STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

NORTH SHORE GAS COMPANY	)	
	)	
Proposed General Increase In Rates For	)	
Gas Service	)	12-0511
	)	
	)	(Cons.)
THE PEOPLE GAS LIGHT AND COKE COMPANY	)	
	)	12-0512
Proposed General Rate Increase In Rates For	)	
Gas Service.	)	

<u>REPLY BRIEF OF THE CITIZENS UTILITY BOARD AND THE CITY OF CHICAGO</u>

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REPLY BRIEF OF THE CITIZENS UTILITY BOARD
AND THE CITY OF CHICAGO

NOW COME, the Citizens Utility Board ("CUB"), through its attorneys, and the City of Chicago by Stephen Patton, Corporation Counsel, ("CUB-City"), pursuant to section 200.800 of the Rules of Practice of the Illinois Commerce Commission (the "Commission" or "ICC"), ("Rules"), 83 Ill. Admin. Code § 200.800, and the schedule established by the Administrative Law Judges ("ALJs") file their Reply Brief regarding the proposed general increase in natural gas rates of North Shore Gas Company ("North Shore" or "NS") and the Peoples Gas Light and Coke Company ("Peoples" or "PGL"), (collectively "NS-PGL," "utilities" or the "Companies").

I. INTRODUCTION/STATEMENT OF THE CASE

In attempting to persuade the Commission to abandon long-standing ratemaking principles and policies, (in the case of measurement of rate base), or stretching the boundaries of the Public Utilities Act ("PUA"), (in the case of its conditional rate design proposal), the Companies turn traditional ratemaking prescriptions on their heads. While the Companies pay homage to the well-grounded legal construct of test year ratemaking, which allows a utility's rates to be set so as to allow it the *opportunity* to recover its prudent and reasonable costs of service, the Companies then argue this "opportunity" is inherently and automatically stripped from them because the new rates will only be in effect for half of 2013, the Companies chosen test year. Aside from the obvious fact that the Companies' complaints about the test year are a product of their own choosing, because they could have selected a non-calendar test year (July 2013-2014, for example), their point undercuts the basis for setting rates. Rates are set based on a 12-month test year not to perfectly match test year costs to real-time costs incurred while the rates are in effect, but rather to "avert mismatching of revenues and expenses that might permit a utility to inaccurately portray a higher need for rate increases." *Business & Professional People for the Public Interest v. Illinois Commerce Comm'n*, 136 Ill.2d 192, 219 (1989)("*BPI I*"). This matching principle

After rates are set based on the determination of a revenue requirement (which is the sum of expenses and return on rate base for one 12-month test year[1]), those rates remain in effect until new rates are set, which could be – and often is – many years. Case in point, the Companies went 12 years between rate cases (from 1995 to 2007), until recently embarking on an every two-year filing cycle. To now claim that this process brings with it an inherent disadvantage is an obvious self-serving, results-driven, and entirely irrelevant point. The remedy for a future revenue deficiency – whether the product of increased spending in the absence of cost efficiencies or reduced earnings for some other reason – is to file another rate case. If the utility is willing to make the effort of forecasting costs for a period that coincides with the period rates are expected to be in effect, a better remedy might be selecting a test year aligned with the period of concern. That is the appropriate regulatory solution for changed economic circumstances for

[1] *Citizens Utilities Co. v. Ill. Comm. Comm'n*, 124 Ill. 2d 195, 200-01 (1988).

a utility already recovering a guaranteed return on assets funded on the backs of a captive customer base.

Filing a new rate case is also the remedy for the Companies to propose a rate design in lieu of Rider VBA, currently in effect, should the appellate court strike it down at some later date. Using this rate proceeding to provide a contingency plan for a near risk-free fixed cost recovery replacement mechanism (a straight-fixed variable, "SFV," rate design) is contrary to the requirement in the Public Utilities Act ("PUA") that notice of the time a tariff will be in effect be provided at the time the tariff is filed. 220 ILCS 5/9-102(a). The Companies' provisional SFV tariff has less justification and greater ratepayer harms than the Companies' primary proposal. The provisional tariff should therefore be rejected.

The burden of proof is indisputably on the Companies to demonstrate the justness and reasonableness of their proposed rates. 220 ILCS 5/9-201(c). Yet, in some instances, (*viz.*, measurement of rate base and the calculation of state income tax rate), the Companies argue for a dramatic departure from recent Commission decisions, but do not present evidence of changed circumstances sufficient to support the Commission's determinations with substantial record evidence and adequate explanations. 220 ILCS 5/10-201(iv)(A) and (iii). In other cases, (*viz.*, cost of service and S.C. 1 rate design), the Companies give short shrift to contested issues, presenting only a brief, generalized summary of their position without a substantive response to significant testimony challenging the premise of the Companies' proposals. The Companies' failure to detail the evidence supporting the justness and reasonableness of their proposed rates should weigh heavily against them, especially in light of the disparate impact of their proposals on the customers they serve.

III. REVENUE REQUIREMENT

CUB/City Initial Brief Attachments 1 and 2 reflect CUB/City's recommended revenue requirement for Peoples Gas and Light and North Shore Gas, respectively.

VI. Rate Base

C. Potentially Contested Issues

1. Year End Rate Base or Average Rate Base

The Companies proposed that the Commission set rates using the rate base amount forecasted for December 31 of their chosen future test year. Smith, CUB-City Ex. 1.0, 14:313; Hengtgen, NS-PGL Ex. 43.0, 7:136; Feb 6 tr. 412. They later proposed a compromise, the amount forecasted for approximately September 30 of that year. Feb 7 tr. 583-584. The Companies made this proposal knowing (a) that it is a problematic deviation from the standard Commission practice of using an average rate base with a future test year (Feb 6 tr. 441-442) and (b) that following the Commission's average rate base practice more accurately reflects their costs of service for the chosen test year. Feb 7 tr. 577. The Companies complain that the average rate base approach is unlikely to produce rates that will recover their costs during the post-test year period when those rates are expected to be in effect. They propose to modify the Commission's test year cost determination approach in anticipation of rate base cost increases the Companies have not quantified.

a. The Companies' Explanations and Arguments Do Not Validate Their Year-End Rate Base Proposal

Under the PUA, a utility seeking a change in rates has the burden of proving with record evidence that its proposed rate changes are just and reasonable. 220 ILCS 5/9-201(c). Under the Commission's test year rules, the relevant costs are those for the utility's historical or future test year, and (with limited exceptions) rates are set to recover those costs. *See* 83 Ill. Adm. Code

287.40. The Companies propose to use a future test year and to provide costs for only that period, but then to adjust the resulting cost-based rates to recover costs for a different, post-test year period. NS–PGL Init. Br. at 17-18. That proposal is well outside the Commission's established practice and the record evidence does not support the Companies' proposal.

Failing to meet their PUA-mandated burden of proof, the Companies seek to shift responsibility for their desired outcomes to the Commission.

> [T]he Commission is required by law to establish just and reasonable rates; the rates must be just and reasonable to the utility and its stockholders as well as customers; and the rates must be set so as to allow the utility the opportunity to obtain full recovery of its prudent and reasonable costs of service.

NS-PGL Init. Brief at 17. In this account of the ratemaking process, the Companies ignore their statutory duty to provide evidence to support their proposed rates. The Commission cannot lawfully ignore that lack of evidence.

i. The Companies' Opportunities

In their arguments, the Companies do not acknowledge their unused opportunities to avoid the alleged mismatch between rates based on costs for the test year they chose and costs for their preferred (post-test year) cost period. Aside from the distortion of the test year matching principle in that allegation, the Companies' unused opportunities to mitigate the effects of a test year choice are significant. *See* CUB-City Init. Br. at 13. The Commission's consideration of such utility failures in its ratemaking decisions is appropriate, and it has been sustained on appellate review. *See Ameren Illinois Co. v. Illinois Commerce Comm'n,* 2012 IL App (4th) 100962, ¶ 115 ("the utility bears some of the responsibility for the mismatch of these [test year and rate effective period rate base] amounts").

First, the Companies had the option of selecting a test year aligned with (or more representative of) the period whose costs they want rates to recover. As the Companies admit, "[i]n this instance, the Utilities, under the rule, could have selected a future test year ending as late as July 31, 2014, 24 months from the tariff filing date, 83 Ill. Adm. Code § 287.20(b) . . . ." NS–PGL Init. Br. at 23. The Companies go on to describe how they lawfully could have done precisely what they ask the Commission to do for them unlawfully.

> Indeed, if the test year were a future test year ending July 31, 2014, use of the average rate base method would yield a rate base that approximates a rate base as of January 31, 2014, which is one month further out in time than the year end rate base that the Utilities propose.

NS-PGL Init. Br. at 24.

Instead, the Companies chose a more convenient calendar year test period that did not align with the period they expect that rates will be effective. Feb 6 tr. 445-446. The Companies are attempting to compensate for their failure to present cost data for that post-test year period by having the Commission abandon its standard approach. Instead of using an average rate base in future test year cases, they propose the novel combination of a future test year and a year-end rate base.

The Companies attempt to distinguish their earlier compliance with Commission practice (their 2009 and 2011 cases) by claiming that they proposed an end-of-year rate base approach in this case "because of changed circumstances, in particular, the timing of when the rates being set will go into effect and the loss of their infrastructure cost recovery rider." NS–PGL Init. Br. at 20. But those circumstances were known when the Companies selected their 2012 calendar year test period or did not affect the Companies' decision. The likely date when rates will become effective is easily determined from the utility's choice of filing date and the PUA's statutory suspension periods. *See* 220 ILCS 5/9-201(b). As to the rider, the Companies' senior management witness tried to explain the alleged connection, but he admitted that the 2013 appellate court decision voiding an unlawful rider did not actually affect their test year choice. Feb 6 tr. 444.

Second, the Companies also had an opportunity to provide evidence to support their proposed rates. Yet, they provided no evidence quantifying the post-test year costs they want their rates to recover. The Companies chose not to perform the tasks needed to make their case. Moreover, what the Companies do offer – adjustments for only certain rate base costs – is so narrowly focused that single issue ratemaking becomes an issue. As a result, the Commission has no record evidence of the post-test year costs that the Companies want their rates to recover. The record also does not contain cost evidence that allows the Commission to assess whether the proposed rates are just and reasonable.

The Commission cannot lawfully rely on the Companies' unsupported speculation about anticipated rate base changes to support the proposed rates. The Companies' proposal also is inconsistent with the Commission's test year rules and with the prohibition against single-issue ratemaking. A decision approving those proposed rates could not be sustained on judicial review. *Business & Professional People in the Public Interest v. Illinois Commerce Comm.* ("*BPI I*"), 136 Ill. 2d 192, 219 (1989).

ii. The Companies' Arguments

In their Brief, the Companies made three main arguments for their year-end rate base proposal:

> (1) the Commission's rules (83 Ill. Adm. Code § 285.2005(e)) permit use of a year end rate base in a future test year ate case;

> (2) the rates being set in these cases will not go into effect until July 2013, which means that the Utilities will experience the revenue impact of any rate increase for at most half of 2013; and
>
> (3) use of a year end calculation will result in setting rates that better match the Utilities' cost of service during the period in which the rates will be in effect and come closer to giving them the opportunity to recover fully their costs of service.
>
> NS-PGL Init. Br. at 19.

The Companies claim that "points (1), (2), and (3), above, are not really disputed." That claim is false. Under Illinois law, legal opinions and arguments are not proper subjects for testimony. *Bloomington v. Bloomington Township*, 233 Ill. App. 3d 724 (4th Dist. 1992), 735. Though the Commission exercises considerable flexibility in its application of that rule, the absence of legal argument <u>in</u> <u>testimony</u> does not mean that such issues are "not really disputed." In fact, each of the Companies' arguments is unsupported by law and evidence; those assessments required the complete record being addressed in briefs.

NS-PGL Argument (1). The Commission <u>filing</u> <u>rule</u> that the Companies cite (83 Ill. Adm. Code § 285.2005(e)) is no more than that -- a filing requirement. That filing directive <u>does not authorize</u> a year-end rate base.

Moreover, that filing provision is inapposite to the Companies' specific post-test year proposal. While 285.2005(e) does not purport to bar unconventional rate base proposals in future test year cases, it requires more rigorous support for such proposals than is required for future test year costs based on an average rate base. The rule requires 13 month-end balances of all rate base items, starting the month before the test year and continuing only through the end of the test year. 83 Ill. Adm. Code § 285.2005(e). Even that requirement for costs through the test year end would not provide the post-test year rate base costs needed to support the Companies' proposed rates.

NS-PGL Argument (2). The Companies complain that their rates will not go into effect until after the end of the test period they chose. As CUB-City explained in their Initial Brief, any misalignment of the Companies' test year and the Companies' target cost period is a result of knowing choices the Companies made, with full awareness of the effects. CUB-City Init. Br. at 16-18.

NS-PGL Argument (3). The Companies contend that "use of a year end calculation will result in setting rates that better match the Utilities' cost of service during the period in which the rates will be in effect." This argument assumes, incorrectly, that the Commission is free to ignore its test year rules to accommodate the Companies' preference not to perform special forecasts for that period. The Commission is required to follow its own test year rules. *BPI I*, 136 Ill. 2d 192, 219. Also, the argument falsely suggests the presence of record evidence of the costs the Companies will incur during that post-test year period. The Companies have offered only opinion that their rate base costs will be higher than test year costs (without quantification), and they have provided no information on revenue requirement elements other than a single issue, rate base.

iii. The Companies' Responses to Intervenor Arguments

The Companies also purport to address the arguments of Staff and intervenor parties on the following points: (a) established Commission practice; (b) test year rules requirements; (c) unfairness of a year-end rate base (even if test year rules are ignored); and (d) the Companies' inconsistent positions on the appropriateness of an average year approach. The Companies' responses miss the mark on each issue, and those points remain barriers to the unjustified and unlawful relief the Companies seek.

Commission Practice. The Companies concede that no Commission decision has approved the approach they propose. NS-PGL Init. Br. at 22. And the Companies further acknowledge that only two cases even addressed the issue as a question of evidence. In each of those cases, the Commission decided against using a year-end rate base with a future test year.

Though no party contends that past Commission orders are binding precedent, the Commission's actions in this case must be supported by substantial record evidence and must be adequately explained. 220 ILCS 5/10-201(iv)(A) and (iii). Where a decision diverges from an established past practice, a more compelling explanation is required. *People ex rel. Madigan v. Illinois Commerce Comm'n*, 2011 IL App(1st) 101776, ¶17. Here, the only reason the Companies offer for their proposed divergence is self-interest. The requested change in the Commission's regular practice would shield the Companies from the foreseeable effects of their own management decisions. *See* CUB-City Init. Br. at 16-17. A year-end rate base would allow the Companies to avoid the "difficult" (but not impossible or even impractical) task of aligning its objectives (recover costs for a particular future period) and their evidence (data for a different, less convenient test year). Feb 6 tr. 444-446. Granting the Companies' request would allow the Companies (at the same time) to avoid the predictable consequences of their deliberate inaction.

Test Year Rules. The Companies' argument for a year-end rate base ignores the formidable legal obstacles to recovering costs from beyond its test year. The Commission's test year rules require that rates be set on the basis of a utility's costs during a designated test period. Rates cannot be determined using costs from outside the test year. 83 Ill. Ad, Code Part 287;

BPI I, 136 Ill. 2d 192, 219. And rates certainly cannot be determined on the basis of speculation about post-test year rate base costs that are never quantified. 220 ILCS 5/10-103.

Without actual cost of service evidence for the Companies' target post-test year period, the Commission cannot "establish the rates . . . which it shall find to be just and reasonable." 220 ILCS 5/9-201(c). The Companies selected a test year and presented cost data for that period. They did not present needed, comprehensive revenue requirement elements for the post-test year period that is their focus. The Commission has no evidence of post-test year costs adequate to support a rate determination based on that period.

The Companies also complain that other parties maintain that "the revenue requirement should be based on the test year cost of service without regard to when the rates being set will go into effect." That (with specific limited exceptions) is what the Commission's test year rules require, and why the rules allow utilities to propose an appropriate test year. 83 Ill. Adm. Code 287.40.

The Companies proposed a compromise rate base proposal, which they describe as one that takes account of every party's position. In fact, it distorts test year ratemaking in the same manner as their original proposal, to inflate the test year rate base, but for a smaller (compromise) amount of unproven, presumed post-test year investment. Also, rate base costs are the single cost item that is modified for ratemaking.

Alleged Unfairness. If the Commission concludes that, notwithstanding its test year rules, it is authorized to and must address the Companies' fairness arguments (NS–PGL Init. Br. at 21-22), those arguments still fail to establish a basis for the relief they request. The Companies claim that "[t]he Staff and intervenor focus here is on the test year costs, without regard to when the rates being set will go into effect . . . what they actually are analyzing in their proposal is only costs." NS–PGL Init. Br. at 25. That argument is merely a restatement of the Companies' attempt to redefine the test year matching principle. *See* CUB-City Init. Br. at 13-14. "The test-year rule prevents a utility from mismatching revenues and expenses." *Commonwealth Edison Company v. Ill. Commerce Comm'n*, 405 Ill. App. 3d 389, 396 (1st Dist 2010), (2010), 219. Consistently, the PUA requires that the components of the Companies' rate bases "must account for both increases and decreases (over a consistent period) at any point in time." *Id. at 405;* 220 ILCS 5/9-211. Thus, in addition to their misapplication of the matching principle to find a "mismatch" of costs and rates, the Companies' proposal also unlawfully mismatches test year costs defining the revenue requirement with post-test year rate base costs alone.

The Companies correctly note that: "The Commission, in meeting its duty to set just and reasonable rates, must base its decision exclusively on the applicable law and the evidence in the record here." NS-PGL Init. Br. at 21. However, their suggestion that the record in this case shows that a year-end rate base is appropriate is incorrect. The record shows instead that the choice of a test year that is not aligned with the period rates will be in effect, as well as the consequences of that choice, are direct results of the Companies' management decisions. *See* CUB-City Init. Br. at 16-17.

The Companies' claim of record support for their proposed use of a year-end rate base rests on an unsupported assumption that their post-test year costs will exceed the test year revenue requirement. That presumption is both legally irrelevant and factually erroneous. First, using post-test-year costs to set rates is a violation of the Commission's test year rules. It is impermissible for the Commission to approve rates that seek recovery of post-test year, rate base related costs. Second, the Companies' alleged, higher rate base costs in their target post-test year period lack evidentiary support for Commission action favorable to the Companies. The Companies' speculative rate base costs are unproven and unaccompanied by evidence regarding potentially offsetting changes in other revenue requirement items. Yet, the year-end rate base proposal would have the Commission inflate the Companies' test year rate base to cover unproven single issue cost changes.

The Companies had opportunities they chose not to take, and duties they chose not to perform. They now ask that the Commission unlawfully ignore its test year rules, as well as the lack of evidence of the post-test year costs they seek to recover. The Commission cannot lawfully approve the Companies' proposal for single-issue rate adjustments based on speculative, unquantified, post-test year changes in rate base.

2. Plant

b. Accelerated Main Replacement Program Projects

In the Companies' Brief, PGL gives its perspective on the benefits of its planned AMRP effort to improve the City's utility infrastructure: "The primary benefits of replacing the cast and ductile iron main are enhancing the <u>safety</u> and <u>reliability</u> of service for customers." NS-PGL Init. Br. at 30 (emphasis added); *compare* CUB-City Init. Br. at 18-20. The City views those benefits as the most important purposes of PGL's AMRP.

PGL also argues that "the record demonstrates that Peoples Gas has prudently managed AMRP and has made significant strides towards completing AMRP by 2030." NS-PGL Init. Br. at 27. This conclusion is not evident from this record. The halting course of PGL's pipe replacement activity, as the utility gives priority to other objectives, is a particular concern.

With respect to the Staff's proposal to enhance that effort and to assure its timely and efficient completion, PGL argues that "Staff's recommendations are at best uninformed." NS-

PGL Init. Br. at 27. PGL opposes the entire Staff proposal, including its initial assessment phase. *Id.* Yet, despite its opposition to the Staff proposal, PGL has provided nothing to ease concerns rooted in the following uncontested facts:

- The safety concerns about PGL's aged (up to 150 years) corroding and deteriorating pipes are increasingly justified as the condition of the infrastructure worsens as time passes (Hayes, NS-PGL Ex. 14.0 at 7:157; Feb 5 tr. 192);

- PGL's prioritization program cannot assure City residents that the pipes that present a public danger will always be identified (Feb 5 tr. 196);

- PGL's explicit position is that it is no longer committed to complete the AMRP by 2030, without unspecified cost recovery or earnings (Feb 6 tr. 416-418);

- The priority given to budgetary limits, which already has curtailed AMRP activity, will continue (Feb 6 tr. 442-443);

- In PGL's view, continuation of AMRP would be largely at its discretion (Feb 6 tr. 446); and

- The fate of AMRP after 2013 is uncertain, as there are no firm plans beyond the test year (Hayes, PGL Ex. 14.0, 4:88).

Over several pages of its brief, PGL provides its perception of the current status and vision for its AMRP. NS-PGL Init. Br. at 28-30. Even if the facts PGL presents there are true, the well-founded concerns about infrastructure safety and reliability compel support for the Staff proposal. The seriousness of these observed circumstances warrants a regulatory response, if only through an assessment that assures City residents that essential safety and reliability concerns are being competently addressed.

Given the importance of replacing the vulnerable pipes serving City residents – both for public safety and for reliability of service – a "second opinion" (as defined by the first phase of the Staff proposal) remains the prudent course. The need for the second phase of that proposal, as CUB-City understand Staff's proposal, would be contingent on the findings in the first phase.

3. Cash Working Capital

a. Pass-Through Taxes

For the reasons discussed in the CUB-City Initial Brief at 23-24, the AG Initial Brief at 30-37, and in the Staff Initial Brief at 30-31, the Commission should adopt Staff's disallowance of this expense. To do so is consistent with established and well-reasoned Commission practice. The Commission has already considered and rejected all of the arguments set forth in the NS-PGL Initial Brief, in the Companies' most recent rate case, ICC Docket No. 11-0280 cons., as well as in Commonwealth Edison Company ("ComEd") Docket Nos. 10-0467, 11-0721 and 12-0321, and Ameren Illinois Company ("Ameren" or "AIC") Docket Nos. 12-0001 and 12-0293.

b. Pension/OPEB

For the reasons discussed in the CUB-City Initial Brief at 24-25, the AG Initial Brief at 37-40, and in the Staff Initial Brief at 31, the Commission should adopt Staff's disallowance of this expense. The Commission should include an expense lead for pension and Other Post-Employment Benefits ("OPEB"), as proposed by Mr. Brosch and Mr. Kahle.

4. Retirement Benefits, Net

NS-PGL admit that in their last three rate cases, the Commission has disallowed their pension asset from inclusion in rate base, but request reconsideration of that position in the present case. NS-PGL Init. Br. at 51-52. They base their request on five particular points, listed on pages 53-54 of their Initial Brief. However, the Companies admit that four of those five points have been raised and considered by the Commission in previous cases where the pension asset was disallowed. *Id*. at 54. They claim to have presented new data (in surrebuttal) to support one single fact (that cumulative pension contributions have exceeded Generally Accepted Accounting Principles pension expense)—"although somewhat similar points sometimes were made" in prior cases. *See id*. at 53-54. In reality, no new facts were presented that justify a decision to deviate from the Commission's regular practice of disallowing a pension asset. The Commission's previous, well-reasoned decisions should again provide guidance here, and the pension asset should be removed from rate base. Shareholders should not earn a return on these ratepayer-supplied funds.

As the Companies have admitted, all of the facts and arguments presented in this case were presented to and considered by the Commission in past cases. *See* NS-PGL Init. Br. at 54. To deviate from the Commission decisions in those cases would be a drastic departure from past Commission practice. Commission decisions are afforded less deference and require greater justification on appeal where they drastically depart from past practice. *BPI I* at 228 (1989). The new factual and policy bases for change that would be required to justify departure from previous decisions have not been provided in this record. Smith, CUB-City Ex. 2.0, 49:1072-76.

The ratepayer-supplied pension asset should be removed from rate base, consistent with the Commission's rulings in the Companies' previous three rate cases and the recommendations of CUB-City, Staff and AG.

5. Net Operating Losses

a. 2012 Bonus Depreciation and Net Operating Losses

The Companies acknowledge that their decision in surrebuttal to claim Net Operating Losses ("NOLs") for NS and PGL was a departure from their previous statements that the "consolidated group" (*i.e.* their parent company) "was forecasted to absorb those losses." NS-PGL Init. Br. at 56. They claim two "major events" changed the facts such that it was appropriate to claim NOLs on a standalone basis for each Company rather than anticipating the parent company would use those NOLs—1)the enactment of the American Taxpayer Relief Act of 2012; and 2) the end of year 2012 books being closed. *Id*. at 57. Neither of those supposed new facts should be of consequence to the 2012 NOL in particular, which has been known since the inception of the case.

The Companies' claim that the closing of books for 2012 resulted in a yet-unknown NOL should be rejected. In response to discovery in October of 2012, the Companies' stated that "the assumed facts and circumstances were that North Shore would incur a NOL for 2012 on a stand-alone basis, but TEG would have been able to use the North Shore NOL to reduce current or prior tax obligations of the consolidated group." Staff Cross Exhibit 12. The same statement was made for Peoples Gas. Staff Cross Exhibit 13. Those statements were made before the 2012 books were closed, demonstrating that the NOLs were indeed known before the closing of books.

Equally lacking in merit is the Companies' argument that the American Taxpayer Relief Act of 2012 ("ATRA") impacted 2012 NOLs. The enactment of the ATRA affected only 2013 bonus depreciation, not 2012 bonus depreciation. The 2013 bonus tax depreciation did not make any changes to the 2012 bonus tax depreciation or the corresponding deductions claimed on the federal income tax return for tax year 2012. Feb 8 tr. 736:4-11. The 2012 bonus depreciation, and the Companies' stand alone NOLs, as discussed in Staff Cross Exhibits 12 and 13, have been known since the inception of this rate case. The Companies' change of position on surrebuttal, to claim that their parent company would not absorb the NOLs after all, (a claim Staff and intervenors had limited opportunity to test) is a self-serving, strategic move that should not be rewarded by the Commission. The Commission should not allow any adjustment to 2012 ADIT for any 2012 NOLs.

With regard to the 2013 bonus depreciation and NOLs, the impact of 2013 bonus federal tax depreciation on 2013 test year ADIT balances should be fully reflected, subject to applicable NOL related limitations. The amounts presented by the Companies in CUB-City 2.1 (response to AG 20.01) appear to represent the most reasonable quantified impacts on ADIT from 2013 bonus tax depreciation in this record, and should therefore be adopted. Smith, CUB-City Ex. 2.0, 46:1012-19.

6. Accumulated Deferred Income Taxes

a. Appropriate Methodology to Reflect Change in State Income Tax Rate

The Companies criticize the CUB-City proposed methodology to reflect changes in the Illinois State Income Tax Rate ("SIT") as "inconsistent with Commission precedent," (NS-PGL Init. Br. at 58) but that could not be farther from the truth. In reality, as the Companies eventually admit, in the two most recent Commission rate cases since the new state income tax rate became effective, the Commission used the methodology supported by CUB-City. NS-PGL Init. Br. at 61. Just as the Commission did in recent ComEd and Ameren formula rate cases, the Commission should apply standard utility normalization accounting for the known future changes in the SIT. Smith, CUB-City Ex. 2.0, 25:540-42, Smith, CUB-City Ex. 1.0, 57-64:1589-1841.

It is undisputed that Illinois's increased state corporate income tax rate is only temporary-- from 7.3% to 9.5%, effective January 1, 2011 and effective through 2014. CUB-City Ex. 1.0, 55:1522-24. The 9.5% tax rate is composed of two components, a 7.0% income tax and a 2.5%

personal property tax replacement income tax. *Id*. at 55:1524-56:1527, *citing* 35 ILCS 5/201(b)(10), 35 ILCS 5/201(d). In the years 2015-2024, the Illinois corporate income tax rate will be 7.75%, and beyond 2025 the rate will be 7.3%. CUB-City Ex. 1.0, 57:1584-85. The dispute arises because the Companies' approach ignores the known future decline in state tax rates, effectively overstating their Deferred State Income Tax Expense and increasing their revenue requirements, while CUB-City and AG experts recognize the effect of the lower income tax rate by using proper, accepted, normalization accounting. The Commission has recently entered two rate orders, each of which applied the normalization accounting CUB-City propose here. *Ameren Illinois Company d/b/a Ameren Illinois*, Rate MAP-P Modernization Action Plan - Pricing Annual Update Filing, ICC Docket No. 12-0293, Dec. 5, 2012 Order ("12-0293 Order"); *Illinois Commerce Commission On Its Own Motion v. Commonwealth Edison Company*, Annual formula rate update and revenue requirement reconciliation authorized by Section 16-108.5 of the Public Utilities Act, Dec. 19, 2012 Order ("12-0321 Order"). The Companies refuse to conform to the preferred methodology of the Commission.

The Companies used a static state income tax rate of 9.5% to compute deferred state income tax expense for gas plant related timing differences. *Id*. at 65:1875-77, 66:1896-97. The future changes in state income tax rates that are specified in the current Illinois statute are required to be recognized under generally accepted accounting principles, for proper regulatory accounting and to be consistent with a proper application of the Commission's income tax normalization guidance from the Commission Order in Docket No. 83-0309. CUB-City Ex. 2.0, 29-30:634-40. In conjunction with the use of an average 2013 future test year for rate base in this case, the adjustment to reduce Deferred Income Tax Expense should also be coordinated with an adjustment to increase State ADIT by one-half the amount of expense reduction to reflect the related impact on State ADIT on average 2013 rate base.

The Companies continue to misinterpret of the Commission's Order in Docket No. 83-0309, ("Order 83-0309") which addressed the need for consistent tax normalization accounting by Illinois utilities. Order 83-0309 did not address future changes in the Illinois state income tax rate, addressing instead past changes in the federal income tax rate that resulted from the Reagan corporate income tax cuts. Smith, CUB-City Ex. 1.0, 64:1848-51. As a Company witness admitted, one of the objectives of Order 89-0309 is to have consistency for income taxes among Illinois utilities. Feb 8 tr. 717:8-12. That Order stated: "such uniform treatment for ratemaking purposes of such deferred tax accounts for Illinois utilities which utilize deferred tax accounting should be adopted in each utility's next rate filing..." Smith, CUB-City Ex. 2.0, 42-43:932-36. The Commission applied its own guidance from this order in ICC Docket Nos. 12-0321 and 12-0293, which involved precisely the same tax situation in dispute this case. *Id*. at 42:927-28. The Companies are subject to the same Generally Accepted Accounting Practices ("GAAP"), Internal Revenue Code, APB Accounting Rules, and Commission guidance for deferred income taxes. In order to achieve the objective of Order 89-0309 to have uniform treatment among Illinois utilities, normalization accounting must be used for NS and PGL just as it was used for ComEd and Ameren.

The Appellate case cited by NS-PGL at 61-62 does not support the Companies' position, as it is from 1993 and did not address known future changes in SIT such as exist now. Additionally, that decision did not explicitly endorse the use of the Average Rate Assumption Method ("ARAM"), as asserted by the Companies. See NS-PGL Init. Br. at 61-62. Rather, that decision supported the Commission's authority to determine the appropriate method of accounting. Central Illinois Public Service Co. v. Illinois Commerce Comm'n, 243 Ill. App. 3d 421, 440 (1993) That court held, "In light of the findings that the average setup method returns excess ADITs over the remaining life of the assets... we cannot say that the Commission's decision to adopt the average setup method was improper." That statement, cited by the Companies at NS-PGL Init. Br. at 62, is hardly an endorsement for ARAM—it is, simply, the Appellate Court giving the proper level of deference to Commission decisions.

The Companies also continue to misuse the term "flow through" accounting (NS-PGL Init. Br. at 58) in an attempt to undermine the position advocated for by CUB-City, the AG and Staff. "Flow through" accounting generally reflects passing through to ratepayers the tax savings associated with a tax deduction in the *current* period, rather than establishing a Deferred Income Tax Expense to normalize that deduction. Smith, CUB-City Ex. 2.0, 27:581-28:596. That is not what is at issue here. The issue here is how to properly calculate the normalization of Deferred Income Tax Expense that is affected by known *future* state corporate tax rate changes. *Id*. at 28:596-98. Just like the ComEd and Ameren cases cited above, CUB-City advocates for the normalization accounting used by Mr. Smith for Illinois state income taxes. *Id*. at 29-30:638-40. A separate proceeding to address the appropriate methodology to account for the change in SIT is not necessary (see NS-PGL Init. Br. at 58) – the Commission has already provided guidance as to the appropriate methodology; the Companies refuse to accept that guidance.

Finally, the Commission should give no weight to NS-PGL's assertion that the CUB-City proposed method is "inconsistent with the existing regulations regarding normalization." *See* NS-PGL Init. Br. at 62. Indeed, this is the very method approved recently by the Commission for two other Illinois utilities, and the Commission did not use a method that violates the IRS's prescription of normalization for utility ratemaking purposes.

V. Operating Expenses

C. Potentially Contested Issues

1. Incentive Compensation

As the Companies concede, incentive compensation costs are recoverable in rates if the utility demonstrates tangible benefits to ratepayers. *In re Northern Illinois Gas Company*, ICC Docket 04-0779, Final Order of September 20, 2005 at 44; NS-PGL Init. Br. at 77-78. The Companies have not demonstrated tangible net benefits to ratepayers for the O&M cost control metric in their 2013 Non-Executive Incentive Compensation Plan ("Plan"). NS-PGL attempt to demonstrate the necessary ratepayer benefit by pointing to lower O&M expenses in previous years where the cost control metric was in place. NS-PGL Init. Br. at 79-80. However, the Companies admit that they cannot show a direct link between the O&M metric at issue and where the 2013 O&M budget has been reduced as a result of the metric. *Id*. at 80.

The Companies never address the issue of double-recovery raised in testimony (Smith, CUB-City Ex. 2.0 at 17:352-18:379) and discussed in the CUB-City Initial Brief (at 40-41). Specifically, in the event that the Companies, and IBS as a whole, do beat their 2013 O&M budgets, there is no mechanism to pass those savings on to ratepayers; therefore, there is not a *net* benefit to ratepayers.[2] Feb 4 tr. 129:5-10. There is also a significant risk to ratepayers that the incentive compensation expense related to this metric could exceed the 2013 cost reductions that would need to be achieved to justify a payout under the metric. Smith, CUB-City Ex. 2.0 at 16:323-26. The Commission should require a net benefit to accrue to ratepayers for incentive compensation in order for it to be recoverable, and should not allow the Companies'

[2] NS-PGL Vice President Mr. Schott conceded that the amount of incentives paid under the incentive compensation program should not exceed the savings created by such incentives. Feb 6 tr. 400:6-11. Staff witness Mr. Ostrander also agrees that incentive compensation expenses for which the Companies have not demonstrated tangible *net benefits* to ratepayers are not just and reasonable. Staff Ex. 3.0 at 5:83-86.

shareholders to retain savings achieved as a result of incentive compensation funded by ratepayers.

As explained in the CUB-City Initial Brief, the Plan pays out under the O&M cost control metric if O&M expenses for the Integrys family of companies, as a whole, are reduced by certain amounts, measured against the 2013 budget submitted in this proceeding. CUB-City Init. Br. at 37-38; Cleary, NS-PGL Ex. 29.0 at 7:150-56; Feb 4 tr. 124:1-12. The O&M target is a "roll-up" of the targets of all IBS affiliates. Feb 4 tr. 126:8-18. Because the Plan allows payouts under the O&M metric of the Plan whether or not NS and PGL meet their individual targets, the Companies' ratepayers are expected to pay incentive compensation even if no cost reduction is achieved for the Companies. Feb 4 tr. 127:9-15. In fact, if the costs of this metric are allowed in rates, ratepayers will have paid as if the Plan paid out, whether or not Integrys's goal is indeed met. Ratepayers have nothing to gain from funding this metric. If the Companies do not meet their goals, ratepayers have been charged as if they did, and if the Companies do meet their goals, the Companies' shareholders retain the benefits of the reduced O&M costs.

It is the Companies' burden to prove the justness and reasonableness of their proposed rates, yet the Companies have not even provided the 2013 Non-Executive Incentive Compensation Plan for review in this proceeding. The Companies cannot meet their burden by simply providing assurances that the Plan will be substantially similar to a previous incentive compensation plan. Feb 4 tr. 141:13-17. The Commission cannot approve ratepayer recovery of a plan it has not had the opportunity to review.

The Commission should be wary of the Companies' claimed benefits from this metric in previous years, given the significant O&M expense increase predicted for the test year—a 9% increase in 2013 over 2012 for PGL. NS-PGL Ex. 45.0 at 6. The Companies were unable to demonstrate that any particular savings were reflected in the O&M budget as a result of this metric, and a 9% budgeted increase suggests that such savings were not indeed anticipated in the budget.

The Commission should adopt the disallowance as discussed herein and in the CUB-City Initial Brief at 37-41 and AG Initial Brief at 58-66, to disallow of the utilities' Plan costs associated with the O&M savings metric.

2. Non-union Base Wages

For the reasons discussed in the CUB-City Initial Brief at 42 and in the Staff Initial Brief at 49-50, the Commission should adopt Staff's disallowance of this expense. The Companies' projected wage and salary escalation is not reasonable given the current market. The Commission should adopt Mr. Ostrander's reasonable non-union base wages increase, rather than the Companies' unsupported, inflated estimates.

3. Vacancy Adjustment

The Companies present very limited arguments in their Initial Brief with respect to their vacancy factor[3], and fail to acknowledge that a single position may not be filled during the test year. The Companies' position is simply not tenable. In any large company, particularly one the size of Peoples Gas, it is common to have work force vacancies at a given point in time. CUB-City Ex. 1.0, 48:364-366. Vacancies occur, and some time lag between the vacancies occurring and the positions being filled also occurs. *Id*. at 48:369-71. It is unrealistic to assume that every position will be filled. Even the Companies admit to some lag, stating that they "have filled *or are hiring* to fill" open positions. Therefore, as of March of the test year, not every position has

[3] Although the Companies' only mention the AG proposed vacancy adjustment, the Commission should note that CUB-City have also proposed this adjustment, supported by the expert testimony of Ralph Smith.

been filled. Moreover, it is likely that some employees have left unexpectedly, creating more open positions.

The Companies' arguments that every position will be filled are simply not credible given their track record of keeping the actual level of filled positions substantially below their budgeted work force levels—a fact which was true of each month of 2012 at least through September. *Id*. at 50:398-400. Additionally, the Companies' 2013 projections include additional positions, above the 2012 budgeted levels. CUB-City Ex. 2.0, 23:488-491. It is even less likely, then, that this new, higher projected 2013 work force level will be met.

The Companies offer in defense of their proposals the status of headcounts at the <u>end</u> of the year before the test year. For example, as to North Shore, they claim "as of November 24, 2012, the utility was literally just two positions below its budgeted head count and was in the process of hiring for both of those positions." NS-PGL Init. Br. at 90. Even the headcount status for a past year does not address the extended period during that year when the positions were vacant. More important, the Commission's cost determinations for setting rates must be based on test year costs. The Companies' year-end status for a different year says nothing about how long positions will be vacant (or whether they will even be filled) in the future test year. As to that critical issue, the vacancy factor calculated by CUB-City witness Smith from past performance over an entire year is a superior predictor to the Companies' report on a single date at the end of a past year.

The Commission should adopt the adjustment of CUB-City witness Mr. Smith, who calculated a vacancy adjustment for each company by averaging their actual percentage of vacant positions for the first nine months of 2012. CUB-City Ex. 1.0, 51:420-31. The vacancy rate was calculated based on the following:

- January 1 – September 30, 2012, North Shore averaged 4.5 vacant positions—a vacancy rate of approximately 2.661%. *Id*. at 51:423-424. During that time, the budgeted average of IBS full-time equivalent ("FTE") positions allocated to North Shore averaged was 1,370, but the actual filled positions averaged only 1,313—a difference of 57 vacant positions, or a vacancy rate of 4.1450%. *Id*. at 51:425-27.
- From January 2012 through September 2012, Peoples averaged 72.5 vacant positions, a vacancy rate of approximately 5.6%. The budgeted average of IBS FTE positions allocated to Peoples during that time was 1,365, though the actual FTEs were only 1,307—leaving 58 vacant FTEs. These are reflected in CUB-City Ex. 1.2, schedule C-2.

Therefore, consistent with the use of an average test year, Mr. Smith used an average of the "open positions" that the Companies had not filled at the beginning of the test year, but might fill by the end of the test year. *Id*. at 23:491-98. That methodology assumes that open positions are filled gradually during the 2013 test year. *Id*. at 491-98

The Commission should disregard the Companies' untenable (and historically implausible) claims that they will fill every budgeted position for the test year on January 1 of that year, and should instead acknowledge the fact that the Companies will have vacancies throughout the year. Mr. Smith's adjustment is necessary to reflect the reality of open positions during the test year.

4. Distribution O&M

a. Plastic Pipefitting Remediation Project

For the reasons discussed in the CUB-City Initial Brief at 44, and in the Staff Initial Brief at 51-52, the Commission should adopt Staff's disallowance of this expense, which was incurred to replace plastic fittings which the Company admits "may not have technically complied with Part 192 of Title 49 of the Code of Federal Regulations." NS-PGL Init. Br. at 90.

b. Legacy Sewer Lateral Cross Bore Program

For the reasons discussed in the CUB-City Initial Brief at 44-45, the AG Initial Brief at 72-73, and in the Staff Initial Brief at 52-54, the Commission should adopt Staff's disallowance of this expense. Had Peoples Gas replaced its pipeline prudently, these costs would not have been incurred. Therefore, the costs expended under the program are not prudent and reasonable and should be excluded from rate base. Staff Init. Br. at 54.

c. New Chicago Department of Transportation Regulations

The Companies argue that their projected costs related to Chicago Department of Transportation ("CDOT") regulations should not be based on their actual previous experience, but instead should be based on their new projections NS-PGL Init. Br. at 93. PGL has shown, however, that they grossly over-estimate the costs associated with CDOT regulations. Smith, CUB-City Ex. 2.0, 52:1154-57. Given that history of over-projecting, the Commission should require more than the scant support provided by the Companies for this significant expense. A more probable and reasonable estimate of actual 2013 CDOT regulation costs was provided by CUB-City witness Smith.

The Companies complain that "nearly all" of the new regulations begin in January 2013 as support for their estimates. NS-PGL Init. Br. at 93. Even if that were true, it has no bearing on their previous over-estimations. PGL knew when it projected 2012 costs which of those regulations would be in effect, and presumably only projected costs for applicable regulations. Even still, the Company grossly over-estimated those costs.

Furthermore, PGL stated that it is seeking clarifications from CDOT concerning many of the new regulations, and those inquiries suggest such differences between PGL's asserted expectations and actual CDOT implementation are possible. Smith, CUB-City Ex. 2.0 at 51-52:1139-41. The CDOT responses may ultimately make compliance less costly than estimated by PGL. Peoples itself does not know what its true expenses will be, as it has not indicated that it has received the clarification it sought.

The allowed level of recovery for this expense should have empirical support and should not be based on the Company's pure suppositions. The actual cost of compliance with CDOT expenses for the most recent known quarter should be used to estimate the test year costs. CUB-City witness Mr. Smith used the Company's actual expenses from October through December 2012 to compute an annualized allowance for the impact on O&M Expense resulting from the new CDOT regulations. *Id*. at 52-53:1159-62. The Companies' requested higher expense assumes (without providing a basis) that the regulations will be interpreted or applied in a manner different from the actual operation over the period they have been in effect. The Commission should reject the Company's speculative estimates and should use the empirical data available to determine the most probable level of actual test year expense.

7. Administrative and General

a. Adjustments to Integrys Business Support Costs

The Companies' defense of their costs allocated or charged to them from Integrys Business Support fails to acknowledge that their projected test year expense represents a steep increase from previous years. *See* CUB-City Init. Br. at 47. This increase is far greater than would be caused by general wage increases or inflation. Brosch, AG Ex. 1.0, 48-48:1112-21. For the reasons set forth in the CUB-City Initial Brief at 42, the AG Initial Brief at 82-89, and the Staff Initial Brief at 56-60, the Commission should adjust the test year expense for IBS to a more reasonable level.

b. Advertising Expense

The Companies continue to seek recovery of certain sponsorships that they claim are "charitable in nature." NS-PGL Init. Br. at 107. They seem to miss the point that, although they are free to support any events and organizations they choose, support that is promotional, goodwill, or institutional nature is not recoverable from ratepayers. Whether such support is "valued by the communities the Utilities serve" has no bearing on the recoverability of these costs. These expenses are expressly prohibited by Section 9-225 of the Public Utilities Act. For the reasons described in the CUB-City Initial Brief at 48 and in the Staff Initial Brief at 60-63, the Commission should adopt the adjustment proposed by Staff witness Mr. Ostrander.

c. Charitable Contributions

As it has done in previous cases, including ComEd Docket Nos. 10-0467 and 11-0721, and Ameren Docket No. the Commission 12-0001, the Commission should disallow recovery of certain charitable contributions for institutions outside of the Companies' service territories. Again, while the Companies are free to make these contributions, they are not necessarily recoverable from ratepayers. 220 ILCS 5/9-227. As the Commission noted in the Companies' last rate case, charitable contributions must be closely examined, as ratepayers are increasingly in difficult financial positions and every dollar makes a difference to a customer. ICC Docket 11-0282 Final Order of January 10, 2012 at 31. Therefore, these discretionary expenses, which do nothing for the provision of safe and reliable service, must not be made indiscriminately. And, contrary to the Companies' position, there should be more criteria than whether an individual contribution was reasonable in amount. The Commission should adopt Staff witness

Mr. Ostrander's adjustment to remove charitable contributions made to organizations outside of the Companies' service territories.

d. Institutional Events

The Companies' claim that their sponsorships are recoverable because they result in additional fundraising for institutions, "allow for dialogue between charities and the Utilities," and "foster cross-collaboration between the Utilities and the community." NS-PGL Init. Br. at 113. Those claims have no relationship to the PUA or to the findings the Commission must make in this case. Advertising expenses are expressly prohibited by Section 9-225 of the PUA, and the so-called benefits alleged by the Companies are not among the allowable contributions set forth in Section 9-227. Per Mr. Ostrander's adjustment, the Commission should disallow these sponsorships, which the Companies are free to continue making with shareholder funds.

7. Depreciation

a. Bonus Depreciation

See section VI.C.5 *supra*.

8. Invested Capital Tax Computation and Derivative Adjustments

The Companies request that the Commission not consider 2012 beginning and ending balances in determining 2013 test year invested capital. NS-PGL Init. Br. at 128. Common sense dictates that the ending balance of 2012 is a necessary component of computing the 2013 invested capital. Instead, the Companies' compute their invested capital tax using accruals of invested capital tax that, according to their original descriptions of their accounting, would be recorded in 2014. Smith, CUB-City Ex. 2.0, 13:274-14:277. The Companies admit that the invested capital return for 2013 will not be filed until 2014. NS-PGL Init. Br. at 128. That is beyond the test year and it is therefore inappropriate to base the revenue requirement on amounts that will not in fact be recorded in the test year. If Companies are permitted to alter test year costs based on their professions of a different tax treatment at a later point in time, the test year rules that allow the Commission and customers to assess utility cost of service claims from the books of account will be stymied in that purpose.

The Companies' revenue requirement should be based upon the best estimates of the amounts of Invested Capital Tax that will be on the Utilities' books during the 2013 test year. Smith, CUB-City Ex. 2.0, 12:224-27. CUB-City witness Mr. Smith's computation does just that. The Companies have agreed that the estimated tax liability amounts to be recorded as expense for Invested Capital Tax in an accounting year are based upon the amounts shown in the last year's tax return:

> **The Illinois Invested Capital tax is recorded on the books as a monthly accrual. <u>The monthly accrual is based upon last year's tax divided by twelve (months)</u>.** Additionally, quarterly estimated tax payments are made against this accrual. These quarterly estimated tax payments are also based upon last year's tax divided by four (quarters).

Smith, CUB-City Ex. 2.1 at 8-9 (emphasis added). Thus, the amount for ratemaking for a 2013 test year should in turn be based on the amounts shown on the Companies' 2012 tax returns. Smith, CUB-City Ex. 2.0, 12:228. The Companies' Invested Capital Tax amount should based on their 2012 Invested Capital Tax amount – computed in the same manner that the Companies admit they will accrue that expense (a monthly accrual of the prior year's tax divided by twelve). *Id.* The Commission should adopt Mr. Smith's well-reasoned methodology and should reject the Companies' attempt at over-estimation and over-recovery.

VI. RATE OF RETURN

E. Cost of Equity

The Companies' expert purports to estimate and recommend the Companies' market required cost of equity. Moul, PGL Ex. 3.0 at 6-7:117-120. Their Brief reveals a different path to their recommended return on equity.

First, the principal reason the Companies give for an increased equity return, even while interest rates remain very low, is what their expert calls a rising equity premium.

> Even though interest rates remain at historically low levels, the Utilities' cost of equity is increasing because the "equity premium" between interest rates and authorized ROEs for A-rated natural gas utilities is rising. NS–PGL Init. Br. at 131.

However, the "equity premium" the Companies calculate is not based on market data, but on the undetailed regulatory decisions of numerous commissions, for many different utilities, with unknown (but likely varying) risk characteristics. That measurement replicates all the flaws that have led the Commission to reject surveys of other commission's equity return awards, whenever they have been offered as evidence of the market cost of equity for a specific Illinois utility.

As explained in CUB-City's Brief, the 146 observations the Companies offer do not all measure the same thing. *See* CUB-City Init. Br. at 57. Each represents the determination of a particular commission for a specific utility, reflecting that utility's specific risks and other (unknown) circumstances. Consequently, averaging a large number of such estimates of individually distinct returns does not improve or validate the Companies' estimate of their market cost of equity. The Commission is not trying to determine a market-wide average of a category of firms, but the cost of equity for two specific Illinois utilities.

Second, the Companies' assert that those collected returns indicate that "the Utilities' request for a modest increase of their ROE to 10.00% is more in line with market expectations than either the AG's 9.45% or Staff's 9.06%." What investors <u>expect</u> after reviewing such a survey may have little to do with the Companies' actual cost of equity. Again, the Companies appear to give priority to something other than market requirements – here, what investors <u>want</u> (or <u>expect</u> after viewing a misleading survey) , instead of an estimate of what investors <u>require</u>.

Third, the Companies appear to argue for an increased return on equity based on what the Companies believe their ratepayers can afford, instead of the actual cost of equity capital. "As the economy recovers from the Great Recession, the Utilities propose a modest increase in their authorized return on equity, from 9.45% to 10.00%. That is not a valid measure of the Companies' equity cost.

Finally, the Companies again distort the process of measuring market requirements for equity investment. The Companies argue that Staff's betas do not have any bearing on market return requirements "because real investors never see or rely on them." NS–PGL Init. Br. at 145. That analysis is backwards. The proper use of market data is to measure market requirements, not to influence market behavior. Whether the Staff's measurement of relative market volatility influences the market has no bearing on whether the measurement is accurate.

The Companies' also assert that "there is a consistent downward bias in these betas, which have always been lower than Value Line betas." *Id.* As to that claim, one could with equal veracity say that there is an upward bias in the Companies' use of the Value Line betas, which are consistently above other beta estimates. The Commission should reject the Companies' suggestion that "Staff's CAPM model result should be not be considered," because of the alleged bias in its betas. However, if the Companies' argument is accepted, their logic suggests that <u>both</u> Staff's and the Companies' CAPM estimates should be ignored on that basis – a result the Companies almost certainly would not endorse.

The Companies' arguments challenging Staff's cost of equity estimates are unpersuasive. Thus, CUB-City continue to recommend the Commission adopt Staff's proposed cost of equity.

IX. RATE DESIGN

C. Service Classification Rate Design

2. Contested Issues – North Shore and Peoples Gas

The portion of the Companies' Brief that addresses the S.C. 1 bifurcation and the proposed rate designs for Chicago residential customers is small. An expansive response to that brief discussion is therefore unnecessary, and it would be improper under the Commission's Rules of Practice. 83 Ill. Adm. Code 200.800(c). However, the Commission's Rules of Practice also require that parties appearing before the Commission "must be treated fairly." 83 Ill. Adm. Code 200.25(b). When arguments on rate design issues addressed in the record are presented only in the Companies' reply briefs – when no other parties will have an opportunity to respond – the Companies gain an unfair advantage. Arguments that could have and should have been made in the initial brief should be given no weight if they arrive only when other parties are denied an opportunity to respond.

The Commission's rules expressly direct that Commission discretion should be exercised to assure parties the fairness its rules require. 83 Ill. Adm. Code 200.25. The record was complete well before briefing in this case. There is no valid non-tactical reason for a party to address only the supportive elements of the record in its initial brief. Responses to substantive challenges in the evidentiary record must be made in initial briefs, to provide a complete record that can be the "basis for a correct and legally sustainable decision." 83 Ill. Adm. Code 200.25(a). Accordingly, the Commission should give less weight (or no weight at all) to arguments that could have and should have been presented in the Companies' initial brief.

The Companies argue that "a lower fixed cost recovery level would effectively re-couple a large percentage of fixed cost recovery with the <u>amount</u> <u>of</u> <u>gas</u> that <u>customers</u> <u>use</u>, conflicting with prior Commission policy decisions." NS–PGL Init. Br. at 162. As the Companies' own ECOSS shows, a significant portion of their costs of service <u>do</u> vary with the amount of gas customers use. AG Ex. 3.0R, 7:162-164. The Companies admit that demand costs – like the significant cost of their pipes – vary with the amount of gas customers use. PGL Ex. 13.0 at 8:167.

In their Initial Brief, the Companies wield past Commission statements generally favorable to fixed cost recovery through monthly customer charges as though they articulate a policy that has no limits. The Commission's decisions should not be assumed to be so unqualified. The Commission's policy of cost-based rates still requires an appropriate allocation of a utility's accurately classified costs of service, including demand costs.

Demand costs -- which include the costs of gas delivery mains built to accommodate peak demand -- are the biggest driver of a utility's cost of service. Those demand costs should be allocated among customer classes according to the demand they place on the system, not the number of utility customers, as the Companies propose.

The fundamental justification for the Companies' rate proposal is a novel "fixed" cost category that is not a part of accepted cost of service study methodology. *See* Hoffman-Maleug, PGL Ex. 3.0 at 7-9:147-184. According to the Companies' cost of service expert:

> Costs that are classified to the demand cost element are typically allocated to the rate classes using an allocation factor based upon the rate classes' demand imposed upon the system during specific peak days.

Id. at 9:179. Moreover, the Companies' acknowledge (and apparently accept) modifications to cost allocations for relatively small cost-causation differences -- "to reflect, for example, differences in metering costs amongst rate classes." *Id.* at 8-9:178-79. Yet, despite the enormity of the demand differences among customer classes, the Companies lump all customer and demand costs – essentially all non-commodity costs -- into their novel "fixed" cost classification. They then allocate as much as possible of those costs on the basis of customer counts, with no reflection of class demand cost differences.

Just as important, the evidence of record also belies the Companies' false premise that all their costs are fixed. The Companies' ECOSS classifies a significant portion of the Companies' costs as demand related. That is, they vary to serve customer demand – or, the amount of gas customers use at peak. The Companies' cost of service expert made no effort to explain why demand costs are fixed, in any economic or practical sense, acknowledging that customer usage is related to demand and to demand costs. Feb 8 tr. 703; *see* Hoffman-Maleug, NS-PGL Ex. 33.0 at 8:182-192. The Companies contend only that, by their definition, all their costs are fixed – a label they attach to any cost not classified as a commodity cost. In the Companies' ECOSS, usage is related only to "through put" and the associated costs are classified as commodity costs. The remainder of their costs are treated the same as customer costs. This treatment is pursued even though the Companies admit that usage does create demand costs. Feb 8 tr. 705.

From this, the Companies argue that increased monthly customer charges are always an improvement to "fixed" cost recovery, notwithstanding the evidentiary contradiction from their own ECOSS. That biased approach is exacerbated by the unreliability that comes from their arbitrary working definitions. Feb 8 tr. 705. Consider also the following exchange with the Companies' cost of service expert, who conducted the Companies' ECOSS:

> "Q. I understand in the example. Could you give me a definition of fixed cost?
> A. A cost that does not change.
> Q. With what?
> A. Once it's installed with respect to an asset.

Feb 8 tr. 706. That definition would make any cost "fixed." Once money is spent or an asset installed, the cost of that transaction is a sunk cost, and it cannot change. Yet, that is the definition the Companies used to avoid recognizing the variability of demand costs in their rate structure. The implications of Commission acceptance of that peculiar definition of fixed costs is seen clearly every month in customers' fixed customer charges.

The fallacies in the Companies' cost evidence are powerful reasons not to give past Commission discussions of "fixed" cost recovery the exaggerated effect the Companies suggest. These analytical anomalies (and the consequences for customers) warrant a re-examination of the Companies' race to 100% cost recovery, using fixed charges that are beyond all customer control. *See, e.g.,* CUB-City Init. Br. at 60.

As to the Companies' proposed bifurcation of the residential class, the weakness of the Companies' evidence of compliance with the Commission's directive undercuts confidence in the Companies' proposed rate design change. More important, as Staff recognized, it calls for extra care in imposing new, unknown burdens on customers. CUB-City Init. Br. at 62. CUB-City reiterate their call for provisional approval of the bifurcation. In their next case, the Companies should be required to present evidence that the H/NH split mimics a low-use/high-use split at a reasonable degree of precision, and that it eliminates improper subsidy flows to high use customers.

a. Service Classification No. 1, Small Residential Heating

The usage and demand characteristics of the residential heating class are vastly different from those of the non-heating class. The heating class is not homogenous. In fact, it contains a considerable diversity in home sizes. AG Ex. 3.09. The utilities' rate proposals are largely driven by a desire for certainty of recovery, rather than an appropriate and fair allocation of costs caused by this class, and their proposals do not recognize the diversity of the class usage.

AG witness Rubin testified that it is improper to recover demand-related costs on a per-customer basis except in the rare case when a customer class is relatively homogeneous, as with PGL/NS's non-heating customer classes. Utility witness Grace claims that, "[w]hile not yet completely matching fixed costs and fixed charges, Peoples Gas' [and North Shore's] proposed rates will provide more balance than its present rates and will send more appropriate price signals to customers about the fixed costs underlying its delivery service." PGL-NS Ex. 12.0, 10:206-209. This perspective, however, illustrates the utilities' failure to recognize the large disparities within the heating class and to appropriately design rates that recover the substantial demand-related costs that the utilities incur to serve heating customers.

There does not appear to be any material dispute between the Companies' secondary proposal for the residential non-heating class and AG witness Rubin's proposal, which both maintain a flat customer charge with no distribution charge. This is an acceptable rate design only in this rare instance of a homogeneous class, where usage varies little from customer to customer. AG Ex. 3.0, 17:370-373. With consumption varying by just a few therms from customer to customer and from month to month, it is reasonable to simplify customers' bills, eliminate the over-collection of storage-related costs, and adopt a flat rate. *Id.* at 17:376-379. The simplicity of this approach is preferable to the Companies' primary residential non-heating proposal, which would recover 80% of non-storage related fixed costs through the customer charge with recovery of all remaining costs through a flat distribution charge. *Id.*

b. Service Classification No. 1, Small Residential Heating

Like the Companies Initial Brief on the subject of bifurcation of S.C. 1, the Companies provide equally short shrift to the various rate design proposals for the residential heating class. Other than bald references to testimony on the subject, the utilities do not provide any explanation of, let alone justification for their primary proposal to substantially increase the customer charge for residential heating customers and move these customers to a flat distribution charge. NS-PGL Init. Br. at 158. In their Initial Brief, the Companies do not bother to provide any details of their proposal other than the fact that it would recover 80% of non-storage related fixed costs through the customer charge and all remaining costs through a flat distribution charge. *Id.* The utilities failure to make an evidentiary presentation that substantiates what was a hotly contested and heavily litigated proposal, without even a mention of AG witness Rubin's countervailing proposal or the evidence supporting it, should earn the Companies' proposal little to no weight. The utilities only argument against Staff's proposed rate design is that it is "too modest in light of Commission policy on this matter." NS-PGL Init. Br. at 159. The Companies do not present evidence regarding the specific bill impacts of their proposal and do not specifically refute claims by Staff and AG witnesses regarding the impropriety of the Companies' proposal for S.C. 1 heating customers. Again, arguments that could have and should have been made in the initial brief should be given no weight if they arrive only when other parties are denied an opportunity to respond.

In justifying the Companies' requested rate design for the residential heating class, the Companies broadly claim it is "consistent with the Commission's directive to present a bifurcated S.C. No. 1, shows reasonable movement towards greater fixed cost recovery through fixed charges, and includes a flat distribution rate, which is appropriate based on the bill impacts associated with this change." NS-PGL Init. Br. at 159. Each of these unsubstantiated points must be rejected, as the evidence in this proceeding undermines each claim.

First, the Commission's "directive" was not to simply present a bifurcated S.C. No. 1. Contrary to the Companies' suggestions, the Commission in the Companies' last rate proceeding directed the Companies to "present an ECOSS to distinguish between low use and high use S.C. No. 1 customers. Such proposals may include, without limitation, a rate design including a demand charge or a bifurcation of the S.C. 1 class into heating and non-heating classes or some other rate structure that better reflects customer class homogeneity to bring each group's bills more into line with their respective costs of service." ICC Docket No. 11-0280, 11-0281, Order at 188-89. As pointed out in CUB-City's Initial Brief, the Companies failed to produce the type of analysis required by the Commission's order and, instead, simply proposed a bifurcation of the residential class to allegedly address the Commission's concerns. CUB-City Init. Br. at 56. The Companies did not perform a thorough examination of the usage characteristics throughout the residential class.

Second, the notion that all the Companies costs are fixed, do not vary with demand and therefore must be recovered through fixed charges is belied by the evidence in this record, as shown in Section IX.C.2. above. It is demand that largely drives utility costs, yet the utilities' proposal suggests that demand should not be considered in developing a rate structure for residential customers. By asserting that all costs are "fixed," the presumption is that each customer in the residential heating class causes the same costs to be incurred. AG witness Rubin examined the reviewed the U.S. Census Bureau's American Housing Survey for Chicago for the S.C. 1 heating customer base and determined that it is widely divergent, with homes range in size from fewer than 1,000 square feet (8.5% of homes) to 412 more than 4,000 square feet (6.7% of homes). AG Ex. 3.07. The Companies' proposals neither recognize nor appropriately recover the substantial demand-related costs that they incur to serve heating customers. Ex. 3.0, 22:485-90. Except in the rare case when a customer class is relatively homogeneous, it is improper to recover demand-related costs on a per-customer basis. *Id.* This is the flaw that led to the Companies' existing rates that greatly over-recover costs from non-heating customers. *Id.*

Third, the Companies make the base claim that a flat distribution charge is appropriate based on bill impacts resulting from this change without providing the details of those supposedly "favorable" bill impacts. NS-PGL Init. Br. at 158. AG witness Rubin showed, however, that the residential heating class is a very divergent one with widely varying consumption patterns. AG Ex. 3.0, 18-19:406-18. Thus, a two-block volumetric rate structure sends the appropriate demand-related price signal to customers, while providing the utilities with significant stability in the recovery of those revenues. *Id.* at 20:437-40. As Mr. Rubin testified, "if the customer charge is set to recover only customer-related costs, and if demand- and commodity-related costs are recovered on a per-therm basis, then it is possible to have a non-homogenous class with cost-based rates that do not result in significant cross-subsidies within the class." AG Ex. 6.0, 8:150-53.

For all the reasons stated in CUB-City's Initial Brief, therefore, AG Witness Rubin's rate design proposal is the most supportable in this record and should be adopted by the Commission.

c. Alternative Conditional SFV Rate Design

In their Initial Brief, CUB-City addressed the substantial procedural and legal infirmities of the utilities' conditional tariff, which would provide for a 100% SFV rate design to be triggered by events that occur outside of this proceeding, at some later unknown date. CUB-City Init. Br. at. 70-73. CUB-City need not repeat those same arguments here. However, the utilities novel argument regarding the reasonableness of the conditional tariff, (NS-PGL Init. Br. at 159-161) and the process by which it would be triggered (which not even their own rate design witness could not describe) deserve attention. The Companies argue that, since the Commission approved Rider VBA to become permanent in Docket No. 11-0280, anything less than 100% of fixed cost recovery in the customer charge "would not result in the level of decoupling approved by the Commission in the 2011 rate cases." NS-PGL Init. Br. at 160. The utilities again attribute far more to the Commission's 2011 rate order than can reasonably be ascertained.

The Commission did not generally approve of "decoupling" by any means necessary. The Commission is bound by the record in the proceeding before it, and each "finding, decision or order made by the Commission shall be based exclusively on the record for decision in the case." 220 ILCS 5/10-103. The Commission specifically reviewed Rider VBA in light of the prior tariff's track record as a 4-year long pilot. While CUB-City disagree the evidence supported the Commission conclusions regarding the propriety of Rider VBA and the revenue assurance it provides, and again argue here that the evidence undermines the validity of it, the Commission approved *Rider VBA* and nothing more. As it must, the Commission based its decision on the record in that proceeding regarding whether Rider VBA, as proposed and as had been in effect in the previously-approved pilot, should be approved on a permanent basis. The Commission did not find that decoupling – in any form – was generally adopted, nor could it. As the Companies themselves admit, there are several forms of decoupling aside from a Rider VBA or SFV rates. NS-PGL Init. Br. at 161. The Commission was aware that CUB and the AG had appealed the originally-approved Rider VBA pilot (from Docket No. 07-0242) when it made Rider VBA permanent, but did not provide for any contingent plan in case Rider VBA was invalidated. The Commission discussed the mechanics specific to Rider VBA and the results of the pilot in approving the rider as a permanent mechanism, specifically referring to the rider's symmetrical nature in support of its conclusion. 11-0280 Order at 163-64. Only Rider VBA was at issue in 11-0280, <u>not</u> unconditional support for decoupling.

D. Fixed Cost Recovery and Rider VBA

Rather than provide data justifying the need for and propriety of increasing their fixed charges for S.C. Nos. 1 and 2, the Companies essentially rely on the argument that "everyone else has it, so we should, too." The Companies argue that since the Commission approved partial decoupling (80% fixed cost recovery) for Ameren Illinois Company and Northern Illinois Gas Company d/b/a Nicor Gas Company, the Companies' S.C. No. 1 heating customers "would be the only small residential rate class with lesser fixed cost recovery among the state's large gas utilities." NS-PGL Init. Br. at 162. This argument again ignores the Commission's obligation to base its decision exclusively on the record in this proceeding, 220 ILCS 5/10-103, but also fails to present compelling data or other reasons to refute the evidence demonstrating the impropriety of this approach being applied here – evidence not present the other cases.

AG witness Rubin examined the demand costs for the residential class and determined that significant amount of system costs are driven by demand, which undermines the claim that all the utilities' costs are fixed and do not change with usage. Rubin, AG Ex. 3.0, 7:164-65. Thus, the very high customer charges that result from SFV rates are wholly unrelated to the cost of service and are grossly unfair to low-use customers. *Id.* at 7:162-164. Mr. Rubin further testified that decoupling removes the incentive to maintain a reliable system that is capable of meeting 100% of customers' demands for gas service. *Id*. at 28:620-621. Adoption of Rider VBA (or its alternative) is based on the incorrect assumption that all of the Companies' costs are fixed, and that customer demand does not drive costs, assumptions proven incorrect in this record. It should not be problematic, then, that "a lower fixed cost recovery level would effectively re-couple a large percentage of fixed cost recovery with the amount of gas that customers use," (NS-PGL Init. Br. at 162), because these costs should never have been decoupled in the first place.

XI. CONCLUSION

WHEREFORE, CUB and the City respectfully request that the Commission adopt the positions and adjustments set forth in this brief, their Initial Brief, and in CUB-City Initial Brief Attachments 1 and 2.

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Respectfully Submitted,

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