STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

NORTH SHORE GAS COMPANY	:	No. 11-0280
	:	
Proposed general increase in rates for gas service.	:	(Cons.)
	:	
THE PEOPLES GAS LIGHT AND COKE COMPANY	:	No. 11-0281
	:	
Proposed general increase in rates for gas service.	:	

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

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

North Shore Gas Company ("North Shore") and The Peoples Gas Light and Coke Company ("Peoples Gas") (together the "Utilities"), by their counsel, pursuant to the schedule ordered by the Administrative Law Judges, submit this Post-Hearing Reply Brief.

I. INTRODUCTION

A. Overview/Summary

Denying utilities recovery of their real costs of service is not a sustainable strategy, and it harms customers in the long term. The Utilities' rates will be set far below their real costs of service if the Illinois Commerce Commission (the "Commission" or "ICC") approves the punitive historically low rates of return on investment proposed by Staff or the even lower rates of return now urged by "GCI".[1] GCI professes concern for affordable rates that adequately reflect the long-term costs of service and provide a utility with an adequate return on its investment. City-CUB Init. Br. at 2. Actions, however, have consequences. Staff's and GCI's rate of return positions will drive up costs in the long run, if not sooner, by increasing the Utilities' costs of capital and risking a credit downgrade. Fetter Rebuttal ("Reb."), NS-PGL

[1] GCI is the Illinois Attorney General's Office (the "AG"), Citizens Utility Board ("CUB"), and City of Chicago ("City"). GCI previously presented "ranges" of proposed rates of return (ranging from much too low to far lower), but GCI now proposes rates based on the very bottom of those ranges. *See* City-CUB Initial Brief ("Init. Br.") at 4-5. City-CUB filed a corrected Initial Brief. All citations herein are to the corrected version.

Exhibit ("Ex.") 20.0, 7:140-142; Schott Dir., PGL Ex. 1.0, 3:58-63; Schott Dir., NS Ex. 1.0, 3:58-63. *See also* Section VI of the Utilities' Initial Brief[2] and this Reply Brief.

Furthermore, Staff's and GCI's rate of return positions also will be harmful to customers because the Utilities need large amounts of capital obtained at a reasonable price in order to maintain and improve their systems. Although any large gas distribution and transportation system needs ongoing capital improvements, here, Peoples Gas has begun its Accelerated Main Replacement Program ("AMRP"). The AMRP involves accelerating the replacement of old cast and ductile iron main, which the Commission endorsed in the Utilities' 2009 rate cases.[3] The AMRP will provide significant customer benefits, including enhanced safety and reliability, giving more customers the opportunity to install energy efficient equipment, and reducing costs of service significantly over the long term. *E.g.*, Hayes Dir., PGL Ex. 8.0, 12:253-13:277; *Peoples 2009*, pp. 166-173.

GCI would only make things even worse with its punitive proposal to disallow from Peoples Gas' rate base large portions of the 2011 and 2012 AMRP costs. GCI's proposal not only is wrong, but it disregards that Peoples Gas included only half of the 2012 AMRP costs in its proposed rate base to begin with (by using the "average rate base" method for the test year). Moreover, Peoples Gas already explained that it would have no practical choice but to delay significant AMRP work to at least 2013 under GCI's erroneous proposal. *See* Section V.C.1.a.ii. of the Utilities' Initial Brief and this Reply Brief.

An economic downturn is not a justification to pretend that capital markets are more favorable than they really are. Nor is it a good time (there never is one) to hinder a utility from

[2] The Utilities filed a corrected Initial Brief, correcting the page and line numbers of certain citations to the August 31, 2011, transcript. All citations herein are to the corrected version.

[3] *North Shore Gas Co., et al.*, ICC Docket Nos. 09-0166/09-0167 (Cons.) (Order Jan. 22, 2010) ("*Peoples 2009*"), pp. 164-178.

making upgrades to its system that will provide enhance safety and reliability, allow increased energy efficiency, and reduce costs over time. The Commission should approve fair and reasonable rates of return, and reject GCI's punitive disallowance of AMRP costs.

Finally, another of GCI's major positions also is contrary to customers' interests. While Staff supports making permanent the Utilities' decoupling rider, Rider VBA, GCI opposes it. From May 2008 through August 2011, Peoples Gas refunded about $22.9 million and North Shore refunded about $4.7 million to S.C. Nos. 1 and 2 customers. Grace Reb., NS-PGL Ex. 28.0, 30:661-663. Absent the rider, customers would have paid more than their share of the Commission-approved distribution revenues allocated to volumetric charges. Grace Dir., NS Ex. 12.0 REV, 50:1119-1124; Grace Dir., PGL Ex. 12.0 REV, 53:1182-1187. The latter point is the critical ratemaking point. The Utilities' delivery costs are predominately fixed, and yet substantial portions of their fixed costs are allocated to these volumetric charges, even though volumes delivered vary greatly over time due to many factors. The rider improves the accuracy of cost recovery, to the benefit of all. Only GCI sees something wrong with that. Rider VBA should be made permanent. *See* Section VIII.B of the Utilities' Initial Brief and this Reply Brief.

B. Nature of Operations

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II. TEST YEAR (Uncontested)

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III. REVENUE REQUIREMENT

The Utilities' Initial Brief (at 9-10) set forth the basic legal standards relating to the determination of their revenue requirement: the cost recovery principle, the requirement of just and reasonable rates, and the revenue requirement formula. Staff and intervenors do not dispute those standards.[4]

A and B. North Shore and Peoples Gas

North Shore's base rate revenue requirement is $83,384,000, which means that its cost recovery shortfall under current rates will be $8,214,000 in 2012. NS-PGL Init. Br. at 11-12, *et seq.* Peoples Gas' base rate revenue requirement is $601,055,000, which means that its cost recovery shortfall under current rates will be $110,928,000 in 2012. NS-PGL Init. Br. at 11-12, *et seq.* The Utilities have shown the drivers of their cost recovery shortfalls (NS-PGL Init. Br. at 1-3), including the fact that their proposed rates of return are a relatively small driver of their under-recoveries (*id.*), and they have supported every component of their revenue requirements in detail (*e.g., id.* at 14, 42-43, 84-85). The Utilities' cost figures should be approved.

Staff and GCI have presented respective alternative revenue requirement and revenue deficiency figures. Staff Init. Br. at 4; City-CUB Init. Br. at 5. Staff and GCI have not directly engaged on the subject of the drivers of the Utilities' cost recovery shortfalls as such, however, although they have proposed various adjustments. Staff and GCI instead have sought to drive down the Utilities' revenue requirements primarily with punitive historically low proposed rates of return plus, in GCI's case, a punitive proposed disallowance of AMRP costs. NS-PGL Init. Br. at 3-7. Staff's and GCI's low numbers rely on their respective contested adjustments, which are shown to lack merit in Sections IV, V, and VI of the Utilities' Initial Brief and this Reply Brief.

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[4] City-CUB's Initial Brief (at 2) sets forth selected items based on the Findings and Intent section of the Public Utilities Act (the "Act"), 220 ILCS 5/1-102. City-CUB do not and cannot contend, however, that those items are in conflict with, much less overrule, the basic legal standards discussed in the Utilities' Initial Brief. The Findings and Intent provisions of the Act do not expand the jurisdiction or authority of the Commission nor otherwise function as operative provisions of the Act. *E.g., Citizens Utility Board v. Illinois Commerce Commission*, 166 Ill. 2d 111, 126, 651 N.E.2d 1089, 1097 (1995) ("The function of a statutory preamble is to supply reasons and explanations for the legislative enactments.").

Note on Presentation of Figures. In the interests of clarity, the Utilities note that: (1) some of the revenue requirement and revenue deficiency figures presented in these cases are for base rate costs and revenues, such as the Utilities' figures above; while (2) others are for base rate costs and revenues *plus* the costs and revenues reflected in "Other Revenues", the latter being the costs and revenues under riders *except* Rider 2 (Cost of Gas), Rider 11 (incremental costs of environmental activities), and Rider EEP (energy efficiency program costs).[5] The Commission's final Order and its Appendices should appropriately distinguish between those two sets of values, in order to state the correct amounts approved for base rate recovery.

IV. RATE BASE

A. Overview/Summary/Totals

1 and 2. North Shore and Peoples Gas

North Shore's rate base is $192,562,000. NS-PGL Init. Br. at 13. Peoples Gas' rate base is $1,472,853,000. *Id*. at 13-14. The Utilities have supported every component of their rate bases in detail. *E.g., id.* at 14. Their rate bases should be approved. Staff's and GCI's contested rate base adjustments lack merit and should not be adopted, as discussed in Section IV.C of the Utilities' Initial Brief and this Reply Brief.

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

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[5] *E.g.*, Moy Sur., NS-PGL Ex. 39.0 Corr., 3:51-58; NS-PGL Ex. 39.1N (line 5 versus line 10); NS-PGL Ex. 39.1P Corr. (line 5 versus line 10); Staff Init. Br. at App. A, p. 1 (line 1 versus line 5), and App. B, p. 1 (line 1 versus line 5); GCI Ex. 6.1, Schedule ("Sched.") LKM-1 NS, p. 1 (Operating Revenues line versus Total Operating Revenues line), and Sched. LKM-1 PGL, p. 1 (same).

Also, please note that GCI's rebuttal in GCI Ex. 6.1 confusingly presented two versions of each of its Schedules LKM-1 NS and LKM-1 PGL, one set reflecting the upper end of GCI's proposed rate of return ranges, and the other set reflecting the bottom. The two sets are not labeled differently.

C. <u>Contested Issues</u>

1. <u>Plant</u> (All Subjects Relate to NS and PGL Unless Otherwise Noted)

a. <u>Forecasted Test Year Capital Additions</u>

(i) <u>Utility Plant in Service</u>

The Commission should approve the Utilities' surrebuttal figures for plant in service, which reflect Staff's corrected adjustment. NS-PGL Init. Br. at 16; Staff Init. Br. at 9. GCI's proposal to reduce plant in service is based primarily on its punitive proposal to disallow AMRP costs, which is without merit, as is discussed in Section IV.C.1.a.ii, *infra*.

Additionally, GCI claims that the Utilities' plant in service should be reduced by the increases in the capital expenditures forecasts resulting from the incentives provided from the American Recovery and Reinvestment Act of 2009 ("ARRA"). AG Init. Br. at 8. The GCI adjustment must be rejected for several reasons. First, both Utilities witnesses Messrs. Doerk and Puracchio support the increased capital expenditures resulting from ARRA. Doerk Reb., NS-PGL Ex. 24.0, 7:119-137; Doerk Sur., NS-PGL Ex. 41.0, 2:34-4:74; Puracchio Reb., NS-PGL Ex. 33.0 REV 7:155-10:211, NS-PGL Ex. 33.2. In fact, of the projects sponsored by Mr. Puracchio, Staff witness Mr. Seagle did not object to their inclusion in rate base. Seagle Reb., Staff Ex. 17.0, 10:182-17:326.

Second, Mr. Effron's adjustment is unnecessary. Staff witness Mr. Kahle analyzed the Utilities' actual and budgeted capital expenditures over the last three years, 2008-2010. Kahle Dir., Staff Ex. 1.0, 15:317-16:339. Mr. Kahle then applied the average of three-year period to the Utilities' test year capital expenditures. *Id.* The Staff methodology is superior to the GCI adjustment because its accounts for the Utilities' historical experience. As Staff witness Mr. Kahle stated, his "analysis provides a better assessment of the Companies' performance because [his] analysis includes all of the Companies' budgeted capital expenditures rather than a single project as does [GCI witness] Mr. Effron." Kahle Reb., Staff Ex. 10.0 Corr., 15:323-326.

For all the reasons stated above and in the Utilities' Initial Brief (at 16-19), the Commission should approve Staff's corrected proposed adjustment and reject the GCI adjustment. However, if Staff's adjustment is not approved, then the Commission should approve the forecasted plant additions as proposed by the Utilities without Staff's adjustment.

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

The Utilities' Initial Brief has already addressed why GCI's proposed adjustment to Peoples Gas' capital additions related to the Accelerated Main Replacement Program (the AMRP), should be rejected. NS-PGL Init. Br. at 17-18. The Utilities will not repeat those arguments here. Nothing in the AG's and CUB-City's Initial Briefs add support to GCI's proposal regarding the Utilities' plant in service. The Utilities will address several statements in the AG's and the City-CUB's Initial Briefs.

City-CUB make much of Peoples Gas' "erroneous" budget for the capital additions related to the AMRP. *See* City-CUB Init. Br. at 6. However, that argument is a red hearing. Utilities witness Mr. Hayes explained that, while the costs related to the AMRP were not incurred evenly over 2011 as anticipated at the time the budgets were created, the total amount to be expended in 2011 will not change, which was demonstrated by the contracts entered into with four installation contractors, and the meter set ramp ups. Hayes Sur., NS-PGL 42.0, 5:91-99. Further, if for some reason this work cannot be completed, such as a result of permit issues with the City, Peoples Gas has a contingency plan in place. *Id.*

On September 30, 2011, the Illinois Appellate Court for the First District issued its opinion in the appeals of the Commission's *Peoples 2009* Order. The Appellate Court reversed the Commission's approval of Rider ICR. *People ex rel. Lisa Madigan v. Illinois Commerce Comm'n, et al.,* Nos. 1-10-0654, *et al.*, Cons., slip op., pp. 26-28, 52 (Ill. App. Ct. 1st Dist. Sept. 30, 2011) ("*Peoples 2009 Appeal*"). The Utilities might seek rehearing or petition for leave to appeal to the Supreme Court of Illinois.

That setback does not affect Peoples Gas' plans to spend the revised 2011-2012 total amount on AMRP that is reflected in its surrebuttal (subject to the 50% reduction of the 2012 amount due to use of the average rate base method)[6]. However, if the Commission excludes these AMRP capital expenditures from rate base as recommended by GCI, Peoples Gas cannot move forward with these capital expenditures. Being denied millions of dollars of recovery of these costs for this period would force Peoples Gas to limit the 2011-2012 expenditures to what the Commission allows, resulting in delay and higher costs.[7] The disallowance of these costs from rate base would delay the associated customer benefits, including safety and reliability, as described by Mr. Hayes, and significant cost savings over time. Hayes Dir., PGL Ex. 8.0, 12:253-13:277; *Peoples 2009*, pp. 166-173. GCI's proposal should be rejected.

b. <u>Capitalized Incentive Compensation</u> (See also Section V.C.1)

See Section V.C.1 of the Utilities' Initial Brief and this Reply Brief.

c. <u>Non-Union Wages</u> (See also Section V.C.2)

See Section V.C.2 of the Utilities' Initial Brief and this Reply Brief.

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6 Hayes Sur., NS-PGL Ex. 42.0 (entire) (spending plan); Hengtgen Dir., PGL Ex. 7.0, 4:71-83 (average rate base method); Hengtgen Sur., NS-PGL Ex. 40.0 Corr., 14:286 – 41:296; NS-PGL Ex. 40.1P Corr., line 1; NS-PGL Ex. 40.2P Corr., line 1; NS-PGL Ex. 40.3P Corr.

7 Schott Reb., NS-PGL Ex. 17.0, 14:290 - 15:302. Based on GCI's original proposed reduction of $129 million of AMRP costs (gross amount) in 2011-2012 (Effron Dir., GCI Ex. 2.0 Corr., 6:112-120), Peoples Gas would lose approximately $11 million per year until the implementation of rates after its next rate case. Schott Reb., NS-PGL Ex. 17.0, 14:296-299.

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

The Utilities' Initial Brief presented why they contended that the Commission's Order should include original cost determinations based on the amounts reflected in Utilities witness Mr. Hengtgen's direct testimony, and not Staff's somewhat reduced figures that reflect past disallowances of capitalized incentive compensation. NS-PGL Init. Br. at 19-20.

The Appellate Court in the *Peoples 2009 Appeal* since has denied the Utilities' appeal on that issue arising out of the *Peoples 2009* Order, but the time to seek rehearing or appeal has not passed, and the Appellate Court for the Second Judicial District still has pending the Utilities' appeal on that issue arising out of the *Peoples 2007*[8] Order.

Under these partly changed circumstances, in the interests of narrowing the issues, the Utilities are willing to accept Staff's reduced figures, if the Commission's Order further provides that this is without prejudice to the Utilities' seeking approval of higher figures in the event of a decision by the Supreme Court of Illinois or the Appellate Court that reverses in whole or in part the past capitalized incentive compensation disallowances. Absent such a proviso, the Utilities, in the alternative, recommend that their figures be approved.

2. Materials and Supplies – Computation of Associated Accounts Payable

The Utilities' Initial Brief already has addressed why Staff's proposal regarding the computation of the associated accounts payable for Materials and Supplies should be rejected, and GCI witness Mr. Morgan's adjustment, as corrected by Utilities witness Mr. Hengtgen, should be adopted. NS-PGL Init. Br. at 20-21. The Utilities will not repeat those arguments

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[8] *North Shore Gas Co., et al.*, ICC Docket Nos. 07-0241/07-0242 (Cons.) (Order Feb. 7, 2008) ("*Peoples 2007*").

here. Nothing in Staff's Initial Brief adds support to its proposal regarding the computation of the associated accounts payable for Material and Supplies. *See* Staff Init. Br. at 10-11.

3. Gas in Storage – Computation of Associated Accounts Payable

The Utilities' Initial Brief already has addressed why Staff's proposal regarding the computation of the associated accounts payable for Gas in Storage should be rejected. NS-PGL Init. Br. at 21-24. The Utilities will not repeat those arguments here. Nothing in Staff's Initial Brief adds support to its proposal regarding the computation of the associated accounts payable for Material and Supplies. However, the Utilities will address several statements in Staff's Initial Brief.

In its Initial Brief, Staff states that: "Staff indicated that the method of accounting for inventory does not impact the balance recorded as accounts payable. Staff also provided an explanation of the LIFO method of accounting for inventory and the mechanics of the LIFO Liquidation Credit which results from that accounting method based on the Companies' discovery responses." Staff Init. Br. at 12 (citations omitted). It is true that Ms. Ebrey provides a competent recitation of the LIFO accounting method. Ebrey Reb., Staff Ex. 12.0 Corr., 21:370-23:406. After two pages of the description of LIFO accounting, Ms. Ebrey makes a conclusory statement: "As can be seen from these journal entries, the amount that is reflected as accounts payable related to gas purchases is not impacted by the accounting methodology used by the Companies to value their respective inventories at year end." *Id.* at 23:406-409. This demonstrates how Staff's argument is misplaced. It is true that the LIFO method does not impact the accounts payable amount for their respective inventories at <u>year-end</u>. However, Gas in Storage inventory reflected in rate base is a 13-month average for the test year and not the year-end balance. Hengtgen Sur., NS-PGL 40.0 Corr., 4:82-85. The fact that rate base includes a 13-month average is important because for many <u>months</u> of the test year no current year gas purchases are reflected in <u>month</u>-<u>end</u> inventory value. *Id.* at 5:87-90. As a result, Staff's proposal must be rejected. Again, even though proposing a similar adjustment as Staff's regarding associated accounts payable for Gas in Storage (Morgan Dir., GCI Ex. 1.0 Corr., 10:3 – 11:18), GCI witness Mr. Morgan withdrew his adjustment, stating: "Given the Companies' accounting method, my adjustment would be inappropriate." Morgan Reb., GCI Ex. 6.0, p. 2; *see also* NS-PGL Ex. 23.13.

Further, Staff's Initial Brief also addresses the use of the 12-month average of the LIFO Liquidation Credit to compute associated accounts payable to Gas in Storage inventory. It should also be rejected. Staff Init. Br. at 12-13. The LIFO liquidation credit is a liability to purchase gas in the future for injection back into inventory. The credit has no relation to accounts payable for gas in storage during the months that liability exists and therefore in no way should be considered a proxy for an accounts payable adjustment to gas in storage balances. Hengtgen Sur., NS-PGL 40.0 Corr., 5:94-97.

Based on the foregoing and for all the reasons stated in the Utilities' Initial Brief (at 21-24), the Commission should reject Staff's methodology to calculate accounts payable associated with Gas in Storage inventory as it is without merit.

4. <u>Cash Working Capital</u>

a. <u>Pass-Through Taxes and Energy Assistance Charges</u>

(i) <u>Lags for Pass-Through Taxes and Energy Assistance Charges</u>

The Utilities' Initial Brief has already addressed Staff's proposal to reduce the lag days for pass-through taxes and Energy Assistance Charges. NS-PGL Init. Br. at 25-28. The Utilities will not repeat those arguments here. Nothing in Staff's Initial Brief adds support to its proposal regarding lags days for pass-through taxes and Energy Assistance charges.

However, the Utilities will respond to just one portion of Staff's argument. Staff continues to try to conflate the cash working capital ("CWC") facts presented to the Commission in other utilities' rate cases[9] with the different facts presented in this proceeding. Staff's argument must be rejected. First, in the Utilities' last rate case, the Commission already stated that *Nicor 2008* is not controlling. *Peoples 2009*, p. 24. Second, Staff presented no evidence that the facts presented in those proceedings are similar to the facts surrounding the Utilities' remittance of pass-through taxes. In fact, Staff performed no analysis comparing the local laws and agreements of those utilities and those to which Peoples Gas and North Shore are subject. Therefore, the Commission must reject Staff's adjustment as it is not supported by the facts in *this* proceeding. NS-PGL Init. Br. at 27-28.

Staff concedes that the terms upon which the Utilities remit taxes and charges have not changed since the 2009 rate cases. Kahle Transcript ("Tr.") 8/30/11, 271:21-272-2. There is no need for the change Staff proposes. For all the reasons stated herein and in the Utilities' Initial Brief (at 24-28), the Commission should reject Staff's proposal to change the cash working capital methodology for pass-through taxes.

(ii) Leads for Pass-Through Taxes and Energy Assistance Charges

The Utilities' Initial Brief has already addressed Staff's proposal to revise the lead days for the three items, including Energy Assistance Charges, Gross Receipts/Municipal Utility and City of Chicago Gas Use Taxes. NS-PGL Init. Br. at 29. The Utilities will not repeat those

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[9] *In re Northern Illinois Gas Co.*, ICC Docket No. 08-0363 (Order March 25, 2009) ("*Nicor 2008*"); *In re Ameren Illinois Utilities*, ICC Docket Nos. 09-0306 et al. (Cons.) ("*Ameren 2009*"); *In re Commonwealth Edison Company*, ICC Docket No. 10-0467 ("*ComEd 2010*"),

arguments here. Staff's Initial Brief does not address this proposal but it still reflected in the schedules submitted with its Initial Brief. As explained in the Utilities' Initial Brief, these revised leads were based on a misinterpretation of Mr. Hengtgen's testimony, which Staff witness Mr. Kahle admitted. Kahle Tr. 8/30/2011, 266:15 - 267:13.

Staff's revised expense lead days for the three items in question should be rejected as it is not supported by the record and is based on misinterpretation of the Utilities' rebuttal testimony. The Commission should approve the lags and leads for pass-through taxes and energy assistance charges as proposed by the Utilities.

b. <u>Prepayments (Uncontested)</u>

This issue is not contested.

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

This issue is not contested.

5. <u>Retirement Benefits, Net</u>

Staff and the AG's Initial Briefs err on the subjects of the Utilities' pension assets, North Shore's 2009 and 2010 pension contributions, and the Utilities "OPEB" (other post-employment benefits) liabilities.[10] Staff and the AG are correct that the Commission's decisions in the 2007 and 2009 cases excluded Peoples Gas' pension asset from rate base and included the Utilities' OPEB liabilities in rate base.[11] Staff Init. Br. at 16-18; AG Init. Br. at 10; *Peoples 2007*, p. 36; *Peoples 2009*, pp. 35-37. Staff also is correct, however, that the Commission must decide the instant cases based on the evidence in the record. Staff Init. Br. at 17 (citing 220 ILCS 5/10-103, 10-201(e)(iv)(A)). Staff and the AG fail to recognize the new evidence that distinguishes the

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[10] City-CUB's Initial Brief did not address this subject.

[11] The 2009 rate cases Order was affirmed on this subject by *People ex rel. Lisa Madigan v. Illinois Commerce Commission, et al.*, Nos. 1-10-0654, et al. Cons., slip op. (Ill. App. Ct. 1st Dist. Sept. 30, 2011) ("*Peoples 2009 Appeal*").

instant Dockets from the Utilities' 2007 and 2009 rate cases, with respect to both: (1) the Utilities' pension assets and (2) North Shore's 2009 and 2010 pension contributions. The new evidence here makes all the difference.

The Utilities' Pension Assets. Staff's opposition to allowing the Utilities to recover the carrying costs of their prepaid pension expense (*i.e.*, to include their pension assets in rate base) continues to rest on: (1) Staff's factual claim that the Utilities' pension assets (and, implicitly, North Shore's 2009 and 2010 pension contributions) were not funded by investors but instead by customers, because the source of funds was funds from net cash from operating activities (in particular, the collection of customers' utility bills); and therefore (2) invoking the 2007 and 2009 rate cases Orders, which were based on the same factual premise. *See* Staff Init. Br. at 17; *see also* NS-PGL Init. Br. at 31. The AG's position, like GCI's witness' testimony, continues to rest on the 2007 and 2009 rate cases Orders as a *fait accompli* without addressing the merits. *See* AG Init. Br. at 10; *see also* NS-PGL Init. Br. at 31, fn. 37.

The Appellate Court, in affirming the 2009 rate case Order on this subject, recognized that the Commission's decision was based on its finding that the Peoples Gas pension asset was funded by customers. *Peoples 2009 Appeal*, slip op., p. 42.

The evidence in the instant cases, including new facts elicited by Staff at the evidentiary hearing, however, show that the pension assets and North Shore's contributions were funded by investors. First, Utilities witness Ms. Phillips pointed out in her rebuttal testimony that "net cash from operating activities includes the portion of what customers pay on their bills for return of and on rate base as approved during the ratemaking process." Phillips Reb., NS-PGL Ex. 27.0, 9:184-186. In other words, part of what customers pay is the return of and on past capital investments of a utility. The fact that the utility collects that payment does not mean that those collected funds then are not capital of the utility. Neither the facts nor logic supports that inference, which was refuted by Ms. Phillips.

Second, the cross-examination of Utilities witness Ms. Gast by Staff showed another reason that Staff's inference is incorrect. The portion of funds derived from collecting customers' utility bills that ends up as net income is retained earnings, and thus it is a part of equity. Gast Tr. 8/31/11, 401:8 – 401:17.

Each of those facts, neither of which was presented or addressed in the 2007 and 2009 rate cases, and neither of which was refuted by Staff's and GCI's witnesses (NS-PGL Init. Br. at 32-33), precludes any finding that the use of a portion of net cash from operating activities to make pension contributions and create a pension asset is not an expenditure of capital.[12]

The new evidence renders inapplicable here Staff's reference to courts giving less deference to Commission decisions that "drastically depart[] from past practice". Staff Init. Br. at 17 (citing *Bus. and Prof. People for the Pub. Interest v. Illinois Commerce Comm'n*, 136 Ill. 2d 192, 228, 555 N.E.2d 693, 709 (1989) ("*BPI I*")). Staff's resort to that concern also is unjustified here, in any event, given the Commission decisions approving recovery on pension contributions in some cases, referenced below.

The exclusion of the Utilities' pension assets from rate base also is contrary to law, as shown in the Utilities' Initial Brief. NS-PGL Init. Br. at 33-35. Staff's and the AG's Initial Briefs do not show otherwise.[13]

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[12] In addition, it remains undisputed that the pension assets are part of the Utilities' balance sheets and, with respect to defined benefit plans, which is what is involved here, the Utilities own the assets, with the employees being the beneficiaries of the trust. Phillips Reb., NS-PGL Ex. 27.0, 9:192-195. Those additional facts were raised in the 2007 and 2009 rate cases, where then, as here, they were uncontested.

[13] *Peoples 2009 Appeal* distinguishes the case of *Citizens Utilities*, 124 Ill. 2d 195, 529 N.E.2d 510 (1988), on the grounds that it rejected reducing rate base on a customer-supplied funds theory when that would involve retroactive ratemaking. *Peoples 2009 Appeal*, slip op, p. 42. However, Staff's and GCI's theory is that customers under past rates must have paid for the pension assets, so their theory is a form of retroactive ratemaking.

North Shore's 2009 and 2010 Pension Contributions. Staff and the AG also fail to recognize the additional new evidence on the subject of North Shore's pension contributions. The 2007 rate cases Order did not allow the inclusion of, nor otherwise allow a return on, the Utilities' 2006 pension contributions, but that was based on the same factual premise of customer-supplied funds discussed and refuted above.

The Utilities also provided other new evidence. First, the level of pension expense in North Shore's approved revenue requirement set in the 2009 rate cases was about $2.9 million per year, much less than the $4,001,111 and $11,139,238 that North Shore contributed in 2009 and 2010, respectively. Phillips Reb., NS-PGL Ex. 27.0, 10:207-213.

Second, the theory that customers somehow were funding the 2009 and 2010 North Shore pension contributions also is fallacious for another reason. Neither of the Utilities has recovered its approved rate of return on common equity since 2003. Gast Dir., NS Ex. 2.0, 4:71; Gast Dir., PGL Ex. 2.0, 4:71. Thus, customers were not paying the Utilities' total costs of service, and it is not logical or fair to infer that customers nonetheless were funding these pension contributions.

The Commission's Order in ComEd's 2010 rate case approved ComEd's recovery of costs relating to its 2009 pension contribution, which was shown to be funded using internally generated funds, although the recovery was set at the level of annual customer benefit. *ComEd 2010*, pp. 50-51, 98 (also approving recovery at a debt rate of return of ComEd's 2005 pension contribution as it had in ComEd's 2005 and 2007 rate cases, albeit at a lower level based on the theory that some of the cost had been amortized).

Accordingly, in the alternative, North Shore should recover the carrying costs of its 2009 and 2010 pension contributions by including them in rate base or, alternatively, as an income item at the annual customer benefit level (in terms of reduced pension expense in the utility's revenue requirement) of those two pension contributions, *i.e.*, $1,260,000 per year. Phillips Dir., NS Ex. 11.0, 7:142-146.

The OPEB Liabilities. Finally, in the alternative, if the Utilities are not allowed to recover the carrying costs of their prepaid pension expense, or, in North Shore's case, even to earn a recovery as to its 2009 and 2010 pension contributions, then the Utilities' OPEB liabilities should not be included in rate base. While not new, it remains a fact that the pension assets / contributions and OPEB liabilities are similar in nature and should be treated on a consistent basis. Phillips Reb., NS-PGL Ex. 27.0, 2:40-42, 12:244-250. The Commission did not so rule in the 2007 and 2009 rate cases, but the Orders did not identify and there is no valid factual or legal reason for disparate treatment of these items. Staff's and the AG's Initial Briefs identify none.

6. Accumulated Deferred Income Taxes

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

The Utilities' Initial Brief has already addressed many of the arguments raised in the AG and City-CUB Initial Briefs regarding their proposal to reflect 100% of the tax accounting method changes elected by the Utilities in accumulated deferred income taxes ("ADIT"). NS-PGL Init. Br. at 36-41. The Utilities will not repeat those arguments here. Nothing in the AG and City-CUB Initial Briefs adds support to their arguments concerning the 50/50 sharing of the effects of the tax accounting changes in ADIT. However, the Utilities will reply to certain arguments in the AG and City-CUB Initial Briefs that are incorrect and must be rejected.

(i) Repairs Change

City-CUB and AG argue that the benefit related to the Repairs Change is unnecessary because there simply is no significant IRS audit risk. In providing "background", City-CUB state that "the United States Department of Treasury proposed changes, in 2006, that affect

Section 1.263(a)-0 through Section 1.263 (a)-3(h)(2) of Treasury Regulations relating to the capitalization of certain repairs and replacements of plant property. Essentially, the proposed treasury regulations change the 'unit of property' concept in such a way as to make it possible to expense certain costs for tax purposes that would have to be capitalized under current regulations. The determining factor for whether project expenditures are capitalized or expensed is whether it is considered a 'unit of property,' as that concept is used for plant construction expenditures." Utilities witness Mr. Stabile clearly explained why this "background" information does not accurately portray the effect of the proposed regulations. NS-PGL Init. Br. at 37-39. *See also* Morgan Dir., GCI Ex. 1.0 Corr., 12:1 – 13:2.

The City-CUB "background" information is accurate only in two respects: (1) the proposed regulations were first proposed in 2006 and (2) the proposed regulations *generally attempt* to define a unit of property. As Mr. Stabile explained, when re-proposing the regulations in 2008, the Treasury Department made clear that it could not accomplish defining a unit of property as it relates to network assets, which are the bulk of a gas company's property. Stabile Reb., NS-PGL Ex. 26.0, 6:116-120. Specifically, the preamble to the proposed regulations provides that

> These new proposed regulations provide the same definition of network assets as the 2006 proposed regulations and continue to reserve on providing a special rule for network assets. The IRS and Treasury Department think that in many situations, the unit of property for network assets should be smaller than the unit of property determined under the functional interdependence test. <u>The IRS and Treasury Department generally think that the unit of property rules for network assets should be addressed on an industry by industry basis in Internal Revenue Bulletin guidance. Industries are invited to submit requests for guidance under the Industry Issue Resolution (IIR) program after these regulations are finalized.</u>

Id. at 130-140 (emphasis added). Further, Revenue Procedure 2009-39, which allows for automatic or deemed consent of this election, adds that "taxpayers may not change a method of accounting in reliance upon the rules contained in the proposed regulations until the rules are published as final regulations in the Federal Register." *Id.* at 7:155-157. Thus, these rules are far from final and are still subject to the IIR process, which is just under way for the gas industry, and ultimately, the Treasury Department's final regulations on this matter which may be completely different from the decisions made in the IIR process. *Id.* at 7:166-8:178. Of course, as noted by City-CUB Initial Brief (at 9-10), before making this election, Peoples Gas and North Shore monitored the filings of other utilities and consulted with their tax accountants – just as any taxpayer would – but it does not change the basic fact that "unit of property" is not defined. Thus, to the extent that the Utilities' definition assigned to "unit of property" upon which they based their tax accounting method change is different from the results of the IIR process and ultimately the final regulations, they are at risk. Mr. Stabile's testimony regarding the history of this election, the status of the IIR process, and the final regulations are unrebutted. Finally, the Commission already recognized the risk associated with tax accounting method change in its *ComEd 2010* Order (May 24, 2011), noting that ComEd's behavior in <u>not</u> electing the change was not imprudent. *ComEd 2010* Order, p. 114.

In their Initial Brief (p. 9), citing Mr. Stabile's rebuttal testimony, City-CUB state the Utilities "are concerned that the IRS might reveal that the Companies should have recorded an amount different from the amount they have recorded." That is a complete mischaracterization of Mr. Stabile's testimony in order to support their arguments concerning the risk associated with this election. At page 8, lines 189-195, of his rebuttal testimony, NS-PGL Ex. 26.0, Mr. Stabile was asked the question: "With respect to audit risk, [GCI witness] Mr. Morgan states 'Moreover, the risk does not appear to be as significant as the Companies suggest. The Companies acknowledge that this tax accounting change has become more common in the utility industry. The Companies have access to the best practices of the industry and accounting guidance from industry groups regarding this tax accounting change. Given that the Company is not on the forefront on this issue, its risk of errors is diminished. Morgan Dir., GCI Ex. 1.0 Corr., 14:7-12. Do you agree?" In response to this question, Mr. Stabile stated:

> No. To portray the risk in such a manner indicates there is not an in depth understanding of the issue. For example, Mr. Morgan seems to believe an IRS audit is simply about finding errors. <u>Instead, IRS auditors focus on issues.</u> <u>Even if the unit of property is reasonable, and even if a company has applied that unit of property correctly, there is still a lot of judgment and factual information that the IRS can challenge.</u> For example, even with the unit of property concept, no amount incurred that will materially increase the value or substantially prolong the useful life of any unit of property, adapt the property for a new use, or as part of a plan of rehabilitation, modernization, or improvement to any unit of property would ever be able to be considered as a repair. The audit risks in a post-change environment are going to be extremely significant until the whole of the IIR and regulation process settle.

Stabile Reb., NS-PGL Ex. 26.0, 9:196-206 (emphasis added). Thus, this is not merely about whether debits and credits were applied correctly. The IRS auditors will focus on definitions applied and the facts involved. Finally, as Mr. Stabile stated in response to a question from CUB counsel:

> Q So there's nothing unique about this particular tax accounting change in terms of its potential for being subject to audit; is that true?
>
> A No, that's not true. That's the point. It's hugely unique. These are very large dollar items with significant risk. They're not like any of the normal day to day IRS audits that occur. And there's just so many variables in there that – you know, there's technical issue you're talking about FIN 48. There's the fact that the regs aren't final. So all of the things that I've outlined in my testimony, these are significantly different than your normal day-to-day risks that we have with audit.

Stabile Tr. 8/29/2011, 164:9-22.

As Mr. Stabile stated at hearing, there have been positive developments to the extent to "which [it] is sufficient for the Company to actually extend itself out to try to achieve these benefits, but it doesn't mean that there isn't substantial risks." Stabile Tr. 8/29/2011, 165:1-10. The Utilities decided to make the election in hopes of achieving benefits for both customers and shareholders earlier. However, there is risk and it is equitable to share those risks with customers. To reflect 100% of the benefit in ADIT would send a message to utilities in Illinois to not make such elections until all treasury regulations and methodologies are final. Staff agrees. Kahle Reb., Staff Ex. 10.0 Corr., 24-508-527.

Thus, the Commission should reject the City-CUB arguments and allow a 50/50 sharing of risks as well as benefits between customers and shareholders with respect to the Repairs Change.

(ii) Overhead Change

The Utilities' Initial Brief has already addressed many of the arguments raised by the AG regarding its proposal to reflect 100% of the Overhead Change in ADIT. NS-PGL Init. Br. at 36-41. The Utilities will not repeat those arguments here. The record demonstrates that the IRS has designated this election a Tier 1 issue, which include "'high-risk' transactions and issues that represent [the Large Business and International Division's] highest compliance priorities." Stabile Reb., NS-PGL 26.0, 10:231-12:294.

(iii) Conclusion

The AG claims that the Utilities' shareholders will experience some sort of "windfall" if the Commission approves the 50/50 sharing of risks and benefits associated with the tax method accounting changes. AG Init. Br. at 14. That is simply not true and the Commission has already rejected this argument. As the Commission noted with respect to the Repairs Change in its *ComEd 2010* order, "The Commission also cannot conclude that only ComEd's shareholder will benefit when and if ComEd elects to use this new tax procedure. As Staff points out, when the IRS issues guidelines on this new procedure, and when ComEd avails itself of this procedure, (providing it proves to be beneficial) ratepayers will benefit in the future." *ComEd 2010*, p. 114.

Further, as Mr. Hengtgen explained, when a utility takes a tax deduction and reflects the impact of the deduction in its financial statements, the benefits of that deduction will inevitably be conveyed to customers through reduced rates. However, to the extent an election is subject to a final determination after audit or other Treasury action or law change that reverses a utility's position, it usually results in a utility returning the benefit without the ability to recover equivalent amounts from customers. Hengtgen Dir., NS Ex. 7.0, 14:304-15:319; Hengtgen Dir., PGL Ex. 7.0, 17:361-377. Finally, Staff does not object to the Utilities' proposal. Specifically, Staff witness Mr. Kahle states:

> While splitting the risk of this tax position with ratepayers may provide the Companies with "free" or low cost capital in the short term, the Companies bear 100% of the burden of tax payments and possible interest expense if the Companies do not prevail in their position. If the Companies do prevail in their position, however, ratepayers will receive 100% of the benefit of reduced rate base in the succeeding rate case.

Kahle Reb., Staff Ex. 10.0 Corr., 24:518-523.

Thus, there is no "windfall". The Utilities' proposal to share 50/50 the risks as well as the benefits with customers should be approved.

b. <u>Derivative Adjustments from Contested Adjustments</u>

The Utilities' addressed AG's arguments regarding the 50/50 sharing of the risks associated with the Repairs Change and Overhead Change in Section IV.C.6.a. of this Reply Brief and in its Initial Brief at pages 36-41.

D. Accumulated Depreciation (Uncontested Except for <u>Derivative Adjustments from Contested Adjustments)</u>

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

V. **OPERATING EXPENSES**

A. **Overview/Summary/Totals**

1 and 2. **North Shore and Peoples Gas**

North Shore's base rate operating expenses are $68,706,000. NS-PGL Init. Br. at 42. Peoples Gas' base rate operating expenses are $500,540,000. *Id*. The Utilities have supported every component of their operating expenses in detail, as well as their "repairs revenues" and their Gross Revenue Conversion Factor. *E.g.*, *id.* at 42-43. Their operating expenses (and operating revenues) should be approved. Staff's and GCI's contested adjustments lack merit and should not be adopted, as discussed in Section V.C and V.F of the Utilities' Initial Brief and this Reply Brief.

B. **Uncontested Issues**

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C. **Contested Issues**

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

Staff's and GCI's respective proposed disallowances of the Utilities' incentive compensation costs (*see* Staff Init. Br. at 24-29; AG Init. Br. at 16-19; City-CUB Init. Br. at 14-15) should not be adopted. These proposals, particularly Staff's proposed disallowance of costs related to the Utilities' Non-executive Incentive Compensation Plan's O&M cost control metric, are not lawful based on the record evidence in the present case and prior Commission rulings. Nor is this conclusion changed by the First Judicial District's decision in *Peoples 2009 Appeal*.

a. **Non-executive Incentive Compensation Plan (Staff Only)**

While the Utilities fully addressed Staff's arguments in support of Staff's proposed disallowance of the 50% of the Non-executive Incentive Compensation Plan's costs that are related to its O&M cost-control metric in their Initial Brief (*see* NS-PGL Init. Br. at 50-57), a few points merit highlighting, here.

In its Initial Brief (at 27), Staff acknowledges that the Commission has approved recovery of incentive compensation costs related to metrics designed to control O&M expenses by paying incentive compensation to employees when certain budgeted target levels of O&M expenses are met. Staff argues, however, that the Utilities failed to present evidence here that their O&M metric, which works in a similar manner to those approved in prior Commission decisions, would benefit customers. *Id*. at 27-28. Staff's characterization of the evidentiary record is wrong. Utilities witness Ms. Cleary expressly testified that if the Utilities meet or beat the O&M expense target level in the plan based on their 2012 test year budget, this will directly benefit customers by reducing the expenses to be recovered in future rate cases. Cleary Reb., NS-PGL Ex. 25.0, 12:243-245. That is consistent with the Commission's conclusions in other proceedings, such as in ComEd's 2005 rate case in which the Commission ruled that "[l]owering O&M expenses, all else being equal, has the obvious effect of reducing the expenses to be recovered in future rate cases." *ComEd* 2005, pp. 95-96. The Commission reached the same conclusion in the Utilities' 2007 rate cases, where the Commission examined an incentive compensation metric "based on controlling these [O&M] expenses" and stated that "we consider this as beneficial to ratepayers." *Peoples 2007*, pp. 66-67. The evidence, therefore, clearly demonstrates that the Utilities' O&M cost-control metric here, as with those in the previous Commission Orders cited by the parties, provides a direct benefit to customers. Accordingly, the Commission should approve the recovery of the costs for this metric as it did in its previous Orders cited by the Utilities in their Initial Brief. *See* NS-PGL Init. Br. at 51-52 and fn. 44.

Likewise, as discussed fully in the Utilities' Initial Brief (at 53-55), the use of the Utilities' 2012 test-year budget to set the O&M cost-control target level was proper. Staff continues to challenge this on the basis of the Commission's decision denying ComEd's alternative rate regulation plan pursuant to Section 9-244 of the Public Utilities Act, 220 ILCS 5/9-244, *In re Commonwealth Edison Co.*, ICC Docket No. 10-0527 (Order May 24, 2011) ("*ComEd Alt. Reg.*"). Again, Staff's attempt to rely on this decision to support a proposed disallowance in a complete future test year base rate case is an inappropriate apples-to-oranges comparison. The Commission's decision regarding the use of budgets in its *ComEd Alt. Reg.* Order was based on insufficient transparency, whereas it is undisputed that the O&M budget at issue here was subject to the full scrutiny of all the parties in a complete base rate setting proceeding. Cleary Reb., NS-PGL Ex. 25.0, 12:252 – 13:263; Ebrey Tr. 8/30/11, 238:12-17. Accordingly, as the Commission has done in other base rate cases in which a metric is measured against a budgeted target level (*see* NS-PGL Init. Br. at 54-55), the Commission should allow recovery of expenses for the Utilities' O&M cost-control metric.

Finally, it should be noted that Staff fails to make any arguments in its Initial Brief that the O&M cost-control metric's expenses should be disallowed because non-Illinois affiliates are included in measuring performance under this metric. For the reasons set forth in the Utilities' Initial Brief (at 55-56), such an argument lacks merit and should be rejected by the Commission in its entirety. If, however, the Commission does make a disallowance of expenses for the O&M cost-control metric on this ground alone, it is uncontested that the disallowance should be made based on the same allocation determined by Staff for portions of the Executive Incentive Compensation Plan (44% for Peoples Gas and 46% for North Shore). *See* NS-PGL Init. Br. at 56-57.

b. **<u>Executive Incentive Compensation Plan</u> (Staff and GCI)**

Both Staff's and GCI's proposed disallowance of certain costs related to the Executive Incentive Compensation Plan lack merit and should be denied.

With respect to the plan's Earnings Per Share ("EPS") metric, which comprises 70% of the plan's costs, while both Staff and GCI acknowledge that an EPS target can be achieved by cost reductions that benefit customers,[14] they continue to oppose recovery of these costs without regard of the evidence. GCI's argument is based on the Second Judicial District's decision in *Commonwealth Edison Co. v. Illinois Commerce Commission*, 398 Ill. App. 3d 510, 518-519, 924 N.E.2d 1065, 1078 (2d Dist. 2009) ("*ComEd 2005 Appeal*"), affirming the Commission's denial of cost recovery for an EPS-based portion of ComEd's incentive compensation plan because a nexus between potential cost-savings and customer benefits was not proven. Unlike in *ComEd 2005 Appeal*, however, the Utilities here presented more than just general testimony that their EPS target could be met by cost savings. Rather, the Utilities presented specific evidence demonstrating a concrete example of how the EPS metric at issue in fact incentivized their executives to forego a general wage increase in order to improve EPS. Cleary Reb., NS-PGL Ex. 25.0, 5:100-104; Cleary Sur., NS-PGL Ex. 43.0, 3:62 – 4:72. Contrary to GCI's argument, this savings in base wages pertains to operations and service delivery and was of direct benefit to customers.

This evidence also distinguishes the present case from *Peoples 2009 Appeal*, in which the First Judicial District affirmed the Commission's denial of the Utilities' "financial" incentive compensation expenses based on a finding that there was not a sufficient nexus between those expenses and customer benefits. *Peoples 2009 Appeal*, pp. 34-35. The evidentiary record in *Peoples 2009 Appeal* did not include such evidence of a specific actual example proving that the

[14] *See* Staff Init. Br. at 26-27; Ebrey Tr. 8/30/11, 226:7-10; AG Init. Br. at 18; Effron Tr., 8/30/11, 202:5-20.

financial metric at issue incentivized cost reductions that benefit customers. Rather, the court based its decision on the fact that the record in those rate cases demonstrated only that the plans there were "designed to attract and retain highly qualified and motivated employees." *Id.* at 35. Thus, *Peoples 2009 Appeal* is distinguishable from the present case just as is *ComEd 2005 Appeal*.

Moreover, Staff's argument that the Utilities' evidence shows only a "de minimis" impact on the Utilities' costs and EPS mischaracterizes the evidence. The undisputed evidence is that in this one example alone, the EPS metric incentivized the Utilities' executives to save $127,082 in operating expenses (base wages) that otherwise could have been passed on to customers. Cleary Reb., NS-PGL Ex. 25.0, 5:100-104; Cleary Sur., NS-PGL Ex. 43.0, 3:62 – 4:72. The Utilities submit that this is not an insubstantial amount of cost-savings for customers. This conclusion is even more evident when this cost savings is considered in relation to the incentive compensation costs at issue. The Utilities' costs for the EPS metric are $1,101,800 (70% of the Utilities' combined Executive Incentive Compensation Plan costs of $1,574,000). Thus, the $127,082 in proven cost savings is equal to 11.5% of the costs for the EPS metric ($127,082 / $1,101,800). In whatever light examined, the evidence compels the conclusion that these savings are not "de minimis" and that the EPS metric directly benefits customers in a substantial way. Likewise, this evidence supports the denial of Staff's additional proposed disallowance on the plan's operational metrics related to the Utilities meeting their EPS target. *See* NS-PGL Init. Br. at 59-60; Staff Init. Br. at 27. At the very least, in the alternative, the Commission should allow the recovery of $127,082 of the costs related to the EPS metric of the Utilities' Executive Incentive Compensation Plan based on this uncontradicted evidence of direct customer benefit (operational cost savings) equal to this amount.

Staff's proposed disallowance for the operational metrics of the Utilities' Executive Incentive Compensation Plan based on inclusion of non-Illinois affiliates' performance in those metrics also runs afoul of the evidentiary record. The Utilities provided specific and detailed evidence proving that by sharing best practices and programs related to safety, customer satisfaction and environmental impacts at a corporate level, benefits accrue directly to Illinois customers. *See* NS-PGL Init. Br. at 58-59. Indeed, the Utilities provided specific evidence of the benefits that this arrangement has provided to Illinois customers, such as a significant safety improvements shown by Peoples Gas and North Shore reducing their OSHA recordable rates from 10.43 to 3.34 and 11.31 to 2.59, respectively, between 2010 and the first quarter of 2011. Cleary Reb., NS-PGL Ex. 25.0, 6:119-132; Cleary Sur., NS-PGL Ex. 43.0, 4:87 – 5:98. Staff does not contest this conclusion in its arguments.

c. <u>Omnibus Incentive Compensation Plan (Stock Plans)</u> (Staff and GCI)

Staff and GCI both rely upon the fact that the Commission denied recovery for similar stock plans in the Utilities' previous rate cases as the basis for disallowing their costs here. *See* Staff Init. Br. at 29; AG Init. Br. at 18-19; City-CUB Init. Br. at 15. These arguments, however, ignore that the Utilities did present additional evidence in the present case beyond the fact that these plans are needed to attract a qualified and motivated workforce. Utilities witness Ms. Cleary also testified that the stock plans help the Utilities maintain a steady and experienced executive team, which leads to a more efficient and successful operation of the Utilities that inures to the benefit of customers. Cleary Reb., NS-PGL Ex. 25.0, 17:357-360. Looked at another way, it is undisputed that customers benefit from an efficiently and successfully run utility, and attracting and maintaining a qualified, skilled, motivated and experienced workforce is integral to that occurring. Thus, as the uncontradicted evidence is that such a workforce would not be possible but for the Utilities offering the stock plans, the stock plans benefit the Utilities' customers. *See United Cities Gas Co. v. Illinois Commerce Comm'n*, 225 Ill. App. 3d 771, 776-778, 587 N.E.2d 581, 584-585 (4th Dist. 1992) (holding that evidence showing consulting and noncompete agreements were integral to acquisition that benefitted customers and that but for such agreements, the acquisition would not have occurred, required finding that the agreements themselves benefitted customers). This evidence is uncontradicted and supports the rejection of Staff's and GCI's proposed disallowances.

d. The Utilities' Incentive Compensation Costs on the Whole Are Recoverable as Prudent and Reasonable Operating Costs

Peoples 2009 Appeal and *ComEd 2005 Appeal* upheld disallowances of incentive compensation costs.

Certain points should be noted, however. The court in *Peoples 2009 Appeal* did not hold that the Commission legally *must* apply a direct benefit standard, only that doing so was within the Commission's discretion under the Act, and the Court's holding was that the Commission did not abuse its discretion in finding that the Utilities failed to meet that standard as to the "financial" metrics in question there based upon on the evidentiary record in that specific case. *Peoples 2009 Appeal*, pp. 32, 35. *ComEd 2005 Appeal*, while affirming the Commission, did so in a situation where only about half of the incentive compensation was disallowed, and the Court took the somewhat unusual step of noting that it might not have reached the same decision as the Commission. *ComEd 2005 Appeal*, p. 12.

Here, the Commission is faced with an entirely different evidentiary record with new facts about incentive compensation plans which, except for the stock plans, have undergone significant changes since the Utilities' previous rate cases reviewed in *Peoples 2009 Appeal*. The uncontradicted evidence presented by the Utilities in the present rate cases, summarized in the Utilities' Initial Brief (*see* NS-PGL Init. Br. at 50-64), firmly establishes that the costs of their incentive compensation plans are undisputedly prudent and reasonable, and that they each directly benefit customers in various ways including but not limited to the direct tradeoff against base compensation. Moreover, as discussed in the context of the incentive stock plans, above, customers benefit from a well and efficiently run utility, and the uncontradicted evidence is that but for the Utilities' reasonable and prudent incentive compensation plans, they would not be able to attract and maintain the workforce integral and necessary to a well and efficiently run utility being possible. The costs of these incentive plans, therefore, are recoverable because they make possible the benefits customers receive from having a well and efficiently run utility. *See United Cities Gas Co.*, 225 Ill. App. 3d at 776-778, 587 N.E.2d at 584-585. For these reasons, as well as the reasons presented in the Utilities' Initial Brief (at 61-64), the Commission should approve the Utilities' incentive compensation costs in their entirety as prudent and reasonable operating expenses, as well as for the individual direct benefits each plan provides to customers as discussed above and in the Utilities' Initial Brief.

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

For the reasons expressed in the Utilities Initial Brief (NS-PGL Init. Br. at 65-68), Staff's proposed reductions to the Utilities' non-union base wage increases should be rejected.

Staff's argument that the overall 3.9% increase in the base wage amounts for the Utilities is equal to what the World at Work Salary Budget Survey says only the "highest performers" should receive fails to address that the 3.9% amount contains different components and does not represent an across the board wage increase for all employees. First, only 3.0% of this amount is an across the board general wage increase – consistent with what is projected for wage increases generally by the World at Work Salary Budget Survey for 2011-2012. Cleary Reb., NS-PGL

Ex. 25.0, 19:412-418; Cleary Sur., NS-PGL Ex. 43.0, 11:225-233; Ebrey Reb., Staff Ex. 12.0 Corr., 13:238 – 14:254. Second, .3% of the wage increase amount is a discrete pool of funds used to give performance raises only to certain top-performing employees – not an across the board raise. Cleary Reb., NS-PGL Ex. 25.0, 20:440-445. This is consistent with Staff's own acknowledgment that "highest performers" may receive wage increases of more than 3.0%, with some as high as 4.0%. *See* Staff Init. Br. at 30. Third, the remaining .6% of the increase in the overall amount of base wages is for pay raises related to promotions – i.e., changes in employees' relative positions within the Utilities. Cleary Sur., NS-PGL Ex. 43.0, 11:239 – 12:246. These are not wage increases, per se, but rather, the new positions of the promoted employees have higher market based rates of pay than their previous positions, which in the aggregate are equal to .6% of the previous year's base wages for the Utilities. *Id*. Thus, reliance upon the World at Work surveys or consumer inflation predictions are inapposite to this portion of the Utilities' increase in wage base.

Furthermore, Staff's reliance on a forecast of the Consumer Price Index ("CPI") for the 2011-2015 period to recommend a decrease in the level of general wage base increase for the 2012 test year lacks merit. The Commission's determination in the present case is supposed to be limited to the 2012 future test year – which is specifically addressed by the World at Work Salary Budget Survey's prediction of a 2.9% increase in 2012 general wages. *See* Ebrey Reb., Staff Ex. 12.0 Corr., 14:253-254; Cleary Reb., NS-PGL Ex. 25.0, 19:405-411. Indeed, Staff's reliance on the fact that the CPI forecast covers more than the test-year would be a violation of the Commission's test year rules and policies. Moreover, as explained fully in the Utilities Initial Brief (NS-PGL Init. Br. at 67), the CPI is a measure that is not designed to calculate changes in wages and thus, is not relevant to the issue as is the World at Work Salary Budget Survey.

Accordingly, the Commission should approve the Utilities' 3.9% increase in the level of base wages in 2011 and 2012 that is comprised of: (a) a 3.0% base wage increase; (b) performance raises that, in the aggregate, total .3% of the previous year's wage base; and (c) wage increases commensurate with promotions that, in the aggregate, total .6% of the previous year's wage base.

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

The Utilities' Initial Brief has already addressed the arguments raised in the AG and City-CUB briefs regarding their adjustment relating to headcounts. Utilities' Init. Br. at 68-69. The Utilities will not repeat those arguments here. Nothing in the AG and City-CUB Initial Briefs add support to their arguments concerning headcounts and their adjustment should be rejected for all the reasons stated in the Utilities' Initial Brief (pp. 68-69).

4. Self-Constructed Property

The Utilities' Initial Brief (at 69-70) showed: (1) that GCI's proposal to remove $1,722,000 of costs of self-constructed property from Peoples Gas' operating expenses on the ground that they should have been capitalized and treated as an addition to plant is incorrect; and (2) if GCI's proposal were adopted to be adopted, then that $1,722,000 would have to be added to Peoples Gas' rate base.

Staff agrees that GCI's proposal is unnecessary. Staff Init. Br. at 31-32.

The AG and City-CUB addressed their proposal in Section V.C.6.b of their Initial Briefs. Their arguments are erroneous. They each claim that accounting principles require that the expenses in question be capitalized (AG Init. Br. at 22; City-CUB Init. Br. at 18-19), but all that

GCI has shown is that it is permissible, not that it is required. NS-PGL Init. Br. at 69-70. Also, they inappropriately once again fail to address that, if they were right, then this $1,722,000 would have to be added to Peoples Gas' rate base. Accordingly, GCI's proposal should be rejected, but, if it were to be adopted, then the costs must be added to Peoples Gas' rate base.

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

Staff adheres to its proposal to use actual 2010 net write-offs as the method to determine the Utilities' uncollectibles expense for purposes of revenue requirements and their uncollectibles expense riders, Riders UEA and proposed UEA-GC, rather than the Utilities' percentage of revenues method, which is based on current period revenues and costs. Staff briefed this proposal entirely in Section VIII.A of its Initial Brief. The Utilities divided their discussion between this Section V.C.5 and Section VIII.A of their Initial Brief, and will do so as well in this Reply Brief, as explained below.[15] Staff's proposal should not be adopted.

Revenue Requirements. There is no dispute regarding the revenue requirement impacts of Staff's proposal. Staff's proposal would result in a $510,000 increase in uncollectibles expense in Peoples Gas' revenue requirement and a $421,000 decrease as to North Shore. NS-PGL Init. Br. at 70. Yet, even though it would result in a net $79,000 increase in revenue requirements, the Utilities oppose Staff's proposal.

Staff proposes that, for the 2012 test year, the Utilities' forecasted 2012 uncollectibles expenses figures based on the most up to date information should not be used, and instead they should be replaced by actual figures for 2010 net write-offs. *See* Staff Init. Br. at 89-90. Staff does not claim, however, to have shown any flaw in the forecasts. Staff instead asserts this raw proposition: "Actual information is preferable to estimates since it is more accurate, and should be used whenever available." *Id*. at 90. Staff does not provide any support for that proposition

[15] Neither the AG nor City-CUB addressed this subject.

with respect to the subject at hand, nor does Staff support it as a general proposition, and it does not make sense as a general proposition in a future test year rate case, which by its nature is forecasted. That is not to say that using actuals can never be shown to be superior to a forecast in any given instance, but there is no evidence to support that here.

The updated 2012 forecasts are superior, because they are based on the most current data, including current Gas Charge revenues. NS-PGL Init. Br. at 71. Staff's proposal in relation to the revenue requirements should not be adopted.

<u>The Riders</u>. Staff's proposal is inadvisable with respect to Riders, for three reasons discussed in the Utilities' Initial Brief (at 71-72). First, if Staff's method were to be adopted, the information needed for the riders would be inaccurate and incomplete, and inferior to use of up to date forecasts. Second, Staff's method would lead to a mismatch between revenues and uncollectible expense being recorded. Finally, Staff's method is seriously flawed by using data from a single year. Staff has not refuted those three points. As to the third, Staff itself notes that uncollectibles expense fluctuates. Staff Init. Br. at 90.

Staff's Initial Brief (at 90-91) argues that stipulations approved by the Commission in ICC Docket Nos. 09-0419/09-0420 Cons. do not preclude the Commission from adopting Staff's proposal here. Even if that were so, that does not mean it would be a good idea. It would not.

Moreover, while the stipulation may not expressly state that Staff's method is barred, one of them required the Utilities "to address the uncollectible amount included in the utility's rates in specified, distinct ways for the gas cost uncollectible amount and for the non-gas cost uncollectible amount." Grace Reb., NS-PGL Ex. 28.0, 11:225-228. The Utilities' method passes that test, but Staff's method fails it. NS-PGL Init. Br. at 71; *see also* Grace Sur., NS-PGL Ex. 45.0, 26:557 – 27:576 (additional inconsistencies between stipulations and Staff's method).

A further serious problem is that Staff has not adequately addressed the tariff language changes required by its proposal. *See* Section VIII.A of the Utilities Initial Brief and this Reply Brief. Staff's proposal should not be adopted.

6. Administrative & General

a. Injuries and Damages Expenses

GCI's proposal to reduce Peoples Gas' injuries and damage expenses by $3,077,000 from the $13,575,000 level in Peoples Gas' direct and rebuttal: (1) is based on erroneous interpretation of a data request response, (2) uses outlier data from 2010 that is inferior to the updated 2012 test year forecast figure of $12,142,000 presented in Peoples Gas' surrebuttal, and (3) is overstated by $1,433,000 because it is not corrected for Peoples Gas' having reduced the original $13,575,000 figure by $1,433,000 to $12,142,000 in surrebuttal. NS-PGL Init. Br. at 72-74.

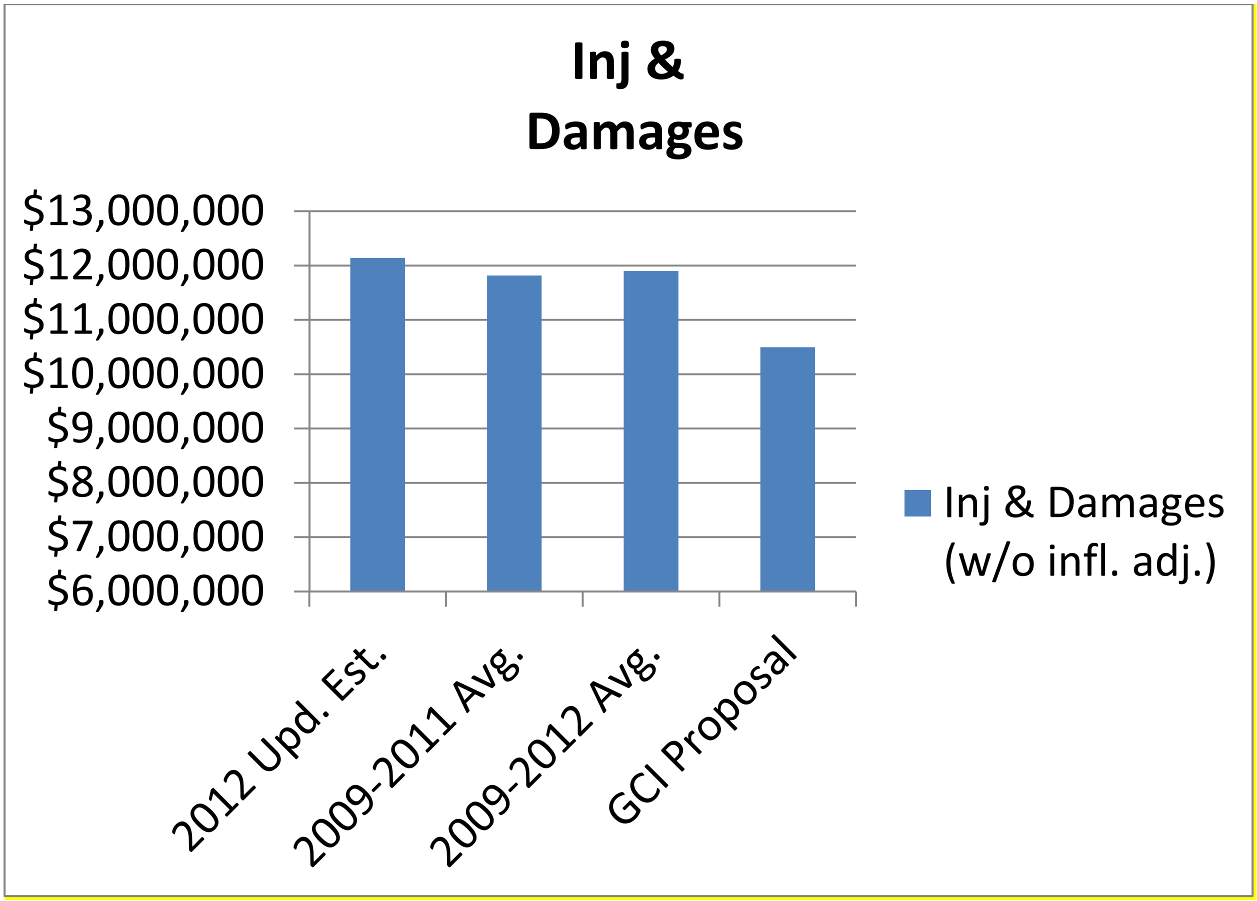
Staff agrees that Peoples Gas sufficiently supported its updated 2012 figure for injuries and damages expense and that GCI's adjustment should not be adopted. Staff Init. Br. at 33-34.

GCI claims (1) that Peoples Gas failed to sufficiently support the assumption of a major claim at the maximum exposure level in 2012, yielding $1,119,000 of their proposed adjustment (AG Init. Br. at 21; City-CUB Init. Br. at 16); and (2) Peoples Gas did not sufficiently support its increase in medical costs in 2012, which they suggest warrants an additional $1,958,000 adjustment, based on the (mistaken) premise that there was a $3,077,000 increase in the total amount of this expense from 2009 to 2012 ($3,077,000 minus $1,119,000 equals $1,958,000) (City-CUB Init. Br. at 16). GCI's claims lack merit and do not justify their proposal, for several reasons.

First, GCI cannot negate the fact that their proposal is based on misinterpretation of a data request response. GCI's premise of an increase of $3,077,000 from 2009 to 2012 in the total amount of the expense is false. GCI's figure is based on its misinterpretation of a data request response that related to amounts allocated or charged from affiliates, and GCI failed to factor in that the handling of this expense was moved entirely to the affiliate as of 2012. The total expense in 2009 was $12,913,000. The 2012 forecasted figure as of Peoples Gas' direct and rebuttal was $13,575,000. That is an increase of $672,000 or 5.13%, not $3,077,000. Gregor Reb., NS-PGL Ex. 21.0 Corr., 11:223-229; Gregor Sur., NS-PGL Ex. 38.0, 3:50-59.

Second, GCI ignores that over half of injuries and damages expense consists of workers compensation expenses, and that medical costs increased 3.41% in 2010 and are forecasted to increase by approximately 3% in each of 2011 and 2012. That more than explains the original forecasted increase. Gregor Reb., NS-PGL Ex. 21.0 Corr., 11:229-236.

Third, even if there were anything to GCI's claims, which there is not, that would not support their proposal of using 2010 outlier data to set injuries and damage expense. The Utilities presented the actual figures for 2009 and 2010, as well as updated forecast figures for 2011 and 2012 in surrebuttal. NS-PGL Init. Br. at 72-73 and fn. 53. Peoples Gas' surrebuttal updated 2012 forecast figure of $12,142,000: (1) is lower than the 2009 level of $12,913,000 that was the starting point of GCI's calculation; (2) is very close to the average (mean) of the 2009 and 2010 actuals and the 2011 updated forecast, $11,817,667; and (3) also is very close to the four year average (mean) of the 2009 and 2010 actuals and the 2011 and 2012 updated forecasts $11,898,750; and it should be kept in mind that the foregoing calculations do not adjust the 2009, 2010, or 2011 figures for inflation. *Id*. at 72-73. In contrast, GCI's proposal would set the level at $10,498,000, far below the averages. *Id.* at 73. The outlier nature of GCI's proposal versus the updated 2012 test year estimate and the averages was illustrated by the following table in the Utilities' Initial Brief (at 73).



Finally, GCI again ignore that $1,433,000 of their proposal is double-counted with the $1,433,000 reduction that Peoples Gas made in surrebuttal. *Id*. at 72.

In the Utilities' 2007 and 2009 rate cases, the Commission rejected contested adjustments to injuries and damage expense as unwarranted. *Id*. at 73-74, citing *Peoples 2007*, p. 57; and *Peoples 2009*, pp. 84-85. The Commission should do so again.

b. <u>Adjustment to Account 921 - Office Supplies and Expenses</u>

The only contested issue with respect to Account 921 is addressed in Section V.C.4 of the Utilities' Initial Brief and this Reply Brief.

c. Rate Case Expenses

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

The Utilities and Staff agree that the level of rate case expenses included in the Utilities' surrebuttal revenue requirements is just and reasonable, and that the evidentiary record contains more than sufficient information for the Commission to so find consistent with Section 9-229 of the Act, 220 ILCS 5/9-229, except the Utilities do not agree with Staff's position that a total of $93,000 should be removed based on Staff's challenge to a portion of the metrics of the Utilities' Non-Executive Incentive Compensation program. NS-PGL Init. Br. at 74-76; Staff Init. Br. at 34-35. The Utilities, in the interests of narrowing the issues, have agreed (NS-PGL Init. Br. at 76) that the determination of that $93,000 can rise or fall with Staff's challenge, which is addressed in Section V.C.1 of the Utilities' Initial Brief and this Reply Brief.

GCI's "Over-estimation" and "Insufficient Support" Complaints. GCI's Initial Briefs present their second abrupt change of direction on this subject in the instant rate cases. Their new "over-estimation" complaint and their revived / revised "insufficient support" complaint are untimely and wrong.

GCI had two different positions in testimony on the rate case expenses of these Dockets. GCI's witness, Mr. Morgan, in his direct testimony, indicated that he needed additional information on the subject, noting some particular areas where he had potential concerns, but he did not propose any adjustments. Morgan Dir., GCI Ex. 1.0 Corr., 21:14 – 22:4. Mr. Morgan, in his rebuttal testimony, as the Utilities understand it, indicated that he was satisfied by the information he later received, and, in any event, he certainly made no claim of any insufficiency nor proposed any adjustments on that basis. *See* Morgan Reb., GCI Ex. 6.0, p. 5. Instead, Mr. Morgan, for the first time in his rebuttal, proposed a "50/50 sharing" of rate case expenses between the Utilities and customers, *i.e.*, to disallow 50% of the expenses. Morgan Reb., GCI Ex. 6.0, p. 7. The "50/50 sharing" proposal, which GCI also pursues, is discussed further below.

Now, in their Initial Briefs, the AG and City-CUB claim over-estimation, and they also go back to contending that the Utilities' support of their rate case expense is insufficient in certain respects, based on (1) a mixture of concerns that Mr. Morgan raised in his direct but did not claim still concerned him in his rebuttal; and (2) in the AG's Initial Brief, new arguments that should have been made in Mr. Morgan's rebuttal. *See* AG Init. Br. at 24, 28-32, 33;[16] City-CUB Init. Br. at 19, 20-21.

GCI's untimely claims in their Initial Briefs are procedurally improper, an unfair bait and switch, and they are incompatible with the law regarding the burden of proof and the order of proof. A utility bears the burden of proof that its proposed rates are just and reasonable, 220 ILCS 5/9-201(c), but once it makes out a *prima facie* case, the burden of going forward with the evidence shifts to the other parties that challenge its costs.

> In proceedings before the Commission, once a utility makes a showing of the costs necessary to provide service under its proposed charges, it has established a *prima facie* case. *City of Chicago v. People of Cook County, 133 Ill. App. 3d 435, 478 N.E.2d 1369, 88 Ill. Dec. 643 (1985).* The burden then shifts to others to show that the costs incurred by the utility are unreasonable because of inefficiency or bad faith. *City of Chicago v. People of Cook County, 133 Ill. App. 3d 435, 478 N.E.2d 1369, 88 Ill. Dec. 643 (1985).*

Illinois Bell Tel. Co. v. Illinois Commerce Comm'n, 327 Ill. App. 3d 768, 776, 762 N.E.2d 1172, 1173-1174 (3d Dist. 2002). Moreover, the utility does not bear the burden of proof on all the issues that conceivably are relevant to the reasonableness of its rates, nor is it required in its direct case to anticipate and disprove the objections that opposing parties might make. *City of Chicago*, 133 Ill. App. 3d at 442, 478 N.E.2d at 1375. Furthermore, the norm in Commission

[16] The AG's Initial Brief incorrectly places most of its discussion of the rate cases expenses of the instant cases under the heading relating to amortization of 2009 rate cases expenses.

practice is that the utility has the right to close the evidence in a rate case, 83 Ill. Admin. Code § 200.570, and no exception to that principle was ordered in these cases. That norm is in accordance with long-standing Illinois procedural law. *E.g.*, Ill. S. Ct. R. 233; *Liptak v. Security Benefit Assoc.*, 350 Ill. 614, 618, 183 N.E. 564, 566 (1932).

GCI's untimely claims are not supported by, and instead are negated by, the evidence, in any event. First, neither the AG's nor City-CUB's Initial Brief even acknowledges that Mr. Morgan's rebuttal testimony does not support, and, instead, if anything, refutes any claim of over-estimated or insufficient evidence of rate case expenses.

Second, nor do they make any real effort to address the Utilities' and Staff's testimony on this subject.

Third, the AG's primary complaint is its over-estimation claim, *i.e.*, that substantial portions of the forecasted rate case expense had not yet been incurred based on invoices / charges from outside consultants, the Utilities' affiliate (support, consulting, and testimony), and outside counsel through July 31, 2011. *See* AG Init. Br. at 28-29 (Stafflogix), 30 (intercompany costs), 31 (intercompany costs and SFIO Consulting), 32 (outside counsel).[17]

The AG's complaint, however, does not take into account (except in passing, *see, e.g.*, AG Init. Br. at 32) the time lag that the invoices through July 31, 2011, generally are for work performed through June 30, 2011, that Staff and intervenor rebuttal and the Utilities' surrebuttal were filed in August 2011, that the evidentiary hearing was in August and September 2011, that the Utilities continued to answer discovery through the hearing, and that post-hearing activities include two rounds of briefs, a draft Proposed Order, briefs on exceptions, replies, presumably an

[17] City-CUB's Initial Brief on the subject of the sufficiency of the evidence supporting rate case expenses relies entirely on Mr. Morgan's direct testimony. City-CUB Init. Br. at 20-21. City-CUB's discussion of that testimony is somewhat bizarre, because it includes assertions about information that was not provided in discovery at that point but that was provided later, with no recognition of the latter fact.

oral argument, analysis of the Commission's Order, and work relating to the compliance filing. *E.g.*, Moy Dir., NS Ex. 6.0, 16:344-351; Moy Dir., PGL Ex. 6.0, 16:351 - 17:357; Moy Reb., NS-PGL Ex. 22.0 2 Corr., 9:181 – 10:201, 10:214 – 16:351; Moy Sur., NS-PGL Ex. 39.0 Corr., 4:68-69, 7:145 – 11:218; NS-PGL Exs. 39.4N and 39.4P; NS-PGL Ex. 39.9. The AG's claim that "the lion's share of the work" of outside and affiliate consultants and expert witnesses was complete as of July 31, 2011 (AG Init. Br. at 31) is supported by no testimony and ignores that the invoices through July 31, 2011, generally were for work performed through June 30, 2011, as well as the other points above.

The AG's over-estimation complaint also does not take into account that the Commission in *ComEd 2010* denied the AG's proposed rate case expenses adjustment based on the AG's "over-estimation" claim there, finding in part:

> ComEd correctly asserts that often, more work has to be done in rebuttal in a Commission case than in the direct case. This is, unfortunately, often the situation at the Commission. This can be especially the case in a rate proceeding, where typically, there are no pleadings to guide the parties and the Administrative Law Judges. Additionally, ComEd has the burden of proof here, which usually entails more work than that which is done by other parties. Also, ComEd was required to prepare its witnesses for cross-examination and to prepare its lawyers for the cross-examination of non-ComEd witnesses. It does not appear that Mr. Smith took these tasks, which can be laborious, into account. The Commission additionally notes that there is no evidence that Mr. Smith, when calculating his percentages, took the totality of the circumstances that the practice of law, and especially the practice at the Commission, requires. The Commission therefore declines to reduce the attorney's fees in the manner proffered by the AG.

ComEd 2010, p. 81.

The AG's over-estimation complaint also does not take into account that Staff already proposed adjustments based on discovery responses served through August 15, 2011, and the Utilities accepted those adjustments plus did further updating in surrebuttal resulting in additional incremental reductions that Staff in turn has accepted in its Initial Brief. Ostrander Supp. Reb., Staff Ex. 20.0 (entire); Moy Sur., NS-PGL Ex. 39.0 Corr., 4:68-69, 7:145 – 9:143;

NS-PGL Exs. 39.4N and 39.4P; NS-PGL Ex. 39.9; Staff Init. Br. at 34-35. The AG's over-estimation complaint lacks any merit and should be rejected.

Finally, the AG's other scattershot "insufficient evidence" complaints about some of the outside consultants lack merit and is erroneous. The AG recognizes that certain of the Stafflogix personnel are witnesses in these cases, but asserts that it is "unclear what [non-testifying Stafflogix consultants] are contributing to the rate case". AG Init. Br. at 28-29. Mr. Morgan's direct testimony raised this subject, and Utilities witness Ms. Moy answered in rebuttal (NS-PGL Ex. 22.0 2 Corr., 13:284 – 14:295), as well as providing further documentation in discovery, including extensive materials such as timesheets produced beginning on June 7, 2011 (*id.* at 10:214 - 12:251), much of which was included in NS-PGL Ex. 39.9. Mr. Morgan's rebuttal, filed on August 15, 2011, expressed no claim that the additional information was insufficient. Also, the AG's Initial Brief has its facts wrong, as would have been discussed in the Utilities' surrebuttal if the AG's new points had been timely raised in GCI's rebuttal. The AG claims that a particular Stafflogix consultant billed $538,894. *See* AG Init. Br. at 29. That figure is over 500 times too high. The actual figure billed is $836. NS-PGL Ex. 39.9 at Bates number PGL 0011292. The AG similarly asserts that there is insufficient detail on inter-company costs and SFIO Consulting. AG Init. Br. at 30, 31. Once again, Mr. Morgan's direct testimony raised this subject, and Utilities witness Ms. Moy answered in rebuttal (NS-PGL Ex. 22.0 2 Corr., 14:315 – 15:320), pointing to further documentation in discovery, much of which was included in NS-PGL Ex. 39.9. Once more, Mr. Morgan's rebuttal expressed no claim that the additional information was insufficient. Throughout the discovery process, from June 7, 2011, and onward, the Utilities submitted timesheets as part of the monthly supplemental responses to Staff data request JMO 10.01 (as Attachment 03). Moy Reb., NS-PGL Ex. 22.0 2 Corr., 10:214-217 and fn. 6; NS-PGL Ex. 39.9. The timesheets reflect high level activity (*e.g.*, Perform Regulatory Services, Budget and Forecasting, Sales and Forecasting, etc.), the areas/individual job titles that worked on the current rate cases captured by a specific project, type of labor costs, home area/department that it is billed from, number of hours billed, and amount. Again, there was no evidence from the AG via further data requests or in Mr. Morgan's rebuttal, which was filed on August 15, 2011, that a thorough review of the Utilities' data request responses prompted any such concerns.

GCI's untimely over-estimation and insufficient information complaints should be rejected as improper as well as lacking in merit.

<u>GCI's "50/50 Sharing" Proposal</u>. GCI now presents Mr. Morgan's rebuttal "50/50 sharing" proposal as an alternative to GCI's over-estimation and insufficient information claims. AG Init. Br. at 33-34. The AG's Initial Brief's discussion of the "sharing" proposal is cursory. City-CUB's Initial Brief's discussion of this item is somewhat longer, but still superficial. City-CUB Init. Br. at 21-22. GCI's proposal is wrong for multiple reasons.

First, the Utilities' Initial Brief showed that rate case expenses, while intermittent and unpredictable, when they occur are a normal cost of doing business that the Utilities are entitled to recover. NS-PGL Init. Br. at 77. Indeed, GCI here fails to take into account the AG's own recognition that: "In every rate case, a utility incurs a rate case expense, and it is well settled that it is entitled to recover the cost of the rate case. *Du Page Utility Co. v. Illinois Commerce Comm'n*, 47 Ill.2d 550, 561[, 267 N.E. 2d 662, 668] (1971)[, *app. den*., 404 U.S. 832 (1971).]." AG Init. Br. at 24. "While a matter of first impression in this court, we find that rate-case expense is ordinarily properly and fairly allowed as an operating expense." *Du Page*, 47 Ill. 2d at 561, 267 N.E.2d at 668 (citations omitted).

Second, the Utilities have ample incentives to control rate case expenses. NS-PGL Init. Br. at 77. GCI has never been able to refute this fact.

Finally, the Utilities pointed out that Section 9-229 does not alter the foregoing legal and factual points. *Id*. at 77-78. In brief, Section 9-229 does not provide for or support any "sharing" of rate case expenses. Accordingly, the Commission should approve the Utilities' rate case expenses as revised in their surrebuttal.

(ii) Amortization of Rate Case Expenses Associated <u>With Docket Nos. 09-0166/0167 (cons)</u>

Staff and GCI adhere to their respective positions on the amortization of 2009 rate case expenses that will still be unamortized (un-recovered) as of 2012, but the contested portions should not be adopted. NS-PGL Init. Br. at 78-79.

<u>Staff</u>. Staff somewhat briefly reiterates its proposal that the amortization should be adjusted to remove rehearing costs. Staff Init. Br. at 35-36. Staff does not argue any rationale in its brief. The Utilities have shown that the contested portion of Staff's position is unwarranted. NS-PGL Init. Br. at 78-79.

The AG and City-CUB offer alternative support for Staff's position, in terms of rehearing and appeal costs. AG Init. Br. at 32-33; City-CUB Init. Br. at 24. However, like Staff, they have not shown any valid basis for disallowing these costs. Their position also is peculiar in that they routinely seek rehearing and appeal from rate case Orders. City-CUB points to Section 9-229, which requires the Commission to include in its orders specific findings regarding "amounts expended by a public utility to compensate attorneys or technical experts to prepare and litigate a general rate case filing." City-CUB Init. Br. at 24. City-CUB's point is illogical. The fact that Section 9-229 requires specific findings regarding those amounts does not mean that a utility cannot recover amounts for other services, if rehearing and appeals were to be deemed to fall outside of Section 9-229.

GCI. GCI still claims (inconsistently with its normalization proposal, discussed in Section V.C.6.c.iii, *infra*) that even though the expenses in question were approved for recovery in the Utilities' 2009 rate cases (*Peoples 2009*, pp. 42-43), recovery of the portion that still will not have been recovered by 2012 now should be barred on the theory that it somehow constitutes single issue and retroactive ratemaking. The AG makes only passing references to that position, and makes little in the way of a substantive point. AG Init. Br. at 25, 28.

City-CUB makes more of an argument, but is mistaken. City-CUB claims that "ratemaking principles" require replacing unamortized past rate case expenses with the current rate case expenses, because otherwise this is single issue and retroactive rate-making. City-CUB Init. Br. at 22-24.

City-CUB's argument is erroneous. The Commission's instructions for "Part 285" Schedule C-10 recognize that past rate case expenses may be included in a utility's revenue requirement. 83 Ill. Admin. Code § 285.3085(d). So, it would not seem to be the case that ratemaking principles preclude such.

What is at issue is a regulatory asset, on each of the utility's books, that was approved in its prior rate case, and that has a remaining unamortized amount as of 2012. Single issue and retroactive ratemaking are not violated by recovery of those amounts. Moy Sur., NS-PGL Ex. 39.0 Corr., 5:103 – 6:118. The unamortized amount to be recovered through the rates being set here does not exceed what was approved then, as noted in the Utilities' Initial Brief (at 78, 79), so that is not an issue. Past Commission Orders provide for recovery of this type of expense, and have rejected the same GCI theory. NS-PGL Init. Br. at 79. There is no basis for a different result here.

(iii)<u>Normalization of Rate Case Expenses</u>

GCI (inconsistently with its "50/50 sharing" proposal) also proposes to "normalize" rate case expenses. However, GCI has never given a good reason for doing so. NS-PGL Init. Br. at 79-80. Nothing has changed. *See* AG Init. Br. at 25-28; City-CUB Init. Br. at 25-26. Staff continues to recommend against GCI's proposal. Staff Init. Br. at 36-37.

GCI tosses around a lot of abstractions, but they seem to come down to a few ideas. The AG seems to think that regulatory assets for rate case expenses "guarantee" recovery and there must be something bad about that. However, if a utility bears the expense and it is approved, then it should be allowed to recover it. There is nothing wrong with that. Plus, we have seen that there is not a guarantee, in that the Utilities still have not fully recovered their approved 2009 rate case expenses, as discussed above. The AG also reiterates its discontent with rates that include recovery of rate case expenses from more than one case, but that has been refuted above. The AG additionally presents its theoretical arguments for normalization, but cannot alter that either method may lead to over- or under-recovery, and the proposal also is premature. NS-PGL Init. Br. at 79-80. City-CUB's Initial Brief (at 25-26) distills essentially the same points as the AG, except for claiming that *ComEd 2010* provides additional support as to concern about rates that recovery expenses of a current and a prior rate case, but that has been addressed above and *ComEd 2010* approved no disallowance for that nor approved normalization. GCI's proposal should not be adopted.

d. **Gas Transportation Administrative Costs**

See Sections V.C.6.d and XI.C, XI.D.1, and XI.E.1 of the Utilities' Initial Brief and Sections XI.C, XI.D.1, and XI.E.1 of this Reply Brief.

e. **Solicitation Expense**

The Utilities have appropriately reflected for the 2012 test year the effect of their affiliate Integrys Business Support ("IBS") recovering from another affiliate, Peoples Energy Home Services ("PEHS"), the proper amount for solicitation services provided by IBS to PEHS relating to the Pipeline Protection Program ("PPP") offered by PEHS. NS-PGL Init. Br. at 80-81.

Staff's Initial brief devotes almost 10 pages to this subject. Staff Init. Br. at 37-47. Staff discusses certain facts regarding PPP, past errors or omissions by IBS and the Utilities, and "eight reasons" why, in Staff's opinion, the Commission should not accept the Utilities' position and, instead, should either (1) reduce North Shore's and Peoples Gas' operating expenses by $116,361 and $656,267, respectively, based on Staff's estimates of the "market value" of the solicitation services, which is based on Staff's estimates of the margin that PEHS makes on the PPP; or, alternatively, (2) reduce North Shore's and Peoples Gas' operating expenses by $11,000 and $60,000, respectively, based on the average solicitation expenses in 2005-2007 adjusted for inflation (based on reference to Gregor Reb., NS-PGL Ex. 21.0 Corr., 5:100-105; NS-PGL Exs. 21.1N and 21.1P).

Staff's position appears to reflect a lack of recognition that their alternative proposal already has been adopted. The Utilities already reduced their revenue requirements by that $11,000 and $60,000. The Utilities did so in rebuttal, and they carried that over to surrebuttal.[18]

[18] NS-PGL Ex. 22.1N Corr., p. 1, line 20, col. (D); NS-PGL Ex. 22.2N Corr., p. 3, cols. (G), (K); NS-PGL Ex. 22.1P Corr., p. 1, line 20, col. (D); NS-PGL Ex. 22.2P Corr., p. 3, cols. (G), (K); NS-PGL Ex. 39.1N, line 20, col. (C); NS-PGL Ex. 39.1P Corr., line 20, col. (C).

Staff's Initial Brief seems to be confused on the subject of what already is reflected in the Utilities' surrebuttal revenue requirements. See, e.g., Staff Init. Br. at 44. The Utilities' surrebuttal testimony identified that IBS' 2012 forecast did include an amount of $16,572 for charges for solicitation services to PEHS. Gregor Sur., NS-PGL Ex. 38.0, 8:150-153. Staff may be unconvinced or may think that figure was miscalculated (*see, e.g.*, Staff Init. Br. at 42, 43, 44), but that does not alter what IBS forecasted. Staff's innuendo attacking the Utilities' witness (Staff Init. Br. at 44, 46) is unwarranted, because it confuses IBS' forecast with the Utilities' forecast, and it fails to identify any actual contradiction in the Utilities' testimony. The Utilities witness did not discover this $16,572 amount until after her rebuttal, which she then presented in her surrebuttal, and then she answered Staff's detailed data request regarding this figure. Peoples Gas' response to Staff data request DAS 13.03, contained in Staff Cross. Ex. 15 at pages PGL 0012874 – PGL 0012878. Much more importantly, however, none of Staff's points alters the fact of the $11,000 and $60,000 adjustments that the Utilities made in rebuttal and carried over to surrebuttal, set forth above. The fact that the Utilities made these adjustments on top of the $16,572 is to customers' benefit, and it is not a reason to criticize the Utilities.

Staff questions the credibility of the $11,000 and $60,000 figures, but they were based on an average of the costs from 2005-2007 and included all customer relations billings, not just solicitation. This adjustment was generous in that since the transaction in which Integrys Energy Group. Inc. became the parent of the Utilities, the only customer relations activity that is still being provided to PEHS is for solicitation. These amounts were supported in NS-PGL Exs.21.1P and 21.1N.

The question with respect to revenue requirements, therefore, is whether to adopt Staff's position to charge not at fully distributed cost, but instead to switch to a methodology based on charging based on the estimated market value of the service based on the affiliate's estimated margin. (If such a switch were to be made, then the rebuttal adjustments would have to be reversed to avoid double-counting.) Staff does not present any sound reason for doing so.

Staff appears to agree that charging fully distributed cost, not market value based on margin, is the normal mechanism in this type of affiliate transaction. *See* Staff Init. Br. at 39. Charging based on cost is what is required under the Master Non-Regulated Affiliated Interest Agreement. Gregor Sur., NS-PGL Ex. 38.0, 8:165-170.

Staff's position is punitive, based on Staff's view of past errors and omissions by IBS and the Utilities. Staff suggests that switching to market value based on margin is fair here, based on the view that the Utilities failed to credit customers with recovery of fully distributed costs in their 2007 and 2009 rate cases. *E.g.*, Staff Init. Br. at 40-41.[19] That view is punitive, and it violates a well-known principle: two wrongs do not make a right. That view also is a novel and inappropriate form of retroactive ratemaking, because it denies use of the appropriate methodology in these cases as a punishment for what is seen as a past error in calculating revenue requirements. Staff's view also ignores that the Utilities did not in fact over-recover their costs after the 2007 and 2009 rate cases. The Utilities' actual rates of return fell short of their approved rates of returns after the 2007 and 2009 rate cases. Gast Dir., NS Ex. 2.0, 4:71; Gast Dir., PGL Ex. 2.0, 4:71. So, the hypothetical slight over-recoveries did not actually happen, rather, the opposite occurred.

Staff's position also is excessive. Again, as discussed earlier, the Utilities' revenue requirements already have been reduced, and they actually under-recovered their costs after the

[19] Staff also later complains about failure to credit repairs revenues in the 2007 and 2009 cases, but even Staff's figures after including Staff's proposed change in methodology to increase what PEHS is charged is only $2,456 for North Shore and $17,313 for Peoples Gas. *See* Staff Init. Br. at 47-49. In fact, the missing billings from 2008 to 2010 were $910 for North Shore and $7,174 for Peoples Gas. Gregor Sur., NS-PGL Ex. 38.0, 10:205-209.

2007 and 2009 cases. Moreover, even setting aside those facts, if costs credited in the 2007 and 2009 cases should have been roughly $10,000 per year as to North Shore (see NS-PGL Ex. 21.1N) and roughly $60,000 per year as to Peoples Gas (see NS-PGL Ex. 21.1P), then it is disproportionate to reduce their revenue requirements by $116,361 and $656,267, respectively, in the instant cases. Indeed, the rates set in those cases have only been in effect since February 2008 (2007 cases), so the "missed" credits through January 2012 would total roughly $40,000 as to North Shore and roughly $240,000 as to Peoples Gas. Staff's punitive proposal would make customers whole for the "missed" credits in roughly half a year, if not sooner, and then give them a windfall for as long as the rates set in the instant cases stay in effect.

Staff's proposal should not be adopted. In the alternative, if Staff's proposal is adopted, then it should be offset by the adjustments that the Utilities made in rebuttal and carried over to surrebuttal, to avoid double-counting.

7. Depreciation

a. Depreciation Expense on Forecasted Additions

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

b. Derivative Adjustments from Contested Adjustments

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

8. Revenues

a. Repair Revenues

The Utilities in surrebuttal corrected their revenue requirements by adding revenues of $1,000 as to North Shore for charges to PEHS for repairs and $11,000 as to Peoples Gas. Gregor Sur., NS-PGL Ex. 38.0, 10:210-214; NS-PGL Exs. 38.3N and 38.3P. The Utilities' figures are based on the correct fully distributed cost methodology. Gregor Sur., NS-PGL Ex. 38.0, 9:191 - 10:214.

Staff again seems to want to punish the Utilities, by switching methodologies, based on past failures charge PEHS the right amount, but, as noted earlier, the missing billings from 2008 to 2010 were $910 for North Shore and $7,174 for Peoples Gas. Gregor Sur., NS-PGL Ex. 38.0, 10:205-209.

Staff proposes larger adjustments based on the theory that the Utilities' should charge PEHS the same rate for repairs as the Utilities charge customers who request repair service, calculating the adjustments based on the rate charged to customers, multiplied by the number of each type of repair performed for PEHS, and then subtracting what PEHS already paid the Utilities. Staff Init. Br. at 48-49; *see also* Gregor Sur., NS-PGL Ex. 38.0, 9:191 – 10:196.

Staff's proposal is incorrect. The Utilities are using the correct methodology, as stated above. In addition, Staff is demanding that the Utilities charge PEHS based on what the Utilities charge non-PPP customers for repairs that are not a utility service. The Utilities are entitled to charge an amount that includes a margin for this non-utility service, and do not have to charge the same as they charge their affiliate. Gregor Sur., NS-PGL Ex. 38.0, 11:215-220. Staff's proposal should not be adopted.

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

Staff and the Utilities agreed on the adjustment the Utilities made in surrebuttal to bill and letter fee revenue. Staff Init. Br. at 50.

Staff's Initial Brief (at 50-51) reiterates Staff's proposal for an investigation. City-CUB filed not testimony on this subject but now agrees with Staff. City-CUB Init. Br. at 28.

The amounts involved do not justify the burden and expense of an investigation. NS-PGL Init. Br. at 82.

Moreover, IBS Customer Care has been billing PEHS since August 2011, and the Utilities made an uncontested adjustment for the bill/letter fee amount for 2011. Peoples Gas' response to Staff data request DAS 9.08, contained in NS-PGL Redirect Ex. 1 at page NS 0006452.

c. <u>Warranty Products (Revenue and Non-Revenue)</u>

IGS proposed that the Utilities provide non-affiliated companies access to the Utilities' bills and solicitation services. IGS Init. Br. at 6-9. IGS's proposals should be rejected for several reasons. First, the proposals were untimely (first offered in rebuttal testimony) and not in proper rebuttal to any other testimony. Second, the proposals ignore that the Utilities provide services to their affiliates under Commission-approved agreements that establish the costs that the Utilities must bill to the affiliates. The Utilities acknowledged past errors in the billing, but they have rectified those errors in this proceeding such that the proposed rates include a proper cost allocation to PEHS. Gregor Sur., NS-PGL Ex. 38.0, 7:142-10:214. Third, the notion that the Utilities should not provide what IGS deems "below market" (IGS Init. Br. at 8) services to their affiliates is flawed because the Commission-approved agreement dictates what the Utilities charge and another affiliated interest agreement dictates what non-utility affiliates charge other non-utility affiliates (Gregor Reb., NS-PGL Ex. 21.0 Corr., 5:90-95, 6:113-116); in any event, IGS has not shown that this level is below market. Fourth, the subsidy that IGS alleges (IGS Init. Br. at 7) is based on Staff arguments that the Utilities should charge PEHS amounts in excess of what the applicable affiliated agreements allow. However, those arguments do not establish improper charges or a subsidy. As Staff witness Mr. Sackett agreed, the service in question is for pipe for which customers are responsible, customers need not contract with the Utilities or with an affiliate for pipe repair work and the Commission does not regulate a third party's services or charges. Sackett Tr. 9/1/11, 763:12-764:17. Thus, what the Utilities charge their affiliate must not be a market rate and need not be what the affiliate charges its customers or what the Utilities charge customers for this service.

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

This issue is not contested.

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

This issue is not contested.

F. Gross Revenue Conversion Factor

1. Uncollectible Rate

The Utilities correctly have used the Gross Revenue Conversion Factor ("GRCF") of 1.711941 for North Shore and 1.744262 for Peoples Gas. Moy Sur., NS-PGL Ex. 39.0 Corr., 13:274-279. Staff's proposed net write-off method for uncollectibles expense would affect the uncollectibles rate portion of the GRCF calculations for the Utilities, *id*. at 13:279-282, but Staff's proposal should not be adopted, as discussed in Section V.C.5 of the Utilities' Initial Brief and this Reply Brief.

2. Derivative Adjustments from Contested Adjustments

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VI. RATE OF RETURN

A. Overview

The Commission recognizes the important but nonetheless limited role of the mathematical cost of equity models as a means to an end, namely to estimate the actual returns demanded by investors in real world financial markets. The Commission therefore recognizes the need to consider the results of these models in the context of the authorized returns actually set by state commissions and other contextual information available to and relied on by real world investors.

Yet, Staff and GCI remain adamant that the models – these theoretical attempts to recreate reality – should be elevated over reality, even when it is shown that their assumptions and results bear no semblance to it. Staff and GCI remain steadfast in their position that only the models are relevant and only <u>their</u> models are "objective." *See, e.g.,* Staff Init. Br. at 74 ("while Mr. Moul's analysis is consistently results-driven, Staff's analysis is consistent in application and result"). Indeed, GCI devotes an entire section of its brief arguing that Mr. Moul's analysis was entirely subjective while Mr. Thomas' was entirely objective. City-CUB Init. Br. at 30-34. There is nothing "objective" about an analyst who claims to have the only "right" answer and who will not countenance comparisons of his or her analysis to market expectations.

The Commission understands, however, that slavish devotion to the mathematical models virtually guarantees error. This is because "each of the financial models is theoretical and has its own limitations." *Peoples 2009*, p. 123. Moreover, far from being coldly objective, "[t]he models are highly dependent on analyst judgment as to the inputs, and therefore are susceptible to manipulation." *Id.* Even GCI acknowledges "the cautions that attend an interested party's development of evidence specifically for its own litigation." City-CUB Init. Br. at 48. Thus, when an analyst chooses and designs models that yield results that are far out of the mainstream, as the results of Messrs. McNally and Thomas are, those cautions become real. An extreme result is *prima facie* evidence of unreliability.

Neither Staff nor GCI evidence any concern for the potentially negative consequences of their recommendations to customers. The Utilities' investment risk would increase substantially under Staff's proposed revenue requirement, to the point at which the Utilities' credit ratings would be subject to downgrade under S&P standards. The Utilities' financial ratios would decline to the BBB rating level, just one step above the lowest investment grade rating and two above "junk." Although Staff and GCI do not seem to be concerned, a downgrade would result in increased capital costs for the Utilities and, ultimately, their customers. Thomas, 9/6/11 Tr. 953:18 – 954:5. Despite Staff's and GCI's disinterest, the Utilities urge the Commission to consider the potential real world consequences of its capital cost decisions in these cases.

B. Capital Structure (Both Utilities)

1. Actual v. Imputed Capital Structures

Staff cites *Citizen Utilities Board v. Illinois Commerce Commission,* 276 Ill. App. 3d 730, 658 N.E.2d 1194 (1st Dist. 1995) ("*CUB v. ICC*") for the proposition that a utility holding company has an incentive "not to establish an optimal, lowest cost of capital structure for the utility." Staff Init. Br. at 57. This may be true in the abstract, but there is no record evidence to support Staff's assertions that the Utilities' "proposed capital structure clearly reflects these incentives (harmful to the ratepayer but beneficial to Integrys shareholders)" and "Staff's proposal does not." *Id.*

To the contrary, the Utilities' proposed capital structure is precisely the capital structure the Commission has twice recently approved as reasonable. The Utilities have not changed how they employ the various components of their capital. Therefore, the Utilities' proposed capital structure is presumptively just, reasonable and beneficial to customers. This capital structure has supported the Utilities' relatively strong credit ratings, which have served to keep the Utilities' capital costs lower than they would be otherwise. Gast Reb., NS-PGL Ex. 18.0, 4:71-78; Fetter Reb., NS-PGL Ex. 20.0, 15:310-319.

Staff fails to explain how the Utilities' twice-authorized capital structures were beneficial in 2008 and 2010 but would be harmful in 2012. Staff also fails to acknowledge the Commission's strong and longstanding disinclination to ignore a utility's actual capital structure and to impute an artificial capital structure for ratemaking purposes. In order to disregard a utility's actual capital structure and, thus, its actual capital costs, the Commission requires a demonstration that the utility's actual capital structure is "unreasonable, imprudent or unduly affected by such circumstances as double leverage so as to unfairly burden the utility's customers." NS-PGL Init. Br. at 95. That standard is appropriate because imputing a hypothetical capital structure can accomplish the disallowance of a portion of a utility's actual costs of service just as surely as an adjustment to the utility's rate base.

Staff apparently believes it can avoid this showing by arguing that the Utilities are also proposing a "hypothetical" capital structure because it does not contain the short-term debt Staff seeks to impute. Staff is incorrect. The Commission has decided twice in the last three years that the Utilities' capital structure does not contain short-term debt because the Utilities do not use short-term debt to fund rate base and they borrow on a short-term basis only to cover seasonal and temporary cash shortfalls. Thus, the Utilities' proposed capital structure – 56% equity and 44% long-term debt – is the Utilities currently authorized capital structure, and their actual capital structures are very close to this ratio. NS-PGL Init. Br. at 102. There is nothing hypothetical about the Utilities' current and proposed capital structure.

By contrast, none of the components of Staff's proposed capital structure – equity, long-term debt or short-term debt – bear any semblance to reality. Rather, they represent Staff's opinion on what the Utilities' capital structures should be. As the Utilities have shown, Staff arrives at its proposal to weaken the Utilities' capital structures and degrade their financial strength through result-driven comparisons to their corporate parent, Integrys Energy Group, Inc. ("Integrys") and to the Gas Group. NS-PGL Init. Br. at 99-102.

Staff argues that the Utilities' proposed capital structure would violate Section 9-230 of the Act, 220 ILCS 5/9-230, because their standalone financial risk and actual credit ratings are lower by virtue of their affiliation with Integrys. Staff Init. Br. at 53-55. Staff's argument is based on a comparison that is based entirely on historical data. But according to Staff elsewhere in its brief, using only historical information to draw conclusions about utility investment risk and capital cost is "arbitrary." Staff Init. Br. at 71. That is because, according to Staff, "analyses using older data reflect information that the market no longer considers relevant." *Id.* Moreover, using such historical information inevitably injects the very subjectivity that Staff decries, because it "requires the analyst to subjectively determine what data is no longer relevant." *Id.* Staff cannot have it both ways.

The Utilities, by contrast, do not reject an analyst's use of historical data out of hand. But the analyst must put historical data into context and determine whether and how it remains relevant to investors' forward-looking perceptions. Moul Reb., NS-PGL Ex. 19.0 REV, 10:215 – 11:226. Staff did not evaluate the relevance of historical comparison of the Utilities and Integrys to the present or, more important, the test year. Without a such a showing of similarity or at least a trend, differences in the financial ratios and capital structures of the Utilities and Integrys that may have existed in 2008-2010 can have no relevance to what the Utilities' capital structures should be for the purposes of their 2012 rates.

Even if it was relevant, Staff's comparison of the Utilities to Integrys has little practical use in this case, as Staff's proposed imputed capital structures did not correct for any risk difference between the Utilities and Integrys. Rather, they purported to address alleged differences between the Utilities and <u>the Gas Group</u>. Even those comparisons are meaningless because they compared the Utilities' <u>hypothetical future</u> financial risk based on the surreal assumption that the Utilities will achieve 100% recovery of their 2012 revenue requirements with the Gas Group's average financial risk based on its <u>historical actual</u> financial performance. *See* Kight-Garlisch Reb., Staff Ex. 13.0C at 6:92 – 7:114; Kight-Garlisch, 8/31/11 Tr. 412:4-12. No utility operates under such optimal conditions, where they are prospectively assured full revenue requirement recovery. This unrealistic comparison was obviously stacked against the Utilities and the result was as expected; the comparison showed that the Gas Group had more risk in the past than the Utilities would if they assuredly earned their revenue requirements in full in 2012. Staff's result is just as invalid as its assumptions, and be rejected.

The Utilities will not repeat here all of the other flaws of Staff's Gas Group comparisons. *See* NS-PGL Init. Br. at 100-101. What bears repeating, though, is that Staff's misapplication of the S&P risk matrix understated the actual impacts that Staff's proposed capital structures would have on the Utilities' financial risk.[20] Based on Staff's revenue requirements, including the capital components and costs that Staff included in its revenue requirements, both Utilities would be squarely in the "Aggressive" financial risk profile. That risk level is higher than the Gas Group's "Significant" profile, and would imply a downgrade of the Utilities' current credit

[20] Staff's use of the S&P financial risk matrix to impute a capital structure appears to have no precedent. Staff has identified only two prior cases in which it used the S&P financial risk matrix to set the utility's capital structure for ratemaking purposes. Both involved a tiny water utility and all Staff did in those cases was to compare the utility's proposed capital structure to the average capital structure of other water utilities. In neither case did Staff conduct the type of implied financial risk analysis that it did in this case using the S&P financial risk matrix. *Sundale Utilities, Inc.*, ICC Docket No. 08-0549 (Order April 22, 2009); *Sundale Utilities, Inc.*, ICC Docket No. 04-0637 (Order Aug. 9, 2005).

ratings. NS-PGL Init. Br. at 101-102. That risk differential would in turn imply an upward adjustment to the Utilities' returns on equity. NS-PGL Init. Br. at 102-103.

As Staff itself argues, "Financial theory posits that investors require higher returns to accept greater exposure to risk." Staff Init. Br. at 57. The *CUB v. ICC* court likewise recognized the direct relationship between the amount of equity in a firm's capital structure and cost of capital: "since equity always costs more than debt, as a corporation increases its proportion of equity, its total cost of capital generally increases, <u>although the cost of debt and the cost of equity both decrease</u>." 276 Ill. App. 3d at 744, 658 N.E.2d at 1205 (emphasis added). Staff's failure to recognize the true impact of its proposed imputed capital structures on the Utilities' financial risk and ROEs renders its proposal at best incomplete and at worst punitive.

2. <u>Short-Term Debt</u> (Both Utilities)

Staff's Initial Brief evidences the utter lack of support for Staff's position that the Utilities' imputed capital structures should include short-term debt. Ignoring both substantial evidence and the Commission's prior determinations that the Utilities propose to use short-term debt in the test year only to fund short-term seasonal cash shortages just as they always have (Gast Reb., NS-PGL Ex. 18.0, 11:201 – 12:230), the sole evidentiary basis Staff cites to the contrary is a statement by the Utilities "that they fund the difference between rate base and 'permanent capital' with short-term debt." Staff Init. Br. at 61. Staff has taken this statement out of its context and the citation is therefore misleading. The data request responses – NS-PGL Exs. 35.1P and 35.1N – from which the statement was cut show that it referred to a single point in time (December 31, 2012) and "does not reflect the longer term view provided in the remainder of the response that the Utilities are funding differences between rate base and permanent capital with cash." Gast Sur., NS-PGL Ex. 35.0, 4:68-71.

C. Cost of Long-Term Debt (Both Utilities)

Staff's justification for including Peoples Gas' Series PP bonds in its long-term debt cost for 2012 defies reality. Because Series PP was retired in 2008, the outcome of ICC Docket No. 11-0476 cannot have any consequence in the test year. Staff argues that Series PP should not be "removed" until the Commission enters an order in that docket (Staff Init. Br. at 62), but in reality there is nothing to "remove" from Peoples Gas' forecasted long-term debt balance because these bonds are long gone from the Utility's balance sheet. In reality, Staff is asking the Commission to impute a non-existent issuance into the Utility's capital structure, to the tune of $51 million. Staff's request has no basis in reality and therefore should be rejected.

D. Cost of Short-Term Debt (Both Utilities)

This issue is not contested. *See* Utilities Init. Br. at 104.

E. Cost of Equity (Both Utilities)

1. Putting the Mathematical Cost of Equity Models In Context

Staff and GCI argue that any comparison of their ROE recommendations to the real-world ROEs authorized by this and other state commissions for the other energy utilities with which the Utilities compete for capital is "meaningless," "useless," and against "clearly stated policy." Staff Init. Br. at 69; City-Cub Init. Br. at 37. In its adamancy that the Commission should not look beyond the mathematical cost of equity models and consider what the market sees as competing returns, Staff claims that any such comparison would require an in-depth study of each and every other authorized return. Staff Init. Br. at 69; City-CUB Init. Br. at 34-37.

The Commission does not share Staff's opinion that real world ROE information is "meaningless" and "useless." The Commission's "clearly stated policy" is quite to the contrary.

The Commission has found such information not only useful but also necessary to consider the "context" of its decision-making on cost of equity, ruling in the Utilities' last rate cases:

> As prudent regulators, we must be cognizant of this context because each of the financial models is theoretical and has its own limitations. The models are also highly dependent on analyst judgment as to the inputs, and therefore are susceptible to manipulation. Although these models provide the best information of what we need for the purposes at hand, their limitations require that we also consult general financial market information to ensure that the model results presented us are generally consistent with real world conditions, and to guide our determination of reasonable rates of return of return on equity based on the models that we deem appropriate for our consideration.

Peoples 2009, p. 123. It is elementary that a firm's cost of equity is set by a market in which investors have choices. Those choices – and the returns allowed on the other equities that investors could purchase – are the "context" in which the market determines the Utilities' cost of equity.

When the Commission compares the parties' ROE proposals with "real world conditions" in these cases, it will find that the Utilities' proposed 10.85% compares much more favorably to recent authorized returns (as recent as June 30, 2011 in Mr. Fetter's samples) and financial market expectations (10.0% for the natural gas utility industry as a whole in 2012)[21] than Staff's proposed 8.75% and GCI's proposed range of 7.09% - 8.94%. Likewise, while the Utilities propose a modest increase in their currently authorized ROEs to reflect the continued volatility and risk in the financial markets despite historically low interest rates, Staff and GCI propose sharp decreases without any explanation for how the Utilities' ROEs could change so dramatically in just two years. NS-PGL Init. Br. at 112-113.

Staff's argument that the Commission cannot consider collective observations drawn from large samples of utility ROE data without an in-depth analysis of each every ROE in the sample was contradicted quite effectively by Staff's own cost of equity witness. Mr. McNally

[21] Moul Reb., NS-PGL Ex. 19.0 REV, 4:82-90.

argued that his use of stock prices from a single day in May 2011 for his DCF model was reasonable because he "employed a sample [of natural gas utilities] to minimize the effects of any potential 'inefficiencies' in stock prices, as estimates for a sample as a whole are subject to less measurement error than individual company estimates." McNally Reb., Staff Ex. 14.0, 8:159-162 (emphasis added). On cross examination, Mr. McNally explained that when you pick an "unbiased sample, … any single company is just as likely to be above or below the true mean." McNally, 8/31/11 Tr. 516:5 – 517:1. The "inefficiencies" cancel each other out, and you can rely on the collective picture drawn by the sample as a whole. *Id.* at 517:2-5.

If, as Mr. McNally claimed, this works for a sample of just eight companies (the size of the Gas Group), then Staff cannot legitimately complain about Mr. Moul analyzing a sample of 93 returns authorized for energy utilities in 2009 and 2010 to find that Staff's proposed ROEs are far below that average return of 10.32% in that time frame. Moul Reb., NS-PGL Ex. 19.0 REV, 3:46-48; NS-PGL Ex. 19.1. Nor can Staff credibly challenge as "useless" Mr. Fetter's findings that Staff's ROE proposal would match the one lowest return issued to any energy utility anywhere in the country in the last 5 years (based on a sample of 347 returns) and 20 years (based on a sample of 926 returns). Fetter Reb., NS-PGL Ex. 20.0, 13:282 – 14:296; NS-PGL Exs. 20.2 and 20.3. Based on these findings, Mr. Fetter concluded that a return "anywhere near the Staff or [GCI] recommendations" would likely put the Utilities' currently strong credit ratings into jeopardy. Fetter Reb., NS-PGL Ex. 20.0, 14:297-300. Presumably, the Commission would not consider such a result "meaningless."

2. <u>Comparability of the Gas Group</u>

The Utilities have thoroughly debunked Staff's "principal components analysis" as a Rube Goldberg device[22] that was designed and implemented to achieve Staff's desired result, namely a conclusion that the Utilities are less risky than the Gas Group. NS-PGL Init. Br. at 106-110. The Utilities urge the Commission to reject this analysis, not only on its merits but also for the manner in which Staff sprung it on the Utilities just two weeks before the hearing and then refused to produce the information needed to understand and respond to it.[23]

Staff erroneously cites Ms. Kight-Garlisch's comparisons of the Utilities and Gas Group based on the S&P financial risk matrix to support its position that Utilities have less investment risk than the Gas Group. Staff Init. Br. at 70. As shown above, one of the comparisons was based on past financial performance only, while the other one compared the Gas Group's historical financial performance to the Utilities' ideal financial performance in 2012, and even the latter comparison understated the Utilities' risk. If Staff's proposed revenue requirement was used, including Staff's proposed capital components and costs, then according to the S&P risk matrix both Utilities would be significantly <u>more</u> risky than the Gas Group and the Utilities' ROEs would need to be adjusted upward accordingly. NS-PGL Init. Br. at 98.

[22] "A 'Rube Goldberg Machine' is an extremely complicated device that executes a very simple task in a complex, indirect way. This is now used as an expression to describe any system that's confusing or complicated and came about from Goldberg's illustrations of absurd machines." http://www.rube-goldberg.com/

[23] Further, approximately two and one half hours before this Reply Brief was due to be served on the ALJs, Staff filed a Motion For Leave to File Late Filed Staff Exhibit 21.0, which is a single page from an introductory section of the book from which NS-PGL Cross Ex. 3 was taken, titled "Using This Book." Staff possibly intends to argue that this page supports the view that the rules set forth in this textbook apply only to a principal components analysis as used in applied social science research. Nothing in NS-PGL Cross Ex. 3, however, limits the application of the mathematically and statistically based rules for performing a reliable principal components analysis in this textbook to when the data is "social science" based. Such a conclusion is further undercut by the very fact that, as admitted on cross examination, Staff possesses and relies upon this textbook. McNally Tr. 8/31/11, 562:19 – 565:12, 566:12-17. Conversely, if Staff were correct, then this would mean that a principal components analysis is a statistical method that is meant to be used only in the social science arena and thus, is not appropriate for use in a financial analysis where the circumstances prohibit the development of sufficiently large populations and variable sets.

For its part, GCI seems to have misunderstood the reason Mr. Moul ran his models on a second proxy group, a "Combination Group" of gas and electric utilities. GCI charges that Mr. Moul used this group to "increase his cost of equity estimate." City-CUB Init. Br. at 39. GCI even claims that his use of the Combination Group was "unexplained." *Id.* GCI is wrong on both counts.

As Mr. Moul explained in both his direct and rebuttal testimony, he ran his models using the Combination Group not to measure the Utilities' cost of equity but to test the DCF model's reliability in estimating cost of equity for natural gas utilities. In other words, he "used the results for the Combination Group to assess the Gas Group result. Moul Dir., NS Ex. 3.0 REV, 5:93 – 6:118; PGL Ex. 3.0 REV, 5:93 – 6:118. Unlike the extremely low results the model generated for the Gas Group, the model generated results for the Combination Group that were similar to those generated by Mr. Moul's other models. This exercise supported Mr. Moul's conclusion that the DCF model's current inability to estimate reliable costs of equity for natural gas utilities is due to a current "anomaly" unique to them. Thus, he based his original recommendation of 11.25% on his Risk Premium and CAPM results for the Gas Group with consideration to that group's lower risk compared to the Utilities. NS Ex. 3.0 REV, 45:975 – 46:992; PGL Ex. 3.0 REV, 45:974 – 46:991. To arrive at his updated recommendation of 10.85%, he averaged the 74-basis-point decline in the DCF return for the Combination Group and the 35-basis-point increase in the CAPM for the Gas Group. Moul Reb., NS-PGL Ex. 19.0 REV, 7:140-151. Thus, if anything, Mr. Moul's use of the Combination Group resulted in a <u>decrease</u> of his ROE recommendation for the Utilities.

3. **<u>Staff's Use of Spot Data</u>**

In trying to justify its use of a single day's data to run its mathematical cost of equity models, Staff can only resort to hyperbole. Staff Init. Br. at 71. Far from "absurd," the Utilities merely state the obvious. Data from one day several months before the hearing (and even longer before the Commission's decision) is indisputably historical. Unlike Mr. Moul and Mr. Fetter, however, Mr. McNally made no attempt to put his historical information in context with current and forecast information. It is not as simple as what information is more recent, but rather how the particular items of historical information chosen by the analyst squares with the historical, current and forecast information that actual investors actually rely on when making investment decisions. Staff's abject refusal to undertake the contextual review required to validate its <u>choice</u> of spot data renders its analyses arbitrary and suspect. The fact that Staff's results are also so far out of line with market expectations confirms that they are unrealistic and unreliable.

Nor can Staff dispute that the choice of the single date is subjective. The Commission has held: "Staff's reliance on such data without considering what it represents is itself <u>arbitrary</u>." *Peoples 2009*, p. 125 (emphasis added). Staff has made no showing regarding the "conditions or financial climate of the spot day and whether any of these might cause material inefficiencies." *Id.* at pp. 125-126. Absent that showing, Staff's choice of its spot data was arbitrary and its analyses were neither objective nor reliable.

Staff also exclaims that by the Utilities' reasoning, "a current cost of common equity is <u>impossible</u> to produce." Staff Init. Br. at 71 (emphasis in original). That is not true, nor what the Utilities argue. A theoretical perfect cost of equity is possible to produce, but only for one day. A day later and that cost of equity is no longer current. But this is beside the point for the Commission's task at hand. The Commission's task is not determine what a utility's cost of equity <u>was</u> on a single day months' past, but rather to estimate a cost of equity that is "reasonably representative for the period the utility's rates will be effective." Moul Reb., NS-PGL Ex. 19.0 REV, 13:271-272. The mathematical cost of equity models can provide estimates of such a cost of equity only if the analyst considers the full range of information available to, and actually used by, investors in establishing returns over time and then assess in an unbiased way the conditions likely to prevail in that timeframe.

Of the three analysts who testified on cost of equity, only Mr. Moul performed a contextual analysis. The grounds for his ROE recommendation were not limited to the results of mathematical models, as were the recommendations of Messrs. McNally and Thomas. Only Mr. Moul's analysis took into account recent authorized returns set for energy companies, forecasts of expected returns for the natural gas utility industry, and other contextual information that actual investors rely on to make their investment decisions.

4. <u>Staff's Methodological Inconsistency</u>

Mr. Moul's point on consistency was a very simple one, yet it appears to have been completely lost on Staff. *See* Staff Init. Br. at 73-75. Mr. Moul simply pointed out that Staff has changed its cost of equity methods from case to case without explaining why the changes were necessary. Mr. Moul obviously agreed with Staff's use of a constant growth DCF model in this case, but Staff did not explain why it changed its DCF model for this case any more than it did in the Utilities' last rate cases. In this case, Staff also presented a new methodology for imputing the Utilities' capital structure, again without explaining why it was necessary to do so in this case when it was not necessary in the Utilities' 2007 and 2009 rate cases. In light of its actions over the Utilities' last three rate cases, Staff's assertion that its "analysis is consistent in application and approach" is not credible. Staff Init. Br. at 74. Staff's approach has undeniably changed in each of the Utilities' last three rate cases. Those changes, beyond creating the perception of a result-driven approach to cost of capital, also prove how subjective the process is.

Staff tries to turn the consistency charge against Mr. Moul, asserting that "the acceptance of each of his arguments would produce a higher ROE estimate." *Id.* Precisely the same point can be made about Staff's (and GCI's) arguments, except that acceptance of each of their arguments would produce a lower ROE estimate. This finger pointing leads nowhere and misses the basic point that all of the models require subjective choices and those choices must be realistic if the results are to be realistic. Instead of trying to resolve the (apparently) endless debate over whose analyses are "objective" or "subjective," the Commission can and should test the <u>reasonableness</u> of the parties' recommendations against readily available markers such as returns set for other utilities by this Commission and others, market forecasts of utility returns and other contextual information that is readily available to and relied on by real world investors. If the Commission does this in this case, it will find the Utilities' proposed ROE to be in the mainstream and those proposed by Staff and GCI well outside the mainstream.

5. <u>Risk Premium Analysis</u>

Staff challenges one aspect Mr. Moul's reliance on historical growth rate data – to develop the equity risk premium for his Risk Premium model – as "inappropriate." Staff Init. Br. at 76. As discussed above, if Staff is correct then Mr. McNally's reliance on historical spot data was also inappropriate. Staff cannot have it both ways.

Moreover, it is important to understand that Mr. Moul did not simply plug historical data into his model. Rather, as Mr. McNally acknowledged on cross examination, Mr. Moul reviewed market returns on the stocks of the S&P Utilities over two historical periods, averaged the two to determine "the central tendency of the historical returns" and adjusted that result to reflect current and forecasted "differences in fundamentals" between the Gas Group and the S&P Utilities. Moul Dir., NS Ex. 3.0 REV, 32:694 – 35:761; PGL Ex. 3.0 REV, 32:693 – 35:760; McNally, 8/31/11 Tr. 511:2 – 512:3. Thus, the point of using this data was not to assert that past performance on any particular day was definitive of future performance (which is the result of Staff's reliance on spot data), but to point out that relatively stable, long-term relationships between two sets of assets are evidence of an underlying market perception of differing risk that is likely to continue into the future. Unable to provide contrary evidence, Staff must resort to a pejorative dismissal of Mr. Moul's careful and contextual use of historical data.

6. DCF Model

Staff attacks Mr. Moul's position that the DCF model is currently an unreliable measure of natural gas utility market equity cost as "nothing more than unsupported speculation." Staff Init. Br. at 77-78. GCI claims that Mr. Moul "disregarded" the DCF in these cases simply "because he deemed the result 'far too low.'" City-CUB Init. Br. at 38. Neither comes to grips with Mr. Moul's point: when a model does not square with reality at a given point in time, it is the model, not reality, that must give way. By taking the contrary position, Staff and GCI expose not only their slavish devotion to their mathematical models, but also how far they are willing to go to champion the outlandish results their models generate.

Mr. Moul explained precisely why the DCF is currently an unreliable measure of the cost of equity for natural gas utilities. The stock prices of every member of the Gas Group have risen significantly since the Utilities' last rate cases, while the growth rates of every member of the Gas Group have declined significantly. Moul Reb., NS-PGL Ex. 19.0 REV, 16:326 – 17:338. This combination of high stock prices and low growth rates are causing the DCF model to generate unrealistically low costs of equity for these firms, and according to Mr. Moul is "an anomaly, one that cannot be sustained." *Id.* at 17:341-342. In focusing exclusively on the industry's low growth rates and the generally low interest rate environment, Staff fails to address the anomaly of significant concurrent increases in Gas Group stock prices.

For the reasons Mr. Moul gave, the Commission should disregard DCF results in this case.

7. <u>Leverage Adjustment</u>

According to Staff's initial brief, the "notion" that a company's risk, and therefore its cost of equity, is higher if its capital structure is valued at a lower book value than if it is valued at a higher market value is "absurd." Staff Init. Br. at 84. Yet Mr. McNally admitted on cross examination that this is indisputably true. If the "only difference" is that a company's equity ratio is 55% at book value, then "it will have a higher degree of financial risk if that same company had a 66% equity ratio" based on market value. McNally, 8/31/11 Tr. 518:2-9. Regardless of the company's "intrinsic risk" (whatever that is), the <u>market</u> will price the company's stock differently depending on its capital structure, and the company's capital structure is highly dependent on whether it is valued based on book or market value.

The logic underlying Mr. Moul's leverage adjustment is irrefutable. If a market cost of equity that is based on a utility's market value capital structure with more equity and less risk is applied to the utility's book value capital structure with less equity and more risk, then all other things equal the utility <u>cannot</u> earn its authorized return because the market value cost of equity applied to amount of book value equity will not generate the total dollar return necessary to earn the total dollar return when the market value cost of equity is applied to the utility's market value equity. NS-PGL Init. Br. at 119-120.

The Utilities acknowledge that the Commission has not accepted Mr. Moul's leverage adjustment in past cases. The Commission may have been confused by claims like GCI makes in this case that this adjustment is just another "market-to-book" adjustment. City-CUB Init. Br. at 40. It is not, no matter how many times it is mischaracterized as such.

There is no record support for GCI's assertion that Mr. Moul's leverage adjustment "has the effect of preserving the existing relationship of market price to book value." *Id.* To the contrary, "[t]he leverage adjustment is not intended, nor was it designed, to address the reasons that stock prices vary from book value" Moul Dir., NS Ex. 3.0 REV, 27:604-605; PGL Ex. 3.0 REV, 27:603-604. "The leverage adjustment deals with the issue of financial risk and <u>does not transform the DCF result to a book value return through a market-to-book adjustment</u>." NS Ex. 3.0 REV, 27:606-608; PGL Ex. 3.0 REV, 27:605-607 (emphasis added).

The Utilities urge the Commission at least to consider that applying ROEs based on market value capital structures to book value structures without making the leverage adjustment will prevent the Utilities from earning their total dollar actual market costs of equity, all other things equal. Indeed, failing to make Mr. Moul's adjustment would mean that even if the Utilities were to earn 100% of their authorized revenue requirements they would still not generate sufficient earnings to cover their total dollar market costs of equity. If the mathematics chosen to set an authorized return for regulatory purposes are such that the utility cannot earn that return in the eyes of the market, then there is something wrong with that math.

8. <u>CAPM Size Adjustment</u>

Mr. Moul presented academic research in support of his opinion that CAPM results must be adjusted because that model tends to understate the cost of equity for firms that are relatively small compared to the sample. Moul Dir., NS Ex. 3.0 REV, 40:870 – 41:891; PGL Ex. 3.0 REV, 40:869 – 41:890. Mr. McNally and Mr. Thomas presented academic research in support of their view that no such relation exists, although Mr. McNally concedes that if it does exist, "that relationship is likely the result of some other factor or factors that are related to both size and return, such as liquidity or information costs." McNally Dir., Staff Ex. 5.0C, 32:638 – 37:735; Thomas Dir., GCI Ex. 5.0, 25:559-564. Mr. Moul explained why the academic research presented by Staff and GCI did not support their position, and presented more recent research that contradicted their research. Moul Reb., NS-PGL Ex. 19.0 REV, 28:565 – 29:583. Mr. McNally responded with arguments about why the research he relied on was valid and the research Mr. Moul relied on was not. McNally Reb., Staff Ex. 14.0, 24:515 – 28:603.

The Commission need not resolve this highly opinionated dispute between experts. Rather, if and to the extent the Commission accepts the analysts' CAPM results for setting the Utilities' ROEs in this case, it should accept each result as presented by the analyst.

F. Weighted Average Cost of Capital

1. Peoples Gas

The Commission should include in Peoples Gas' 2012 rates an overall rate of return of 8.11% comprised of a capital structure of 56% equity and 44% long-term debt, a cost of equity of 10.85% and a cost of long-term debt of 4.62%.

2. North Shore

The Commission should include in North Shore's 2012 rates an overall rate of return of 8.50% comprised of a capital structure of 56% equity and 44% long-term debt, a cost of equity of 10.85% and a cost of long-term debt of 5.51%.

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VIII. RIDERS – NON-TRANSPORTATION

A. Riders UEA and UEA-GC

Staff recommends the net write-off method to determine uncollectible expense. Staff Init. Br. at 89-91. The Utilities oppose this for the reasons stated on pages 70-72 and 122-124 of their Initial Brief and in Section V.C.5, *supra.* In addition, Staff's proposal is deficient because it provided incomplete and inadequate guidance for addressing the many language and formula changes required for Rider UEA and proposed Rider UEA-GC to implement a net write-off method. Finally, Staff's description of the Stipulation in Docket Nos. 09-0419/09-0420 (cons.) is incomplete. Staff is correct that the Stipulation did not expressly preclude the use of the net write-off method. Staff Init. Br. at 90. However, the Stipulation required the Utilities to file a gas cost uncollectible expense rider mechanism "similar to" that which was withdrawn in the 2009 rate case, *i.e*., a rider mechanism premised on a percentage of revenues methodology. The Stipulation provided, in part, that: "The amount that will be billed to customers pursuant to the rider will be determined by multiplying uncollectible factor(s) that will be based on each of Peoples Gas' and North Shore's uncollectible accounts expense for each eligible rate class as approved by the Commission and set forth in Peoples Gas' and North Shore Schedules of Rates for Gas Service times the charges billed pursuant to Rider 2, Gas Charge either directly or by reference." Grace Sur., NS-PGL Ex. 45.0, 27:571-76. The Utilities' proposed Rider UEA-GC is consistent with this directive; the net write-off method is not. The Utilities' proposed Rider UEA-GC and proposed changes to Rider UEA should be approved as set forth in NS-PGL Exs. 28.2 and 28.3.

B. **Rider VBA**

1. **Approving Rider VBA on a Permanent Basis**

a. **AG**

The AG opposes making Rider VBA permanent. AG Init. Br. at 36-61. City-CUB support the AG's arguments. City-CUB Corr. Init. Br. at 50. The AG's arguments are flawed and should be rejected. *See* NS-PGL Init. Br. at 124-128.

First, the AG contends that Rider VBA is unnecessary because the Utilities do not expressly link it to energy efficiency and because "lost revenues" associated with energy efficiency are insignificant. This misapprehends the purpose of a full decoupling mechanism such as Rider VBA and distorts what such a rider is designed to accomplish and what the Commission found it should accomplish. (A full decoupling mechanism determines adjustments for all changes in usage, irrespective of the cause.) Rider VBA, as proposed by the Utilities and as modified by Staff witness Ms. Ebrey, does nothing more than make periodic adjustments such that Service Classification ("S.C.") Nos. 1 and 2 customers do not pay more or less than the distribution revenue requirement approved by the Commission in a rate case. The Commission recognized this basic function of the rider when it found that "[i]n our view, Rider VBA is a reasonable response because it simply involves the recovery of margin revenues that we have already established in this case. In terms of the mechanism itself, the record shows that Rider VBA is designed with symmetry, transparency, and accountability. In these respects, this rate mechanism works to the benefit of both the Utilities and their customers." *Peoples 2007*, p. 151.

The Commission did not approve Rider VBA "in exchange for" (AG Init. Br. at 42) the implementation of energy efficiency programs. The most obvious indication that they are not linked is that the Commission approved Rider VBA only as a four-year pilot and approved the energy efficiency programs with termination tied to replacement by a state-mandated program, *i.e.*, energy efficiency programs would necessarily continue to exist beyond the four-year pilot. Notwithstanding the AG's skepticism ("alleged elimination of the throughput incentive" (AG Init. Br. at 43)), the Utilities offer and will continue to offer energy efficiency programs, which are antithetical to encouraging throughput.

Rider VBA is not a "lost revenues" rider, and the AG's efforts to portray it as such do not make it so. As the Commission correctly found in the 2007 rate case, "Rider VBA does not seek to recover lost profits." *Peoples 2007*, p. 149. The AG's consternation that the Utilities do not forecast lost margin (AG Init. Br. at 45) is a fundamental misunderstanding of the decoupling rider; calculating these data serve no purpose. The rider's adjustments are, and would continue to be, under the Utilities' proposal and Ms. Ebrey's proposal, tied to the Commission-approved revenue requirement. Adjustments occur, as with the mechanism approved in the 2007 rate cases, through the application of a mathematical formula (*Peoples 2007*, p. 151) that is based on the Commission-approved revenue requirement. It is irrelevant what causes the formula to generate a credit or a charge adjustment; it may be, as examples, the effect of weather or energy efficiency. Grace Reb., NS-PGL Ex. 28.0, 30:643-652. Indeed, net refunds have occurred during the rider's existence -- hardly what one would expect from a "lost revenues" mechanism. *Id.*, 30:661-663.

The Commission found that "Rider VBA is appropriate as it reflects the particulars of declining and variable customer usage patterns and the concomitant revenue recovery impacts for Peoples Gas and North Shore. In our view, this evidence of usage patterns and margin recovery fluctuations calls for a regulatory response. This, we note, is not a novel idea." *Peoples 2007*, p. 150. These findings still hold true. Peoples Gas' customer demand continues to decline, and North Shore's remains essentially flat. Kuse Dir., PGL Ex. 4.0 REV, 1:18-21; NS Ex. 4.0 REV, 1:19-21. The Utilities must implement energy efficiency programs under Section 8-104 of the Act and are subject to penalties if they fail to meet statutory savings levels. 220 ILCS 5/8-104(i). Whatever the reason for declining demand and irrespective of whether the Utilities spend more or less on energy efficiency, the facts are that declining demand is forecast to occur, which would tend to mean the Utilities would under-recover their authorized revenue requirements. On the other hand, other factors (*e.g.*, weather) may cause the Utilities to over-recover their authorized revenue requirements. Rider VBA addresses either outcome through a charge or credit. Finally, the Commission's observation that decoupling is not a novel idea is likewise still true; the number of states approving decoupling mechanisms has doubled since 2007 (10 to 20) and the number of utilities with decoupling has more than doubled (17 to 46). Grace Sur., NS-PGL Ex. 45.0, 22:456-459.

Second, the AG contends that Sec. 8-104 of the Act, which requires gas energy efficiency programs, limits lost revenues because it caps the rate impact of energy efficiency spending. AG Init. Br. at 47. The cap merely means that, at some point, the amount of lost demand may be less than the statutory requirements. It does not excuse the Utilities from offering energy efficiency programs and achieving whatever savings are possible within the cap.

Third, the AG makes much of lower gas prices and the relationship to energy efficiency. AG Init. Br. at 47-52. Even the AG's data show that the cost of gas is more than half of total bills. AG Init. Br. at 49. Moreover, much of the rest of the bill consists of variable charges. *See, e.g.*, NS Ex. 12.1 at 21 and PGL Ex. 12.1 at 21, which show a sample S.C. No. 1 customer bill. In other words, energy efficiency will directly affect well over half of a customer's bill. It is not apparent why the evidence that the portion of that bill attributable to gas costs may have diminished from 60% to 55% (AG Init. Br. at 49) makes decoupling an inappropriate response to declining load. More importantly, Rider VBA adjustments are applied per therm, so if the adjustment is a charge, customers who consume less gas pay a lesser Rider VBA amount in addition to lower gas costs and lower variable charges. Grace Reb. NS-PGL Ex. 28.0, 30:643-646.

Fourth, the AG states that only the Utilities have decoupling mechanisms in Illinois. AG Init. Br. at 46. The AG fails to acknowledge that, in lieu of decoupling, the Commission authorized the Ameren gas utilities and Nicor Gas to recover 80% of their fixed costs through fixed charges.[24] That level of recovery not only far exceeds what the Utilities recover or have proposed to recover through their fixed charges, but the AG has proposed to decrease the Utilities' level of recovery through fixed charges. This recalls the AG's support for energy efficiency programs in the 2007 rate cases but opposition to a mechanism to address the under-recovery of the approved revenue requirement that the efficiency programs could produce ("While the GCI parties fully support EEP, they pay no mind to what this means for the Utilities." (*Peoples 2007*, p. 151)). Now, the AG seeks to reduce fixed cost recovery through fixed charges, faults the Utilities for not making greater energy efficiency expenditures, erroneously defines fixed costs to exclude demand-classified costs, and opposes decoupling. That is, the AG supports rate design policies that greatly increase the likelihood that the Utilities will not have a realistic opportunity to earn their approved revenue requirements.

Fifth, the AG emphasizes that the "regulatory bargain" is that utilities have an "opportunity" to earn a return and claims, incorrectly, that Rider VBA "guarantees" that the

[24] *In re Central Illinois Light Co., Central Illinois Public Serv. Co. and Illinois Power Co.*, ICC Docket Nos. 07-0588, 07-0589 and 07-0590 (Cons.), at 237 (Order, Sept. 24, 2008); *In re Northern Illinois Gas Company d/b/a Nicor Gas Company*, ICC Docket No. 08-0363, at 91 (Order Mar. 25, 2009).

Utilities earn "a designated profit level." AG Init. Br. at 53. Rider VBA is based on the approved revenue requirement and is not a "guarantee" of earning the authorized rate of return. To state the obvious example, if the Utilities' costs are above those approved in the rate case, Rider VBA is not a means to recover the higher costs (notwithstanding the AG's claims (AG Init. Br. at 54-56) that Rider VBA represents single issue ratemaking). Indeed, if Rider VBA "guaranteed" that the Utilities earned a specified profit level, the Utilities' returns would not be deficient. Schott Dir., PGL Ex. 1.0, 12:249-250; NS Ex. 1.0, 12:236-237.

Sixth, the AG contends that Rider VBA is unlawful single issue ratemaking. AG Init. Br. at 54-56. As the AG stated, the appeal of Rider VBA is pending and this argument is before the Appellate Court. However, the AG's arguments are flawed. The AG's incorrect conclusion is that Rider VBA "changes future customer rates to account for changes in only a single element of the revenue requirement formula -- forecasted revenues for the Residential and General Service customer classes, while ignoring all other changes." AG Init. Br. at 55. Rider VBA does not change customer rates. In a rate case, the Commission approves a revenue requirement. The Utilities use that revenue requirement with the approved rate design to determine the various charges to assess customers. Rider VBA does not change the revenue requirement or any element in the revenue requirement formula. Rider VBA calculates a positive or negative (*i.e.*, a credit) adjustment that aligns the amount paid by customers with the Commission-approved amount that the Utilities are authorized to recover from those customers.

Finally, the Utilities agree with the AG that the fact that Rider VBA has produced net refunds is not a reason to make it permanent. AG Init. Br. at 56-59. The reasons to continue Rider VBA are that it is a symmetrical and transparent formula for collecting the approved distribution revenue requirements -- not more or less -- from customers if the Commission chooses not to provide fully for recovery of fixed costs through fixed charges.

b. <u>Staff</u>

Staff concluded that Rider VBA is preferable to a straight fixed variable ("SFV") rate design. Staff Init. Br. at 91-96. Although the Utilities also supported decoupling rather than SFV, they do not concur with some of Staff's rationale. In particular, having greater fixed cost recovery in volumetric rates is inconsistent with cost causation principles and with Commission policy. NS-PGL Init. Br. at 124-125, 139. As Staff witness Dr. Brightwell acknowledged (Brightwell Dir., Staff Ex. 6.0, 4:70-72), Rider VBA is on appeal and, given that uncertainty, it is important that the Commission continue its policy of increasing fixed cost recovery through fixed charges. Moreover, the Commission is mindful of how it balances energy efficiency against a rate design based on cost causation. As the Commission observed in reviewing Nicor's decoupling proposal and its modified SFV proposal, "[t]he portion of fixed costs that are currently recovered through a volumetric charge are in fact fixed costs, and thus cannot be conserved." *In re Northern Illinois Gas Company d/b/a Nicor Gas Company*, ICC Docket No. 08-0363, at 91 (Order Mar. 25, 2009).

2. <u>Tariff Language</u>

Staff supported the Utilities' proposed tariff language, except for proposed provisions to address customer switching between Service Classification ("S.C.") No. 2 and S.C. No. 3 (North Shore) or S.C. No. 4 (Peoples Gas) and *vice versa*. Staff Init. Br. at 91-96. The Utilities showed why such a provision is important for Rider VBA to function as intended, *i.e.*, to avoid customers over- or under-paying the approved revenue requirement. NS-PGL Init. Br. at 126-128. Even if less switching occurs than in prior years (Staff Init. Br. at 96-97), any switching may cause distortions that the Utilities' proposal can easily prevent.

C. Rider ICR[25]

1. Accumulated Deferred Income Taxes

Staff acknowledges the complexity associated with GCI's proposal to include accumulated deferred income taxes ("ADIT") in the Rider ICR calculation. Staff Init. Br. at 96. The AG argues for the inclusion of ADIT in the calculation. The Utilities fully addressed and refuted these arguments in their Initial Brief. NS-PGL Init. Br. at 129.

IX. COST OF SERVICE

A. Overview

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B. Embedded Cost of Service Study

1. Uncontested Issues

a. Sufficiency of ECOSS for Rate Design

Only Staff addressed Sections IX.A and IX.B in its Initial Brief, and there are no issues for the Utilities to address in this Reply Brief.

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

[25] On September 30, 2011, the Illinois Appellate Court reversed and remanded the Commission's approval of Rider ICR in the Utilities' 2009 rate case, in *Peoples 2009 Appeal*, as noted earlier. The time to seek rehearing and/or further appeal has not elapsed.

The AG addressed some of these issues in the context of the S.C. No. 1 rate design in Section X.C.2.a, *infra*.

X. RATE DESIGN

A. Overview

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B. General Rate Design

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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

Only Staff addressed Sections X.A, X.B and X.C.1 in its Initial Brief, and there are no issues for the Utilities to address in this Reply Brief.

2. Contested Issues – North Shore and Peoples Gas

a. Service Classification No. 1

The AG opposes the Utilities' S.C. No. 1 rate design. AG Init. Br. at 66-86. City-CUB support the AG's arguments. City-CUB Corr. Init. Br. at 50. The Utilities refuted the AG's arguments, notably the AG's erroneous definition of fixed costs and the resulting flawed rate design proposal of its witness, in their Initial Brief and this reply will be limited. NS-PGL Init. Br. at 132-133, 137-141.

The AG's S.C. No. 1 rate design objections are centered on its incorrect conclusion that the Utilities proposed "to recover most of their demand-related costs on an *equal amount per-customer* basis through the customer charge." AG Init. Br. at 69 (emphasis in original). In fact, the Utilities proposed to recover <u>all</u> non-storage related demand costs through volumetric distribution rates and not a fixed charge (*i.e.*, not through the customer charge). All storage related demand costs would be recovered under proposed Rider SSC, Storage Service Charge. Grace Dir., NS Ex. 12.0 REV, 14:296-298; PGL Ex. 12.0 REV, 16:342-344. For sales customers, a Rider SSC Storage Service Charge applies to sales customers on each therm of delivered gas (again, not through a fixed customer charge). For transportation customers, the Rider SSC Storage Banking Charge applies to each therm of storage capacity. Grace Dir., NS Ex. 12.0 REV at 43:977-44:984; PGL Ex. 12.0 REV at 46:1037-47:1044. Despite devoting 20 pages to the topic, the AG's argument must fail because it rests on a fundamental misunderstanding of the Utilities' proposal.

The AG's erroneous definition of fixed costs is clear from its observation that the Utilities have reduced their A&G O&M costs since the 2009 rate cases. If these costs are fixed, the AG believes it is difficult to explain how they could be reduced. AG Init. Br., at 70-71. The AG would apparently (and incorrectly) equate "fixed" with "unchanging" and that is wrong. Fixed costs include demand-classified costs and customer-classified costs. Demand costs are those that do not directly vary with customer count and usage, and customer costs are those that do not vary with consumption. NS-PGL Ex. 29.4. The Commission previously found that "[w]e find compelling Ms. Grace's explanation that demand costs (also known as capacity costs) are fixed costs and not volumetrically based. *Peoples 2009*, p. 225. Nothing has changed. Grace Reb., NS-PGL Ex. 28.0, 8:160-9:177.

The AG argues that it is improper to set rates based on short run marginal costs (AG Init. Br. at 73-75), thus implying that this is what the Utilities are proposing. The AG is incorrect. The Utilities' proposal is based on fully distributed, embedded cost studies. Hoffman Malueg Reb., NS-PGL Ex. 29.0, 18:389-399.

The AG addresses the impact of the Utilities' proposal on lower use customers relative to higher use customers.[26] AG Init. Br. at 75-81. The basic problems with the AG's arguments are: (1) its incorrect belief that the Utilities are proposing to recover demand-related costs through a fixed charge; and (2) its incorrect definition of fixed costs. As the Commission found in connection with Nicor's residential rate design: "Because 94% of Nicor's fixed costs are the same, regardless of the size of the residence, currently, ratepayers owning larger residences pay a portion of the cost of supplying gas to smaller residences through the volumetric charges."[27] The Utilities, with 100% fixed costs, are similarly situated.

The Utilities' S.C. No. 1 rate design is reasonable and should be approved, together with the retention of Rider VBA. If the Commission does not approve Rider VBA, then S.C. No. 1 should be an SFV rate design with 100% fixed cost recovery in the customer charge. Grace Dir., NS Ex. 12.0 REV, 17:377-379; PGL Ex. 12.0 REV, 19:423-425.

D. <u>Tariffs – Other Non-Transportation Tariff Issues</u>

1. <u>Uncontested Issues - North Shore and Peoples Gas</u>

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[26] In their 2007 rate cases, the Utilities proposed bifurcating S.C. No. 1 into a heating class and a non-heating class. The AG and City-CUB opposed that proposal. *Peoples 2007*, pp. 204, 205. ("The evidence of record, [City-CUB] contend, establishes neither that the alleged disparity in the cost of serving S.C. 1 heating and non-heating customers is significant, nor that bifurcation would mitigate any intra-class subsidy within S.C. 1.")

[27] *In re Northern Illinois Gas Company d/b/a Nicor Gas Company*, ICC Docket No. 08-0363, at 89 (Order Mar. 25, 2009)

a. **Terms and Conditions of Service**

b. **Service Activation Charges**

c. **Service Reconnection Charges**

d. **Rider 2**

e. **Rider 9**

Only Staff addressed Sections XI.D (subsections 1.a, 1.b and 1.c only) in its Initial Brief, and there are no issues for the Utilities to address in this Reply Brief.

E. Bill Impacts

Only Staff addressed Section XI.E in its Initial Brief, and there are no issues for the Utilities to address in this Reply Brief.

XI. TRANSPORTATION ISSUES

A. Overview

IIEC/CNE includes some introductory statements in this section of its brief. IIEC/CNE Init. Br. at 1-7. On page 4, it incorrectly states that "Rider SST customers selecting zero backup receive a storage bank of zero. This is accurate only for S.C. No. 3 (North Shore) and S.C. No. 4 (Peoples Gas) customers. All but S.C. No. 1, Small Residential Service, customers are eligible for Rider SST, Selected Standby Service. Rider SST customers served under S.C. No. 2 and Peoples Gas' S.C. No. 8 receive the full amount of base rate storage bank, even if they select zero backup. Grace Reb. NS-PGL Ex. 28.0, 16:345-348.

B. Uncontested Issues

1. **Allowable Bank (AB) Calculation**

2. **Rider CFY**

3. **Rider AGG (except Aggregation Charge)**

4. Rider SBO

Neither Staff nor intervenors addressed Section XI.B in their Initial Briefs, and there are no issues for the Utilities to address in this Reply Brief.

C. Administrative Charges

IGS contends that small volume transportation ("SVT") service customers pay twice for certain administrative costs. IGS Init. Br. at 12-16. The fundamental flaw with IGS's argument is that the "administrative costs" that SVT customers pay through their service classification (*e.g.*, for the Utilities' call center) are for services that those SVT customers receive from the Utilities. The Aggregation Charge is a charge under Rider AGG, Aggregation Service, to recover, from SVT suppliers, the costs associated with the Utilities supporting their services to suppliers. Rider AGG is available only to suppliers serving SVT customers. Services to customers and services to suppliers are distinct. SVT customers are not paying twice for the same services. For that matter, SVT suppliers are not paying twice for the same service because they pay none of the costs recovered through charges under service classifications. *See* NS-PGL Init. Br. at 159-161.

D. Large Volume Transportation Program

1. Administrative Charges

Staff argues for a reduction in test year expenses for amounts recovered through transportation administrative charges. Staff Init. Br. at 110-112. The Utilities fully addressed and refuted Staff's arguments on pages 146-149 of their Initial Brief. Staff's arguments are premised on the conclusion that the Utilities have "historically over-budgeted." The flaw with that approach to adjusting the charges is that the brief (two, and in some cases, three years of data) period underlying Staff's analysis included significant unexpected events (transition activities associated with a merger) that are not reasonably expected to occur in the test year.

2. Transportation Storage – Issues

Staff and IIEC/CNE oppose many of the Utilities' proposed changes to their large volume transportation ("LVT") program.[28] The Utilities generally addressed and refuted Staff's and IIEC/CNE's arguments on pages 149-155 of their Initial Brief. Accordingly, this Reply Brief will focus on a few specific points.

First, Staff's observation that the transportation intervenors have rejected proposed restrictions (Staff Init. Br. at 114) is irrelevant to the merits of the proposal. It is no surprise that alternative gas suppliers and transportation customers oppose losing the disproportionate storage rights they have enjoyed, at sales customers' expense, for many years. As IIEC/CNE witness Mr. Gorman said, the Utilities have been able to operate their systems in a satisfactory manner (IIEC/CNE Ex. 1.0, 11:217-218), by which he meant satisfactory to the transportation customers. Gorman Tr. 8/31/11 at 371:14-15.

Second, Staff's contentions that unbundling "should not require that the service be altered" and that the Commission did not "permit" the Utilities to "reinvent the wheel" (Staff Init. Br. at 114, 115) are flawed. IIEC/CNE makes similar arguments. IIEC/CNE Init.Br. at 8-9. For reasons detailed in Utilities witness Mr. Connery's direct testimony (NS Ex. 14.0, PGL Ex. 14.0) and summarized in the Utilities' Initial Brief (at 149-155), it is not appropriate to carry over operating parameters from a different tariff service supported by different assets, *i.e.*, to retain Rider SST's operating parameters for proposed Rider SBS. NS-PGL Ex. 30.0, 7:151-153. Indeed, if unbundling were simply removing standby service from Rider SST with no other

[28] Integrys Energy Services - Natural Gas, LLC also addresses this section in its initial brief, but it relies entirely on Staff's and IIEC/CNE's witnesses' testimony and advances no arguments not covered by responding to them.

changes, the Commission could have ordered that to occur in connection with Staff's proposal in the 2009 rate case or directed that the Utilities implement that simplistic proposal in this case. Instead, the Commission called for a collaborative process and foresaw the possibility that agreement may not be reached. *Peoples 2009*, p. 235. When the Federal Energy Regulatory Commission ("FERC") ordered interstate pipelines to unbundle their sales service from their transportation services, the FERC "recognized that pipelines need to impose 'reasonable operational conditions' on their services to effectively manage their systems … ." The FERC stated, with reference to early unbundled tariffs and its directives in Order Nos. 436, that "[i]n evaluating those operational conditions, the [FERC] dealt with many complex matters in its effort to ensure that there was no discrimination between the transportation embedded within the pipelines' bundled, city-gate, firm sales services and their open access firm transportation services. 59 FERC ¶61,030 (1992), Order No. 636, p. 66. The Utilities undertook the modeling and asset analysis needed to develop an unbundled service supported by the assets underlying it. The arguments that equate the Commission's unbundling directive with increasing flexibility is not in the Commission's Order. Staff witness Mr. Sackett agreed that the Commission did not actually use the words "increased flexibility" despite contending that there is language in the Order requiring an increase in flexibility. In fact, the Commission issued a straightforward directive that the Utilities engage in a collaborative process to develop unbundling proposals. Sackett Tr. 9/1/2011, 758:6-17.

Third, the fact that LVT customers may use or may want to use storage differently than other customers (Staff Init. Br. at 116; IIEC/CNE Init. Br. at 15, 18-19) should not give them superior rights unsupported by the assets' underlying characteristics. Indeed, the contention that the LVT customers are different is questionable. S.C. No. 2 customers' load factors are essentially equivalent to S.C. No. 1 customers, around 23%. Even the load factors for large customers, Peoples Gas' S.C. No. 4 and for North Shore's S.C. No. 3, are only 38% and 53%, respectively. NS-PGL Ex. 30.0, 8:166-177. Staff witness Mr. Sackett agreed that customers with very different load factors taking service under the same rider should have the same rights. Sackett Tr. 9/1/11, 758:18 - 759:17. The fact that customers are different or may want to use storage differently does not, of itself, entitle them to different rights, whether taking service under the same or different riders. Connery Sur., NS-PGL Ex. 46.0, 5:90-106.

Fourth, the conclusion that taking flexibility from transportation customers and giving it to sales customers would create a direct subsidy (Staff Init. Br. at 119) is a *non sequitur*. The Utilities propose to eliminate a subsidy from sales customers to transporters. Eliminating the subsidy by giving all customer classes equitable access to storage does not create a new subsidy.

Fifth, Staff's comments about system integrity (Staff Init. Br. at 119) set the bar very low for determining what changes to the LVT program are appropriate. If the Utilities' systems must fail to warrant limiting transportation customers to the rights supported by the assets serving them, that is a recipe for continued inter-class subsidies. Yet, as long as system integrity is preserved, Staff witness Mr. Sackett appears to consider the system as operating adequately and efficiently. Sackett Tr. 9/1/11, 753:11-755:19. In a similar vein, IIEC/CNE concludes that nothing in the current programs prevents the Utilities from operating their storage systems as they see fit. IIEC/CNE Init. Br. at 16. This ignores the evidence that the Utilities respond to transportation customers, whose deliveries are typically unresponsive to changes in their requirements, to balance their systems and stay within physical and pipeline tariff limitations. Connery Sur., NS-PGL Exs. 46.0, 11:238-13:281; 46.2; 46.3. Even IIEC/CNE witness Mr. Gorman agrees that storage services are subject to physical and operational constraints

(Gorman Tr. 8/31/11 at 369:5-371:6), but IIEC/CNE is apparently unwilling to have those constraints apply to the storage services they receive.

Sixth, Staff's focus on the "net impact" on sales customers (Staff Init. Br. at 120-125) is misplaced. Giving transportation customers overly broad access to storage on the basis that, on net, over some undetermined period of time, their actions may balance out, is not harmless to sales customers. The Utilities, and therefore the sales customers, must react to the transportation customer deliveries and not *vice versa*. When transportation customers choose not to vary deliveries with changes in their requirements, as the record shows they do, then sales customers bear the brunt of balancing the swing. Any favorable daily storage capability or storage bank availability afforded the sales customers is by chance and at the discretion of the transportation customers. If the sales customers benefit or are neutral, it is, again, merely by a chance opportunity and not because the transportation customers were obligated to provide that opportunity to make the sales customers whole for earlier overuse. In contrast to the unlikely equity of that structure, the Utilities' proposals provide each customer group operating parameters that afford equitable access to such opportunities as they arise. Connery Sur., NS-PGL Ex. 46.0, 4:72-85, 11:238-13:281.

3. Associated Rider Modifications

a. Rider SBS/SST

IIEC/CNE's comments on Riders SBS/SST are generally based on their criticisms of the unbundling proposal and are addressed in Section XII.D.2 of this Reply Brief, *supra*.

b. Rider FST

Staff opposes the change to Rider FST that would require these customers to deliver a portion of their Maximum Daily Quantity on certain days. Staff Init. Br. at 126-128. IIEC/CNE also addresses Rider FST. IIEC/CNE Init. Br. at 25-26. The Utilities addressed these issues on pages 156-157 of their Initial Brief. Staff's argument is flawed.

First, Staff incorrectly states that Rider FST is for "smaller transportation customers." Staff Init. Br. at 126. Rider FST is available to all S.C. Nos. 2, 3 (North Shore), 4 (Peoples Gas) and 8 (Peoples Gas) customers, *i.e.*, the same customers who may take service under proposed Rider SBS. Grace Reb., NS-PGL Ex. 28.0, 16:332-340; PGL Ex. 12.1, 94; NS Ex. 12.1, 93.

Second, the contention that the proposed delivery requirement will affect customers on all days is wrong. The requirement applies to Critical and OFO Supply Shortage Days, *i.e.*, days when the Utilities anticipate that requirements will exceed supply based on specific criteria. NS Ex. 12.1 at 19-20; PGL Ex. 12.1 at 19-20. Staff witness Mr. Sackett's concern is that customers delivering less than the required quantity will be penalized and will feel obligated to deliver that quantity every day to avoid a penalty. He agreed, however, that if the customer is notified of a shortage day prior to the nomination deadline, this would mitigate his concern. Sackett Tr. 9/1/11, 761:8-13. In fact, the Utilities must declare shortage days no less than two hours before the deadline. NS Ex. 12.1, 19-20; PGL Ex. 12.1, 19-20.

Third, Staff proposes that, if the Commission approves the requirement, the cost discount should equal the amount that the customers are required to deliver. Staff Init. Br. at 128. The Utilities proposed to apply a 20% discount to firm transportation costs in calculating the Demand Gas Charge. Connery Sur., NS-PGL Ex. 46.0, 10:208-221. Staff did not explain why the percentage delivery requirement, likely applicable on only a few days of the year, should be a proxy for the demand cost reduction. To the extent it is tied to Staff's claim that customers will feel compelled to deliver gas every day, that claim assumes customers will choose not to manage their deliveries and is not based on any tariff requirement.[29]

c. Rider P

IIEC/CNE's comments on Rider P are generally based on their criticisms of the unbundling proposal and are addressed in Section XII.D.2 of this Reply Brief, *supra.*

d. Rider SSC

IIEC/CNE's comments on Rider SSC are generally based on their criticisms of the unbundling proposal. IIEC/CNE Init. Br. at 27-28. IIEC/CNE provides no argument about the merits of or structure of the cost recovery mechanism; it simply repeats arguments about unbundling. Grace Reb., NS-PGL Ex. 28.0, 17:362-367. Staff supported Rider SSC. Staff Init. Br. at 128.

e. Transition Riders

IIEC/CNE contend that transition riders are unnecessary if their or Staff's proposals are adopted. IIEC/CNE Init. Br. at 28-29. The Utilities disagree. NS-PGL Init. Br. at 158-159.

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

1. Aggregation Charge

IGS's proposal that all customers eligible for SVT service pay the administrative costs associated with the Utilities' services to suppliers (IGS Init. Br. at 16-22) was addressed and refuted on pages 159-161 of the Utilities' Initial Brief. However, the Utilities respond to IGS's false statement that the Commission considered Nicor's approach to recovery of administrative

[29] It is curious that Staff presumes transportation customers will not perform even the most perfunctory of supply management activities -- checking if the Utilities declared a shortage day, yet apparently does not believe that the absence of even such minimal day-to-day supply management may lead to an unfair burden on sales customers who, by default, must shoulder the responsibility for day-to-day system balancing.

costs to be the standard that the Utilities should adopt or explain why they are not adopting it. IGS Init. Br. at 18. As Staff correctly explains in its Initial Brief (Staff Init. Br. at 129) the portion of the 2009 rate case Order relied on by IGS was plainly directed at operational parameters. Specifically, the *Peoples 2009* language quoted in IGS's brief is found in Section XIII.D.1 of that Order and is entitled "Allocation of and Access to Company-owned Assets." Beginning on that same page cited by IGS (*Peoples 2009*, pp. 253-254), the Commission identifies three specific Nicor operational requirements that the Utilities' SVT program must include. IGS is correct only to this extent -- that the allocation of administrative costs was an issue set for the workshops.

2. Purchase of Receivables (withdrawn)

IGS includes some stray arguments about allocation of SVT administrative costs in this part of its brief. IGS Init. Br. at 25-26. The Utilities address these issues in Sections XI.C and XI.E.1, *supra*.

XII. **CONCLUSION**

Therefore, North Shore Gas Company and The Peoples Gas Light and Coke Company, for all reasons set forth above, appearing of record, or reflected in their Initial Brief filed on September 22, 2011, or their draft proposed Administrative Law Judges' Proposed Order filed on September 27, 2011, respectfully request that the Commission enter findings and make conclusions on all uncontested and contested issues consistent with the Utilities' positions taken in testimony and/or stated herein regarding the evidence in the record and the applicable law.

Dated: October 6, 2011

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