capital with cash." *Id*.(emphasis in original). Beyond the attempt to revise their previous response to a Staff DR in their initial brief, the Utilities do not finance with cash.

Here again, the Utilities are playing a shell game in order to distract from the facts. Cash does not finance or fund anything. Cash is not a *source* of financing but rather a *use* from financing. Company witness Ms. Gast clearly agreed with this fundamental truism at hearing. Tr. (Aug. 31, 2011), at 401.

Moreover, Ms. Kight-Garlisch explained that due to the fungible nature (i.e., perfect substitutability) of capital, one cannot identify which capital sources fund which assets. Staff Ex. 13.0C, at 2. The Commission explained this fundamental principle:

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

The Commission, accordingly, has concluded that all assets, including assets in rate base, are assumed to be financed in proportion to total capital. *See CIPS/UEC Proposed general increase in rates, Order*, Docket Nos. 02-0798, 03-008 and 03-0009 (Cons.) (October 22, 2003), p. 67.

Consequently, because the Utilities have stated that they rely on short-term debt as a source of funds (Staff Ex. 13.0C, at 2), short-term debt should be included in their capital structures unless it is shown that short-term debt does not support rate base. The Utilities, other than a transparent attempt at distraction tactics, have not shown that short-term debt does not support rate base. To the contrary, the Utilities have stated that they fund the difference between rate base and "permanent capital" with short-term debt. NS-PGL Ex. 35.1N and 35.1P.

d. Staff's Proposal Would Not Increase The Utilities' Financial Risk To Standard & Poor's Agressive Risk Profile

The Utilities complain that " [a]t Staff's proposed capital structures and the financial ratios that would result from its proposed 2012 revenue requirement, capital components and cost, both Utilities would be squarely in the "Aggressive' risk profile." Utilities IB, at 98. This allegation is entirely inaccurate.

In fact, Ms. Kight-Garlisch explained that the S&P financial risk ratios based on Staff's proposed revenue requirement, capital components and costs in this proceeding clearly show that it is necessary to impute capital structures for the Utilities to ensure that their rates of return *are reasonable*. Table 2 (Table 1 in Staff Ex. 13.0C, at 6) below shows the financial risk ratios and the implied financial risk of each ratio for 2012 based on Staff's proposed revenue requirement for North Shore and Peoples Gas at 50% (Gas Group average equity ratio) and 56% equity (Utilities' proposed imputed equity ratio). The calculation of the ratios is presented in Staff Ex. 13.0C, Schedule 13.5.

Table 2

Equity Ratio	FFO/Debt		Debt/EBITDA		Debt/Capital	
2012	Ratio	Implied Risk*	Ratio	Implied Risk*	Ratio	Implied Risk*
North Shore-50% (Gas Group)	28.1%	S	3.2X	S	50%	S/A
North Shore-56% (Utilities' Proposal)	33.2%	I	2.7X	I	44%	I
Peoples Gas- 50% (Gas Group)	31.1%	I	3.1X	S	50%	S/A
Peoples Gas- 56% (Utilities' Proposal)	36.5%	I	2.6X	I	44%	I
* I=Intermediate, S= Significant and A= Aggressive						

The implied financial risk was determined using the S&P business and financial risk matrix. ICC Staff Ex. 13.0C, Attachment A. The Utilities' proposed imputed capital structure would result in a relatively low degree of financial risk for a gas distribution utility. In comparison, the average capital structure of the Gas Group (including goodwill) is not nearly so conservative. The mean equity ratio for the Gas Group is 50.4% (including short-term debt but with no adjustment for goodwill), with a standard deviation (“σ”) of 4.8%. Further, the Gas Groups’ other two financial risk ratios are also weaker than the Utilities. Thus, the Gas Group’s financial risk ratios indicate that its risk is higher than that of North Shore and Peoples Gas. Staff Ex. 13.0C, at 6-7. The Gas Group’s cost of common equity is a fair rate of return on common equity for the Utilities only if the Gas Group’s and the Utilities’ total risk (business risk + financial risk) are similar. Given the Gas Group’s greater financial risk, its cost of common equity would exceed that for a company with a similar degree of business risk but with the lower financial risk implied in the Utilities’ proposed imputed capital structures. Stated differently, if the Gas Group’s average capital structure were equal to the Utilities’ proposed capital structures, the Gas Group’s average cost of common equity would be lower than the 8.85% value Mr. McNally estimated. In Staff’s judgment, given the difference between the implied forward-looking financial risk for the Utilities and the average financial risk of the Gas Group, it is necessary to impute a capital structure for the Utilities. Staff IB, at 58-59.

The Utilities also argue that, their proposed capital structure“[supports the Utilities’ current “A” *issue* credit ratings, ratings that have allowed the Utilities to access the capital markets and obtain capital at reasonable cost even in the wake of the credit crisis of 2008-2009.” Utilities IB, at 94-95. However, the Utilities actually have a BBB+ *issuer* credit rating. ICC Staff Ex. 4.0, at 7. The Utilities mix apples with oranges in that they confuse “issuer” with “issue.” Ms. Kight-Garlisch explained she used the *issuer* credit ratings for the Utilities instead of their Senior Secured Debt ratings, which the Utilities reference above, which are *issue* credit ratings. S&P defines an *issue* credit rating as:

> A Standard & Poor's issue credit rating is a current opinion of the credit worthiness of an obligor with respect to a specific financial obligation, a specific class of financial obligations, or a specific financial program.

Whereas, S&P defines an *issuer* credit rating as:

> A Standard & Poor's issuer credit rating is a forward-looking opinion about an obligor's overall financial capacity (its creditworthiness) to pay its financial obligations.

Staff's credit rating comparison was based on the S&P matrix. S&P uses *issuer* credit ratings as the baseline for *issue* credit ratings and then establishes the *issue* credit rating depending on S&P's assessment of the recoverability of outstanding interest and principal of an *issue* in the event of default. The ratings based on the S&P risk matrix are *issuer* credit ratings. ICC Staff Ex. 13.0C, at 5.

The Utilities also erroneously argue that Staff's inclusion of short-term debt in their capital structure weakens the capital structure that has "allowed them to maintain reasonably strong credit ratings." NS-PGL IB, at 96. The Utilities are wrong. The credit rating agencies already factor in all of the Utilities' debt, including its short-term debt when assessing credit ratings. ICC Staff Ex. 13.0C, at 4.

e. Staff's Use Of The Gas Group Is Proper

The Utilities complain that "Staff's use of the Gas Group to impute capital structure was improper." Utilities IB, at 99. This issue is really about whether (1) the Utilities' proposed capital structures are lawful under Section 9-230 and reasonable for ratemaking purposes; and if not (2) whether imputing a capital structure based on the Gas Group capital structure meets those legal standards instead. Since Staff has addressed those issues above, we will not repeat them here.

2. North Shore

See VI(B)(1) above.

C. Cost of Long-Term Debt

1. Peoples Gas

The Utilities contend that "the Peoples Gas' Series PP long-term debt does not exist." They note that it "was retired in 2008." Utilities IB, at 103-04. In response to Staff's position that because the Commission has not entered a final order in Docket No. 11-0476, Staff continues to recommend that Series PP remain in Peoples Gas' average 2012 balance and cost of long-term debt.

In response, the Utilities contend that Peoples Gas "did not need Commission approval to retire the Series PP bonds and they have been retired." Regardless of the use of the term "retired," the important fact is that the Commission ordered the Company to come before it for approval of the Series PP long-term debt transaction under Section 7-102. Since the Commission has not approved Peoples Gas' retirement of the Series PP long-term debt as required by Section 7-102, the entire transaction is *void ab initio*, or in other words it is treated as if it never existed, until such time as the Commission approves it, if it will approve it.

In *Metro Utility Co. v. Illinois Commerce Commission*, 634 N.E.2d 377 (2nd Dist. 1994)("*Metro*"), the Commission refused to review certain expenses in a rate case because these expenses arose from an affiliate contract that was not approved by the Commission as required under Section 7-101 of the PUA. The Commission argued that "[a]llowing a public utility to use an unapproved contract as the basis for establishing expenses in a rate case would allow the public utility to circumvent largely the section 7-

101 approval requirement." *Metro*, at 383. The appellate court agreed with the Commission and concluded that "unapproved affiliated interest contracts are void [and] the Commission is required to disallow such contracts in a ratemaking proceeding." *Id*. The Metro court explained that:

> [U]nder section 7-101 the Commission was required to disallow Metro's unapproved affiliated interest contracts in Metro's ratemaking case. This is because the plain language of section 7-101(3) provides that every public utility contract or arrangement with an affiliated interest not approved by the Commission under section 7-101 shall not be effective and is void. Because the unapproved contracts were of no effect and void, they could not serve as the basis for test year expenses.
>
> *Id.*, at 382.

In this proceeding, although the Peoples Gas' Series PP long-term debt needs Section 7-102 approval, not 7-101, the same legal principle applies. Moreover, if the Commission were to ignore the Peoples Gas' Series PP long-term debt in this proceeding, it would be pre-determining and tying its hands in the 11-0476 Section 7-102 proceeding. *See e.g., Gibbs v. Consolidated Gas Co. of Baltimore*, 130 U.S. 396, 410 (1889)("The law cannot recognize as valid any undertaking to do what fundamental doctrine or legal rule directly forbids. Nor can it give effect to any agreement the making whereof was an act violating law."); *Chicago and Western Indiana Railroad Co. v. Englestein*, 333 Ill. 117 (1928). Consequently, because the Commission has not entered a final order in Docket No. 11-0476, Staff continues to recommend that Series PP remain in Peoples Gas' average 2012 balance and cost of long-term debt.

2. North Shore

See VI(C)(1) above.

D. Cost of Short-Term Debt

1. Peoples Gas

Other than whether short term debt should be included in the capital structure (addressed above), there is no issue on the cost of short-term debt.

2. North Shore

See VI(D)(1) above.

E. Cost of Common Equity

1. Peoples Gas

a. Overview

With respect to the cost of common equity, the Companies' initial brief is largely based on two general arguments: (1) the Companies conclude, from results-based comparisons, that Staff's recommendation is so "extremely low" as to be "unworthy of serious consideration" and (2) the Companies suggest that their analysis has been entirely consistent, while Staff's analysis has been inconsistent, as a result of Staff's apparent "partisan" "policy objective." NS-PGL IB, p. 94. While their attacks on Staff's character and integrity lack any basis in reality, the seriousness of the charges and the effects the Companies' overstated cost of common equity estimate would have on the Companies' customers are very real indeed and, thus, demand response.

To begin with, the Companies compare Staff's results to other authorized returns over the last 20 years and conclude that Staff's recommendation must be too low. NS-PGL IB, pp. 86-89. Staff addressed this in its Initial Brief. Staff IB, pp. 69-70. The Companies refer to those comparisons as a "back-drop of real-world financial market data." NS-PGL IB, p. 90. However, looking at <u>historic</u> regulatory data to judge <u>current</u>

return requirements ignores the current real-world financial data. That data, including market prices, interest rates, and the Companies' current risk level, indicate a return of 8.75%, as Staff's analysis demonstrated. In fact, the analysis presented by the Companies' own witness provides a remarkably similar result, when adjusted for consistency with the Companies' last rate case. Both Staff's and the Companies' recommendations are approximately 115 basis points lower in this case than in the last case, based on an apples-to-apples comparison. Staff IB, p. 70. The current market environment of uncertainty that the Companies frequently cite pushes investors to less risky investments in a flight to quality, driving the prices of those investments up, indicating that investors are willing to accept a lower ROE to invest in those safer investments. Utilities are among those safer investments, as evidenced by their betas, which are substantially below the market beta of one. Staff IB, p. 72. Moreover, interest rates are near a 20-year low. Staff IB, pp. 69-70. Mr. Moul acknowledges that ROEs are a function of interest rates. PGL Ex. 3.0 REV., p. 30; PGL Ex. 3.13E, p. 1. Thus, low interest rates suggest a lower ROE. Finally, the Companies continue to ask for, and receive, riders that reduce their risk relative to what they were even a few years ago, let alone up to 20 years ago. Staff's result is consistent with this real-world financial data – as one would expect, since it is based on that real-world financial data. In contrast, the Companies' proposal is inconsistent with current real-world financial data. Despite all the current real world data indicating a falling ROE, the Companies not only seek to look backward to justify their ROE recommendation, but, in fact, recommend an ROE above the recent average of the historical authorized ROEs they cite. NS-PGL IB. pp. 89, 112-113.

The Companies note that financial markets remain at higher levels of volatility than before the 2008 financial crisis. NS-PGL IB, p. 88. However, the Companies' selective comparison fails to establish the larger context. This is not surprising, for had they done so, it would reveal that the volatility from the time of Mr. Moul's analysis through Mr. McNally's July 20, 2011 update was consistently below the 20-year average. Staff IB, pp. 78-79; NS-PGL Ex. 36.0, p. 4. Clearly this was not a period of high volatility, as the Companies imply.

The Companies also suggest that Staff "ignore[s] the realities that drive the Utilities' cost of capital and rely instead upon their opinions about what the Utilities' costs should be." NS-PGL IB, p. 85. This is an absolutely incredible statement for the Companies to make, as a recurring theme in the Companies' witnesses' testimony is that the model results are mere guidelines – that *their* opinions of what the Companies' costs of capital should trump the model results – going so far as to remove market-based model results because, based on Mr. Moul's opinion, the model is not producing the proper results. Indeed, when asked whether Staff and GCI witnesses used judgment in interpreting the results of the models, Mr. Moul responded, "Not as much as I would like to see them use." Tr., August 31, 2011, p. 495. Moreover, the Companies' initial brief later complains that Staff and GCI "urge the Commission to focus primarily if not exclusively on their model results." NS-PGL IB, pp. 90-91. Thus, the Companies' position is unclear: did Staff rely on its judgment too much or not enough? All we know is that the Companies disagree with whatever Staff did. Thus, contrary to the Companies' claim, their argument regarding Staff's ROE recommendation is clearly not about the degree of judgment Staff used. Indeed, the Companies cannot even seem to make up their own mind about just exactly what degree of judgment Staff did or did not use. Rather, this is an example of the Companies grasping for criticisms because they are displeased with the results Staff's objective, market-based analyses produced.

In fact, the Companies' initial brief is replete with general truisms that the Companies couch as criticisms of Staff's analysis. The issue of judgment, as discussed above, is a prime example. The Companies suggest that Staff's analysis is somehow invalid because of Staff's use of judgment. However, all analysts use judgment, including the Companies' own witness. Indeed, as noted above, the Companies' primary cost of equity witness suggests that Staff should have used more judgment. Thus, whether or not a party used judgment in its analysis reveals nothing and does nothing to advance the argument. The Companies also note that Staff's models have theoretical shortcomings. NS-PGL IB p. 91. The Companies cannot get their facts straight here either. Mr. McNally testified that the DCF and CAPM models are correctly specified (Staff Ex. 5.0, p. 18), which the Companies' witnesses did not contest. This means that the models are theoretically correct. Nonetheless, all cost of equity measurement models require some inputs such as investor expectations of growth and non-diversifiable risk that cannot be observed. Thus, proxies are needed. This is a shortcoming of implementation, not theory, that applies to all models, including the Companies' own models. Thus, this is just another general truism that reveals nothing regarding the Companies' cost of common equity. The Companies then go on to state that "[a]t best, these models can only model the real world." NS-PGL IB, p. 91. Of course! What other purpose would a model serve? This is yet another general truism. However, it is unclear just what point the Companies are trying to make. They conclude that the models should not control over reality. But the reality is that no one can observe investor expectations, so any ROE estimate will necessarily involve modeling, which the Companies' initial brief later acknowledges. NS-PGL IB, p. 104. For example, extrapolating current expectations based on past authorized ROEs is a form of modeling, albeit a poor one, as Staff explained. Staff IB, p. 69. The Companies seem to be suggesting that the past realities of other companies with other risk levels under other circumstances should control over the current realities facing Peoples Gas and North Shore. That is clearly false. The Companies have also devoted much effort to describing possible ramifications if they are authorized a rate of return below their cost of capital. NS-PGL IB, pp. 86-88, 96, 98-99. However, no one disputes that there could be negative consequence, **if** the Companies are not given the opportunity to earn their investor required rate of return. But that, too, is nothing more than a general truism. Moreover, it fails to address the truly critical issue, which is determining just what the Companies' investor required rate of return is.

The Companies' initial brief also contains numerous personal attacks on Staff's integrity and character. The Companies' allegations of unethical behavior on Staff's part are gratuitous, offensive, unsubstantiated, and false. The following are examples of the insinuations of some sort of impropriety on Staff's part from the Companies' initial brief:

- Staff is not approaching cost of capital with the intent of making recommendations that balance utility shareholder and customer interests. NS-PGL IB, p. 94.
- Staff has become partisan and pursues reductions in utility capital costs as a policy objective. NS-PGL IB, p. 94.
- Staff would "prefer" that the Commission ignore, or at least minimize its consideration of, real-world information. NS-PGL IB, p. 90.

- Staff has used different methodologies to justify extreme positions. NS-PGL IB. p. 92.
- Staff's principal components analysis was "designed to reach a desired result." NS-PGL IB. p. 93.
- Mr. McNally picked growth rate sources "to suit his purposes." NS-PGL IB, p. 117.
- Staff is neither credible nor conscientious. NS-PGL IB, p. 115.
- Staff relied on self-calculated betas that are "biased on the low side" because published betas were not sufficient "for Staff's purposes." NS-PGL IB, 120-121.

The number of these attacks is not indicative of a party that simply got carried away once or twice, but rather, indicates that the Companies have embraced character assassination as a general strategy.

The Companies claim that Staff's principal components analysis "appears to have been designed to reach a desired result." NS-PGL IB, p. 93. They further claim Staff did not explain why it was necessary to present that analysis in its rebuttal testimony. However, as is quite evident from Mr. McNally's rebuttal testimony, Mr. McNally presented his principal components analysis directly in response to Mr. Moul's insistence in his rebuttal testimony that Mr. McNally should have adjusted his ROE estimate for the alleged difference in risk between the Gas Group and the Companies, even though Mr. Moul had not done so in his own analysis. Staff Ex. 14.0, p. 28. Moreover, Staff explicitly detailed this in its Response to the Companies' Motion to Strike. The ALJs obviously found that it was explained sufficiently, as that Motion was denied – twice. Tr., August 29, 2011, pp. 39-41. Despite those rulings, the Companies continue to press the issue, asking Mr. McNally at hearing for an explanation that had already been clearly provided in Staff's Response to the Companies' Motion to Strike. Mr. McNally then, once again, explained his reasoning. Tr., August 31, 2011, p. 531-

534. For the Companies to now claim that "Staff offered no explanation" is demonstrably false. Ironically, it is the Companies who fail to provide any justification for their claim that that analysis "appears to have been designed to reach a desired result." One reason for that omission would be because, of course, it was <u>not</u> designed to reach a desired result.[3]

The Companies suggest Staff's ROE analysis is plagued by inconsistencies, while Mr. Moul's analysis has been "entirely consistent." NS-PGL IB, pp. 5-6,84-85, 92-94, 111-113; NS-PGL Ex. 36.0, p. 5. The Companies' claim is wildly inaccurate. Staff has already demonstrated that not only are the Companies' criticisms internally inconsistent, but they are inconsistent with the Commission decisions and the Companies' own arguments in their last case, and even inconsistent with the Companies' own arguments in this proceeding. Staff IB, p. 70, 73-74; Staff Ex. 14.0, pp. 13-15. The appalling degree of inconsistency in the Companies' criticisms continues in the Companies' initial brief. The Companies cite two "significant ways" that Staff allegedly changed its methodology with respect to ROE. First, the Companies claim that, of their three most recent rate cases, this proceeding represents the first time Staff took issue with the comparability of the Gas Group to the Companies. In fact, they state that "Staff in the Utilities' last two rate cases accepted Mr. Moul's Gas Group for the mathematical ROE models <u>without presenting any analysis</u>." NS-PGL IB. p. 93, emphasis added. That is absolutely false. Indeed, in <u>**the very next paragraph**</u> in their

[3] Significantly, Staff did not adjust the Gas Group's cost of common equity downward despite the fact that Staff's principal components analysis indicates that PGL is less risky than the Gas Group. Rather, Staff used the principal components analysis for the limited purpose of testing Mr. Moul's claim that the Companies are sufficiently greater in risk to cause Mr. McNally to underestimate their costs of common equity. Staff Ex. 14.0, p. 28-29.

initial brief – a paragraph that purports to present the next “significant way” that Staff allegedly “changed its methodology” – the Companies state the **exact opposite**:

> In the Utilities’ last two rate cases, after applying its financial models, Staff performed a financial risk analysis comparing the Utilities to the Gas Group to propose downward adjustments to the Utilities’ ROEs. In this case, Mr. McNally presented no such analysis.

NS-PGL IB, p. 94, emphasis added. Thus, the Companies not only directly contradict themselves in back-to-back paragraphs within the same document, but ironically, those two paragraphs are purported to demonstrate Staff’s “ever-changing and inconsistent methodologies.” Both paragraphs are factually incorrect. Staff clearly presented analyses of the risk of the Companies relative to the Gas Group in each of those three cases (including risk analyses by both Mr. McNally and Ms. Kight-Garlisch in this proceeding). Moreover, in each case Staff adjusted its cost of capital for the risk differential indicated in the respective risk assessment. Staff Ex. 4.0, pp. 5-9; Staff Ex. 13.0, p. 5-8; Staff Ex. 14.0, p. 33-36; ICC Docket Nos. 07-0241/07-0242 (Cons.), Order, February 5, 2008, pp. 78, 80, 85, 94-95; ICC Docket Nos. 09-0166/09-0167 (Cons.), Order, January 21, 2010, pp. 105-106. In fact, the Companies should be well aware that Staff performed a risk analysis, and made a subsequent risk adjustment, in the Companies’ last rate case, since it is the subject of, and was upheld in, a very recent Appellate Court decision.[4] People v. Illinois Commerce Comm’n, Nos. 1-10-0654, 1-10-0655, 1-10-0936, 1-10-179-, 1-10-1846 and 1-10-1852, Consolidated, Appellate Court

[4] The only material difference between the Staff risk analyses across the Companies’ three most recent rate cases is that in this case, Staff proposes to adjust the Companies’ capital structures rather than apply financial risk (and Section 9-230 based) adjustments to the costs of debt and common equity.

(First District-Fifth Division) September 30, 2011, Slip Opinion, p. 49. Likewise, the Companies' claim that their analysis has been "entirely consistent" is not based in reality. In fact, their inconsistencies are so numerous that Staff does not have the time to address them all. Nevertheless, below are some of the most egregious examples:

- Mr. Moul discards his DCF results in this proceeding due to recent economic conditions, but accepted his DCF results in the Companies' last rate case when that argument would have been much more applicable.
- Mr. Moul used Value Line growth rates in the last rate case, but not in this case, despite presenting nearly identical growth rate discussions in both cases.
- Mr. Moul did not use Morningstar growth rates in the last rate case, but did use them in this rate case.
- Mr. Moul did not find Value Line's published growth rates suitable for use in his analysis, yet he used Value Line data to defend his use of Morningstar growth rates.
- Mr. Moul applies an "outlier" line of reasoning for discarding his DCF results, but does not do so for his Morningstar growth rates, when that reasoning actually applies to the growth rates but not to his DCF results, since the results of the other ROE analyses to which his DCF results were compared are inappropriately inflated.
- Mr. Moul utilized a second proxy group in this proceeding, but did not do so in the Companies' last rate case.
- Mr. Moul uses Blue Chip forecasts for the next six quarters (i.e., 3Q 2011 through 4Q 2012 (see PGL Ex. 3.0, p. 38; NS-PGL Ex. 19.09)) in his analysis, but changed his position at hearing, saying that the forecast for the fourth quarter of 2012 was the most relevant.[5]
- Mr. Moul argues that Mr. McNally should have made an upward adjustment to his ROE estimate even though Mr. Moul did not make such an adjustment to his own estimate.
- Mr. Moul mixes and matches changes in his Combination Group DCF results with changes in his Gas Group CAPM results in his rebuttal testimony update.

[5] This switch is even less comprehensible in light of the Companies' election to file rate cases in 2012 rather than enter into a sourcing agreement with a clean coal SNG brownfield facility.

We must give the Companies credit for one consistency in its case: every single one of those inconsistencies increases the Companies' estimate of their cost of common equity.

All the above notwithstanding, the primary issue in this proceeding is <u>not</u> the degree of judgment used…or authorized returns from up to 20 years ago…or fabricated inconsistencies…or allegations of missing explanations…or unspecified relative risk adjustments…or Staff's integrity. The real issue is that the Companies do not want to accept the cost of common equity produced by current market data applied to the market-based models the Commission has consistently relied on for many years. Thus, the Companies have manufactured every argument they could in a desperate attempt to obfuscate the facts. Indeed, they implore the Commission to turn from the record evidence and, instead, "ask itself" what ROE investors would consider reasonable. NS-PGL IB, p. 90. Of course, that is no surprise, since the record does not support the Companies' position. In fact, the only way the Companies' recommendation could be accepted, would be to ignore the record and emphasize judgment – their judgment – over objective analyses.

The unadulterated market results of established cost of equity models indicate a much lower cost of common equity than the Companies propose. The difference between the Companies' and Staff's cost of common equity recommendations is due almost entirely to Mr. Moul's adjustments to those models, or the results thereof; his growth rate; and his inclusion of a risk premium model. Staff Ex. 14.0, p. 2. Both the adjustments he applied and the use of a risk premium model have been repeatedly rejected by this Commission in prior proceedings, while the derivation of his growth rate estimate represents an unfounded departure from the approach he used in the last proceeding. Without the augmentation from those factors, the Companies' ROE result would be almost identical to Staff's. Specifically, inputting the Companies' own dividend, price, growth rate, interest rate, beta, and market return estimates into the DCF and CAPM the Commission has typically relied on produced a cost of common equity of 9.23%, before Mr. Moul added his leverage adjustment (0.465%) and his size adjustment (0.60%). NS-PGL Ex. 9.02; NS-PGL Ex. 9.09, p. 1. Additionally, if Mr. Moul had used a simple average of the growth rates from the same sources he used in the Companies' previous rate case, that 9.23% estimate would fall to 8.89%. That is only 4 basis points different than Staff's cost of equity estimate, before adjustment for Rider UEA. When it comes down to it, current market environment, interest rates, objective market-based models, the falling ROEs indicated by both witnesses' recommendations in this case and the Companies' last rate case, and even the unadjusted ROE resulting from the Companies' inputs in this proceeding <u>all</u> support a cost of common equity similar to Staff's estimate. None support the Companies' recommended ROE.

b. Sample Comparability

The Companies maintain that Peoples Gas and North Shore are higher in risk than the companies that compose the Gas Group. NS-PGL IB, pp. 103-106. Although the Companies spend a substantial portion of their initial brief on this issue (6½ pages), it is not clear why, as the Companies seem to have abandoned Mr. Moul's claim that Mr. McNally should have adjusted his cost of equity estimate for this alleged risk differential. Abandoning that claim would be logical, since Mr. Moul did not make such an adjustment to his own cost of equity estimate. However, given that the parties seem to agree that no risk adjustment is warranted, the Companies' decision to continue to argue this issue in its initial brief is perplexing. Nonetheless, so that there is no mistake, Staff will address the Companies' arguments and explain why no risk adjustment is necessary.

This issue and its evolution are really quite simple. Based on a rudimentary analysis, Mr. Moul concluded that the Companies are riskier than the Gas Group, but apparently found the alleged risk difference to be insufficient to warrant any adjustment to the ROE. Mr. McNally reasonably concluded that the operating risks of the Companies and the Gas Group are similar,[6] accepted Mr. Moul's sample, and proceeded to use it in his analysis of the Companies' investor required rate of return on common equity. Staff Ex. 5.0, p. 2. Like Mr. Moul, Mr. McNally made no adjustment to his sample ROE to reflect any alleged risk differential between the Companies and the Gas Group. Thus, a rational person would expect the Companies to have no objection to Mr. McNally's adoption of the same sample and the same (non)adjustment as Mr. Moul applied. However, after making no cost of equity adjustment to his own ROE estimate, Mr. Moul criticized Mr. McNally's ROE estimate for doing the same. NS-PGL Ex. 19.0, p. 10. In response, Mr. McNally explained the critical flaws in Mr. Moul's relative risk assessment and, in the alternative, presented a more comprehensive qualitative and quantitative analysis to more accurately assess the overall risk of the Companies relative to the Gas Group. Contrary to Mr. Moul's conclusion, Mr. McNally's

[6] Mr. Moul selected the companies in the Gas Group wholly on the basis of their business operations, which reflect their operating risk. In addition to the business operations similarities upon which Mr. Moul selected his sample, the S&P business risk profiles for every company in the Gas Group, and both Peoples Gas and North Shore, is in the "Excellent" category, which is their lowest business risk category. Staff Ex. 14.0, p. 29. Ms. Kight-Garlisch dealt with the financial/overall risk of the Companies relative to the Gas Group.

analysis established that the Companies are, if anything, slightly lower in risk than the Gas Group. Thus, it is clear that no upward ROE adjustment is warranted.

Mr. McNally demonstrated that *each* of the seven factors Mr. Moul reviewed in his rudimentary risk assessment was either critically flawed or did not support Mr. Moul's conclusion. Staff Ex. 14.0, p. 32. For example, one of those factors was the variability of the return on book equity, as measured by the coefficient of variation. Mr. McNally presented four reasons why Mr. Moul's reliance on that factor is improper. Staff Ex. 14.0, p. 31. One of those four reasons was that the coefficient of variation for the Companies is based on distorted data, as its calculation was based on data from 2005 through 2009, which reflected $300 million in refunds to customers, forgiveness of bad debt, and other costs (the "Refunds") related to alleged improper gas charge reconciliations that the Commission found, with respect to the Peoples Gas, to move beyond imprudence to egregious.[7] Thus, any ratio calculated from that data presents a distorted view of the risk of the Companies. Three of the seven factors Mr. Moul reviewed, including the coefficient of variation, are distorted by this error.

In response, the Companies claim it is Mr. McNally's criticism of Mr. Moul's analysis that is flawed. NS-PGL IB, 105. However, the only support they present in defense of Mr. Moul's risk assessment is to suggest that the impact of the Refunds on the coefficient of variation factor is relatively small. Specifically, Mr. Moul estimated that the after-tax net income effect of the Refunds would be $62 million and $2.6 million for Peoples Gas and North Shore, respectively in 2006. NS-PGL Ex.36.0, p. 9. It is not

[7] Docket No. 01-0707, Order, March 28, 2006, pp. 138-140. Essentially, if the Commission raised the Companies' rate of return on common equity on the basis of Mr. Moul's risk analysis, it would allow the Companies to exact a risk premium from its customers for People Gas's egregious behavior.

clear that Mr. Moul's estimates are correct, as Mr. Moul's testimony does not explain how he calculated the after-tax net income impact of the Refunds. Further, Mr. Moul did not provide similar figures for 2007, during which Refunds also occurred. Staff ex. 14.0, p. 30. Nevertheless, in comparison, Staff's recommended net operating incomes for the 2012 test year, six years and three rate cases later, are $88 million and $13 million for Peoples Gas and North Shore, respectively. Staff IB, Appendix A, p. 1 and Appendix B, p. 1. Thus, the 2006 after-tax effect Mr. Moul presented would represent a **70%** reduction to Peoples Gas's 2012 net operating income and a **20%** reduction to North Shore's 2012 net operating income. If the Companies find a change to net income of that magnitude to be insignificant, it is not clear why they are quibbling over a potential risk adjustment for which the effect on the Companies' revenue requirements would be miniscule in comparison. Moreover, any ratio calculation that is not significantly affected by a change in income of that magnitude is not sensitive enough to be of much value in pinpointing a company's operating risk. Thus, even though the Companies only attempt to address *one* item in *all* of Mr. McNally's criticisms of Mr. Moul's risk assessment, that attempt only serves to further establish that that factor is not appropriate for assessing relative risk. Moreover, the Companies' response did not even attempt to address the effect of the Refunds on the other two factors distorted by the Refunds, the other three problems with the coefficient of variation noted by Mr. McNally,[8] nor the inapplicability of the other four factors. Thus, the Companies'

[8] This includes a violation of the mathematical order of operations in calculating the Gas Group average for the coefficient of variation. Since the sample average is miscalculated, any comparison to that "average" is meaningless. Mr. Moul calculated the coefficient of variation for the Gas Group by first averaging the returns and then calculating a single coefficient of variation for the sample, rather than calculating separate coefficients of variation for each company in the (continued…)

response clearly fails to redeem Mr. Moul's risk assessment. As a result, the record is devoid of any support for an unspecified upward ROE adjustment based on the risk of the Companies relative to that of the Gas Group.

With regard to Mr. McNally's risk assessment, the Companies claim that it "fails to support a finding that Peoples Gas' investment risk is lower than the Gas Group's investment risk." NS-PGL IB, p. 106. However, given that an upward ROE risk adjustment is without basis in the record (or even the advocacy of the Companies) and that Staff did not propose a downward ROE risk adjustment, Staff's finding that the Companies' total risk levels are the same or slightly lower than those of the Gas Group is of minimal significance. Yet, the Companies dedicate nearly five pages of their initial brief to addressing Mr. McNally's risk analysis.

The Companies' protestations against Mr. McNally's risk assessment appear to be another unfortunate attempt to resurrect their twice-failed Motion to Strike Mr. McNally's principal components analysis. Unfortunately, the Companies' arguments on this subject are laden with falsehoods and misconceptions. For example, in attempting to paint Mr. McNally's principal components analysis as extremely complex and unusual, Mr. Moul vehemently proclaimed that that analysis is "unlike any I have seen in my 35 years of performing ROE analyses and testifying on them." NS-PGL Ex. 36.0, p, 9. However, the record demonstrates that his absolute statement is absolutely false. In fact, both Mr. McNally and Mr. Moul participated in an IAWC rate proceeding in which Mr. McNally also presented a principal components analysis to Mr. Moul. Order, ICC

(continued from previous page)

Gas Sample and then averaging them. Staff Exhibit 14.0, p. 31; PGL Ex. 3.0, p. 10; PGL Ex. 3.3, p. 1.

Docket No. 00-0340 (Illinois-American Water Company), February 15, 2001, pp. 8, 10-12. Mr. Moul also claimed that the work papers Staff provided do not let him know the years involved in Mr. McNally's analysis. NS-PGL Ex. 36.0, p. 10. That, too, is fallacious. Not only were the years involved included in Staff's work papers, but they were explicitly noted in Mr. McNally's testimony. Staff Ex. 14.0, p. 33. The Companies argue that Staff failed to explain whether the data was all calendar year or fiscal year. NS-PGL IB, p. 107. That is false as well. Mr. McNally indicated that the data was the end-of-year data published in company annual reports, except for the equity ratio, which was a four-quarter average. Tr., August 31, 2011, pp. 541, 557. In addition, citing only the transcript, the Companies assert that Staff did not disclose how the data used in the ratios was averaged over the three year period. NS-PGL IB, p. 107. That, too, is false. Although Mr. McNally, under cross examination, was unable to recall at that moment a specific detail from an analysis he had run more than three weeks earlier, that information was provided in his work papers. The Companies also suggest that Staff was not forthcoming with underlying data and equations. NS-PGL IB, p. 107. That is simply false. First, the work papers Staff provided contained the data necessary for the Companies, with a little bit of effort on their part, to replicate Staff's analysis on readily available statistical software.[9, 10] Staff provided the Companies the ratio inputs from which its principal components analysis was run. The Companies grouse that the underlying data to those ratios was not provided. However, they did not need that data,

[9] The SAS manual from which the Companies' own exhibit, NS-PGL Cross Ex. 3, was drawn states, "…after completing a chapter on a given topic, you will understand the basic issues related to the analysis. You will also be able to write SAS programs to perform the analysis…." Staff Ex. 21.

[10] Staff is not obligated to provide the Companies with software to create programs.

since Staff provided them with the ratios themselves. Second, the Companies did not need Staff to provide the underlying data for them anyway, as it was publicly available information. Third, they could have requested additional information through discovery requests. In fact, they did send data requests, which Staff answered in a timely manner. Fourth, the Companies were invited to view the information Staff was unable to provide (due to copyright law) at Staff's offices. The Companies did not avail themselves of that opportunity. Thus, Staff did not fail to disclose information. If the Companies failed to procure the information they ultimately desired, they have no one to blame but themselves.

The Companies also suggest that Staff's principal components analysis was not performed properly. NS-PGL IB, p. 108. The Companies cite a SAS software manual and pedantically insist on a strict adherence to the guidance therein as a matter of some imagined absolute statistical law. However, that textbook[11] is not a definitive statistical rulebook, but a software user's guide. In fact, the manual itself refers to its recommendations as "guidelines." NS-PGL Cross Ex. 3, p. 3. Moreover, that manual is not written primarily for the analysis of accounting data, but is targeted largely toward social sciences. Indeed, the very first sentence in the description of its purpose states that the manual is "designed to provide an easy-to-understand introduction to some of the more advanced statistical procedures used in social science research." That section further states that it will enable the reader to "summarize the results according to the guidelines of the *Publication manual of the American Psychological Association*

[11] It is not clear why the Companies' initial brief quotes the word "textbook" when referencing this manual. It is, by definition, a textbook. In fact, the manual refers to itself variously as a "text" and a "book." Staff Ex. 21.

(the most widely used publication format in the social science literature)." Staff Ex. 21. Furthermore, throughout the chapter cited by the Companies, the manual follows an example of how to interpret attitudes based on opinions expressed through a job satisfaction survey.[12] As Mr. McNally explained, attitudes gleaned from a job satisfaction survey are not nearly as precise as the accounting data underlying Mr. McNally's analysis. Thus, certain guidance provided for the manual's broader target audience may not be perfectly applicable in the analysis of utility risk. Tr., August 31, 2011, pp. 614-615. The Companies' priggish emphasis on those guidelines, as if absolute statistical law, does not render Staff's principal components analysis invalid, but rather, reveals the Companies' lack of comprehension of the analysis.

For example, the Companies take Mr. McNally to task with respect to his performance of a "scree test" discussed in the SAS manual, noting that he "admitted" his scree test was not performed using a graphical plotting of the data. NS- PGL IB, p. 108. However, as Mr. McNally explained, a graphic presentation is not required to perform a scree test. Tr., August 31, 2011, pp. 5931-594. The SAS manual explains the scree test as follows:

> Why do they call it a "scree" test? The word "scree" refers to the loose rubble that lies at the base of a cliff. When performing a scree test, you normally hope that the scree plot will take the form of a cliff: At the top will be the eigenvalues for the few meaningful components, followed by a break (the edge of the cliff). At the bottom of the cliff will lie the scree: eigenvalues for the trivial components.

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[12] For example, the manual's hypothetical example uses a principal components analysis to interpret responses to statements such as: on a scale of 1 to 7, assess your level of agreement with the following sentence: My supervisor treats me with consideration. NS-PGL Cross Ex. 3, p. 3.

Next, perform a scree test and look for obvious breaks in the eigenvalues. NS-PGL Cross Ex. 3, pp. 25 and 27. One does not need a graph to understand that the "break" in a series of, for example, 1, 2, 3, 4, 11, 12, 13 falls between the fourth and the fifth observed factors.[13] Plotting those numbers on a graph would provide nothing more than a visual aide. Similarly, Mr. McNally explained that there was "a pretty big gap" between his fourth and fifth principal components, which confirmed the propriety of retaining 4 factors for his analysis. Tr., August 31, 2011, pp. 591-592. The Companies' arguments exhibit a classic example of the difference between knowledge and understanding, for they can recite what they've read, but fail to comprehend its meaning.

The Companies also questioned Mr. McNally's analysis because he "predetermined the numbers of factors" he would retain for that analysis. NS-PGL IB, p. 108. Like their scree test argument, this argument also reveals a lack of understanding on the Companies' part, despite the fact that it, too, was explained by Mr. McNally. A principal components analysis is intended retain factors that account for a meaningful amount of variance and eliminate those that do not. But the variance explained by each factor cannot be known until the program is run. Thus, as Mr. McNally explained, the analyst must input the number of factors to retain, run the program, and then review the output to test the suitability of his selected number of factors. If the output fails the tests, a different number of factors is selected, and the process is repeated. The number of factors Mr. McNally input was "an educated guess based on our past

[13] In precisely the same way, one does not need a graph of the Companies' previously authorized ROEs and the parties' ROE proposals to understand that the Companies seek to increase the authorized ROE, while the other parties' proposals would decrease the authorized ROE. NS-PGL IB. pp. 112-113.

practices and past knowledge of what typically…falls out from these" analyses. Mr. McNally further explained that the suitability of retaining four factors was confirmed by each test of the output. Tr., August 31, 2011, pp. 592-593. It should also be noted that the Companies' initial brief misleads when it notes, without providing any context, that the retention of a fifth factor would have reduced the unexplained variance by nearly half. NS-PGL IB, p. 108. As Mr. McNally explained, each subsequent factor adds less and less explanatory value. Tr., August 31, 2011, p. 595. The first four factors had already accounted for approximately 79% of the total variation, leaving only approximately 21% of the variance to be explained by the other eight factors combined. While the fifth factor contributes the most toward explaining the remaining 21%, it still accounts for only approximately 8% of the total variance.[14] NS-PGL Cross Ex. 5, p. 2. Thus, the fifth factor was rightfully categorized among the "scree," or factors that explain a minimal amount of the total variance, and discarded. As noted above, multiple tests confirmed the suitability of retaining four factors; none suggests a fifth factor should have been retained.

The Companies also criticize Mr. McNally's principal components analysis for the "inclusion of different types of companies into the sample population than used in Mr. Moul's analysis." NS- PGL IB, p. 108. However, the Companies did not establish that a risk comparison must involve only the companies used by Mr. Moul. Mr. McNally explained at hearing that each of the 95 companies he employed in his principal components analysis is in the regulated utility industry. Tr., August 31, 2011, pp. 575-

[14] $8 \div 21 \approx 38\%$. Thus, the Companies' characterization of the fifth factor's explanatory power as "nearly half" of the 21% variation explained by the 8 discarded factors, is an exaggeration.

578. His principal components analysis compares the risk level of the Companies relative to that of the sample companies via factor scores calculated in terms of standard deviations from the regulated utility industry average. Those scores indicate that the Companies' total risk levels are the same or slightly lower than those of the Gas Group. Those results were confirmed by two analyses performed by Ms. Kight-Garlisch. Staff Ex. 14.0, pp. 33-36.

The Companies also criticize Mr. McNally's principal components analysis, claiming it is based on an "inadequate sample size." NS-PGL IB, p, 109. The rule of thumb given in the SAS manual is that the number of "subjects" should be the greater of 5 times the number of variables being analyzed, or 100. NS-PGL Cross Ex 3, p. 13. The 95 utilities, or "subjects," Staff's analysis utilized was well above the 60 required by the former and just shy of the latter. Tr., August 31, 2011, pp. 583-584. As explained previously, the SAS manual the Companies cite is targeted toward social science applications, and its instructions are guidelines rather than absolute statistical requirements and are not applicable to risk analysis based on precise, regimented accounting data. The context would have been clear to the Companies if they had bothered to look at the title of the section from which they draw their citations: "Example: Analysis of the Prosocial Orientation Inventory." NS-PGL Cross Ex. 3, p. 1. The next few paragraphs of the manual set forth an example of a survey in which the participants are asked to score how frequently they engage in specific activities using a scale of one to seven. NS-PGL Cross Ex. 3, pp. 10-11. This social science perspective is even evident in the subsection specifically addressing the number of observations:

> Principal component analysis is a large-sample procedure. To obtain reliable results, the minimal number of <u>subjects</u> providing usable data for the analysis

> should be the larger of 100 subjects or five times the number of variables being analyzed.
> To illustrate, assume that you wish to perform an analysis on responses to a 50-item questionnaire (remember that, when responses to a questionnaire are analyzed, the number of variables is equal to the number of items on the questionnaire). Five times the number of items on the questionnaire equals 250. Therefore, your final sample should provide usable (complete) data from at least 250 subjects. It should be remembered, however, that any subject who fails to answer just one item will not provide usable data for the principal component analysis, and will therefore be dropped from the final sample. A certain number of subjects can always be expected to leave at least one question blank (despite the most strongly worded instructions to the contrary!). To ensure that the final sample includes at least 250 usable responses, you would be wise to administer the questionnaire to perhaps 300-350 subjects. *Emphasis Added,* NS-PGL Cross Ex. 3, p. 13.

As Mr. McNally testified, accounting data is not similar to "subject" answers to questionnaires. Specifically, attempting to predict human behavior based on attitude surveys of people with vastly diverse backgrounds and perspectives is much more difficult than assessing a utility's risk level relative to other utilities based on uniform accounting data. Moreover, unlike a social science questionnaire, as contemplated in the SAS manual, in which any number of additional subjects can be included at the analysts' discretion, the number of utility companies with sufficient data is beyond the analyst's control. Mr. McNally utilized all 95 regulated utilities on the S&P Utility Compustat tape that had sufficient data to calculate the twelve ratios employed in the analysis. Mr. McNally could have defined his "industry" more loosely to add 5 non-utility companies just for the sake of adhering zealously to the manual's guidelines, but, as he explained, he had to balance the number of companies and their relevance to the Companies. Tr., August 31, 2011, p. 580.

The Companies also claim that Mr. McNally's principal components analysis is invalid since each factor did not necessarily have at least three variables load onto (i.e., be highly correlated to) it. NS-PGL IB, pp. 109-110. The SAS manual refers to this as the "interpretability criteria." As that name suggests, the objective of this criteria is to provide clarity in identifying what trait, or "construct," each factor represents. Tr., August 31, 2011, p. 614-614. Once again, the SAS manual guidelines, being targeted as social sciences, are not applicable to the analysis of utility accounting data. As Mr. McNally explained, it is much more difficult to define what a question regarding a subject's feelings measures than to understand what specific financial and operating ratios measure. Therefore, principal components analyses of social science issues need more variables, or "items," to load onto each factor in order to reveal the construct that factor is measuring. Indeed, the SAS manual mentions having as many as "10, 20, or even more items to assess a single construct":

> One additional note on scale length: the <u>recommendation</u> of three items per scale offered here should be viewed as an absolute minimum, and certainly not as an optimal number of items per scale. In practice, <u>test and attitude scale developers</u> normally desire that their scales contain many more than just three items to measure a given construct. It is not unusual to see individual scales that include 10, 20, or even more items to assess a single construct. Other things held constant, the more items in the scale, the more reliable it will be. The recommendation of three items per scale should therefore be viewed as a rock-bottom lower bound, appropriate only if practical concerns (<u>such as total questionnaire length</u>) prevent you from including more items. For more information on scale construction, see Spector (1992).

NS-PGL Cross Ex. 3, p. 12. Clearly, the author is referring to social science research <u>to assess attitudes on a scale</u>, not accounting data. We are not aware of any context in which accounting data is deemed to possess an "attitude." Thus, a minimum of 3, let alone 10, 20, or more items in a "scale" is not necessary with financial and operating ratios because we know what each ratio measures.[15] Indeed, as Mr. McNally explained, he could have added additional variables, knowing in advance what factor they would load on, just for the sake of satisfying the Companies' criticisms, but it would not have added any value in interpreting what risk that factor measures. Tr., August 31, 2011, p. 615. While it can be beneficial to have more than one ratio measuring a given risk and, thus loading onto a given factor, in order to gain *a more accurate assessment* of that risk, it is not necessary to have three or more ratios load onto a given factor in order to determine *what* risk is being measured. To illustrate, one could view the Statue of Liberty from multiple angles – each angle would present a slightly different perspective and, together, they would provide a more complete picture. Nevertheless, from any of those angles, one could still recognize it as the Statue of Liberty. Therein lies the concept behind a principal components analysis. A principal components analysis allows the analyst to gain a more complete picture of risk by using numerous ratios, but distilling the bulk of the explanatory value of all those ratios into a manageable number of factors that are uncorrelated and, thus, do not duplicate the coincident explanatory value of any ratios. NS-PGL IB, p. 106. In contrast, Mr. Moul's analysis fails to eliminate any duplicative explanatory power within the factors he considered and appears to give equal weight to each factor. PGL Ex. 3.0, p. 12; NS Ex. 3.0, p. 12. Thus, while certain factors may measure the same specific risk, he gives them all full weighting, thereby overstating the contribution of certain risks toward total risk and, conversely, understating the contribution of other risks toward total risk. This

[15] If we did not already know what type of risk a given ratio measures, then accounting ratio-based comparable risk analyses, such as Mr. Moul's, would be useless.

approach can create a distorted assessment of total risk if a company has more (or less) of a specific risk that is over- or under-weighted in his total risk assessment. Moreover, the Companies' criticism of Staff's analysis on the grounds of "interpretability criteria" would apply even more so to Mr. Moul's analysis. That is, if the Companies believe that not having more than one variable load on a given factor renders the risk measured by that factor unidentifiable, then any interpretation of the factors Mr. Moul reviewed is dubious, since each represents a single variable.

All the above notwithstanding, a review of the raw ratio inputs themselves confirms the conclusions of that analysis. The table below presents the 12 operating and financial ratios for each company in the Gas Group and the sample average, as well as the ratios for Peoples Gas.[16]

Company	cerat	cfcap	cfdebt	farev	fcfcap	fficov	ncfexp	npexp	opmar	revstab	ebitstab	earnstab
AGL RESOURCES INC	0.4201	0.1060	0.1854	2.3894	-0.0024	5.0962	0.7188	9.2018	0.1417	0.9363	0.7246	0.6259
ATMOS ENERGY CORP	0.4847	0.1291	0.2510	1.1281	0.0139	4.7486	0.8790	8.7684	0.0624	0.8318	0.9211	0.7630
LACLEDE GROUP INC	0.4812	0.1114	0.2160	0.6655	0.0594	5.1825	1.5408	15.4631	0.0441	0.8873	0.9131	0.9278
NEW JERSEY RESOURCES CORP	0.5321	0.0943	0.2011	0.5077	0.0349	6.1765	0.9684	13.5148	0.0323	0.6108	0.6070	0.5900
NORTHWEST NATURAL GAS CO	0.4823	0.1202	0.2325	2.3524	0.0159	5.0472	0.9498	12.8301	0.1123	0.9710	0.9078	0.9428
PIEDMONT NATURAL GAS CO	0.4766	0.1323	0.2531	1.8522	0.0418	5.8611	1.1023	13.7746	0.0849	0.9412	0.9142	0.9037
SOUTH JERSEY INDUSTRIES INC	0.5013	0.1335	0.2673	1.4081	0.0322	7.7690	1.0389	9.7366	0.0971	0.9009	0.4568	0.4672
WGL HOLDINGS INC	0.5705	0.1513	0.3705	1.2195	0.0808	7.7222	1.6195	16.9104	0.0593	0.9852	0.7630	0.7729
AVERAGE	0.4936	0.1223	0.2471	1.4404	0.0346	5.9504	1.1022	12.5250	0.0793	0.8831	0.7760	0.7492
PEOPLES GAS	0.5356	0.1441	0.3122	2.1996	0.0751	7.5945	1.9490	19.3529	0.0507	0.9647	0.9775	0.9706

cerat: Common Equity Ratio
cfcap: Cash Flow to Capitalization
cfdebt: Cash Flow to Debt
farev: Fixed Assets to Revenues
fcfcap: Free Cash Flow to Capitalization
fficov: Funds Flow Interest Coverage
ncfexp: Net Cash Flow to Expenditures
npexp: Net Plant to Expenditures
opmar: Operating Profit Margin
revstab: R-Squared of Quarterly Revenues
ebitstab: R-Squared of Quarterly EBIT
earnstab: R-Squared of Quarterly Earnings

Staff Ex. 14.0, p. 33; NS-PGL Cross Ex. 5. Although the output of Staff's principal components analysis is clearer to interpret – which is a primary purpose of

[16] The operating and financial ratios of NSG are not in the record.

implementing that analysis – it can still be seen from the above raw ratios that the overall risk of Peoples Gas is lower than that of the Gas Group, as Staff concluded. Staff Ex. 14.0, p. 35. With the exception of operating profit margin, PGL scores higher than the Gas Group on each of the ratios than the Gas Group, indicating lower risk.

c. Spot data

The Companies argue that Staff has not justified its reliance on spot data market prices. NS-PGL IB, pp. 113-115. The Companies claim the use of spot data invites subjectivity and error and can produce anomalous results, especially in periods of high volatility. Staff's addressed this issue in its Initial Brief. As Staff explained, Mr. McNally's analysis relied on the most recent data available at the time of his analysis. His analysis date was not dictated by some hidden agenda to hurt the Companies, but by the schedule of this proceeding. Staff IB, p. 71. Mr. McNally did not seek out a particularly volatile day for his analysis and, in fact, replicated his analysis 6 additional times – every Wednesday for five consecutive weeks and again on Wednesday, August 10th – to test his initial results.[17] That the results of those seven analyses were all within 17 basis points demonstrates that his May 12, 2011 analysis was <u>not</u> the anomaly the Companies imply. Staff Ex. 14.0, pp. 9-12. Moreover, Staff's updates demonstrate the Companies' claim that Staff "completely ignored" the Commission's directive to "check"

[17] Clearly, by updating his analysis on the same day of the week for five consecutive weeks, Mr. McNally was not "manipulating" the results through a biased spot date selection. Further, Mr. McNally explained that the reason for the three week gap between his sixth and seventh update is that he I intended for the July 20th analysis to be his last update before filing his rebuttal testimony, but added the August 10th analysis specifically to address the increased market turmoil during that week and provide a more complete picture of the recent market environment. Staff explicitly recommended against the use of that result due to the high degree of market volatility at that time. This further demonstrates the inaccuracy of the Companies' implication that Staff failed to note the market environment.

its results to be an absolute falsehood.[18] In fact, one of the "checks" proposed by the Commission was "the use of an alternative sample date." Staff not only provided an alternative date, but six of them. Still, the Companies are not satisfied. They maintain that Staff failed to provide the "contextual showing," which they unilaterally pronounce to be overall market volatility. NS-PGL IB, p. 114. However, as Staff explained, one should be wary of overall market volatility as a barometer of the normalcy for utility returns, since utility returns do not react in step with overall market movements. Staff IB, p. 72. Nevertheless, and contrary to the Companies' implication, the one measure of market volatility in the record, the Chicago Board Options Exchange Volatility Index ("VIX"), shows the market volatility on the date for each of Staff's analyses to be below-average (aside from the August 10th analysis, which is discussed in the footnote above). Specifically, the average VIX value was 20.40 from January 1990 through January 2011, whereas the VIX value at the times of each of Mr. McNally's analyses was never above 19.91, except for the August 10th update, which Mr. McNally explicitly warned against using. Staff IB, pp. 78-79; NS-PGL Ex. 36.0, p. 4; Staff Ex. 14.0, p. 10. Thus, it is clear that the context supports Staff's use of spot data from May 12, 2011 and reveals the Companies' arguments to be false.

As Staff explained, the most recent spot price will always be more timely than a historical average and is, thus, preferable. An analysis using the most current data reflects all information that is available and relevant to the market at the time of that

[18] In addition to the six updates Staff provided, Staff also notes that the VIX index measures of market volatility, market prices, interest rates, and relative ROE trends all support Staff's conclusions. Staff IB, pp. 69-70, 72, 78-79. Those factors also show that, contrary to the Companies' claim, it is clear that Staff is "acutely attuned to [the market] environment," and that a "contextual showing" has been made, as the Commission desires. NS-PGL IB, p. 114.

analysis, while analyses using older data reflect information that the market no longer considers relevant, a fact Mr. Moul acknowledges. Therefore, use of a historical average requires the analyst to subjectively determine what data is no longer relevant, needlessly and inappropriately replacing the collective judgment of all investors with his own. Staff IB, p. 71.

d. DCF model selection

The Companies maintain that the results of the DCF model should be discounted or discarded, as those results are "unreliably low" due to the current economic environment and cannot be sustained. NS-PGL IB, p. 116-117. Staff addressed this in its Initial Brief. As Staff explained, the Companies' conclusions are based on a faulty comparison of Mr. Moul's DCF result to results that were inappropriately inflated through techniques that have been repeatedly rejected by the Commission. When those errors are corrected, the results show that his DCF is not understated, but rather, that his risk premium and CAPM analyses are overstated. Staff IB, p. 78. Moreover, the Companies have provided nothing to support the conclusion that the DCF results cannot be sustained.

The Companies now point to extra-record evidence from their previous rate case, and suggest that the large difference between the DCF results in that case compared to the DCF results in this case indicate that the model itself is invalid. NS-PGL IB, p. 117. This is a results-based approach that ignores the current market environment. The lower current DCF estimates are a result of the low growth rate and low interest rate environment Mr. Moul cites, which simply indicates that the cost of capital is low. A relatively low cost of capital is not a reasonable rationale for dismissing the results of a model that reflects those low costs. The Companies have provided nothing to demonstrate that current growth rates and dividend yields are somehow invalid or misstate investors‘ expectations and requirements, much less that the DCF model the Commission has consistently relied on for decades is itself invalid. Staff IB, p. 78.

e. DCF Growth Rates

The Companies argue that Mr. McNally's criticism of Mr. Moul's inflated DCF growth rate amounts to "quibbling" and suggest that Mr. McNally "reserves to himself the same discretion to pick growth rate sources to suit his purposes." NS-PGL IB, op. 117. First, Mr. McNally's argument is not simply "quibbling." In fact, to characterize the argument as "quibbling" trivializes one of the central issues of the case. As noted earlier, Mr. Moul's inflated growth rate is one of three factors responsible for almost all of the difference between Staff's and the Companies' ROE recommendations. Using the same three growth rate sources Mr. Moul used in the last rate case would produce an average growth rate of 4.20%. Staff IB, p. 81; PGL Ex. 3.8, p. 1. In contrast, Mr. Moul's substitution of the Morningstar growth rates for the Value Line growth rates he used in the Companies' last rate case produces an average growth rate 52 basis points higher, at 4.72%.[19] Staff Ex. 5.0, p. 30. In addition, Staff noted that Mr. Moul further inflated his growth rate by not using that 4.72% average, but by subjectively selecting a growth rate 28 basis points higher (i.e., 5.0%) based on nothing more than his "opinion" that it was "reasonable." By doing so, he effectively granted the most extreme of his

[19] Although the growth rate estimates from all the sources discussed in this argument changed in Mr. Moul‘s rebuttal update, his decision to use Morningstar growth rates was made in his direct testimony based upon the numbers cited above. Nevertheless, even based on his rebuttal update the Morningstar growth rate is still an obvious outlier relative to the IBES, Zacks, and Value Line growth rates.

growth rates – those from the new source he introduced in this proceeding – more than double the weight given the other growth rates. Staff IB, p. 83-84. This manner of determining his final growth estimate is arbitrary and capricious.[20] Indeed, this is made all the more evident by the fact that Mr. Moul still used a 5.0% growth rate estimate in his rebuttal update even though the average growth rate had fallen by 14 basis points (from 4.72% to 4.58%). NS-PGL Ex. 19.02.

Second, Mr. McNally's source for growth rate estimates, Zacks, was not chosen "to suit his purposes." Rather, that source has consistently been used by Staff for several years; it provides a consensus of analyst growth estimates that has been repeatedly accepted by the Commission and, in fact, was used in Mr. Moul's own analysis.

Third, Mr. McNally did not "reserve to himself" the discretion to pick growth rate sources. Mr. McNally never suggested that the Companies could not choose their own growth rate sources[21] or that Morningstar is an inherently improper source. Rather, Mr. McNally's perfectly valid criticism was that Mr. Moul had not only changed his growth rate sources from the last proceeding without any justification, but in so doing, he eliminated the lowest of the three growth rates he utilized in the last rate case[22] and, instead, substituted a growth rate 27% higher than the next highest estimate. While the

[20] If determining a growth rate in this manner does not constitute "reserving to oneself the discretion to pick growth rate sources to suit one's purposes," nothing does.

[21] For example, Mr. McNally made no comment whatsoever regarding the Companies' choice to use IBES growth rates. That certainly would not have been the case if Mr. McNally had any intention to "reserve to himself" the discretion to pick growth rate sources.

[22] Mr. Moul concluded that the Value Line growth rate estimates represent a reasonable assessment of investor expectations, despite eliminating them in this proceeding. PGL Ex. 3.0 REV., p. 21.

average of the Value Line growth rates he eliminated is tightly clustered with those of his other two sources, the average Morningstar growth rate he added is clearly an outlier relative to other estimates. Staff IB, pp. 81-82. Moreover, Mr. McNally provided two analyses that demonstrated that the Morningstar growth rate was unsustainable.[23] Mr. Moul provided no response to those analyses, except to proclaim them incorrect and present a flawed counter analysis. NS-PGL Ex. 19.0 REV., p. 18. Mr. McNally then explained that Mr. Moul's counter analysis was incorrectly calculated because it erroneously assumes that all new shares are sold at market price, which for each company in the sample is well above its book value. Thus, his analysis overstates the sustainable growth, making it unreliable. Staff Ex. 14.0, p. 17.

Now, the Companies argue that Mr. McNally's assessment of Mr. Moul's counter analysis amounts to a "specious response." The Companies contend that "stock and stock options issued as part of compensation are issued at market price." NS-PGL IB, pp. 117-118. The Companies are wrong, and apparently quite confused. Stock and stock options issued as part of compensation are clearly not issued at market price. Indeed, if employees had to pay the issuing company the current market price to redeem them, they would not be "compensation" at all.[24] As Mr. McNally explained, stock options will not be exercised unless the exercise price[25] is less than the market

[23] Note: Mr. McNally did not suggest that this renders the Morningstar growth rates invalid; it simply means they cannot be used in a constant growth DCF, in which the growth rate is assumed to be sustainable into perpetuity.

[24] That would be similar to an employee having to buy his paycheck from his employer for the amount of the check.

[25] The "exercise price" is the price the option holder would be required to pay in exchange for one share of stock. According to Companies witness Gast, this is set equal to the market price on the day the stock option was granted. As she acknowledged, the stock option will not be exercised on the day it is granted. Tr. August 31, 2011, p. 397. It will only be exercised on (continued…)

value of the stock at the time of exercise. Therefore, the Companies will receive less than market value for each new share of stock issued when stock options are exercised. Moreover, the Companies receive no cash for stock grants at all. Staff Ex. 14.0, p. 17; Tr., August 31, 2011, pp. 397-398. Rather, companies effectively grant stock and stock options in exchange for labor rendered. Tr., August 31, 2011, p. 397. However, unlike cash, the Companies cannot reinvest labor into their operations to create sustainable growth. Thus, to assume, as Mr. Moul did, that companies receive current market value compensation, in the form of reinvestable capital, in exchange for stock and stock options overstates the sustainable growth.

The Companies then argue that "if Mr. McNally was right, he contradicted Staff's long-held position that current market price is the sole determinant of the cost of equity." NS-PGL IB, p. 118. The Companies provide no explanation, let alone evidence, to show how those two things would be contradictory. In fact, they are not. Investors are well aware of a stock compensation programs and factor that into the price they are willing to pay for a share of common stock. The price an investor is willing to pay for a share of common stock still reveals his required rate of return on that investment.

Finally, the Companies claim that "Mr. McNally's point is purely theoretical because Mr. Moul's growth rate analysis reflected only stock shares expected to be issued and did not include stock options that are not subsequently exercised in the future." NS-PGL IB, p. 118. It is unclear what point the Companies are trying to make. Unfortunately, the Companies have again failed to provide any explanation. Obviously, forecasts will only

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(continued from previous page)

some later date, when the market price is higher than it was at on the day the option was granted.

reflect actions expected to occur and will not reflect actions that are not expected to occur, much less those that the forecaster somehow knows will not occur. What the Companies seem to be suggesting is that the Value Line forecasted increase in the number shares outstanding does not include the expected exercise of stock options. However, the Companies provide no evidence to support that claim. Regardless, such a claim implies that Value line assumes that stock options are never actually exercised. If so, then all credibility of the underlying Value Line information is lost, since stock options obviously do get exercised.[26] Staff Cross Ex. 1, p. 75. Thus, either Value Line forecasts do <u>not</u> account for the exercising of stock options, which renders Mr. Moul's underlying data inaccurate, or they <u>do</u>, which contravenes Mr. Moul's assumption that all new shares are issued at market value. Either way, his analysis is unreliable.

f. Leverage Adjustment

Despite the Companies' leverage adjustment having been repeatedly litigated, and repeatedly rejected by the Commission, the Companies continue to argue for a leverage adjustment to their DCF and CAPM analyses. The Companies state that Staff does not, and cannot, challenge the "rock solid principal" that the risk level of a company with a market value to book value of equity ratio of greater than one is lower when its capital structure is measured with market values than when its capital structure is measured with book values. NS-PGL IB, pp. 118-119. That statement is unequivocally false. Indeed, the Companies must not have been paying attention, as

[26] Given the small forecasted changes in certain companies' number of shares outstanding (shown in NS-PGL Ex. 19.12), it is more likely Value Line's forecasts do reflect an expectation of exercised stock options, which, correspondingly, would increase shares in relatively small increments.

that is exactly the position Staff has taken throughout this proceeding. Staff Ex. 5.0, pp. 31-32; Staff Ex. 14.0, pp. 20-21; Tr., August 31, 2011, pp. 517-518; Staff IB, pp, 84-85. The simple fact is, the Companies' purported "rock solid principal" is complete nonsense. As Staff explained, the cost of common equity is a function of financial risk, which arises solely from a company's debt service requirements. The equity ratio is merely a tool that can be used to measure the degree of financial risk. However, changing the manner in which the equity ratio is measured does not change a company's debt service requirements and, thus, does not change a company's financial risk. Staff IB, pp. 84-85.

Regardless of the tangents taken in the course of arguing this issue, ultimately, the Companies' argument is that for companies with a market value to book value of equity ratio other than one, a market value based ROE should not be applied to a book value capital structure without a leverage adjustment. NS-PGL IB, p. 118, 119, 120. They are wrong. As Mr. McNally explained, the market value can, and will, immediately adjust to any changes in investor expectations so that the expected return equals the required return – if the expected return rises, investors will immediately bid the market price up, and if the expected return falls, investors will immediately bid the market price down. Thus, the market price <u>always</u> reflects the investor required return, regardless of the book value of capital. That is why it is appropriate, indeed necessary, to use a <u>market-based cost of common equity</u> for regulatory rate setting.[27] Similarly, book value <u>always</u> represents the actual debt and equity capital available to a company to invest in

[27] However, a company's market value can change even when there has been no change to the company's debt service requirements. Therefore, market value does not necessarily reflect a company's financial risk and should not be used to measure the capital structure for regulatory rate setting.

assets serving its customers, regardless of the market value of capital. That is why it is appropriate and necessary to use a book value capital structure for regulatory rate setting.[28] The application of the market required return to the book value capital structure simply takes the return investors demand to earn from a dollar invested in the common equity of a company, given the amount of risk in the common equity of that company and the current price of risk, and applies it to the number of common equity dollars invested in the assets of that company. Staff Ex. 14.0, p. 23.

The Companies' initial brief presents an example of a utility with greater market value than book value and concludes that "without a leverage adjustment, and again holding all else equal, the utility cannot earn its total cost of equity." NS-PGL IB, p. 119. This example reveals a lack of understanding of the leverage adjustment issue and the related arguments. First, it directly contradicts Mr. Moul's stated rationale for the leverage adjustment, about which he unequivocally states, "The leverage adjustment is not intended, nor was it designed, to address the reasons that stock prices vary from book value. Hence, any observations concerning market prices relative to book are not on point." Emphasis added, PGL Ex. 3.0, p. 27.

Second, the Companies incorrectly state that the utility's total dollar cost of equity is $60 when the utility's dollar cost of equity is actually only $50 (10% * $500).[29] Thus,

[28] However, book values do not adjust to changing investor expectations. Thus, a company's book value can only reflect the investor required return when the book value equals the market value. Therefore, book value should not be used to estimate the cost of common equity for regulatory rate setting.

[29] There is only $500 invested in assets serving rate payers. The $100 difference between the company's book value of equity and its market value of equity is simply profit that went to the original investor, who invested the $500 now serving rate payers, but sold his stock to the current investor for $600. Rate payers receive no benefit from that $100 and, therefore, are not responsible for providing a return on it.

contrary to the Companies' claim, the utility in the example will earn its total cost of equity. Further, the new shareholder will also get $50 and should not expect otherwise, since the Commission has not ever accepted leverage adjustments when setting the authorized rate of return on common equity. If the new shareholder is not satisfied with a $50 return on a $600 investment, he would not have made that investment at that price in the first place.[30] Nevertheless, it is not the Commission's objective to ensure that investors on the secondary market receive their required return.[31] The Court explicitly confirmed this in Federal Power Com. vs. Hope Natural Gas Co. 320 U.S. 591 (1944) (1944 U.S. LEXIS 1204, p. 10) stating, "Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid, even though they might produce only a meager return on the so-called 'fair value' rate base." Id. By disguising their fair value adjustment as a "leverage adjustment," the Companies are attempting an "end-run" around the Hope decision.

Finally, the Companies' conclusion from their example ignores the reason an investor would expect to earn $60[32] despite a required rate of return and rate base that

[30] Essentially, the Companies' argument is that the Commission is responsible for protecting investors from foolish investment decisions. Note that Staff does not believe that investors are foolish when paying above book value for a utility stock. Staff believes that investors are aware of how rates are determined and price stocks accordingly.

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

[32] Given the 10% required rated of return, the investor willing to pay $600 for that company's common equity obviously expects the company to earn at least $60.

remained the same,[33] which, under original cost ratemaking, would produce earnings of only $50 per year. One explanation is that the investor recognizes that companies often have other sources of cash flows in addition to the operating income component of the revenue requirement set by a regulatory commission. As noted above, under original cost ratemaking, rate payers provide a return only on rate base. Inflating that return to compensate investors for capital not invested in rate base, from which investors may draw additional non-regulated returns, is neither fair nor appropriate; moreover, such an adjustment would effectively void the Commission's authority to establish original cost rate base.

g. Betas

The Companies claim that Staff's regression beta estimate is biased downward. NS-PGL IB, pp. 120-121. This is prime example of not only the results-driven approach the Companies have used throughout the case, but the inconsistencies in their arguments and their persistent attempt to draw attention from the central issues. The Companies' conclusion that the regression beta is biased downward is results-based, stemming solely from a comparison to Value Line beta estimates, which illogically assumes the conclusion that the Value Line beta results are correct and, therefore, that the regression beta results are biased downward simply because they are lower. Obviously, one could just as easily conclude that it is the Value Line betas that are biased upward. The fact is, there is no reason to believe either is "biased"; they are simply calculated differently (i.e., weekly vs. monthly observations). Staff Ex. 5.0, pp. 13-16. That is precisely why Staff uses multiple approaches to estimating beta. In fact,

[33] The Companies' conclusion is explicitly qualified with the phrase "holding all else equal."

this highlights yet another inconsistency with the Companies' arguments, as Mr. Moul advocates the use of multiple sample companies, models, and growth rate estimates, but only utilizes a single source for his beta estimates. Furthermore, this argument is relatively inconsequential, as even if the regression beta was removed from Staff's beta average, the resulting average would only be 0.01 different (i.e., 0.59 instead of 0.58), which would raise Staff's ROE estimate by only 4.5 basis points. Staff Ex. 5.0, p. 16-17. In contrast, the 68 to 80 basis point difference caused by Mr. Moul's substitution, and subsequent overweighting, of a significantly higher growth rate for a lower growth rate is more than fifteen times as large. Yet, the Companies refer to Staff's arguments regarding that issue as "quibbling." *See* Section VI.E.5. Thus, in relation, the Companies' beta argument seems little more than a distraction from the central issues. Moreover, this argument has been litigated numerous times, and numerous times Staff's beta has been accepted by the Commission. In fact, this was litigated in the Companies' last rate case in which the Commission's Final Order stated:

> We agree that, in the same way we rely on multiple models to determine the cost [of] equity, Staff's well-considered use of multiple beta sources is beneficial to reduce measurement error from any individual estimate. Moreover, we find that Staff's beta estimate appropriately weights the beta estimates from those three sources. Thus, we adopt Staff's beta estimate of 0.59.

ICC Docket Nos. 09-0166/09-0167 (Cons.), Order, January 21, 2010, pp. 126-127. Staff used the exact same procedure in this proceeding. Accordingly, the Commission should make the exact same ruling.

2. North Shore

See Section VI(E)(1) above.

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

Staff continues to recommend that, for Riders UEA (Uncollectible Expense Adjustment, applies to classes 1,2,4, and 8) and UEA-GC, the Commission order the Companies to switch from using the uncollectible amount set forth in Account 904 to using net write-offs in each tariff. To be consistent with Section 19-145 (a) of the Act, the Commission should also order that net write-offs be used to determine the utility's uncollectible amount in rates.

The Companies state that their proposed Rider UEA-GC is consistent with the requirement in the stipulation approved by the Commission in Docket Nos. 09-0419 and 09-0420 ("Stipulation") that the rider be "similar to" an uncollectible gas cost rider that the Companies had proposed, but withdrawn, in their 2009 rate cases. NS-PGL IB, p. 122. The stipulation, however, does not define the method for determining the amount of the uncollectible expense to include in utility rates or set forth a method for determining the amount of uncollectible expense to be recovered through riders. The stipulation does not limit the Commission's discretion in determining the method for computing the appropriate amount of uncollectible expense to be billed to customers. Therefore, using the net write-off method to determine uncollectible expenses is perfectly consistent with the Stipulation. Staff IB, p. 90.

The Commission should order the Companies to use net write-off method to determine the uncollectible amount to be recovered in Rider UEA. If the Commission orders the Companies to use the net write-off method in Rider UEA, the Commission, for consistency, should make the same order for the Proposed Rider UEA-GC.

B. Rider VBA

1. Merits of Rider VBA

Staff continues to support making Rider VBA permanent rather than increasing the percentage of fixed costs that are recovered through fixed customer charges. Staff does not agree with the Attorney General's assertion that no other utilities that have energy efficiency programs have decoupling mechanisms to recover fixed costs. Recovering high percentages of fixed costs through fixed charges, such as the 80% that is currently being recovered by Ameren (electric and gas) and Nicor serves to diminish the impact of sales volumes on revenue collection. Although it does not completely decouple revenue collection from sales volumes, it serves to diminish risks from variability in sales and stabilize revenues. Staff also believes the passage in which the AG makes this claim misrepresents previous Commission action and is counter to the arguments the AG made in the docket to which it cites. Specifically, the AG's brief states:

> It is worth noting, too, that should the Commission grant the Companies' request to approve Rider VBA on a permanent (or even a continued pilot)

> basis, PGL and North Shore would be the only utilities in the state to have recovery of their approved revenue requirements *guaranteed* through Rider VBA. Neither Commonwealth Edison nor Ameren, utilities that have been operating energy efficiency programs since 2008, have decoupling mechanisms to recover lost revenues associated with energy efficiency or to otherwise help recover "fixed costs", as NS-PGL claims they need. Northern Illinois Gas Company ("Nicor") specifically requested the approval of a cost recovery mechanism that recovered so-called "lost revenues" associated with their proposed programs in its Section 8-104 petition filed last year. ICC Docket No. 10-0562, Ex 3.0 (Malcolm Quick testimony) at 7-10. That request, like the NS-PGL request, claimed such a mechanism was needed to ensure "fixed cost" recovery established in the last rate case. That request was denied.

AG brief pp. 46-47.

Dr. Brightwell's testimony supported making Rider VBA permanent because the Commission promoted revenue stability for Ameren's gas utilities and Nicor by approving rates that recovered 80% of fixed costs through fixed charges in those utilities' most recent rate cases. Staff Ex. 6.0, p. 2. Dr. Brightwell argued that Rider VBA was a better alternative in the case of Peoples and North Shore Gas for numerous reasons which are set forth in Staff's Initial Brief. None of Staff's reasons included encouraging utilities to increase the promotion of energy efficiency. The reasons included increasing incentives for customers to conserve, to protect customers from asymmetric risks of over and under collection and to reduce the redistribution of cost recovery from higher volume users to lower volume users. See Staff Initial Brief pp. 91-95. Staff also notes that the AG is incorrect with respect to the electric utilities as well. The Commission increased the percentage of fixed costs ComEd recovers through fixed charges from 37% to 50%. The Commission also referred to its increases in fixed cost recovery for Nicor and Ameren as decoupling and indicated that the increase to only 50% for ComEd was to avoid rate shock, hinting that larger percentages of fixed costs may be recovered through fixed charges in the future. See Docket 10-0467, Final Order dated May 24, 2011, pp. 231-232.

The AG also claims that the Commission denied Nicor's request to recover revenues lost due to energy efficiency measures in Docket 10-0562. The AG fails to adequately explain, however, that the issue was never brought before the Commission since the testimony of Malcolm Quick cited above was stricken from the record when the ALJ upheld a Joint Motion to Strike by CUB and the AG. Docket 10-0564, Notice of Administrative Law Judge Ruling, dated November 12, 2010. Amongst the reasons that CUB and the AG argued that the testimony should be stricken were concerns about single issue ratemaking that should be addressed in a rate case rather than an energy efficiency docket. Docket 10-0564, Motion to Strike and Deny the Request for an Expedited Schedule of the Citizen's Utility Board and the People of the State of Illinois, dated October 25, 2010, pp. 7-8. The AG now argues in this rate case that Rider VBA should not be made permanent because the Commission did not approve a lost revenue recovery rider for Nicor. Staff is perplexed by the irrational circularity of the AG's reasoning. For these reasons as well as the reasons Staff provided in its initial brief, Staff continues to recommend that if the Commission believes revenue stability is a desirable goal, it should approve Rider VBA on a permanent basis rather than move to a fixed straight variable rate or a rate that recovers 80% of fixed costs through fixed customer charges.

2. Tariff Language

The Companies took issue with some of Ms. Ebrey's proposed language changes to Rider VBA. The Companies claimed that Ms. Ebrey's proposal did not take into account customer migration. Companies IB, pp. 126-127. While the Companies claim explanation was provided regarding customer migration between rate classes and the factor causing said migration, Id., p. 128, they also acknowledge that such migration may not occur at the levels seen during 2009 and 2010. Staff IB pp. 95-96. Therefore, the added complication of the Companies' proposal to adjust revenues due to migration should be rejected.

C. Rider ICR

1. Accumulated Deferred Income Taxes

Staff's position on this issue is unchanged. Staff IB, p. 96. Staff agrees with the Attorney General that there are potential complications related to the annual reconciliations of plant additions, AG IB, p. 65, but maintains that adding ADIT to rider ICR introduces a complex element to the reconciliation which could overly complicate the reconciliation. However Staff would note that on September 30, 2011, the First District Appellate Court issued its opinion regarding the appeal of the Companies' 2009 rate cases (ICC Docket No. 09-0166/0167) and one of the issues on appeal concerned Rider ICR. The court held that the Commission exceeded its discretion in approving Rider ICR. People v. Illinois Commerce Comm'n, Nos. 1-10-0654, 1-10-0655, 1-10-0936, 1-10-179-, 1-10-1846 and 1-10-1852, Consolidated, Appellate Court (First District-Fifth Division) September 30, 2011, Slip Opinion, p. 28. Given that decision this issue would seem to be a moot point.

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

b. Classification of A&G Related to O&M

c. Classification of Fixed Costs

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

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

In its Initial Brief, Staff recommended that the Commission adjust test year expenses recovered in transportation tariffs downward by the amount proposed by Staff witness Sackett to reflect the Companies overly high projections of transportation expenses as evidenced by the Companies' consistent over budgeting of costs associated with transportation customers in each of the past three years. Staff IB, pp. 110-112.

The Companies claim that 8% is a significant level when it pertains to reduction in budget from the past rate case. NS-PGL IB, p. 147. However, this would indicate that the 16%-67% of historical over-budgeting is significant as well and cannot be ignored.

The Companies object to the method used by Staff to reduce the amount of these costs and argue that their budget is based on the best available information at the time it is created, NS-PGL IB, p. 148, and is under budget only due to "unanticipated events." Id. All of the unanticipated events listed reduce the actual costs from the budgeted amounts. However, all of them are related to the labor component which does not explain the Companies' under budgeting in other categories. Further, the Companies made no effort to explain why non-labor and IT costs were low. All costs for all years were below the budgeted amount.

The Companies did not provide any evidence that in years prior to the period reviewed by Staff that the labor budgets were at or above budget, or that this was a one-time, limited occurrence. They had an opportunity to provide such evidence but they could not. The total lack of any such evidence indicates that this is not a unique phenomenon.

The Companies assert that, "Mr. Sackett's approach of reducing the test year budget by calculating a factor by which cost categories in prior years' budgets exceeded actual costs (Sackett Dir., Staff Ex. 9.0, 7:141 - 8:147; Sackett Reb., Staff Ex. 18.0, 4:70-5:90) assumes that unexpected events that caused costs to be lower than forecast would occur again." NS-PGL IB, p. 148. The Companies characterization of this approach is incorrect. Mr. Sackett has not identified specific factors leading to change; rather he has pointed to a general trend likely caused by the Companies motive to cut costs that will be present in the test year. The trend is likely to reoccur even if Staff cannot identify the exact venue that will take.

The Companies also assert that Staff's method was incorrect because Staff did not identify specific factors that would cause the actual costs to be less for the test year. It is not Staff's task to *anticipate* specific "unanticipated events." The burden of proof is on the Companies; as noted above the Companies had ample time and data to demonstrate that these circumstances were anomalies and that on average over time the budgeted costs were good predictors of what actual costs would be. They could not to provide that evidence.

Because the Companies have historically had costs that have been under what they have budgeted, it is not reasonable to make ratepayers pay for the full amount of these forecasted expenses. Therefore, Staff continues to recommend that the Commission order that the test year expenses be reduced by the amount proposed by Mr. Sackett.

D. Large Volume Transportation Program

1. Administrative Charges

2. Transportation Storage – Issues

Response to Companies

As noted in its Initial Brief, Staff supports the unbundling and the elimination of standby proposals but soundly rejects the additional daily and monthly restrictions. Staff IB, pp. 112-125. Illinois Industrial Energy Consumers ("IIEC") together with Constellation New Energy – Gas Division ("CNEG") have likewise rejected these restrictions. IIEC/CNEG IB, pp. 24-25.

The Companies initial brief identifies what it terms the "fundamental flaw," of Staff and intervenors criticisms of its proposal. According to the Companies the flaw "is that Staff and intervenors would perpetuate inter-class subsidies resulting from all classes of customers (sales, SVT and LVT) relying on the same storage assets but receiving different access rights." NS-PGL IB, p. 150. However, the Companies admitted that they had not attempted to establish the presence of inter-class subsidies, NS-PGL Ex. 46.0, p. 4, and the Companies have provided no evidence of these alleged inter-class subsidies. Staff IB, p. 120. It is impossible to perpetuate what does not exist.

The Companies also argue that "the same assets with the same contractual and operating capabilities support service to all the Utilities' customers. Allowing one class of customers superior rights to those assets necessarily means other customers are subsidizing those rights." NS-PGL IB, p. 151. The Companies argument assumes this is a zero sum game. However, this is not a zero-sum game. It is possible to have more flexibility than is needed most of the time and yet not have the actions of one group negatively impact the other groups. The Companies are trying to prevent the actions of an *individual* transportation customer or pool from having a negative impact on sales customers by altering the entire transportation program for all transportation customers. As Staff witness Sackett discussed in his direct testimony, the Companies' analysis improperly applies restrictions needed for the entire system onto individual customers, largely ignoring the diversity of transportation customers. Thus, the small amount of protection that the Companies' proposal offers comes at the price of a large amount of flexibility for transportation customers. This proposal will only reduce the efficiency of the transportation program without proportionate benefits for sales customers. Staff Ex. 9.0, p. 24. Thus, in addition to being unnecessary, the modifications put forth by the Companies are an overly strict method of accomplishing the Companies' aim.

Finally, the Companies assert that they have "developed a stand-alone storage service based on comprehensive modeling of the assets that support its ability to offer such a storage service. The proposal's key aspect is that all customer classes using these assets – sales, SVT and LVT – would have comparable rights and obligations. Said differently, customers receive the service for which they are paying and no customer class would subsidize another's use of storage." NS-PGL IB, p.155.

What the Companies fail to grasp is that by virtue of the design of transportation programs and the residual impact on sales customers, all capacity that is not utilized by individual transportation customers is available for use by sales customers. This is a benefit to sales customers[34] even if they do not use this capacity, because they have the option to use the underutilized capacity at no charge to them. The empirical evidence that those transportation customers as a group do not use their monthly inventories indicates that some of this seasonal capacity, which is paid for by transportation customers, is available to sales customers at all times. CNEG Exs. 1.4 and 1.5. This is also likely to occur in other diversity-subject issues like daily restrictions. Tr., September 1, 2011, p. 720.

While the design of the proposed program alleges that it will be equal rights for all, any un-used capacity from transportation customers is available for sales customers; however, if the sales customers do not use their capacity, it is not available for transportation customers. The Companies' program does not work both ways. Additionally, the Companies acknowledge that while the Critical Day ("CD") withdrawal rights are proportional, non-CD withdrawal rights are less than proportional. Tr., September 1, 2011, pp. 716-717.

The Companies were even unable to convince their own affiliate, Integrys Energy Services ("IES"), an Alternative Retail Gas Supplier ("ARGS) that their proposals were necessary and reasonable; IES concurs with Staff's analysis and recommendations. IES IB, pp. 2 and 5.

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[34] A sales customer is a non-transportation customer; i.e. one that purchases commodity gas from the Companies at the PGA price. See, PGL Rider 2 – Gas Charge, ILL. C. C. NO. 28, Seventh Revised Sheet No. 33, (Canceling Sixth Revised Sheet No. 33); NSG Service Classification No. 1, Ill. C. C. NO. 17, Fourth Revised Sheet No. 6 (Cancelling First Revised Sheet No. 6) and PGL Service Classification No. 1, ILL. C. C. NO. 28, Fourth Revised Sheet No. 5 (Cancelling First Revised Sheet No. 5)

Staff recommends that the Commission conclude that the Companies have not demonstrated the need for their proposed monthly storage limits and daily delivery restrictions. Therefore, the Commission should reject their proposals.

Response to IIEC/CNEG

IIEC/CNEG has recommended that if the Commission approves the daily and monthly target and associated cashouts that it also require the Companies to provide a deadband[35] around those targets that will enable the first 5% over the target to be cashed out at the market price. Although Staff is vehemently opposed to any new restrictions and cashouts, Staff agrees that IIEC's version is more equitable than the Companies proposed cashouts.

IIEC/CNEG opposes the Companies proposals to institute Operational Flow Orders ("OFO") into the tariffs. However, Staff supports the Companies' proposal. While the Companies have not demonstrated that their system requires this restriction, all major LDC in Illinois have both Critical Days and OFOs.

3. Associated Rider Modifications

a. Rider SBS/SST

The Companies propose in their brief to eliminate Rider SST and implement Rider SBS as presented by the Companies in direct testimony. NS-PGL IB, pp. 155-156.

Staff believes that Rider SBS should be implemented with the operational parameters of Rider SST in place with the one exception being that for Supply Shortage

[35] A deadband is a level of imbalances between deliveries and usage that is chased out without penalty at the market price.

Critical Days the percentage that the Companies have proposed are proportional and acceptable to all parties.

IIEC/CNEG has proposed that if the Commission deems the daily and monthly operational parameters are necessary for Rider SBS, then Rider SBS should be scrapped entirely and Rider SST left in place. IIEC/CNEG IB, p. 25. Staff believes that Rider SST is marginally better than Rider SBS with all of the unnecessary daily and monthly parameters in place. However, this would leave all of Staff's concerns from the past rate case that Rider SST customers cannot have access to bank without buying the unneeded standby that is linked to it still unresolved.

b. Rider FST

Rider FST is the Companies LVT tariff for smaller transportation customers. It has more flexibility than Rider SST and is monthly balanced. The Companies have proposed to add certain restrictions on to Rider FST to keep it in line with their proposals for SBS parameters.

The Companies attempt to justify their modifications to Rider FST in their Initial Brief.

> The proposed Rider FST changes are fully supported by the modeling that underlies the current SVT program and proposed Rider SBS. Just as it is appropriate to remove subsidies from sales customers to transportation customers, it is important that the different LVT riders operate under the same equitable access to storage parameters.
> NS-PGL IB, p. 157.

However, as Staff pointed out in its Initial Brief, if those customers subscribe to full standby so that they can have full standby on a Critical Day, then the value of this service would be fundamentally reduced. The Companies are proposing to eliminate a popular service by making Full Standby Service full standby in name only. Since the

Companies are currently providing this full standby service year round the underlying assets have not changed. Staff continues to recommend that the Commission reject the Supply Shortage Day delivery requirement for Rider FST. Staff IB, pp. 126-128.

In the alternative, if the Commission determines that it is necessary to turn "Full Standby" into something less than its name implies, then the Commission should require the Company to change the name of the service to Limited Standby Service to reflect what it would become and to provide its customers with a broader reduction in costs. Staff recommends that the amount that these costs are reduced be equal to the amount that those customers are required to deliver for each utility. In other words, reduce non-storage costs by 27% for Peoples Gas and 39% for North Shore.

c. Rider P

Rider P provides for pooling of a supplier's transportation customers in order to make transportation service more efficient. The Companies propose to revise Rider P to address changes to Rider FST and proposed Rider SBS. NS-PGL IB, p. 157.

Staff recommends that this rider be unchanged except to make it consistent with the finally approved version of Rider SBS.

IIEC/CNEG argues that "If the Commission on the other hand adopts IIEC's modifications to Rider SBS corresponding modifications should be made to Rider P (i.e. modifications relating to any limits or restrictions on use of storage). If the Commission adopts Staff witness Sackett's proposal for unbundling then the Utilities would need only to make the conforming changes to Rider P. Sackett Sept. 1 Tr. at 763; IIEC/CNEG IB, p. 27.

IIEC/CNEG has recommended that, if the Commission does approve the daily and monthly targets, that it require the Companies to provide super pooling across all of a supplier's pools, including those on Rider FST. It asserts that this is the case in the present tariff. IIEC/CNEG would like to see that super-pooling expanded to monthly parameters. IIEC/CNEG IB, p. 27.

If the Commission orders the implementation of these daily and monthly parameters, then Staff supports the super-pooling recommendations of IIEC/CNEG and would also support super-pooling for daily parameters as it is appropriate to take as much diversity into account as possible. The Companies have acknowledged that diversity applies to daily parameters as well as monthly and seasonable ones. Tr. p. 720, September 1, 2011.

d. Rider SSC

The Companies propose to revise Rider SSC Storage Service Charge, to accommodate their storage unbundling proposals. NS-PGL IB, pp. 157-158.

IlEC/CNEG continue to recommend the rejection of Rider SBS. Without Rider SBS, Rider SSC is unnecessary. However, if the Commission determines Rider SBS should be adopted with the critical changes recommended by IlEC/CNEG or if the Commission adopts the position of Staff witness Sackett, Rider SSC would be necessary to unbundle and recover the base rate storage costs from Sales [sic.] customers. IIEC/CNEG IB, p. 28.

Staff continues to recommend that this rider be approved.

e. Transition Riders

Staff recommends that these proposed riders be changed to make them consistent with the finally approved version of Rider SBS.

E. Small Volume Transportation Program (Choices for You^{SM} or "CFY")

1. Aggregation Charge

IGS proposes to have administrative costs supporting the Companies Small Volume Transportation ("SVT") programs recovered from all customers eligible for these programs rather than those only participating in them. Staff believes that there is no reason for sales customers to bear any portion of the administrative costs supporting transportation programs. Staff Ex. 18.0, p. 6-7. The costs for these programs, while over-budgeted, have been and continue to be for costs exclusive to transportation programs.

IGS, in its Initial Brief, argues that the there is an overlap between the services provided by Gas Transportation Services ("GTS") and the services provided in support of all customers. IGS IB, pp. 12-14. Gas Transportation Services ("GTS") exists to support the SVT programs, Choices For You ("CFY"), and Large Volume Transportation ("LVT") programs, Full Standby Transportation service ("FST") and Selected Standby Transportation service ("SST"). It supports CFY primarily by supporting the CFY *suppliers* providing services under Rider AGG. Thus the call center services provided by GTS are primarily handling calls from *suppliers* regarding their receipt of services from the Companies. NS-PGL Ex. 28.0, p. 41.

Similarly, the billing provided by GTS goes to the suppliers for services received under Rider AGG and the collection of these same administrative charges. Lastly, the bill reconciliation that is conducted is to reconcile Rider AGG suppliers' bills, not CFY customers. Therefore, while the services provided under GTS are similar to those provided for all customers, they are distinct in that they primarily support AGG *suppliers* not CFY *customers*.

The Companies have used an allocator to allocate labor costs for GTS because not all of the work performed by GTS is in support of transportation programs. They used the fraction 15/17th because that was the estimated level. Tr., September 1, 2011, pp. 672-684. IGS opposes using this allocator because the Companies do not have a specific calculation upon which to base this allocation. IGS IB, pp. 17-24. The use of an allocator is appropriate in this case because the level of allocation is close to the amount one would expect given the nature of services provided and the types of other non-transportation tasks described by the Company witness. While it is possible that these employees are working on other tasks for the Companies that are not related to transportation service, it is clear that the work of supporting these suppliers is occurring. No party maintains that no one is performing the listed functions and it seems reasonable that it is this group.

The amount of overlap is likely to be *de minimus* and while "similar" services may be performed by each group, the services performed by GTS, by-and-large, are services for transportation customers either ratepayers or suppliers. There is no evidence that sales customers call GTS. Tr., September 1, 2011, p. 675. Even if services overlap somewhat, there is no evidence that the costs overlap; i.e., that the Companies are over-recovering. NS-PGL IB, p. 161.

IGS points to call center activity to support its proposal to have all administrative costs borne by all eligible customers. IGS IB, pp. 12-13. While CFY customers do pay for the main call center through base rates, CFY customers benefit from the main call center and will call in to that call center with basic CFY calls. So the main call center performs services related to utility distribution services, utility commodity services and transportation commodity calls. That call center will refer those customers to their suppliers or to GTS.

To support its position that all eligible customers benefit from SVT, IGS claims that the Companies concede this point. "In this proceeding, IGS has developed substantial additional evidence, demonstrating that all eligible customers do benefit from the Choices For You program; and *the Companies have confirmed that evidence*. (*See, e.g.*, IGS Ex. 1.0 at 31:740-743, 33:788-794; Tr. at 692:6-693:15.)" IGS IB, pp.17-18, emphasis added.

The Companies never confirmed this assertion. What the witness stated was that *if* the customer group benefits, they should be charged their "fair share" of the cost. When asked, "And we'd agreed earlier that as a general matter, if a customer group benefits from a program, it should be allocated its fair share of the cost, right?," the Company witness responded, "Correct." Tr., September 1, 2011, p. 693. Thus the Companies agreed that if there was a benefit, it should be paid. It did not confirm that this benefit existed.

IGS also contends that the Commission directed the Companies to implement this feature of the Nicor's SVT program. "The Companies … have not presented any explanation as to why they failed to follow the Commission's directive." IGS IB, p. 25.

However, the directive and requirement for this discussion and inclusion was directed at operational parameters, not administrative costs. The Commission only instructed the parties to address these matters in those workshops. Those matters were discussed, but there was no consensus.

That order confirms that the Commission was not inclined to require any socialization but rather only that the matter must be addressed in the workshop, which it was. "At this point, the Commission adopts the Utilities' position to recover these costs through specific charges to suppliers. Because the Commission has adopted Staff's position to hold workshops, *the Administrative Costs are matters that can be reviewed in that forum*. See the discussion of the adoption of the workshop process above." Order, January 21, 2010, Docket No. 09-0166/0167 cons., p. 260, emphasis added.

Thus Staff still supports the separate recovery of these costs exclusively from suppliers. However, given that there is not a basis for the 15/17th labor allocation used by the Company to allocate the costs of GTS to SVT customers, Staff supports IGS's recommendation that the Commission require the Companies to undergo a detailed cost study and time recording between this rate case and the next in order to have better records of time allocation for GTS labor. This measure of the historical time allocation in support of transportation services would provide a firmer basis to address this issue in a future rate case.

2. Purchase of Receivables (withdrawn)

XII. CONCLUSION

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

Respectfully submitted,

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