

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

AGL Resources, Inc., Nicor Inc., and)
Northern Illinois Gas Company)
d/b/a Nicor Gas Company)
Application for Approval of a Reorganization) Docket No. 11-0046
pursuant to Section 7-204 of the)
Public Utilities Act.)

BRIEF ON EXCEPTIONS
OF THE STAFF OF THE
ILLINOIS COMMERCE COMMISSION

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NOW COMES Staff of the Illinois Commerce Commission (“Staff”), by and through its undersigned counsel, pursuant to Section 200.800 of the Illinois Commerce Commission’s Rules of Practice (83 Ill. Adm. Code 200.800), and respectfully submits its Brief on Exceptions to the Proposed Order (“PO”) issued by the Administrative Law Judge (“ALJ”) on September 29, 2011, in the instant proceeding.

The PO generally reflects the issues raised by AGL Resources Inc. (“AGL”), Nicor Inc. (“Nicor”), and Northern Illinois Gas Company d/b/a Nicor Gas Company (“NG”) (collectively, “Joint Applicants”), Staff, and the other parties who have intervened. Although Staff supports some of the conclusions contained in the PO, there are some issues that Staff takes exception to which are stated below. In addition, technical corrections in individual sections will be addressed in their respective sections in this Brief on Exceptions.

I. Section 7-204(b)(1)

A. Staff's Argument

The PO errs in finding that the JA have demonstrated that the reorganization will not result in a diminution of NG's provision of adequate, reliable, efficient, safe and least-cost public utility service as required by Section 7-204(b)(1). In essence, the PO adopts the JA's position that evidence of an integration process that is "soundly conceived, adequately staffed and progressing satisfactorily" (PO, p. 13), is an acceptable substitute for substantive evidence of AGL's familiarity with NG and its plans for operation of NG's gas utility service in the future. The Commission should decline to make the Section 7-204(b)(1) finding based upon the evidence the JA have provided. Beyond Staff's disagreement with the PO's conclusion regarding this contested issue, Staff has concerns regarding the PO's discussion of Staff's position. When describing Staff's position, the PO fails to explain Staff's concerns regarding the JA's failure to disclose its plans to operate NG. The requirement that the reorganization not result in a diminution of NG's provision of adequate, reliable, efficient, safe and least-cost public utility service is fundamental to public utility regulation. See 220 ILCS 5/1-102. Paramount concern should be given to the JA's failure to provide evidence on its ability to assure that NG will continue to provide adequate, reliable, efficient, safe and least-cost public utility service after the reorganization.

The burden of proof is on the JA to establish that they will operate the utility going forward in a manner that either meets or exceeds the level of service currently provided by NG in every facet of the operations. Staff witness Mark Maple, a Senior Gas Engineer, conducted Staff's review of the reorganization under Section 7-204(b)(1).

Staff's analysis first focused on the information that AGL reviewed in the due diligence report. (See Staff Ex. 11, pp. 4-10) That information provided no substantive evidence regarding NG operations such as gas storage, gas supply portfolio, or the distribution infrastructure or AGL's familiarity with it. (*Id.*, p. 9) Staff inquired into the JA's integration planning process. (See *Id.*, pp. 10-12) However, the JA provided no documentation in this regard and simply stated that they "are engaged in an integration planning process with the objective to best identify best practices and determine the most cost effective manner to perform a variety of functions following the completion of the proposed merger." (*Id.*, pp. 10-11) Based upon the JA's failure to provide any meaningful evidence regarding AGL's knowledge of NG's gas utility operations or the JA's plans for NG operations subsequent to the reorganization, in Staff's direct testimony no conclusion could be drawn regarding the likelihood for a diminution in NG's provision of adequate, reliable, efficient, safe and least-cost public utility service after the reorganization. (*Id.*, p. 14)

In rebuttal testimony, the JA did not offer additional evidence of AGL's familiarity with NG's operations or the JA's plans for NG operations on a going forward basis. Rather, the JA identified 3 factors to be considered by the Commission. The JA indicated that the Section 7-204(b)(1) inquiry should start with an assessment of the acquirer. (JA Ex. 8.0, p. 5) Staff responded that it did not disagree but that its assessment of the acquirer is focused solely on the acquirer's knowledge of and plans for operation of NG. Second, the JA relied upon their commitment to retain full time equivalent employees ("FTEs") for a period of 3 years. (JA Ex. 8.0, p. 9) While Staff acknowledged that the FTE commitment helped lay a foundation for continued

adequate service quality, the commitment was not to maintain the identical employees or practices. Moreover, the commitment did not address concerns about plant and operations. (Staff Ex. 17.0, p. 4) Third, the JA pointed to NG's history of providing safe, adequate service and being the low-cost gas provider in Illinois. (JA Ex. 8.0, p. 6) However, as Staff pointed out, NG's *history* is not at issue under Section 7-204(b)(1), the question is about NG *operations subsequent to the reorganization*. (Staff Ex. 17.0, pp. 5-6, emphasis added)

The JA also protested Staff's inquiry into and criticism of the information provided regarding the integration process, stating that Staff missed the point. (JA Ex. 8.0, p. 6) In response, Staff clarified that what is of concern is "what AGL knows about Nicor Gas operations and how AGL will continue to operate it after the reorganization." (Staff Ex. 17.0, p. 6) The JA went on to assert that the first step in the integration process was for the companies to fully understand each others current processes, structure and practices. (JA Ex. 8.0, p. 6) Staff responded that this was exactly Staff's concern, but that this understanding should have been formed during the due diligence review or before filing the Application with the Commission. (Staff Ex. 17.0, p. 7) Next, the JA stated their commitment that no decision would be made that would impair NG's service. (JA Ex. 8.0, pp. 6-7) Staff responded that it did not intend to imply that the JA would intentionally make decisions that would impair NG's service. (Staff Ex. 17.0, p. 7) The role of Staff is to review operational plans and to provide impartial oversight. It would not be prudent to simply take the JA's, or any utility's, word that they will make decisions in the best interest of ratepayers. Staff's role is to conduct an analysis of the JA's plans and then to make a recommendation to the Commission. The Commission's

role is to provide general supervision to the utilities and, under Section 7-204(b)(1), make a determination regarding whether NG's quality of service will diminish as a result of the reorganization. The Commission must insist on seeing that the JA have at least some understanding of NG's distribution system and how the JA will operate it before the Commission should approve the reorganization.

Referring to the integration process, the JA also argued that Staff recommendation "misses the big picture" on why the Section 7-204(b)(1) requirement has been satisfied. (JA Ex. 8.0, p. 7) In Staff's view, Section 7-204(b)(1) is not about the "big picture;" it is about an analysis focused on the basic question of whether ratepayers will continue to receive the same adequate, reliable, efficient, safe and least-cost service after the reorganization as they received prior to the reorganization. (See Staff Ex. 17.0, p. 8) A detailed map of a carefully organized integration process (Id.) does not inform Staff or the Commission as to future operations of NG. In the absence of substantive evidence that AGL familiarized itself with the physical system and operations of NG and the JA's plans for operations on a going forward basis, Staff cannot recommend that the Commission make a Section 7-204(b)(1) finding. Staff repeatedly emphasized this concern and stated that regardless of where the information came from, this is the information Staff needed to change its recommendation.

The PO states, "[t]he question really raised by the objections of Staff and AG/CUB is whether the integration process must be *completed* before the Commission can reasonably render the finding required by subsection 7-204(b)(1)." (PO, p. 13, emphasis in original) This reveals a misunderstanding of Staff's position. The misunderstanding is likely the result of the statement in Staff's Initial Brief, "the only

means by which the JA can satisfy this burden is to reveal to Staff and the Commission their detailed final integration plans for all of the various operations of the utility.” (Staff IB, p. 6, “) This conclusion is a product of the failure of the JA to provide any evidence that decisions have been made as to the standards and procedures to be implemented at NG post reorganization. Staff has clearly and firmly communicated its need for evidence of AGL’s familiarity with NG’s gas utility operations and the JA’s plans for operating the NG system post merger, regardless of its source. (See for example Staff Ex. 17.0, p. 9) Staff tried to discover this information by inquiring into the due diligence process, but found that AGL Resources apparently performed very little review of operations before committing to acquire NG and created very few reports to document its review. In fact, the JA took the mystifying position that “AGL Resources did not have to prepare due diligence reports to know about Nicor Gas’ operations.” (See Staff IB, p. 7) In the absence of evidence of AGL’s familiarity with NG in the due diligence report, Staff inquired into the integration process. But, again Staff met with an absence of information. (See discussion *supra*) Staff did not demand that the JA rush through the integration process, but asked the JA to demonstrate that they have thoroughly studied every aspect of the companies involved and how AGL will continue to operate NG after the reorganization. (Staff Ex. 17.0, p. 6) While Staff concedes the value of a carefully organized process, Staff made clear that its ultimate concern is what AGL knows about NG operations and how AGL will continue to operate it after the reorganization. (*Id.*)

The PO places some emphasis on the provision of some 3500 pages of the JA’s integration planning documents (PO, p. 11) that were provided on July 13, 2011, nearly three months after Staff filed direct testimony and only 5 days prior to the hearing.

While the documents provided were voluminous, it is the content, not the quantity of documents that should determine whether, even at that late date, the JA had sustained their burden of proof. Staff did not find the documents to be informative as to how the JA intend to operate NG on a going forward basis. The documents demonstrate that the parties have been meeting on various aspects of utility operations, but do not provide any findings or conclusions and do not indicate the way the utility will be operated in any of those aspects. (Tr., p. 830, July 20, 2011) Thus the documents do not aid in Staff's review to determine whether the reorganization would result in changes in operations that would result in the diminution of service. In order to determine whether there would be a diminution in service, it is necessary to know that the acquiring company understands all aspects of the utility and that the standards and practices of the current organization will not be changed in a way that is detrimental to future service. If decisions have not been made in that regard, it cannot be concluded that service will not be diminished. (*Id.*, p. 831) Staff has been unable to decipher anything in the documentation provided by the JA that indicates that they have decided how they will operate NG on a going forward basis. (*Id.*, p. 832)

In Staff's view, the PO errs in placing such emphasis on what it describes as the one significant difference between the JA's and Staff's characterization of the record. (See PO, p. 11) The 3500 pages of integration material that the JA introduced into the record at the hearing is not relied upon by Staff because Staff did not find it to be significant. Staff criticized the evidence as not being material at all. (Staff RB, pp. 9-10) In fact, the JA do not point to any evidence within the documents upon which the Commission could rely in making a finding that the reorganization will not diminish NG's

provision of utility Service. (*Id.*) The witness who sponsored these documents testified that he was familiar with “almost of all this information.” (Tr., p. 695, July 20, 2011) The only other statement he made about the documents was that they contain no indication that there would be any layoffs of any specific personnel at Nicor. (*Id.*, p. 696) Based upon this limited testimony in support of the voluminous exhibit, Staff objected to its entry in to evidence. (*Id.*, p. 702) The objection was over-ruled. (*Id.*, p. 706) However, the fact remains that no one has identified one piece of evidence from the exhibit which would support a finding regarding how the JA will operate NG on a going forward basis. While the PO characterizes the documentation as significant, it does not identify one fact contained within the 3500 pages that the Commission could rely upon in determining how NG will be operated subsequent to the reorganization. In the absence of any facts indicating how NG will be operated subsequent to the reorganization, the Commission should not make a finding that the reorganization will not result in any diminution of NG’s provision of adequate, reliable, efficient, safe and least-cost public utility service.

B. Staff’s Exceptions

For all the foregoing reasons, Staff respectfully requests the Commission modify pages 11-15 of the PO, as shown below, to adopt Staff’s position regarding Section 7-204(b)(1) and find that the JA have not demonstrated that the reorganization will not diminish NG’s ability to provide adequate, reliable, efficient, safe and least-cost public utility service. Staff proposes the following changes to the PO¹:

¹ Please note that since Staff proposes new footnotes and the deletion of footnotes to the PO, that footnotes do not correspond to the PO.

1. Finding 1: “the proposed reorganization will not diminish the utility’s ability to provide adequate, reliable, efficient, safe and least-cost public utility service”

a. Issues Presented & Analysis

Two disputed issues have been framed under subsection 7-204(b)(1) - first, whether there is enough evidence to find that NG’s pre-merger ability to provide adequate, reliable, efficient, safe and least-cost public utility supply ~~statutorily sufficient~~ service will not be diminished by the proposed Reorganization and, second, whether the JA have, in fact, committed to maintain union contracts and Illinois employment levels. The two issues are related, insofar as the latter issue bears upon NG’s ability to sustain pre-merger service quality². The Commission will nonetheless analyze them separately, so that the parties’ arguments are more clearly delineated.

1.) Sufficiency of JA’s Evidence

Concerning NG’s post-merger ability to deliver quality service, the JA primarily relied upon the testimony of AGL’s Executive Vice President in charge of utility operations that he has been involved in acquisition of other gas distribution utilities, that AGL has a proven track record of merging and integrating companies safely and reliably and that AGL has made a commitment that NG’s ability to provide adequate, reliable, efficient, safe and least-cost public utility will not degrade after the merger.³ The JA also committed to maintaining the same over-all number of full time equivalent employees (“FTEs”).⁴ ~~Staff and AG/CUB have not offered their own evidence to show that future utility service will fall short of statutory standards. Rather, they have challenged, as they are entitled to do, the nature and weight of JA’s evidence, insisting that it is insufficient to render the finding required by subsection 7-204(b)(1). Thus, Our task is not to sift through competing information - indeed, Staff’s position is that the JA “have provided no evidence for the Commission to consider”⁵ - but to determine what information the statute requires and whether the JA have placed it in the record.~~

² For brevity, we will generally use service “quality” as a surrogate for the multiple attributes of service (“adequate, reliable, efficient, safe and least-cost”) addressed by the statute

³ JA RB at 5.

⁴ JA IB at 14.

⁵ ~~Staff IB at 14.~~

As Staff sees it, the JA's evidentiary case principally consists of recitations about NG's pre-merger service quality, AGL's track record with previous mergers, declarations of good intentions and a pledge not to reduce NG's aggregate staffing for three years⁶. Therefore, Staff takes the position that the burden of proof is on the JA to establish that they will operate the utility going forward in a manner that either meets or exceeds the level of service currently provided by NG in every facet of the operations and that the JA have failed to provide evidence to make this finding. Engineering Staff cited the insufficiency of the JA's evidence in both direct and rebuttal testimony as its rationale for recommending that the merger be disallowed. In direct testimony Staff criticized the lack of information regarding operations, gas storage, gas supply portfolio or NG's distribution infrastructure contained in the due diligence review performed by AGL⁷. Staff also noted that the JA provided no substantive information regarding the integration process, but only noted that they are "engaged in the integration planning process."⁸ In rebuttal testimony, Engineering Staff indicated the JA had not yet provided evidence to satisfy Staff regarding what actions AGL had taken to familiarize itself with the day-to-day and long-term operations and planning of NG in order to assure that subsequent to the reorganization, NG would continue to provide adequate, reliable, efficient, safe and least-cost public utility service. Staff concluded that the JA had provided no substantive evidence that AGL has a fundamental knowledge of the NG operational system.⁹ In regards to the JA commitment to retain FTEs, Staff points out that they are committing only to retain "equivalent" employee hours for a three year period and explained that NG employees could be let go, assigned to other duties, or even work for other AGL Resources affiliates while AGL Resources employees in another state work for the NG utility.¹⁰ In sum, Staff charges, the JA have "failed to provide any meaningful evidence about how they intend to buy gas operate the storage fields, perform maintenance, procure supplies, or any other critical operational details post-reorganization."¹¹ AG/CUB concur that "the record lacks evidence" pertaining to actual utility operations¹².

⁶Staff RB at 6.

⁷ Staff Ex. 11.0 at 8.

⁸*Id.* at 10.

⁹ Staff Ex. 17.0 at 3.

¹⁰ Staff RB at 11.

¹¹ Staff RB at ~~14~~ at 8.

¹² AG/CUB IB at 8.

~~With one significant exception, t~~ The only material difference between the JA's and JA do not cite any evidence that differs materially from Staff's characterization of the record is in regard to. ~~That exception concerns the integration planning process the JA have conducted. since the Reorganization was announced.~~ Specifically, JA emphasize that explain, several hundred employees of AGL, NI and NG have worked since January 2011 on understanding and meshing the "processes, structures and practices" of the merging entities¹³. JA state that these integration planning endeavors "assess the current state for each and every area of the two companies."¹⁴ The JA further assert that their work on final operating plans will continue "until the Reorganization is closed."¹⁵ JA underscore that approximately 3500 pages of documentation generated by JA's integration planners were submitted to Staff and presented during the evidentiary hearings in this case¹⁶.

As noted above, Staff requested information of the integration planning process prior to filing direct testimony. Staff acknowledges receiving JA's integration planning documents, but protests that the voluminous approximately 3500 pages of documentation was provided nearly 3 months after the direct testimony filing and did so less than a week before evidentiary hearings commenced¹⁷. Moreover, Staff contends, the JA "do not point to any evidence within the documents upon which the Commission could rely in making a finding that the reorganization will not diminish [NG's] provision of utility service."¹⁸ Staff testified that the documents do not provide any findings or conclusions and do not indicate the way NG will be operated after the reorganization.¹⁹ Staff additionally categorizes much of the submitted information as overly general, trivial and, at times, duplicative²⁰.

Again, the essential question posed by the foregoing arguments is whether the information and declarations JA have offered are appropriate and sufficient for supporting a finding that NG's post-merger ability to provide quality service will not be diminished. Staff and AG/CUB argue de

¹³ JA RB at 7-8.

¹⁴ JA Ex. 13.0 at 11.

¹⁵ *Id.* at 13.

¹⁶ *Id.* at 7-8; JA Ex's. 20 & 21.

¹⁷ Staff RB at 9.

¹⁸ *Id.*

¹⁹ Tr., July 20, 2011, p. 830.

²⁰ *Id.* at 9-10.

~~not appear to believe that evidence regarding the prior performance of the acquiring entity - that is, its "track record" - is not determinative of pertinent to the post-reorganization performance of the utility being acquired. While the Commission agrees that track record evidence is not necessarily determinative an important consideration, it is not sufficient evidence on its own to satisfy the requirements of subsection 7-204(b)(1). Instead, it should be used to weigh and evaluate the likely success of the integration plans that the JA intend to implement. In this instance, the JA have provided no such detailed plans, and thus the track record evidence is of little use. certainly relevant and has whatever probative weight the would-be acquirer's track record deserves.~~

~~In this instance, JA have shown that AGL has acquired natural gas distribution utilities on three previous occasions²¹ and (as catalogued above) now controls six such companies with 2.3 million customers in six states²². That experience in acquisition and management within the pertinent industry, and the expertise presumably derived from such experience, is unquestionably probative of an ability on the part of AGL to manage NG without diminish the utility's quality of service. Stating that in the reverse, it would not be sensible to ignore an acquirer's prior and continuing achievements (or failures) regarding the very functions it will have to perform to meet the statutory standards involved here. Comparable evidence was adduced in the 2007 merger involving Peoples Gas and North Shore Gas, without challenge to its probity from any party²³. Analogously, applicants for alternate gas supplier certification must show they "possess sufficient technical, financial and managerial resources and abilities to provide the [intended] service,"²⁴ which, under our associated rules, necessitates presentation of what is, in essence, "track record" evidence²⁵.~~

²¹ JA Ex. 8.0 at 5.

²² JA Ex. 1.0 at 4.

²³ ~~WPS Resources et al.~~ (application pursuant to Section 7-204 of the Act), Dckt. 06-0540, Order, Feb. 7, 2007 at 11.

²⁴ ~~20 ILCS 19-110(e)(1).~~

²⁵ ~~E.g., 83 Ill. Adm. Code 551.100 (requiring proof of four years of experience performing essential management functions). Similarly, when a prospective telecommunications provider seeks certification to provide local exchange service under 220 ILCS 5/13-405, the attributes and expertise of the applicant (its "technical, financial, and managerial resources and abilities") are what the relevant statute addresses and what the Commission, in fact, considers in such cases. XO Communications Services, Inc., Dckt. 04-0519, Order, Dec. 15, 2004 (as a "garden variety" example of such proceedings).~~

In addition to the track record evidence here, the JA emphasize that certain decisions they have made will increase the likelihood that the Merger will not diminish NG's ability to supply quality service. They point to their commitment (described above, in section II.C. of this Order) to maintain the utility' aggregate staffing level for three years, with a five-year commitment for specific staffing and programs concerning pipeline safety (discussed in connection with subsection 7-204(b)(5) ("Finding 5") below). The JA also stress the specific measures they have promised in order to protect NG's financial health and access to capital (discussed in connection with subsection 7-204(b)(4) ("Finding 4") below), as well as NG's pre-existing financial strength. While there is merit to maintaining staffing levels for three years, it is also recognized that three years is a relatively short time in the life of a utility. The JA are not making a commitment to retain the same experienced employees or even the same number of workers in each job function, only an overall equivalent number of employees in the company.²⁶ Further, the JA have given no indication of what the staffing levels will be after the three-year commitment. ~~The Commission views the foregoing commitments as both empirically sound in their own right and indicative of an intention to maintain future utility service quality.~~

Beyond their evidence of prior and ongoing operating experience, and of specific pledges in support of future operations, the JA point to the ongoing process of integrating the merging entities, as described above. The fact that the JA are conducting this process with a significant commitment of personnel is indicative that the JA intend ~~itself evidence~~ that service quality will be maintained after reorganization. ~~Indeed, i~~ It is, conceptually, ~~exactly~~ what needs to occur to achieve a smooth integration of the merging entities. However, the JA's claims regarding the integration process beg t ~~The question really raised by the objections of Staff and AG/CUB: why have the JA provided no substantive evidence regarding AGL's familiarity with and plans for NG operations? —is whether the integration process must be completed before the~~ The JA must provide substantive evidence of their knowledge of and plans for NG operations before the Commission can reasonably render the finding required by subsection 7-204(b)(1).

Staff ~~(particularly through Mr. Maple)~~ and AG/CUB are correct that evidence of the completion of integration planning (and, for that matter, the completion of integration implementation) would afford greater certainty for the requisite statutory finding. The JA respond, however, that culmination of the integration process cannot reasonably be required

²⁶ Staff RB at 10-11.

before the merger is actually approved²⁷. That argument has merit, since integration prior to this Commission's decision would have to be unwound if we rejected the proposed Merger, leaving behind wasted resources and disrupted operations. Even approval with additional conditions could cause comparable, if less severe, reworking of integration activities. Similarly, A more appropriate test is whether the ongoing the integration process itself, regardless of how is soundly conceived, or adequately staffed it may be, does not demonstrate that NG's ability to provide adequate, reliable, efficient, safe and least-cost public utility service will not be diminished by the reorganization and progressing satisfactorily. The JA claim that it is²⁸ and no party argues to the contrary. A more appropriate test is what does AGL know about NG operations and how do the JA intend to operate NG on a going forward basis. However, the JA have failed to provide substantive evidence of AGL's familiarity with NG operations or the JA's plans for the future operations of NG.

The Commission holds that it is unnecessary to await completion of the company integration processes in this particular case. The intention of the statute is to sustain the utility's service quality status quo, not to achieve quality improvements. No one contends here that NG's service quality is presently sub-standard or vulnerable to slippage for any reason unrelated to merger. After merger, staffing levels will be maintained, generally by the same people in place now²⁹. The JA have no apparent incentive to compromise any of the attributes of service quality appearing in subsection 7-204(b)(1), and there is no evidentiary track record here of having done so in AGL's previous mergers elsewhere. Therefore, we assume that standard and predictable objectives – to increase revenues, avoid sanctions and sell unregulated services and products under a common brand³⁰ – will incent the post-merger entity to preserve utility service quality. If service quality nevertheless diminishes after reorganization, the Commission has statutory mechanisms for identifying imprudent and unreasonable management³¹.

²⁷ JA RB at 5.

²⁸ A document entitled the "Current State Assessment," dated June 28, 2011, has been presented to the Chief Executive Officers of AGL and Nicor. JA Ex. 13.3 (confidential). It summarizes the integration activities preceding the presentation of the document and describes future tasks and objectives.

²⁹ Specifically, the NG employees "operating the system today will largely be the same group responsible for the activities following the Reorganization." JA Ex. 13.0 at 9 (emphasis added).

³⁰ "Certainly utilities are not added [sic] customers in either of our markets today. So the real opportunity of this deal is around those other businesses." Tr. 680 (Lingenfelter).

³¹ For example, under Section 8-102 of the Act, the Commission can conduct an investigation or management audit of a public utility to "examine the reasonableness, prudence, or efficiency of (continued...)"

* * *

b) Commission Conclusion

The Commission concludes that there is insufficient record evidence to support the finding required by subsection 7-204(b)(1) that the merger will not diminish the utility's ability to provide adequate, reliable, efficient, safe and least-cost public utility service. Although the evidence of AGL's and Nicor's prior and ongoing experience in the operation of natural gas distribution utilities, of AGL's experience with previous mergers of such utilities, of the JA's binding operational and financial commitments (as described in this Order and included in Merger conditions), and of the ongoing activities to integrate the utility with the acquiring entity, are indicative of an intention to maintain NG's current service standards, the JA have refused to provide substantive evidence regarding NG operations post merger. The provision of adequate, reliable, efficient, safe, and least-cost gas utility is of paramount concern to the Commission. In the absence of substantive evidence about NG operations on a going forward basis, the Commission cannot make the requisite Section 7-204(b)(1) finding that NG's ability to provide adequate, reliable, efficient, safe and least-cost public utility service will not be diminished by the reorganization collectively satisfies the statute. No contradictory inferences are supported by the record.

~~With respect to NG's workforce, the Commission approves the JA's commitments to honor NG's existing CBAs and to maintain its current Illinois staffing levels for three years (and, in some cases, five years) after completion of the Reorganization, as these commitments are described in section II.C of this Order. Lacking any supporting evidence, the IBEW's request for a continuation of the staffing levels in each classification in the Local 19, IBEW CBA will not be explicitly included in a merger condition. However, if the terms of the Local 19 CBA would require continued per-classification staffing, then the JA, through their promise to fully honor existing CBAs, will retain that obligation. Job retention for individual employees will also not be included as a merger condition here, again for complete lack of evidence supporting it.~~

* * *

(continued from previous page)

~~any aspect of the utility's operations, costs, management decisions or functions that may affect the adequacy, safety, efficiency or reliability of utility service or the reasonableness or prudence of the costs underlying rates or charges for utility service." 220 ILCS 5/8-102.~~

C. Staff's Alternative Section 704(b)(1) Recommendation

In the event the Commission determines that there is sufficient evidence in the record to make a determination that the reorganization will not result in a diminution of NG's adequate, reliable, efficient, safe and least-cost public utility service, Staff recommends that the Final Commission Order reflect the factual basis for that finding. The Commission should not solely rely upon the track record of AGL (see PO, p. 12) and the *process* of integrating the merging entities (see *Id.*, p. 13, emphasis added). All parties agreed that the no diminution of service finding should be based upon NG's operations on a going forward basis. The Commission may find that there is evidence of NG's operations on a going forward basis either in the 3500 pages of documentation (PO, p. 11) or in other evidence submitted by the JA. If the Commission finds such evidence of NG's operations on a going forward basis that evidence should be identified in the Final Order. To the extent the Commission is able to make a determination regarding the operation of NG on a going forward basis, the Final Order should identify the evidence upon which it relies.

The PO errs in its analogy of the reliance on track record evidence in the 2007 merger involving Peoples Gas and North Shore Gas (PO, p. 12, citing *WPS Resources et al.*, Docket No. 06-0540 Order, February 7, 2007 at 11) with the instant proceeding. The facts presented in the two proceedings are not analogous. While the Applicants in *WPS* provided evidence of their "long history of being highly rated" (*WPS*, p. 11), the Section 7-204(b)(1) finding was not based upon that history. Clearly, information was shared regarding the going forward operations of Peoples Gas and North Shore Gas. The Staff Engineer testifying on the issue

... identified a number of areas of the Gas Companies' operations that WPS Resources had not yet reviewed thoroughly or for which detailed plans for post-closing operations had not yet been developed. ... Accordingly, [the Staff Engineer] proposed conditions to the Commission's approval of the Merger that would address each of the ... areas of concern... (*WPS*, pp. 22-23)

In *WPS*, Applicants agreed to the conditions, with some modification as well as agreeing to certain other conditions proposed by other parties. (*Id.*, p. 26) The Commission found that no party was contending that the proposed reorganization did not satisfy the requirements of Section 7-204(b)(1).

In the instant docket, the JA have failed to provide substantive evidence regarding the going forward operations of NG. As such, the Staff Engineer was unable to identify particular concerns and propose conditions in order that the Section 7-204(b)(1) requirements are satisfied. Thus, the facts in the two proceedings are such that *WPS* does not provide support for reliance on AGL's track record in this proceeding. The reference to *WPS* should not be included in the Commission's Final Order.

Similarly, the reference to 20 ILCS 19-110(e)(1) and 83 Ill. Adm. Code 551.100 should be omitted from the Final Commission Order. These references are not necessary. Staff has not objected to any discussion of the track record of AGL. Staff has objected to reliance on the track record in the absence of any evidence of NG operations on a going forward basis.

D. Staff's Alternative Exceptions

In the event the Commission determines that the record evidence supports a determination that the reorganization will not diminish NG's ability to provide adequate, reliable, efficient, safe and least-cost public utility service. Staff proposes that its

replacement language above for section **1.) Sufficiency of JA's Evidence**, be adopted in its entirety with one proposed deletion below:

* * *

Again, the essential question posed by the foregoing arguments is whether the information and declarations JA have offered are appropriate and sufficient for supporting a finding that NG's post-merger ability to provide quality service will not be diminished. Staff and AG/CUB argue ~~do not appear to believe~~ that evidence regarding the prior performance of the acquiring entity - that is, its "track record" - is not determinative of pertinent ~~to the post-reorganization performance of the utility being acquired~~. While the Commission agrees that track record evidence is not necessarily determinative ~~an important consideration~~, it is not sufficient evidence on its own to satisfy the requirements of subsection 7-204(b)(1). Instead, it should be used to weigh and evaluate the likely success of the integration plans that the JA intend to implement. In this instance, the JA have provided no such detailed plans, and thus the track record evidence is of little use. ~~certainly relevant and has whatever probative weight the would-be acquirer's track record deserves.~~

* * *

In addition, the following changes to section **b) Commission Conclusion** (PO, p. 15) should be adopted:

b) Commission Conclusion

The Commission concludes that there is sufficient record evidence to support the finding required by subsection 7-204(b)(1) that the merger will not diminish the utility's ability to provide adequate, reliable, efficient, safe and least-cost public utility service. Evidence of AGL's and Nicor's prior and ongoing experience in the operation of natural gas distribution utilities, of AGL's experience with previous mergers of such utilities, of the JA's binding operational and financial commitments (as described in this Order and included in Merger conditions), and of the ongoing activities to integrate the utility with the acquiring entity, are indicative of an intention to maintain NG's current service standards, the JA have refused to provide substantive evidence regarding NG operations post merger. The JA also provided substantive evidence of their plans for NG's operations on a

going forward basis.³² This evidence demonstrates . . . The provision of adequate, reliable, efficient, safe, and least-cost gas utility is of paramount concern to the Commission. The JA have satisfied the Commission's concerns by providing this evidence of . . . Based upon the evidence provided about NG operations on a going forward basis, the Commission concludes that the reorganization will not diminish NG's ability to provide adequate, reliable, efficient, safe and least-cost public utility service collectively satisfies the statute. No contradictory inferences are supported by the record.

~~With respect to NG's workforce, the Commission approves the JA's commitments to honor NG's existing CBAs and to maintain its current Illinois staffing levels for three years (and, in some cases, five years) after completion of the Reorganization, as these commitments are described in section II.C of this Order. Lacking any supporting evidence, the IBEW's request for a continuation of the staffing levels in each classification in the Local 19, IBEW CBA will not be explicitly included in a merger condition. However, if the terms of the Local 19 CBA would require continued per-classification staffing, then the JA, through their promise to fully honor existing CBAs, will retain that obligation. Job retention for individual employees will also not be included as a merger condition here, again for complete lack of evidence supporting it.~~

II. Section 7-204(b)(7)

A. Staff's Argument

Staff concurs with the PO conclusions that at least one rating agency will likely downgrade NG following the reorganization, which would lead to higher debt and common equity costs. (PO, pp. 23-24) Those increases in NG's cost of capital would be the result of NG's affiliation with AGL Resources. (Staff RB, p. 12) Given Section 9-230 prohibits the Commission from including in rates any incremental cost of capital due to a utility's affiliation with non-utility and unregulated companies, the increase in cost of capital for post-merger NG, therefore, constitutes an adverse rate impact under Section 7-204(b)(7) of the Act. (Staff RB, pp. 12 and 22) Staff proposed a condition that

³² (insert reference to evidence here)

provides a specific, straightforward and effective means for eliminating the adverse impact of the expected decline in NG credit ratings in future rate cases. (Staff IB, p. 20-22) Yet, the PO instead adopts a vague, time-consuming and expensive proposal of doubtful usefulness from the Joint Applicants (the JA proposal) that would require JA to submit studies addressing the requirements of Section 9-230 in future ratemaking proceedings. (PO, p. 30) For the reasons provided in Staff's briefs (Staff IB, pp. 12-22; Staff RB, pp. 12-22), and the reasons provided hereafter, Staff recommends the Commission modify the PO to adopt Staff's proposed remedy for meeting the Section 7-204(b)(7) requirement of the Act and reject the vague, time-consuming and expensive JA proposal.

Staff identified numerous problems inherent in the JA proposal that render it deficient for satisfying the requirements of Section 7-204(b)(7) of the Act. (Staff IB, pp. 16-20) The PO recognizes that the usefulness of the studies offered under the JA proposal is questionable when the PO states:

...both NG and Staff disparage the usefulness of the proposed study. Staff is at least consistent with its objection to the proposal when it asserts that "the value of a study that compares post-merger [NG] with a [NG] that no longer exists would surely diminish as the time horizon lengthens." But NG simply undermines its own promise when it declares that determining what NG's credit ratings, capital structure, and capital costs would have been absent reorganization becomes an "exercise in speculation" over time and "unreasonable" after three years. (PO, p. 28, emphasis in original)

Yet, the PO adopts the JA proposal, stating:

Nevertheless, there are components of such a study that would likely prove helpful to the Commission... Inherently, information pertaining to the initial three years after reorganization would be included with information associated with any subsequent interval prior to ratemaking... Furthermore, NG states that trustworthy debt-related data will be available for a period beyond three years. Accordingly, we will hold the JA to their commitment to file, in connection with any ratemaking proceeding in

progress after the end of the third post-closing year, a study analyzing the impact of NG's affiliation with AGL and its affiliates on NG's cost of capital (both debt and equity). The Commission will determine the efficacy of that study when it is filed. (PO, p. 28)

Foremost, Staff doubts that any study performed by JA will find increases in NG's cost of capital due to its affiliation with AGL because it is not in JA's interest to do so. Moreover, the PO identifies several instances in which the JA arguments contradict principles implicit in the Commission's Section 7-204(b)(7) analysis (PO, pp. 29-30) and the JA refuse to even admit that one or more rating agencies will downgrade NG following reorganization despite Standard & Poor's unambiguous statement that such a downgrade is expected. (Staff RB, p. 16-18; JA IB, p. 23) Given those fundamental disagreements between the other findings within the PO and JA, it is unlikely any studies performed by JA would assist the Commission with Section 9-230 adjustments in ratemaking proceedings.

Furthermore, those study components that the PO notes "would likely prove helpful to the Commission" are superfluous. 83 Ill. Adm. Code 285 already requires utilities to provide extensive information in connection with rate case filings and JA have not offered to provide any information in future ratemaking proceedings that is more useful than information required under Commission rules. This is evident in the following excerpt from JA testimony:

Q And do you know if the joint applicants have a proposal as to how the Commission would determine what effect non-utility and unregulated affiliates have on Nicor Gas's cost of capital?

A Well, I believe that the Commission would look at all the factors, as the Commission usually does in this type of process, to make that determination. I don't think that necessarily needs to be part of anything that we've [Joint Applicants] proposed. (Staff RB, p. 15)

Additionally, no studies are required for debt-related data since there are already published interest rates for short- and long-term debt that vary according to credit rating. In contrast, estimating the cost of equity is far more complicated. (Staff IB, p. 17) Yet, the JA proposal does not specify a methodology for estimating the effect of AGL companies on NG's cost of equity. Rather, JA and the PO assume that the Commission will be able to fulfill the requirements of Section 9-230 because the law requires it to do so. The PO states:

The JA argue that in any future NG rate proceeding, the Commission will apply Section 9-230 to bar any increase capital cost related to AGL and its affiliates. The Commission agrees with the JA that proper application of Section 9-230 would scour any capital cost increase from NG's ROR if it arises from affiliation with a non-utility... Staff objects, however, that without a predetermined adjustment to NG's capital structure (to limit the equity portion), the use of NG's pre-merger credit rating will not conform to NG's true post-merger capital costs, which will reflect the anticipated credit rating downgrade. While that "mismatch" could indeed materialize, ratepayers would not pay the difference, though, if Section 9-230 is properly applied. That is, under Section 9-230, any higher capital cost resulting from NG's merger would become the burden of shareholders, with ratepayers responsible only for a reasonable ROR... (PO, pp. 24 and 26)

Staff respectfully disagrees with this language, which ignores Staff's warning that relying on the JA proposal to meet the standard of Section 9-230 of the Act is problematic and would rely largely on guesswork rather than rigorous quantitative analysis.³³ Consequently, adopting the JA proposal would make it impossible for the Commission to know whether it removed the last iota of increase in the cost of equity due to the non-

³³ It is significant that of all those who have voiced an opinion on the ability of the Commission to measure and remove the incremental increase in cost of capital due to a utility's affiliation with unregulated and non-utility companies to the last iota, only Staff witness Phipps has any experience in measuring cost of common equity. (Tr. 770) Obviously, one can only have a full appreciation for the difficulties of a task if one has actually performed that task. Staff strongly urges the Commission to heed this experienced voice.

utility and unregulated affiliates of NG, as required by Section 9-230 of the Act.³⁴ (Staff IB, p. 18) Moreover, this conclusion is premised on the false notion put forward by the JA that because the General Assembly declares that a utility's rates cannot include an increase in cost of capital due to its affiliation with non-utility companies, then it becomes a fact that such increases are removable to the last iota. (JA IB, p. 25; Staff RB, p. 19) This is the point that Staff attempted to make clear when it argued:

Staff's proposed condition, on the other hand, is premised on the notion that if the General Assembly dictates every increase in the cost of capital – to the last iota – that is due to a utility's affiliation with non-utility and unregulated entities cannot be included in rates, then either the Commission must determine whether said increase is removable or in the alternative use its authority to prevent that increase in the cost of capital from occurring in the first place. (Staff RB, p. 19)

Thus, the PO mischaracterizes Staff's argument when it alleges Staff argued that Section 9-230 required the Commission to prevent a utility from incurring capital costs that result from its affiliates. (PO, pp. 24-25) To the contrary, Staff was explaining that in the instant case, given the cost of capital for NG will increase following reorganization by virtue of a lower rated entity acquiring NG, the Commission should identify a specific methodology for removing those increases in capital costs that Section 9-230 prohibits. The Commission would reject the reorganization only if it cannot identify such a methodology. Since the JA proposal fails to specify how the Commission would fulfill its statutory obligation under Section 9-230 of the Act, then the Commission should adopt Staff's proposal, which would enable the Commission to remove those incremental increases in capital costs that results from AGL Resources' acquisition of NG.

³⁴ See also *Illinois Bell Telephone v. Illinois Commerce Commission*, ("IBT")283 Ill.App.3d 188, 207 669 N.E.2d 919, 933 (Second Distr., 1996).

Staff also notes that the PO findings regarding the studies will create logistical challenges that will further hinder the Commission's ability to remove the costs prohibited by Section 9-230 of the Act. The PO states, "...the stud[ies] shall be presented to Staff, with all supporting data and work-papers, within a sufficient time to receive Staff recommendations before filing." (PO, pp. 28 and Appendix A) "Sufficient time to receive Staff recommendations before filing" does not provide sufficient guidance as to the timing of the presentation of the study to Staff. The thoroughness and length of such a study is not predictable. Staff does not know whether it will receive a report comprising five pages or 105 pages. Staff does not know whether it will receive an accurate, clear and scrupulously documented study or a biased, muddled, travesty. The Commission can order JA to perform a study but until the study is presented it will not be known the extent to which the study is the former or the latter.

Furthermore, the JA have agreed to freeze NG's base rates for three years after closing unless the financial integrity of NG is jeopardized to the extent of negatively affecting customers, in which case NG is permitted to request a waiver. (PO, p. 31) Given NG could request a waiver to lift its base rates freeze, the likelihood of Staff receiving JA studies in sufficient time for a thorough review and response diminishes further. Thus, to ensure sufficient time under the worst circumstances, Staff requires at least six months to review unspecified studies that will include findings that require investigation by Staff in advance of future ratemaking proceedings and requests for waivers from the JA's base rate freeze commitment.

In contrast to the unspecified JA proposal, Staff offers a specific, efficient methodology for addressing the Section 9-230 issues in future ratemaking proceedings.

Staff proposes to “cap” the common equity ratio of post-merger NG in future ratemaking proceedings in order to avoid a mismatch between the capital structure and corresponding cost rates for debt and equity that would be excessively costly for NG customers, and ultimately violate Section 9-230 of the Act. (Staff IB, p. 21) Staff explained that following the reorganization, JA intend to maintain the current NG equity ratio of 56%, which means there will be no increase in the NG debt ratio to offset increases in debt and equity costs for NG. (Staff IB, p. 13) Absent an adjustment to reflect the debt ratio commensurate with NG’s post-merger credit rating, ratepayers would end up paying rates that combine a high equity ratio that is characteristic of pre-merger AA-rated NG with the higher debt and equity costs that reflect post-merger BBB-rated NG, which would essentially cause ratepayers to suffer “the worst of both worlds.” (Staff IB, p. 20) The Appellate Court has addressed an analogous situation and has stated that:

When a larger corporation owns a utility, the corporation is generally motivated not to establish an optimal, lowest cost capital structure for the utility, but to use instead a structure with a greater percentage of equity than is optimal, thereby allowing the corporation to realize a greater return. The assured profits from the regulated utility can then bolster the security of the corporation, allowing it to sell its own debt instruments at lower cost and use the debt capital to finance riskier, unregulated and competitive ventures. Thus, the corporation maintains an overall capital structure with a higher proportion of low-cost debt, while reporting the capital structure of the owned utility with a higher proportion of high-cost equity. The Commission acknowledged the evidence showing that corporations which own utilities have this incentive to overstate the effective equity in the capital structures of the utilities, saying: "There is no question that a capital structure may be manipulated."

The legislature has directed the Commission to protect against the increased cost of capital sought by a utility with such an inflated level of equity.

"In determining a reasonable rate of return upon investment for any public utility in any proceeding to establish rates or charges, the Commission shall not include any incremental

risk or increased cost of capital which is the direct or indirect result of the public utility's affiliation with unregulated or nonutility companies." *220 ILCS 5/9-230* (West 1992).

* * *

Thus, the Commission should disallow recovery of any cost of capital in excess of that reasonably necessary for the provision of services. If a utility has included excessive equity in its capital structure, it has inflated the rate of return and its capital cost.

(*Citizens Utility Board v. Illinois Commerce Commission*, 276 Ill. App. 3d 730, 745, 746; 658 N.E.2d 1194, 1205, 1206; 26; 213 Ill. Dec. 173, 25-27, 30)

Contrary to the PO, Staff's recommendation is not to nullify the impact of a post-merger credit rating reduction by revising NG's post-merger capital structure in a future proceeding, until total capital cost would equal what it would have been had NG's credit ratings not been lowered. (PO, p. 25) Rather, Staff simply proposes to align capital structure and capital costs, which would allow the Commission to avoid the imprecision and inaccuracy inherent in estimating a cost of equity that assumes NG was never acquired by a lower rated entity.

Moreover, the PO recognizes that NG could increase its debt ratio in the first three years following reorganization. (PO, p. 27) That is, the JA proposal assumes that, for the first three years, NG's financial strength will remain at the AA/A2 credit rating level. However, it is possible that NG pre-merger credit ratings will not be commensurate with the risk of its post-merger capital structure. (Staff IB, p. 17) Nevertheless, neither the JA proposal nor the PO make clear how the Commission would reconcile a more leveraged capital structure with the pre-merger credit rating of NG. In contrast, Staff's proposal avoids this deficiency by aligning the post-merger capital structure of NG with its actual post-merger credit rating.

Staff also disagrees with the following conclusion in the PO:

It is thus not clear to the Commission that Staff's proposal will reduce the complexity of setting a reasonable ROR, since it will identify only a cost/risk element that must be eliminated from consideration. A gas utility sample will still need to be constructed to ultimately determine capital costs. (PO, p. 26)

Staff's proposed condition to align post-merger NG capital structure and capital costs does more than "identify a cost/risk element that must be eliminated from consideration." By aligning capital structure and capital costs, Staff's proposed methodology would enable the Commission to meet its obligation to remove every iota of incremental risk due to non-utility and unregulated affiliates of NG by using a widely accepted financial analysis. (Staff RB, p. 21)

In construing Section 9-230 it has been held that:

if a utility's exposure to risk is one iota greater, or it pays one dollar more for capital because of its affiliation with an unregulated or nonutility company, the Commission must take steps to ensure that such increases do not enter in its ROR calculation. (*IBT*, p. 207)

Thus, removing every iota of incremental risk is necessary in order for the Commission to fulfill the legal requirement set forth in Section 9-230 in future ratemaking proceedings. Where risk due to non-utility and unregulated affiliates of NG is implicated, it is not sufficient to revise the capital structure in order to arrive at a "reasonable ROR" (see PO, p. 26). Under Section 9-230, when a utility is exposed to risk because of affiliation with non-regulated entities, the Commission must determine whether the utility's risk or cost of capital was increased as a result of the affiliation. (*IBT*, p. 206) If so, the Commission must set a ROR which eliminates every iota of any increase from its ROR calculation. The Commission may not allow any such increased risk or cost to affect the ROR. As explained in *IBT*:

In section 9-230, the legislature used the word “any” to modify its prohibition of considering incremental risk or increased cost of capital in determining a reasonable ROR. This usage removes all discretion from the Commission. Section 9-230 does not allow the Commission to consider what portion of a utility's increased risk or cost of capital caused by affiliation is “reasonable” and therefore should be born by the utility's ratepayers; the legislature has determined that any increase whatsoever must be excluded from the ROR determination. It is impermissible for the Commission to substitute its reasonableness standard for the legislature's absolute standard...

...The Commission applied an incorrect construction of section 9-230 and, in doing so, failed to apply the section at all. Rather than determining whether the telephone company's risk or capital costs were greater because of its affiliation with another company, the Commission merely determined that the telephone company's capital structure was reasonable. As a result, the Commission also failed to make a finding of fact upon a principal issue. (*Id.*, p. 207)

The Court in IBT remanded the case back the Commission with instructions to revisit the section 9-230 issue. (*Id.*, p. 211)

Finally, even though a gas utility sample will still be required to set a reasonable ROE for NG in future rate cases,³⁵ that proxy group would assist in determining a just and reasonable ROR whereas implementing Staff's proposal would remove every iota of increased risk or cost of capital caused by NG's affiliation with non-regulated entities. That is, the just and reasonable standard is distinguishable from the stricter requirement to remove every iota of incremental cost that results from NG's non-utility affiliates. Towards that end, the PO notes that Staff described the “analytical difficulties” in adjusting a proxy group's cost of equity to meet the Section 9-230 requirement. (PO, p. 25) Staff also noted that even though this has not precluded the Commission from implementing Section 9-230 in the past, given the foregoing, the complexity inherent in

³⁵ This is true regardless of the post-merger capital structure NG adopts.

Section 9-230 adjustments would only increase in future rate cases. (Staff RB, p. 20)

Therefore, the Commission should adopt Staff's methodology.

B. Staff's Exceptions

For all the foregoing reasons, Staff respectfully requests the Commission modify pages 22-31 and Appendix A of the PO, as shown below, to adopt Staff's proposed condition regarding Section 7-204(b)(7).

6. Finding 7: "the proposed reorganization is not likely to result in any adverse rate impacts on retail customers"

a) Issues Presented & Analysis

The sole dispute under subsection 7-204(b)(7) of the Act is whether reorganization will cause a diminution of NG's credit rating that, in turn, is likely to adversely impact NG's retail rates. As Staff posits it, NG's credit ratings are expected to decline when it becomes a subsidiary of AGL, an entity with higher financial risk. The rating cut would engender higher debt costs, thereby leading to higher equity costs due to elevated risk. The result would likely be a rate increase to account for NG's greater cost of capital³⁶. AG/CUB concurs with Staff's analysis that a credit rating downgrade will occur and that it will lead to adverse retail rate impacts³⁷.

JA reply that a rating reduction is far from likely, particularly in view of measures they have proposed to cushion NG's risk status from negative consequences. JA further argue that even if a downgrade is imposed, a resulting increase in credit costs is uncertain and may, in any event, have no discernible rate impact. Moreover, NG claims, the Commission is required by Section 9-230 of the Act³⁸ (on which Staff and AG/CUB also rely) to remove, in any future NG rate case, the effect of non-regulated affiliated entities on the utility's capital costs, thus precluding the adverse rate impact NG's opponents predict. Also, JA objects that a rate impact projection based on a single cost element (here, capital cost), rather than aggregate costs, contravenes the rule against single-issue ratemaking³⁹.

³⁶ Staff IB at 13 (for all Staff contentions in this paragraph).

³⁷ AG/CUB IB at 13.

³⁸ 220 ILCS 5/9-230.

³⁹ JA IB at 22-26 (for all contentions in this paragraph).

As the Commission sees it, the initial question is whether a credit rating downgrade is indeed likely to be imposed on NG if the proposed merger is consummated. Staff maintains that two of the three principal rating agencies - Standard & Poor's ("S&P") and Moody's - expect to issue a post-merger downgrade⁴⁰. On March 22, 2011, S&P noted that it had placed NG on "CreditWatch" in December 2010, based on its calculation that, post-merger, AGL's *pro forma* credit metrics would be "materially worse than Nicor's."⁴¹ Since S&P expects "to use a consolidated ratings approach on the new company and will equalize the corporate credit ratings of all entities in the corporate structure,"⁴² it would follow that NG's rating would drop to AGL's lower level. S&P did not quantify post-merger rating, but stated its expectation that the consolidated entity would have a credit rating "no lower than BBB+."⁴³ NG's current S&P credit rating is AA⁴⁴ and AGL's current rating is A- (with its current financing subsidiary, AGL Capital Corporation rated BBB+)⁴⁵.

S&P's stated expectations are unequivocal and unqualified by the potential impact of any identified future events. The Commission accordingly concludes that a post-reorganization credit rating downgrade by S&P is, at the least, likely.

Moody's presents a different picture, however. On December 7, 2010, Moody's affirmed NG's rating at A2 (Moody's uses a different nomenclature than S&P), but "changed its outlook to negative from stable"⁴⁶. Moody's observed that AGL is a "more leveraged" entity that "is expected to fund the roughly \$1 billion cash portion of the consideration [for the acquisition of Nicor] with corporate debt, which the Nicor subsidiaries, principally [NG] will help to service along with the AGL subsidiaries." Consequently, Moody's projects downgrading NG by "one notch," to conform with certain lower-rated AGL subsidiaries. However, the alignment of NG's post-merger ratings with those AGL's subsidiaries

⁴⁰ Staff IB at 13-14 (based on Staff Ex's. 15.01 & 15.02. According to the JA, the third rating agency, Fitch,"reaffirmed all of [NG's] ratings after the Merger announcement." JA Ex. 3.0 at 6.

⁴¹ Staff Ex. 15.01. Credit metrics are certain statistical ratios that financial rating agencies use to evaluate the financial risk profile of an enterprise. These typically include, among other things, the ratio of funds from operations to total debt and the ratio of total debt to capital. *Id.* Staff also uses these metrics to analyze company financial strength and risk. *E.g.*, Staff Ex. 9.0, Att. 9.1 (confidential).

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ Staff Ex. 9.0 at 7.

⁴⁶ Staff Ex. 15.02 (for all Moody's-related facts in this paragraph).

“assumes that [NG] will become part of AGL’s money pool arrangement in which subsidiary funds are managed centrally.” Moody’s added that NG’s ratings outlook could be “stabilized” if the Commission constrained NG’s ability to “upstream” dividends to its corporate parent or if NG “were not to be included in AGL’s money pool.” After the ratings agencies’ cautionary announcements, the JA determined that NG will not be included in the money pool. The result, JA contend, is that “there will be no credit unity between [NG] and the lower-rated operating companies post reorganization.”⁴⁷

In view of NG’s subsequent exclusion from AGL’s intended money pool, the Commission finds that Moody’s ratings announcement does not support the conclusion that Moody’s will downgrade NG if merger is approved. The evidentiary record does not address whether the JA altered their earlier plan to include NG in the money pool to satisfy Moody’s⁴⁸, but it does not matter. Moody’s identified two alternate measures that would potentially sustain NG’s credit rating and the JA have agreed to implement one. As all parties addressing this issue agree, the future actions of a credit rating agency cannot be foretold with precision. As a question of likelihood, however, we cannot find it likely that Moody’s (in contrast to S&P) will impose a downgrade, which removes Moody’s as an obstacle to the JA’s meeting their burden of proof on subsection 7-204(b)(7).

The next question, then, is whether the probable S&P downgrade is likely to increase the utility’s cost of capital. The Commission concurs with Staff that a diminished credit rating will cause NG’s capital costs to rise. Irrespective of the magnitude of the increase, it is inevitable that a reduced credit rating, and the inferior credit metrics associated with that lower rating, will “lead to higher debt costs, which in turn, would lead to higher equity costs as well, since higher debt costs increase financial risk.”⁴⁹ That does not necessarily mean, though, that the capital cost increase will result in an impact upon the utility’s rates. Indeed, the JA assert that no such impact will occur.

The JA cite Section 9-230 of the Act, which excludes from utility rate of return (“ROR”) calculations any incremental risk or increased cost

⁴⁷ JA Ex. 14.0 at 4.

⁴⁸ The JA did, however, revise their money pool commitment to satisfy Staff’s concern that NG not be permitted to make cash advances to non-utility affiliates (although NG could borrow from such entities), as set forth in Staff Ex. 9.0, Att. 9.2. JA Ex. 9.0 at 11. Staff had insisted, and NG concurred, that the relevant AGL affiliates would not have been eligible under 83 Ill. Adm. Code 340.40(b) to borrow from NG under extant circumstances. Staff Ex. 9.0 at 22; NG Ex. 9.0 at 11.

⁴⁹ Staff Ex. 9.0 at 15.

of capital “which is the direct or indirect result of the public utility’s affiliation with unregulated or nonutility companies.”⁵⁰ The JA argue that in any future NG rate proceeding, the Commission will apply Section 9-230 to bar any increased capital cost related to AGL and its affiliates.

Staff responds that a statutory requirement to remove increases in NG’s capital costs due to its affiliates does not necessarily mean that such increases will be removable to the last iota. In Staff’s view in order to assure that the Commission will be able, in future rate cases, to ~~The Commission agrees with the JA that proper application of Section 9-230 would effectively scour any capital cost increase from NG’s ROR if it arises from affiliation with a non-utility, the Commission must, in this proceeding, identify a methodology to remove those costs.~~

~~Staff responds, however, that the Commission is obliged to “use its authority to prevent that increase in the cost of capital from occurring in the first place.”⁵¹ As a legal principal, that is simply incorrect. Staff does not argue that Section 9-230 does not prohibits a utility from incurring costs, including capital costs. Staff’s position is that it prohibits the inclusion of such cost from the utility’s ROR calculation when affiliation with an unregulated entity caused the cost. While Staff is correctly asserts, per judicial ruling, that literally any such cost must be excluded from the ROR, down to the last “iota,”⁵² Although Section 9-230 does not require - or even empower - the Commission to prevent the cost from occurring, Section 9-230 does mandate that the Commission must determine whether such costs occur. If so, then the Commission must remove every iota of them must be removed from the ROR.~~

~~Alternatively, Staff also raises a practical concern about the application of Section 9-230 in future ratemaking. Staff avers that it has become “far more challenging” than a decade ago to “remove the incremental costs and risk due to non-utility affiliates.”⁵³ Staff attributes this situation to shrinkage in the number of gas utilities suitable for establishing benchmarks when estimating a gas utility’s cost of equity⁵⁴. Staff acknowledges that this has not precluded the Commission from~~

⁵⁰ 220 ILCS 5/9-230, cited at JA IB at 24-25.

⁵¹ Staff RB at 19.

⁵² Illinois Bell Telephone v. Illinois Commerce Commission, 283 Ill. App. 3d 188, 207, 669 N.E. 2d 919, 933 (2nd Dist. 1996) (“We hold that if a utility’s exposure to risk is one iota greater, or it pays one dollar more for capital because of its affiliation with an unregulated or nonutility company, the Commission must take steps to ensure that such increases do not enter in its ROR calculation.”)

⁵³ Staff RB at 20.

⁵⁴ *Id.*

implementing Section 9-230 in the past⁵⁵, but-maintains that the foregoing analytic difficulties reduce the probability that the Commission will successfully perform its Section 9-230 duty to remove all affiliate-related risk and cost from NG's ROR in a future docket⁵⁶. Thus, Staff finds it necessary to identify a methodology in this proceeding, as a condition to approval of the reorganization, to enable the Commission to remove all affiliate-related risk and cost from NG's ROR in future rate cases. The inability to remove affiliate-related risk and cost from NG's ROR in future rate casesThat is the adverse rate impact that Staff states ~~contends~~-must be addressed now, under the rubric of subsection 7-204(b)(7), before the Reorganization can be approved.

Staff has a proposal for accomplishing that task, presented in oral testimony during evidentiary hearings. Staff recommends that in a future rate-setting, the Commission should require that NG's post-merger capital structure contain no more equity than the post-merger capital structure of its parent company, AGL Resources, provided AGL Resources maintains issuer credit ratings of BBB-/Baa3/BBB-, or better, from S&P/Moody's/Fitch. Staff recommends that this condition represent a ceiling on NG's post-merger equity ratio for ratemaking purposes, rather than a floor, in order to provide interested parties the opportunity to propose capital structures, capital structure adjustments, or a hypothetical capital structure in future rate cases for NG. debt would be increased within NG's capital structure, with equity (a more costly source of capital⁵⁷) correspondingly reduced, until NG's resulting financial metrics are consistent with its post-merger credit rating⁵⁸ (which, again, will presumably be below its pre-merger lever, since, as noted, S&P will rate NG on a consolidated basis with the rest of post-merger AGL).—This alignment of NG's post-merger capital structure and post-merger capital costs would “effectively remove any incremental cost resulting from a potential mismatch” between those elements, Staff believes⁵⁹.

~~—As the Commission construes it, Staff's recommendation is that we determine today that we will nullify the impact of a post-merger credit rating reduction by revising NG's post-merger capital structure in a future proceeding, until total capital cost would equal what it would have been had no credit rating downgrade been imposed. Although this~~Staff's

⁵⁵ Tr. 780 (Phipps).

⁵⁶ Staff RB at 20.

⁵⁷ Citizens Utility Board v. Commerce Commission, 276 Ill. App. 3d 730, 744, N.E. 2d 1194, 1205 (1st Dist. 1995).

⁵⁸ Tr. 792-93 (Phipps).

⁵⁹ Staff IB at 21.

~~recommendation is offered for the sake of greater efficiency and relative simplicity, it would not necessarily yield a capital structure or capital cost that the Commission would actually approve, it meets the requirements of subsection 7-204(b)((7) since its effect will be purpose is solely to remove affiliate-related cost from the ROR reasonableness assessment, not to set a reasonable ROR⁶⁰. Indeed, Staff says that its proposal should only establish a “ceiling” for the post-merger equity in NG’s capital structure, “in order to provide interested parties the opportunity to propose capital structures, capital structure adjustments or a hypothetical capital structure in future rate cases.”⁶¹ ~~It is thus not clear to the Commission that Staff’s proposal will reduce the complexity of setting a reasonable ROR, since it provides a specific, effective means for addressing the Section 9-230 requirement to remove the adverse impact of the expected decline in NG credit ratings in future rate cases will identify only a cost/risk element that must be eliminated from consideration. A gas utility sample will still need to be constructed to ultimately determine capital costs.~~~~

The JA also offer a proposal intended to address the potential impact of the likely credit rating downgrade on NG’s post-reorganization rates. They would use NG’s *pre-merger* credit rating to determine NG’s debt and equity costs in any rate-setting proceeding during the three-year period immediately following closure of the Reorganization⁶². JA describe this as a pledge to “freeze” their existing AA S&P credit rating for the three-year period, which would preclude them from later arguing that NG’s credit rating had changed for “reasons unrelated to the merger, or that another rating is more cost-effective.”⁶³

Staff objects, however, that without a predetermined adjustment to NG’s capital structure (to limit the equity portion), the use of NG’s pre-merger credit rating will not conform to NG’s true post-merger capital costs, which will reflect the anticipated credit rating downgrade. With Staff’s adjustment, while the at-“mismatch” could indeed materialize, ratepayers would not pay the difference, though, if because Staff’s proposed adjustment would enable the Commission to properly apply Section 9-230 is properly applied. That is, under Section 9-230, any higher capital cost resulting from NG’s merger would become the burden of shareholders,

⁶⁰ “[A]ll reasonable rates exclude any incremental risk or increased cost of capital due to affiliation; however, the simple exclusion of such risk or cost does not, *a fortiori*, make rates reasonable.” Illinois Bell Telephone v. Illinois Commerce Commission, *supra*, 283 Ill. App. 3d at 207, 669 N.E. 2d at 933.

⁶¹ Staff IB at 21.

⁶² JA Ex. 14.0 at 7.

⁶³ JA RB at 18. The Commission notes that even if another rating were more “cost-effective,” 9-230 would still require removal of affiliate-related risk and cost.

~~with ratepayers responsible only for a reasonable ROR — i.e., an ROR based on NG's pre-merger credit standing. We are not pre-approving NG's current capital structure for future ratemaking, as Staff suggests⁶⁴. A~~
Importantly, adopting Staff's proposal here would not hinder the Commission's obligation to determine a reasonable ROR in future ratemaking proceedings involving NG given revisions to NG's capital structure could still be part of arriving at a reasonable ROR, but we do not perceive a need to decide that now. That is, w~~When~~When NG's next ratemaking takes place, then extant circumstances (along with NG's pledge to freeze its pre-merger credit rating within the defined three-year period) will determine NG's appropriate capital structure, subject to the cap on NG's equity ratio that would align NG's capital structure with its post-merger credit rating.⁶⁵ -

That does not conclude our discussion of this issue, however. ~~NG's commitment to its pre-merger credit rating has a three-year shelf life. Similarly, a~~As an outgrowth of negotiations with Staff, the JA have agreed that NG's base rates shall be fixed in their current position for three years from the date the proposed reorganization closes⁶⁶. There are qualifiers and ambiguities to this commitment by NG that concern the Commission (which we address below and section IV.B. of this Order). Assuming our concerns are relieved, however, it is not likely that NG's retail rates can be impacted, within the meaning of subsection 7-204(b)(7), by an S&P credit rating reduction during the three years immediately following the Reorganization's closing. Nevertheless, since subsection 7-204(b)(7) (and, for that matter, Section 9-230) contains no time-limiting provision, we recognize that Staff's proposal provides a mechanism by which we can address ~~have to consider~~ the potential rate impact of reorganization after the third year ends.

~~Initially, we note that JA's commercial paper commitments are not material here. As already noted, the JA pledged to maintain a separate commercial paper program for NG, with a credit facility backstop, solely to fund NG's cash working capital⁶⁷. JA later accepted Staff's recommendation to clarify that NG's renewed backstop credit facility would be associated only with NG⁶⁸. JA also agreed to a Staff-proposed~~

⁶⁴ Staff IB at 17.

⁶⁵ A "violation of Section 9-230 does not, *per se*, require the adoption of a hypothetical capital structure." *Bell Telephone v. Illinois Commerce Commission*, *supra*, 283 Ill. App. 3d at 210, 669 N.E. 2d at 935.

⁶⁶ *Agreed Stipulation Between Joint Applicants and Staff*, filed August 24, 2011. Much of the text of the Stipulation appears in section IV.B. of this Order.

⁶⁷ JA Ex. 3.0 at 8. JA Ex. 14.0 at 6.

⁶⁸ JA Ex. 9.0 at 2; Staff Ex. 9.0 at 14.

~~compliance reporting requirement to facilitate Staff oversight of NG's stand-alone credit obligations⁶⁹. While the Commission approves these measures, commercial paper is short-term debt, which is ear-marked for NG's cash working capital needs. The credit downgrading expected by S&P concerns long-term debt, which is rated apart from commercial paper by the rating agencies. We therefore exclude JA's pledges with regard to commercial paper from our analysis here.~~

Also, the Commission cannot avoid considering adverse rate impacts after year three of the Reorganization even though the JA stress that NG will have no long-term debt maturities until 2016 and is "not projected to need to be in the capital markets to raise any new long-term debt or equity prior to that maturity."⁷⁰ There is no commitment from the JA to abjure additional long-term debt before maturity of its existing debt. Moreover, Moody's states that "AGL is expected to fund the roughly \$1 billion cash portion of the [Nicor acquisition] with corporate debt, which the Nicor subsidiaries, principally [NG], will help to service along with the AGL subsidiaries."⁷¹ If NG's funds from operations prove unequal to that task (and NG does not predict customer growth through 2015⁷²), NG could, at least in theory, become a post-merger vehicle for additional long-term debt financing. Even if the post-merger NG did refrain from raising more long-term debt until the maturity of current long-term debt approached, that would simply delay debt activity until some time in 2015, which would be the year the JA's commitments to freeze base rates ~~and rely on NG's pre-merger credit rating~~ would likely expire. The Commission reiterates that Staff's proposal provides a mechanism for addressing the potential rate impact of reorganization after the third year ends.

To the point, JA agree that, whenever the three-year period after the Reorganization's closing ends, they will file a study analyzing the impact of NG's affiliation with AGL and its subsidiaries on NG's cost of capital⁷³. In a curious confluence, however, *both* NG and Staff disparage the usefulness of the proposed study. Staff is at least consistent with its objection to the proposal when it asserts that "the value of a study that

⁶⁹ JA Ex. 9.0 at 2; Staff Ex. 9.0 at 14.

⁷⁰ JA Ex. 3.0 at 5.

⁷¹ Staff Ex. 15.02.

⁷² *E.g.*, Staff Group Cross-Ex. 2 (un-numbered page in exhibit, page 33 in original document).

⁷³ JA Ex. 14.0 at 7-8. The JA characterize this as a study "addressing applicable requirements of Section 9-230." That is potentially too limited. In this proceeding we are acting to preclude the adverse rate impact prohibited by subsection 7-204(b)(7). If, as the JA themselves suggest (JA Ex. 14.0 at 7-8), Section 9-230 no longer applies for some reason three years after closing, the Commission's present intention to establish a condition to avert adverse rate impact from merger-related affiliates will remain in force.

compares post-merger [NG] with a [NG] that no longer exists would surely diminish as the time horizon lengthens.”⁷⁴ But NG simply undermines its own promise when it declares that determining what NG’s credit ratings, capital structure and capital costs would have been absent reorganization becomes an “exercise in speculation” over time and “unreasonable” after three years⁷⁵. In light of Staff’s objections, NG’s inconsistency and the vague references to studies offered by the JA, the Commission has little confidence that the studies that the JA commit to file in connection with future NG rate proceedings will be useful in addressing the requirement set forth in Section 7-204(b)(7) of the Act. Therefore, the Commission does not adopt the JA proposal.

~~Nevertheless, there are components of such a study that would likely prove helpful to the Commission (whether, as is likely, to implement Section 9-230, or, absent that statute, to implement our present intention to preclude adverse rate impact from post-merger affiliations). Inherently, information pertaining to the initial three years after reorganization would be included with information associated with any subsequent interval prior to ratemaking. Neither party dismisses the value of that information. Furthermore, NG states that trustworthy debt-related data will be available for a period beyond three years⁷⁶. Accordingly, we will hold the JA to their commitment to file, in connection with any rate-making proceeding in progress after the end of the third post-closing year⁷⁷, a study analyzing the impact of NG’s affiliation with AGL and its affiliates on NG’s cost of capital (both debt and equity). The Commission will determine the efficacy of that study when it is filed⁷⁸.~~

⁷⁴ Staff IB at 20.

⁷⁵ JA RB at 17-18.

⁷⁶ Tr. 524-25 (Cave).

⁷⁷ In prefiled testimony, JA refers to the proceedings in which it commits to filing its studies as proceedings “where the cost of capital is an underlying determinant factor.” JA Ex. 14 at 7. At hearing, JA clarified that it was referring to “any proceeding where the cost of capital is an issue that determines rates.” Tr. 522 (Cave). JA further clarified that it was not their intention to limit their filing commitment to cases in which cost of capital disputes were of sufficient magnitude to affect the final rate to the customer. ~~So that there is no misunderstanding, the Commission expects, and conditions any merger approval on, submission of the pledged studies in any ratemaking proceeding in which NG’s cost of capital is addressed.~~

⁷⁸ ~~We will assuage some of Staff’s logistical concerns today, however. Staff IB at 16. The studies described in JA Exhibit 14 – for the three years immediately following reorganization and for the indeterminate period thereafter – are voluntarily offered for the purpose of securing merger approval. The Commission, in turn, conditions any merger approval on, among other things, expected production of those studies. Therefore, the costs of the studies are among the costs of accomplishing the proposed Reorganization, which cannot be recovered from ratepayers, in keeping with the August 24, 2011 Stipulation filed in this case. Moreover, the studies shall be presented to Staff, with all supporting data and work papers, within a sufficient time to receive Staff recommendations before filing.~~

Finally, the Commission will make explicit several principles that have been implicit in our subsection 7-204(b)(7) analysis thus far. First, we firmly reject JA's argument that the "adverse rate impacts" prohibited by the statute cannot occur unless the "totality" of a merger, rather than a limited number of cost elements, will likely affect the utility's retail rates⁷⁹. Absolutely nothing in the subsection states or implies that only the "totality" of a proposed merger can have the precluded adverse impact. Subsection (b)(7) bars "any" likely adverse rate impact, of whatever cause associated with reorganization. Indeed, the Commission cannot perceive what would constitute the "totality" of merger, why the legislature would not protect retail customers from adverse rate impacts resulting from less than a "totality," or why resources should be expended debating or implementing a "totality" standard.

Second, we dismiss as irrelevant JA's repeated assertion that "the proposed reorganization includes no rate increase."⁸⁰ The JA may not *intend* for NG's rates to increase due to the merger, but that hardly means that rates will not increase anyway. Furthermore, the statute looks at adverse rate *impact*, which is not synonymous with a rate *increase*. The fundamental requirement for a rate is that it must be just and reasonable⁸¹, and a proposed rate change must also be just and reasonable⁸². A rate must also be non-discriminatory⁸³, and, as discussed above, it cannot, per Section 9-230, reflect capital costs associated with non-regulated affiliates. Accordingly, a merger proposal that would likely render a rate unjust, unreasonable, discriminatory or infused with prohibited capital cost is adversely affecting that rate within the meaning of subsection 7-204(b)(7), irrespective of whether the rate will increase. Moreover, a merger proceeding involves a change of ownership, not ratemaking. Indeed, if ratemaking were allowed, the Commission would have to do the very thing the JA have decried throughout this proceeding - set rates without a full assessment of costs and revenues in a test year.

Third, the prohibition against single-issue ratemaking is not, as JA claim⁸⁴, violated by focusing, in a reorganization proceeding, on fewer

⁷⁹ JA IB at 22. We additionally reject JA's contention that "only one cost component" is impacted by the proposed merger. *Id.* at 25. Staff's position is that when a credit downgrade affects the cost of debt, the utility's equity cost is also affected, and the capital structure may also need revision. Staff Ex. 9.0 at 15. We agree.

⁸⁰ *Id.* at 21.

⁸¹ 220 ILCS 5/9-101.

⁸² 220 ILCS 5/9-201.

⁸³ 220 ILCS 5/9-240.

⁸⁴ JA IB at 25.

than all of the cost elements that the Commission considers when setting rates. Again, this is not a ratemaking case - a distinction the General Assembly certainly understood when it established different schemes for, respectively, reviewing merger requests and setting rates. Yet JA's interpretation of subsection 7-204(b)(7) would transform that subsection into a full-blown rate investigation. Patently, the legislature intended that the Commission, through 7-204(b)(7), would only identify characteristics of the proposed merger that were *likely* to adversely impact rates in subsequent rate proceedings, and to withhold or condition merger approval - not establish rates - when such characteristics were present. Furthermore, JA undermined their own position when they asserted that "improve[d] cost efficiency over time" would negate the rate impact of increased cost of capital⁸⁵. Even if JA had supported that contention with sufficient proof⁸⁶, "cost efficiency" is itself a single issue that does not involve the aggregate analysis of utility costs and rate base items required for ratemaking. The flaw in JA's position is not, of course, that they cited cost efficiency, but that they did so while asserting the necessity of full-blown ratemaking analysis under 7-204(b)(7).

b) Commission Conclusion

Subsection 7-204(b)(7) obliges the Commission to determine whether the proposed reorganization will likely result in an adverse retail rate impact in subsequent rate proceedings. Here, a likely credit rating downgrade by S&P, due to NG's post-merger relationship with AGL and its affiliates, will negatively affect NG's cost of ~~long-term~~ debt, which will, in turn, negatively affect its cost of equity. An increased cost of capital would almost certainly impact NG's retail rates (even if by only a single basis point), because a utility is entitled to an opportunity to recover its precise cost of capital through its rates. That impact can only occur, however, if Section 9-230 is inadequately applied. When Section 9-230 is properly implemented, no scintilla of capital cost attributable to an unregulated affiliate can be included in ratemaking. ~~To facilitate our application of 9-230, the JA have pledged to base future ratemaking, during the three-year interval after closing of the Reorganization, on NG's pre-merger credit rating. Therefore, We approve Staff's proposal this pledge and condition merger approval in this proceeding upon it⁸⁷. That is, in future ratemaking proceedings, NG's post-merger capital structure shall contain no more common equity than the post-merger capital structure of its parent~~

⁸⁵ JA Ex. 9.0 at 10.

⁸⁶ To the contrary, JA has adamantly maintained that "no party in this proceeding has identified any *real* savings directly attributable to this reorganization." JA Ex. 8.0 at 20 (emphasis in original).

⁸⁷ ~~To preclude misunderstanding, the Commission notes here that the commitment to use NG's pre-merger credit rating shall apply to any test year JA select in a future rate proceeding.~~

company, AGL Resources, provided AGL Resources maintains issuer credit ratings of BBB-/Baa3/BBB- or better from Standard & Poor's/Moody's Investors Service/Fitch Ratings. This condition should represent a ceiling, rather than a floor, in order to provide interested parties the opportunity to propose capital structures, capital structure adjustments, or a hypothetical capital structure in future rate cases for NG.

~~We also approve the JA's commitment to refrain from increasing NG's base rates before the end of the third year following closure of reorganization. That commitment is also a condition of merger approval in this case. Since there are exceptions to that commitment (see below and section IV.B. of this Order), we expect that JA's pledge to rely upon NG's post-merger credit rating would be implemented in any rate-setting proceeding commencing before the three-year period expires⁸⁸.~~

~~NG's retail rates might next be set at some time after the three-year period following closing. Section 9-230 would apply then, just as it will during the initial three-year interval. To facilitate implementation, JA have committed to filing a study analyzing the impact of NG's affiliation with AGL and its subsidiaries on NG's cost of capital. The Commission approves the filing of that study, on the terms described above, and makes that another condition of reorganization approval.~~

One of the exceptions to the commitment to freeze NG's base rates for three years after closing is as follows: "The [JA] retain the right to request that the Commission waive the timing provision...if the financial integrity of [NG] is jeopardized to the extent of negatively affecting customers."⁸⁹ By approving this commitment as a merger condition, the Commission affords NG only what the commitment describes - an opportunity to "request" a waiver. NG cannot commence a rate proceeding during the three-year period without first obtaining the waiver, and it will obtain the waiver only by bearing the burden of proving that NG's diminished financial integrity, in particular, is negatively affecting customers of regulated services to a non-trivial degree. Moreover, insofar as jeopardy to NG's financial integrity is the result of imprudent or unreasonable action or inaction by NG or its affiliates, the Commission undertakes no commitment here to requiring ratepayers, rather than shareholders, to bear the costs of easing that jeopardy.

⁸⁸ ~~The Commission also establishes as conditions for merger approval JA's promises to maintain a separate commercial paper program for NG, with a credit facility backstop, solely to fund NG's cash working capital, and their promise to file the compliance reports requested by Staff (as described earlier).~~

⁸⁹ *Agreed Stipulation Between Joint Applicants and Staff*, filed August 24, 2011. The Commission notes that there will be no "Joint Applicants" after merger, so we assume that NG, the regulated utility, would be the party requesting waiver.

In view of the expected effect of proper implementation of Section 9-230, which will be aided by adopting the methodology proposed by Staff, as fulfillment of the JA commitments described here, the Commission does not conclude that the proposed merger is likely to result in an adverse rate impact on retail customers.

* * * * *

Additionally Staff recommends the following changes to Appendix A of the PO, which would adopt Staff's proposed condition regarding subsection 7-204(b)(7) of the Act.

28. In future ratemaking proceedings, Nicor Gas' post-merger capital structure shall contain no more common equity than the post-merger capital structure of its parent company, AGL Resources, provided AGL Resources maintains issuer credit ratings of BBB-/Baa3/BBB-, or better from Standard & Poor's/Moody's Investors Service/Fitch Ratings. This condition shall represent a ceiling on Nicor Gas' post-merger equity ratio for ratemaking purposes, rather than a floor, in order to provide interested parties the opportunity to proposal capital structures, capital structure adjustments, or hypothetical capital structures in future rate cases for Nicor Gas.

~~If, during the three-year period following the date on which the Reorganization is closed, any proceeding involving Nicor Gas' rates is initiated, and insofar as Nicor Gas' cost is capital is addressed in such proceeding, Nicor Gas shall base its debt and equity costs on a study that assumes Nicor Gas's credit rating to be the same as its rating immediately prior to the closing of the Reorganization. Such study shall be prepared by or on behalf of Nicor Gas, and no cost of such study shall be borne by ratepayers of Nicor Gas. Also, the study shall be presented to Staff, with all supporting data and work-papers, within a sufficient time to receive Staff recommendations before filing.~~

29. ~~If, after the three-year period following the date on which the Reorganization is closed, any proceeding involving Nicor Gas' rates is initiated, and insofar as Nicor Gas' cost is capital is addressed in such proceeding, Nicor Gas shall file~~

~~a study analyzing the impact, if any, of Nicor Gas' affiliation with AGL Resources and its other subsidiaries on the cost of capital of Nicor Gas. Such study shall be prepared by or on behalf of Nicor Gas, and no cost of such study shall be borne by ratepayers of Nicor Gas. Also, the study shall be presented to Staff, with all supporting data and work papers, within a sufficient time to receive Staff recommendations before filing.~~

* * * * *

C. Staff's Alternative Recommendation: Impose Deadline for JA Studies

Should the Commission decide against adopting Staff's proposed condition, then Staff recommends the Commission also reject the JA proposal to provide studies because, those studies will not be useful in assisting with Section 9-230 adjustments in future ratemaking proceedings. However, should the Commission affirm the PO and adopt the JA proposal, then Staff recommends the Commission require JA to provide those studies to Staff at least six months in advance of any rate filings that would warrant submission of such studies (or filing of any waivers relating to the JA commitment to freeze base rates for three years after reorganization). Staff proposes the following changes on page 28 and Appendix A of the PO, which would provide clarity to the references to "sufficient time" for JA to provide Staff the studies required for future ratemaking proceedings.

Page 28, footnote 161:

We will assuage some of Staff's logistical concerns today, however. Staff IB at 16. The studies described in JA Exhibit 14 - for the three years immediately following reorganization *and* for the indeterminate period thereafter - are voluntarily offered for the purpose of securing merger approval. The Commission, in turn, conditions any merger approval on, among other things, expected production of those studies. Therefore, the costs of the studies are among the costs of accomplishing the proposed Reorganization, which cannot be recovered from ratepayers, in keeping with the August 24, 2011 Stipulation filed in this case. Moreover, the studies shall be presented to Staff, with all supporting data and work papers, at least six months in advance of the initial filing any ratemaking

proceeding or waiver in which NG's cost of capital is addressed, in order to provide ~~within a sufficient time to receive Staff recommendations before filing.~~

* * * * *

Appendix A:

28. If, during the three-year period following the date on which the Reorganization is closed, any proceeding involving Nicor Gas' rates is initiated, and insofar as Nicor Gas' cost is capital is addressed in such proceeding, Nicor Gas shall base its debt and equity costs on a study that assumes Nicor Gas's credit rating to be the same as its rating immediately prior to the closing of the Reorganization. Such study shall be prepared by or on behalf of Nicor Gas, and no cost of such study shall be borne by ratepayers of Nicor Gas. Also, the study shall be presented to Staff, with all supporting data and workpapers, within a sufficient time to receive Staff recommendations at least six months in advance of the initial before-filing of any ratemaking proceeding or waiver in which NG's cost of capital is addressed.

29. If, after the three-year period following the date on which the Reorganization is closed, any proceeding involving Nicor Gas' rates is initiated, and insofar as Nicor Gas' cost is capital is addressed in such proceeding, Nicor Gas shall file a study analyzing the impact, if any, of Nicor Gas' affiliation with AGL Resources and its other subsidiaries on the cost of capital of Nicor Gas. Such study shall be prepared by or on behalf of Nicor Gas, and no cost of such study shall be borne by ratepayers of Nicor Gas. Also, the study shall be presented to Staff, with all supporting data and workpapers, within a sufficient time to receive Staff recommendations at least six months in advance of the initial before-filing of any ratemaking proceeding in which NG's cost of capital is addressed.

D. Technical Corrections In the Even the Commission Affirms PO Conclusion

Finally, Staff recommends the following technical corrections to the PO, which do not relate to the changes proposed in Staff's Exceptions. Rather, Staff offers these corrections to enhance the clarity and accuracy of the Commission's Final Order.

First, the PO states, "[t]he credit downgrading expected by S&P concerns long-term debt, which is rated apart from commercial paper by the rating agencies." (PO, p. 27) Later, the PO states, "[h]ere, a likely credit rating downgrade by S&P, due to NG's post-merger relationship with AGL and its affiliates, will negatively affect NG's cost of long-term debt, which will, in turn, negatively affect its cost of equity." (PO, p. 30) The PO errs when it suggests that S&P will not downgrade NG's short-term debt ratings following reorganization. Staff explained that a strong link exists between short- and long-term ratings (Staff Ex. 9.0, pp. 11-12); therefore, a downgrade to NG's long-term ratings would likely lead to a downgrade in NG's commercial paper ratings. (Staff IB, p. 15) Therefore, Staff recommends striking the following paragraph on page 27 and the reference to "long-term" debt on page 30 of the PO, as shown below:

Page 27:

~~Initially, we note that JA's commercial paper commitments are not material here. As already noted, the JA pledged to maintain a separate commercial paper program for NG, with a credit facility backstop, solely to fund NG's cash working capital. JA later accepted Staff's recommendation to clarify that NG's renewed backstop credit facility would be associated only with NG. JA also agreed to a Staff-proposed compliance reporting requirement to facilitate Staff oversight of NG's stand-alone credit obligations. While the Commission approves these measures, commercial paper is short term debt, which is ear marked for NG's cash working capital needs. The credit downgrading expected by S&P concerns long term debt, which is rated apart from commercial paper by the rating agencies. We therefore exclude JA's pledges with regard to commercial paper from our analysis here.~~

* * * * *

Page 30:

Here, a likely credit rating downgrade by S&P, due to NG's post-merger relationship with AGL and its affiliates, will negatively affect NG's cost of ~~long-term~~ debt, which will, in turn, negatively affect its cost of equity.

Second, the PO mischaracterizes Staff's argument when it alleges Staff argued that Section 9-230 required the Commission to prevent a utility from incurring capital costs that result from its affiliates. (PO, pp. 24-25) To the contrary, Staff asserts that in the instant case the Commission should identify a specific methodology for removing those increases in capital costs that Section 9-230 prohibits given (1) the cost of capital for NG will increase following reorganization by virtue of a lower rated entity acquiring NG; and (2) the JA proposal fails to specify how the Commission would fulfill its statutory obligation under Section 9-230 of the Act. Therefore, Staff recommends deleting the following paragraphs on pp. 24-25 of the PO:

Staff responds that a statutory requirement to remove increases in NG's capital costs due to its affiliates does not necessarily mean that such increases will be removable to the last iota. In Staff's view in order to assure that the Commission will be able, in future rate cases, to The Commission agrees with the JA that proper application of Section 9-230 effectively scour any capital cost increase from NG's ROR if it arises from affiliation with a non-utility, the Commission must, in this proceeding, identify a methodology to remove those costs.

~~Staff responds, however, that the Commission is obliged to "use its authority to prevent that increase in the cost of capital from occurring in the first place."⁹⁰ As a legal principal, that is simply incorrect. Staff does not argue that Section 9-230 does not prohibit a utility from incurring costs, including capital costs. Staff's position is that it prohibits the inclusion of such cost from the utility's ROR calculation when affiliation with an unregulated entity caused the cost. While Staff is correctly~~

⁹⁰ ~~Staff RB at 19.~~

asserts, per judicial ruling, that literally *any* such cost must be excluded from the ROR, down to the last “iota,”⁹¹ Although Section 9-230 does not require - or even empower - the Commission to prevent the cost from occurring, Section 9-230 does mandate that the Commission must determine whether such costs occur. If so, then the Commission must remove every iota of them must be removed from the ROR.

Third, the PO states, “[t]hat is, under Section 9-230, any higher capital cost resulting from NG’s merger would become the burden of shareholders, with ratepayers responsible only for a reasonable ROR – *i.e.*, an ROR based on NG’s pre-merger credit standing.” (PO, p. 26) Staff disagrees with this statement on two levels. First, given the legal threshold for Section 9-230, removing every iota of incremental cost due to non-utility affiliates, is stricter than determining a reasonable ROR. The PO recognizes this distinction when it states, “a proposed rate change must also be just and reasonable...and, as discussed above, it cannot per Section 9-230, reflect capital costs associated with non-regulated affiliates.” (PO, p. 30) Second, there is nothing in the record concerning the PO’s inference that NG’s pre-merger credit ratings are reasonable for setting rates. Therefore, Staff recommends the following changes to page 26 of the PO:

That is, under Section 9-230, any higher capital cost resulting from NG’s merger would become the burden of shareholders, with ratepayers responsible only for a reasonable ROR – *i.e.*, an ROR that does not reflect an increase in capital costs associated with non-regulated affiliates~~based on NG’s pre-merger credit standing.~~

Finally, Staff believes there is a typographical error on page 30 of the PO, which refers to NG’s post-merger credit rating instead of its pre-merger credit rating.

⁹¹ Illinois Bell Telephone v. Illinois Commerce Commission, 283 Ill. App. 3d 188, 207, 669 N.E. 2d 919, 933 (2nd Dist. 1996) (“We hold that if a utility’s exposure to risk is one iota greater, or it pays one dollar more for capital because of its affiliation with an unregulated or nonutility company, the Commission must take steps to ensure that such increases do not enter in its ROR calculation.”)

III. Staff's Findings and Ordering Paragraphs Exceptions

The Findings and Ordering Paragraphs should be consistent with Staff's recommendations above. Staff proposes the following changes to the PO's Findings and Ordering Paragraphs:

The Commission, having considered the entire record herein and being fully advised in the premises, is of the opinion and finds that:

- (1) NG is an Illinois corporation that is engaged in the distribution of natural gas to the public at retail in this State; NG is a "public utility" as that term is defined in Section 3-105 of the Act;
- (2) the Commission has jurisdiction over the parties hereto and the subject matter herein;
- (3) the recitals of fact set forth in the prefatory portion of this Order are supported by the record and are hereby adopted as findings of fact;
- (4) ~~an Appendix ("Appendix A") should be attached to this Order and fully incorporated into this Order; it should contain the Required Conditions of Approval established by this Commission in this Order, which are indispensable conditions for approval of the proposed Reorganization and for approval of all other relief sought or granted in this Order;~~
- ~~(5) for the reasons set forth in this Order, and subject to the conditions established in this Order (enumerated in Appendix A), the JA have not provided evidence sufficient to make a finding that the proposed Reorganization will not adversely affect diminish NG's ability to provide adequate, reliable, efficient, safe and least cost service as required by perform its duties under the Act, within the meaning of Section 7-204(b)(1) of the Act; this finding is dependent upon the conditions established in this Order and would not be rendered in the absence of those conditions;~~
- (5) in the absence of the finding required under Section 7-204(b)(1) of the Act, the Commission denies the application for approval to engage in the Reorganization. pursuant to Section 7-204 of the Act, and subject to the conditions established in this Order (enumerated in Appendix A), the Commission finds that:
 - a) ~~the proposed Reorganization will not diminish NG's ability to provide adequate, reliable, efficient, safe and least-cost public utility service;~~
 - b) ~~subject to the condition imposed in finding (7) of this Order (in addition to the conditions enumerated in Appendix A), the proposed Reorganization will not result in the unjustified subsidization of non-utility activities by the utility or its customers;~~

- ~~e) — under the proposed Reorganization, costs and facilities will be fairly and reasonably allocated between utility and non-utility activities in such a manner that the Commission may identify those costs and facilities which are properly included by the utility for ratemaking purposes;~~
- ~~d) — the proposed Reorganization will not significantly impair the ability of NG to raise necessary capital on reasonable terms or to maintain a reasonable capital structure;~~
- ~~e) — after approval of the proposed Reorganization, NG will remain subject to all applicable laws, regulations, rules, decisions, and policies governing the regulation of Illinois public utilities;~~
- ~~f) — the proposed Reorganization is not likely to have a significant adverse effect on competition in those markets over which the Commission has jurisdiction; and~~
- ~~g) — the proposed Reorganization is not likely to result in any adverse rate impact on retail customers;~~
- ~~(1) — the inter-affiliate OA should be approved with Staff's recommended subsection 2.2(e) and without JA's version of that subsection, which is disapproved; this is an indispensable condition of approval of the proposed Reorganization and approval of the OA as an inter-affiliate agreement under the Act, without this condition, neither the Reorganization nor the OA would be approved;~~
- ~~(2) — without the condition imposed in finding (7) above, the inter-affiliate OA would be contrary to the public interest and contrary to the interests of the public utility and its customers;~~
- ~~(3) — without the condition imposed in finding (7) above, the inter-affiliate OA would contravene the prohibition against subsidization of an affiliate by a gas utility in 83 Ill. Adm. Code 550.120;~~
- ~~(10) — for purposes of subsection 7-204A(b) of the Act, the SA, the TAA, the four existing agreements between NG and Sequent, and the capacity release arrangements between NG and Sequent entered into in accordance with FERC's capacity release rules, should be approved, subject to the conditions described in this Order (enumerated in Appendix A);~~
- ~~(11) — subject to the conditions established in this Order (enumerated in Appendix A), the JA comply with the minimum information requirements set out in subsection 7-204A(a) of the Act for an application for approval of reorganization;~~

- ~~(12) subject to the conditions established in this Order (enumerated in Appendix A), and in the manner described in those conditions, any savings resulting from the proposed Reorganization shall be allocated to NG's ratepayers and no costs incurred in accomplishing the proposed Reorganization shall be recovered by the JA, or by NG individually, through Illinois jurisdictional regulated rates;~~
- ~~(13) It is unnecessary for the Commission to rule on the applicability of Section 7-102 of the Act insofar as this proceeding concerns the JA's Reorganization application; Section 7-102 does apply to the inter-affiliate OA, which would contravene Section 7-102 without the condition imposed in finding (7) above; and~~
- ~~(14) subject to compliance with the conditions set out in this Order (enumerated in Appendix A), the proposed Reorganization will not be inconsistent with Section 6-103 of the Act, insofar as that statute applies to the subject matter of this proceeding.~~

IT IS THEREFORE ORDERED by the Illinois Commerce Commission that, ~~the application for approval to engage subject to each and all of the required conditions of approval set forth in this Order (in Finding (7), above, and enumerated in Appendix A), the Joint Applicants' request to engage in the Reorganization, through which Nicor Gas would~~ become a subsidiary of AGL Resources Inc., is hereby ~~denied~~approved.

IT IS FURTHER ORDERED that, ~~subject to each and all of the required conditions of approval set forth in this Order (in Finding (7), above, and enumerated in Appendix A), as applicable, Nicor Gas' request to enter into, first, an Operating Agreement governing transactions between Nicor Gas and its current affiliates, as well as with AGL Resources Inc. and AGSC, and, second, a Services Agreement governing allocations to Nicor Gas from AGSC, and third, four agreements with Sequent Energy Management, LP (a Gas Exchange agreement, an Interstate Hub Service Agreement, an Intrastate Hub Service Agreement, and a Base Contract for Sale and Purchase of Natural Gas), as well as capacity release arrangements between Nicor Gas and Sequent entered into in accordance with the Federal Energy Regulatory Commission's capacity release rules, and, fourth, the Tax Allocation Agreement Among Members of the AGL Resources Inc. Affiliated Group, as amended to include the surviving NI companies as parties to that agreement, is hereby~~ approved.

IT IS FURTHER ORDERED that, ~~subject to each and all of the required conditions of approval set forth in this Order (enumerated in Appendix A), as applicable, the proposed accounting entries associated with the Reorganization are approved, on the condition that any effect on such entries resulting from our resolution of disputed issues or our imposition of merger conditions must be~~

~~reflected in such entries, in a manner consistent with the rationale, determinative principles, findings and conclusions of this Order.~~

~~IT IS FURTHER ORDERED that, in carrying out and completing the Reorganization, and in all subsequent Nicor Gas activities and operations subject to the jurisdiction of this Commission, the Joint Applicants shall comply with each and all of the required conditions of approval set forth in this Order (in Finding (7), above, and enumerated in Appendix A), unless expressly relieved of such obligation, in whole or in part, by directive of this Commission.~~

~~IT IS FURTHER ORDERED that subject to the conditions established in this Order (enumerated in Appendix A), and in the manner described in those conditions, any savings resulting from the proposed Reorganization shall be allocated to NG's ratepayers and no costs incurred in accomplishing the proposed Reorganization shall be recovered by the Joint Applicants, or by Nicor Gas individually, through Illinois jurisdictional regulated rates.~~

IT IS FURTHER ORDERED that any objections, motions or petitions filed in this proceeding that remain unresolved should be disposed of in a manner consistent with the ultimate conclusions contained in this Order.

IT IS FURTHER ORDERED that, subject to the provisions of Section 10-113 of the Act and 83 Illinois Administrative Code 200.880, this Order is final, it is not subject to the Administrative Review Law.

IV. Conclusion

WHEREFORE, Staff respectfully requests that the Commission's order in this proceeding reflect all of Staff's recommendations.

October 13, 2011

Respectfully submitted,

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