STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

North Shore Gas Company	:	
	:	**Docket No. 12-0511**
Proposed general increase in rates for gas distribution service	:	
	:	**(cons.)**
The Peoples Gas Light and Coke Company	:	
	:	**Docket No. 12-0512**
Proposed general increase in rates for gas distribution service	:	

REPLY BRIEF OF THE
STAFF OF THE ILLINOIS COMMERCE COMMISSION

JESSICA A. CARDONI
JOHN C. FEELEY
NICOLE LUCKEY
ANGELIQUE PALMER
Office of General Counsel
Illinois Commerce Commission
160 North LaSalle Street, Suite C-800
Chicago, IL 60601
Phone: (312) 793-2877
Fax: (312) 793-1556
jcardoni@icc.illinois.gov
jfeeley@icc.illinois.gov
nluckey@icc.illinois.gov
apalmer@icc.illinois.gov

Counsel for the Staff of the
Illinois Commerce Commission

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

I. INTRODUCTION

A. Overview/Summary

The Initial Brief of the Staff of the Illinois Commerce Commission ("Staff's Initial Brief" or "Staff IB") was served on March 8, 2013. The Initial Brief of North Shore Gas Company ("North Shore") and the Peoples Gas Light and Coke Company ("Peoples Gas") (individually, the "Company" and collectively the "Utilities" or "Companies") ("NS-PGL IB", "Utilities' IB", or "Companies' IB"), the Initial Brief of The People of the State of Illinois *ex rel.* Lisa Madigan, Attorney General of the State of Illinois (the "AG") ("AG's Initial Brief" or "AG IB"), the joint Initial Brief of Citizens Utility Board ("CUB") and the

City of Chicago ("City") (jointly "CUB-City") ("CUB-City's Initial Brief" or "CUB-City IB"), and the Initial Brief of Interstate Gas Supply of Illinois ("IGS") ("IGS's Initial Brief" or "IGS IB") were also served and filed on March 8, 2013.

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

II. TEST YEAR (Uncontested)

III. REVENUE REQUIREMENT

Corrections Reflected in Reply Brief Appendices

Staff's Reply Brief includes Appendices A and B, which correct two errors made in both of Staff's Appendices A and B previously attached to Staff's Initial Brief. Staff's Reply Brief also includes Appendix C for Peoples Gas only, which is Staff's final recommendation for Peoples Gas, which is discussed further below and in Section IV. C. 5. Net Operating Loss.

Correction 1 is reflected on page 11 of both Appendices A and B. Since Staff's position is that the final approved rate base be reflected on an average basis, it is necessary to adjust the Companies' surrebuttal net operating loss ("NOL") deferred tax assets for the effect of the revenue increase to the adjusted deferred tax asset balances on an average rate base methodology. Staff's Initial Brief appendices inadvertently calculated the NOL adjustment using a year end rate base methodology. The correct adjustment, therefore, is the difference between the NOL per Staff, after the effect of the revenue increase, compared to the Companies' NOL at Surrebuttal. Staff has still included the NOL adjustment on a year-end basis should the Commission reject Staff's position.

Correction 2 is reflected on page 1, lines 20 and 21 of both Appendices A and B. The correction reflects the fact that the NOL is solely related to federal income taxes, thus it is inappropriate to adjust state income tax expense for the NOL.

For North Shore, since the effect of the revenue increase adjusts North Shore's NOL deferred tax asset to zero, Corrections 1 and 2 have no effect, other than presentation, on the revenue requirement recommendation. (Staff IB, p. 3)

For Peoples Gas, correction of these errors results in a revenue requirement of $563,641,000 as reflected on page 1 of Appendix B to Staff's Reply Brief, which is a net decrease of $587,000 from Staff's Initial Brief recommendation. The total increase to base rates is $15,548,000 and an increase of $809,000 to other revenues for a total increase of $16,357,000 (2.99%). The overall increase reflected in Appendix B is $81,448,000 less than the $97,805,000 increase requested by the Company in surrebuttal.

<u>Further Changes Necessary to Revenue Requirement Schedules</u>

Since filing its Initial Brief, Staff has become aware that the inclusion of the 2012 NOL deferred tax asset in the Companies' surrebuttal schedules has not been fully incorporated into all Staff adjustments which affect the NOL and deferred tax expense. This is a result of the 2012 NOL amounts not being presented in testimony until the Companies' surrebuttal schedules. While Staff did not oppose inclusion of these amounts initially, Staff now concludes there are several iterative calculations necessary to reflect the Companies' intent to include both 2012 and 2013 NOLs in the revenue requirement calculations. The Staff calculations affected by the Companies' 2012 NOL include at a minimum:

1. Staff Witness Seagle Adjustments (Staff Ex. 24.0, Sch. 24.07 P Rev.) (Peoples Gas only)
2. Non-AMRP Gas (Staff Cross Ex. 11) (Peoples Gas only)
3. Non-Union Wages (Staff Ex. 25.0, Sch. 25.01 N and P) (Both Companies)

Staff is also aware that the AG recommends that the 2012 NOL be disallowed in its entirety. (AG IB, p. 42) Therefore, the Commission decisions on the three above adjustments as well as the 2012 NOL issue will affect the final revenue requirement determinations for Peoples Gas.[1] Due to the inter-related nature of these four issues and their effects on the 2013 NOL deferred tax asset adjustment on page 11 of Appendices A and B, Staff is not able to present all scenarios of revenue requirements that are possible as these calculations have not been entered in evidence. As the AG noted in its Initial Brief, the Company did not present an adequate explanation in testimony for the basis for the NOL, the amounts of the adjustments or how they impact rate base. (AG IB, pp. 43-44) After further consideration of the AG's proposal Staff now recommends that the Commission reject the Companies' late inclusion of the 2012 NOL. Based upon a review of the evidence in the record Staff's position is that there is

[1] North Shore's revenue requirement most likely would not be affected by the above calculations since the effect of the revenue increase eliminates the NOL deferred tax asset, as reflected on Appendix A to Staff's Reply Brief, p. 11.

insufficient detail in the record to calculate all affected calculations resulting from such 2012 NOL. The effect of the Commission accepting the AG's position on the 2012 NOL is calculated on page 15 of Appendix C. See also Section IV. C. 5. Net Operating Loss.

Therefore, for Peoples Gas, Staff now recommends a revenue requirement of $560,198,000 as reflected on page 1 of Appendix C to Staff's Reply Brief, which is a net decrease of $4,030,000 from Staff's Initial Brief recommendation. The total increase to base rates is $12,105,000 and an increase of $809,000 to other revenues for a total increase of $12,194,000 (2.36%). The overall increase reflected in Appendix C is $84,891,000 less than the $97,805,000 increase requested by the Company in surrebuttal.

A. North Shore

Staff recommends a revenue requirement of $81,089,000 as reflected on page 1 of Appendix A to Staff's Initial Brief and Reply Brief.

Staff recommends an increase to base rates of $3,346,000 and an increase of $39,000 to other revenues for a total increase of $3,385,000 (4.36%).

Staff's overall recommended increase is $6,224,000 less than the $9,609,000 increase requested by the Company in surrebuttal.

B. Peoples Gas

Staff recommends a revenue requirement of $560,198,000 as reflected on page 1 of Appendix C to Staff's Reply Brief.

Staff recommends an increase to base rates of $12,105,000 and an increase of $809,000 to other revenues for a total increase of $12,914,000 (2.36%).

Staff's overall recommended increase is $84,891,000 less than the $97,805,000 increase requested by the Company in surrebuttal.

IV. RATE BASE

A. Overview/Summary/Totals

1. North Shore

Staff recommends a rate base of $195,783,000 as reflected on page 5 of Appendix A to Staff's Initial Brief and Reply Brief. Staff's recommendation is $13,333,000 less than the $209,116,000 rate base requested by the Company in surrebuttal.

2. Peoples Gas

Staff recommends a rate base of $1,279,108 as reflected on page 5 of Appendix C to Staff's Reply Brief. Staff's recommendation is $380,163,000 less than the $1,659,271,000 rate base requested by the Company in surrebuttal.

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

1. Cushion Gas Calculation

2. Plant

a. Forecasted Test Year Capital Additions – Utility Plant in Service (PGL)

b. Advanced Metering Infrastructure Project

c. LNG Control System Upgrade and Related Project (PGL)

d. Calumet System Upgrade (PGL)

e. CNG Fueling Station (PGL)

f. Incentive Compensation – capitalized amounts disallowed in prior cases

g. Original Cost Determination as to Plant Balances as of December 31, 2011

3. Budget Plan Balances

4. Accumulated Deferred Income Taxes - 50/50 Sharing Related to Tax Accounting Method Change

C. Potentially Contested Issues (All Subjects Relate to NS and PGL Unless Otherwise Noted)

1. Year End Rate Base or Average Rate Base

Staff has not changed its position on this issue. The Commission should adopt Staff's adjustments to compute rate base on an average methodology, since Staff's method takes into account that investments are made throughout the test year, rather than adopt the Companies' method of a year-end rate base which inappropriately assumes, for rate setting purposes, that all investments are made on the first day of the test year. (Staff IB, p. 12)

The Companies make three general arguments in an attempt to justify their proposal that the Commission should depart from its consistent practice of using an average rate base with a future test year. The Companies argue that: (1) the Commission's rule codified as 83 Ill. Adm. Code 285.2005(e) ("Part 285") permits use of a year-end rate base in a future test year rate case; (2) the rates being set in these cases will not go into effect until July 2013, which means that the Companies will only 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 Companies' 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 IB, p. 19)

The Companies' first point relies upon a misinterpretation of the Commission's rules, and is not determinative of how the Commission should handle this issue. Part 285 does not dictate the type of rate base that the Commission must use to calculate a revenue requirement, rather, its purpose is to provide standard information requirements that are designed to assist the Staff of the Commission to review filings for tariffed rate increases under Sections 9-201 and 16-108 of the Act. However, Part 285 does assume that rate base components will be based upon average data for a future test year while also contemplating something other than average data to determine rate base components as the Companies suggest. ("If the rate base components of a future test year are not derived from average data for the test year or from monthly average data, provide work papers supporting Schedule B-1 that reflect the 13 month-end balances of all rate base items commencing with the month-end balance for the month prior to the beginning of the test year and ending with the month-end balance for the last month of the test year." (83 Ill. Admin Code Section 285.2005(e)) Regardless of this quoted language, the Companies' first argument is unavailing. The primary purpose of Part 285 is informational in nature and in fact Part 285 expressly states that "[T]hese standard information requirements do not bind the Commission to a decision based solely on the data provided pursuant to this Part, and parties and Commission Staff may seek additional information through discovery." (83 Ill. Adm. Code Section 285.110) As discussed above, Part 285 provides for work paper requirements supporting Schedule B-1 in the event components are not based on average data for a future test year selected by the Companies. (Staff Ex. 2.0, p. 10) Thus, if the Companies file a future test year, but do not propose an average rate base, the Companies are still required to provide the information so that an average rate base can be computed. Part 285 adds no value to the Companies' argument and clearly does not support the assertion that a year-end rate base should be used in the current proceeding.

The Companies' second point regarding the likely effective date of the tariffs also is not determinative as to whether an average or year-end rate base should be used. (Staff IB, pp. 14-15) Using a year-end rate base would allow the Companies to earn a return on investments before the investments have been made and continue to earn that return until the Companies' next rate case. (Staff IB, p. 12) The Companies' complaint about experiencing the revenue impact of any rate increase for at most half of 2013 rings hollow. (NS-PGL IB, p. 20) The Commission order in Docket Nos. 11-0280 & 11-0281 (Cons.), the Companies' most recent rate cases entered January 10, 2012, did not set the existing rates for a specific single year as the Companies' arguments imply. The Commission sets rates for a "normal" or a "representative" year. Also, in the prior rate cases, the Companies assumed that rates were being set for a two-year period since rate case expenses were amortized over a two-year period. (Order, Docket No. 11-0280/0281 (Cons.), January 10, 2012, pp. 74, 76 ("The Company seeks amortization of [rate case] expenses over a two year period.") and ("The Commission notes that the only dispute between Staff and the Utilities regarding the rate case expenses of the instance cases is Staff's proposal to disallow $39,000 as to North Shore and $54,000 (amortized as $21,000 and $29,000) as to Peoples Gas which reflect incentive compensation amounts relating to the Non-Executive Incentive Compensation program included in the amounts relating to IBS personnel.“)) Unless a utility files a rate case annually or files formula rates annually based upon actual costs, there will always be a period of time in which rates will be recovered that is outside of a “test year”. The rates set in the Companies’ prior rate cases were not based on the Companies’ actual costs for the test year, but based on projected costs for a “normal” test year, 2012, and rates being charged in 2013 are still based upon that test year of 2012.

To avoid the issue that the likely effective date of the tariffs will be six months after the end of the test year, the Companies could have selected a future test year with an ending date as far out as July 31, 2014. The selection of a future test year ending July 31, 2014 would have caused the likely effective date of the tariffs to be over a year before the ending date of the test year. The Companies argue that, as a practical matter, this option was not chosen because preparing and filing a test year that is not the calendar year or the utility’s fiscal year is difficult. (NS-PGL IB, p. 23) How the Companies could know this is not evident since the Companies did not make an estimate of the cost of preparing forecasts for a non-calendar year test period; did not quantify the monetary affect of using a calendar test year that would not align the test period and the period rates were in effect; and did not perform a cost benefit calculation to determine if preparing a test year that aligned with the period rates were in effect was worth the effort. (Staff IB, p. 14)

The Companies’ third point, that a year-end calculation will result in setting rates that better match the Utilities’ cost of service during the period rates are in effect, is incorrect as a year-end calculation will result in a mismatch between rate base and operating expenses. The Companies' year-end rate base would only be appropriate if all 2013 investments were made at the beginning of the test year. An average rate base derives rates that properly match test year revenues and expenses which will occur throughout 2013 with the level of rate base investment also occurring throughout the year. A year-end rate base would derive revenues and expenses for 2013 which represent a level of investment that would not exist until the end of 2013. (Staff IB, p. 12)

The Companies seem to believe that rates should be set by considering costs expected to be incurred after the test year. The Companies would set rates to recover fully their costs of service anticipated to be incurred during the period in which the rates will be in effect, ("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 IB, p. 19) "The Staff and intervenor focus here is on the test year costs, without regard to when the rates being set will go into effect"), (*Id.*, p. 25), rather than, as Staff discussed above, a "normal" or a "representative" year. The period in which the rates will be in effect is the period beginning July 2013 and ending at an unknown date when rates from the Companies' next rate cases go into effect. In order for a rate base at December 31, 2013 to be appropriate, it would have to be the average rate base for a test year ending June 30, 2014; including revenues and expenses for that test year.

A test year ending June 30, 2014, which would support a December 31, 2013 rate base, includes the period from January 1, 2014 through June 30, 2014. The period from January 1, 2014 through June 30, 2014, is outside of the Companies' chosen test year and not in the record evidence. 220 ILCS 5/10-103 requires the Commission to make its findings based exclusively on evidence in the record. ("… any finding, decision or order made by the Commission shall be based exclusively on the record for decision in the case, which shall include only the transcript of testimony and exhibits together with all papers and requests filed in the proceeding, including, in contested cases, the documents and information described in Section 10-35 of the Illinois Administrative Procedure Act)" (220 ILCS 5/10-103)

Finally, as an alternative, the Companies proposed a rate base which is the average of Staff's proposed June 30, 2013 average rate base and the Companies' proposed December 31, 2013 year-end rate base. This "three-quarter average" rate base as of September 30, 2013 causes the same type of mismatch between rate base and operating expenses as does the Companies' proposed year-end rate base as discussed above.

The Companies' belated alternative proposal, to use a rate base as of September 30, 2013, was introduced in the Companies' surrebuttal testimony. This proposal is not a valid alternative and is without precedent and without support. It was presented after the period of time in which the parties would have had any opportunity to consider or investigate the alternative had passed. Further, even the Companies' witness Hentgen, who offered the proposal, did not offer testimony in its support. (Staff IB, p. 16) (AG IB, p. 18)

2. Plant

a. Forecasted Test Year Capital Additions – Utility Plant in Service (NS)

Staff has not changed its position on this issue. The Commission should reduce North Shore's forecasted test year capital additions to reflect a level that is likely to be spent based on the Company's historical spending pattern. The reduction is necessary to reflect the Company's inability or unwillingness to incorporate into its forecast an allowance for unforeseen changes that history has shown to result in less actual capital expenditures than budgeted. (Staff IB, p. 16)

North Shore contends that Staff's adjustment does not reflect North Shore's experience with public improvement projects. To the contrary, the basis of Staff's adjustment is the Company's experience, in particular its inability to predict the rescheduling or delay of public improvement projects. North Shore has not provided any reason to persuade Staff that public improvement projects will not be rescheduled or delayed in the future. Staff used a three-year average of the Company's spending pattern to provide a historical basis on which to adjust planned capital expenditures for changes of plans and/or circumstances beyond the control of North Shore. (Staff IB, p. 17)

North Shore suggests averaging a different, longer period as the basis for determining a level for capital spending in 2013. (NS-PGL IB, p. 26) Obviously, if one thought that Staff's appropriate three-year period produced undesirable results, one could pick and choose among various alternatives until the desired result is produced. However, Staff's more recent three-year period better represents the Company's current operations and provides a more suitable basis on which to predict North Shore's future capital spending. (Staff IB, p. 17) In an attempt to justify using this other period, North Shore cites to the Utilities' 2007 rate cases, where the Commission discussed spending for awards and damages. (NS-PGL IB, p. 26) Staff can find no apparent link between the predictability for capital spending and the predictability for spending for injuries and damages and this reference adds nothing to the Company's argument on this issue.

b. Accelerated Main Replacement Program Projects (PGL)

i. Section 8-102 Investigation of AMRP

The Commission should adopt Staff's recommendation for a Section 8-102 investigation of Peoples Gas' Accelerated Main Replacement Program ("AMRP") as presented in Staff witness, Mr. Buxton's Rebuttal Testimony. (Staff Ex. 20.0; Staff IB, pp. 17-22) In its initial brief, the Company has provided excuses for its mistakes, but has provided no persuasive argument to explain away Staff's concerns.

Peoples Gas opposes Staff's recommendation for an investigation of Peoples Gas' AMRP in its Initial Brief (NS-PGL, IB, pp. 27, 36, and 38), complaining that it is merely a victim of circumstance where runaway AMRP costs and scheduling problems are concerned. More specifically, the Company calls the rocks it encountered while excavating in 2012, Chicago's trench shoring requirements, Chicago's cross bore program, and the actual underground conditions that Peoples Gas' work crews found while digging "unforeseen," and states that Staff does not contest that point. (*Id*., p. 32) Staff agrees with the premise of the Company's argument, i.e. that the Company did not foresee these problems. However, there is a distinct difference between the terms "unforeseen" and "unforeseeable," and all the "permitting, coordination, and material delivery issues," (*Id*., p. 36), which the Company blames for its increased costs and scheduling problems were *not* unforeseeable. Staff does not contest that Peoples Gas did not foresee the problems it encountered, but Staff believes that Peoples Gas had the ability to foresee most of the problems, if it had tried.

Conditions underground are, in fact, knowable and can be foreseen with adequate preparation. In fact, this is the precise justification for Staff witness Mr. Buxton's suggestion that the following be included within the scope and nature of the recommended investigation: "Assess and evaluate Peoples' use of subsurface utility investigation services and geophysical techniques like ground penetrating radar, computer assisted radar tomography, vacuum excavation, etc. to help with project design, identification of underground obstacles, and with construction permits that do not require modification." (Staff Ex. 20.0, p. 6) It is imperative that the Company take full advantage of such investigative services and techniques going forward to avoid additional "unforeseen circumstances" from further delaying the AMRP.

Peoples Gas argues that with regard to cross bores, "the Utilities have sound procedures and practices" (NS-PGL IB, p. 92), but given that requirements discussed by Staff witness Mr. Darin Burk were not followed by the Utilities, this cannot be the case. Mr. Burk, when discussing Peoples Gas' cross boring of Chicago sewers stated, "It is my opinion that the fact that PGL has identified locations where gas pipelines have been bored through sewers (NS-PGL Ex. 28.0 Rev., pp. 6-7) establishes that the PGL procedures were either inadequate or not followed." (Staff Ex. 19.0, p. 5) Mr. Burk explained the requirements placed on a utility that uses directional drilling.

> A prudent operator must have procedures that allow for the positive identification of the location of all underground utilities and substructures when directional drilling or boring is to be used for the installation of gas

> pipelines. Even when the approximate location of an underground facility has been identified and marked, the depth of the facility must be confirmed to avoid contact during the directional drilling process. The procedures must include methods to confirm that spatial separation of utilities has been maintained. (*Id*., p. 4)

Peoples Gas witness, Mr. Kyle Hoops described Peoples Gas' cross bore practices and procedures in his Supplemental Direct Testimony. (NS-PGL Ex. 20.0, p. 6) Nowhere in that description does Mr. Hoops state that Peoples Gas' procedures included "methods to confirm that spatial separation of utilities has been maintained" and current circumstances make it clear that Peoples Gas' procedures did not maintain spatial separation of utilities. If they had, Peoples Gas would not now be finding and repairing cross bores for three percent of its gas mains and services. (*Id*. p. 7)

Peoples Gas complains that Staff does not understand its AMRP plans and goals, is not aware of the AMRP work that Peoples Gas has completed, and thus Staff's criticisms of its AMRP are based on a false premise. (*Id*. pp. 35-38) Peoples Gas protests that it has been busy preparing to begin AMRP work since making its original proposal in 2009 and that everything is going according to plan. (NS-PGL, IB, pp. 36-38)

Peoples Gas seems to have an excuse for every criticism of its AMRP. However, Peoples Gas has not explained how it will complete its AMRP in 20 years nor has it explained how much the AMRP will cost ratepayers. There is no reconciliation between the high-cost, behind-schedule history of the AMRP and the Commission expectations for the AMRP's future. Staff believes that it is imperative that the Commission is informed of whether Peoples Gas can complete its AMRP at a reasonable cost and within a reasonable time. (Staff IB, pp. 17-18)

Staff's recommended Section 8-102 AMRP investigation is not unnecessary, despite the Company's arguments to the contrary. (NS-PGL IB, p. 38) Staff believes the AMRP's history makes an investigation absolutely necessary. CUB is also concerned about the future of Peoples Gas' AMRP. CUB points out in its IB that Peoples Gas no longer considers itself bound by its commitment to complete the main replacement program on an accelerated schedule and has made AMRP plans that end with 2013, Peoples Gas' rate case test year. (CUB IB, p. 21, *Tr*., Feb 6, 2013, pp. 416-418) CUB also reminds us that Peoples Gas has already curtailed AMRP work due to budget considerations and that Peoples Gas plans to continue prioritizing its budget over the AMRP work in the future. (*Id*.) Further, CUB points out that Peoples Gas has conditioned the AMRP's future on the rate relief that the Commission grants. (*Id*.) Staff agrees with these points and believes that they provide even more justification for Staff's proposed investigation. The Illinois Attorney General supports Staff's recommendation for an investigation of Peoples Gas' AMRP in its Initial Brief.

> The People support Staff witness Buxton's proposal to engage an independent audit of the Company's expenses, methodology, and work plans. The Commission has clear authority under Section 8-102 and general authority under Section 8-505 of the Act to ensure "to require every public utility to maintain and operate its plant, equipment or other property in such manner as to promote and safeguard the health and safety of its employees, customers and the public… ." 220 ILCS 5/8-505.

(AG IB, p. 2)

The Commission has no other option than to learn from an independent source what the AMRP is likely to cost, how long it will take to complete, and to get answers to the thirty-one other important issues listed in Mr. Buxton's rebuttal testimony. (Staff Ex.

20.0, pp. 4-8) Staff continues to recommend that the Commission adopt Mr. Buxton's recommendation for an investigation of Peoples Gas' AMRP.

ii. AMRP Adjustment

Staff maintains its position on this issue. (Staff IB, pp. 22-28) The Commission should adopt Staff's recommendation to exclude certain costs associated with Peoples Gas' AMRP from its base rates. Specifically, the Commission should exclude of $95,794,000 in 2012 and $122,804,000 in 2013 from Peoples Gas' requested rate base addition for AMRP costs. (Staff Ex. 16.0, p. 22)

Peoples Gas disagrees with the basis for Mr. Seagle's recommendations. Peoples Gas states that it has demonstrated that (1) it has met the scheduled work for 2012, (2) it can reasonably forecast costs, and (3) it can prudently manage AMRP projects. (NS-PGL IB, p. 30) Staff continues to disagree. Further, Peoples Gas in its Initial Brief misinterprets a key element of Mr. Seagle's basis for proposing this adjustment.

Regarding Peoples Gas' first statement that it has met its scheduled work for 2012, Mr. Seagle agrees that Peoples Gas did meet its "revised" cost estimate, but only because it curtailed its 2012 AMRP work schedule in October of that year. (*Id*., p. 32) Further, Peoples Gas' claim completely ignores the fact that it had to severely decrease the miles of main it would replace, by roughly half, without any corresponding cost reduction. Further, the Company's actions also risk further delays in completing the AMRP in a reasonable time frame. Relative to this contention, Mr. Seagle explained his major concerns with Peoples Gas' construction methodology in detail in Staff's Initial brief. (Staff IB, pp. 23-25)

The record shows that Peoples Gas' second statement, that it can forecast its AMRP cost, is inaccurate. As Staff explained in detail in its Initial Brief, Mr. Seagle found that Peoples Gas only finished about *half* of the AMRP work it planned to complete, but incurred approximately the same capital costs. In other words, AMRP project costs per mile were almost *double* Peoples Gas' projections. (Staff Ex. 6.0, pp. 39-40) (Staff IB, p. 26) Further, Peoples Gas draws an inaccurate inference from Mr. Seagle's position that he agrees that the costs for the 2012 AMRP projects reflected in rate base represents work actually completed. (NS-PGL IB, p. 35) Peoples Gas ignores Mr. Seagle's position that the costs although accurately reflected in rate base are not necessarily prudently incurred. As stated previously, Peoples Gas only finished about *half* of the AMRP work it planned to complete, but incurred approximately the same capital costs. (Staff Ex. 6.0, pp. 39-40) This simple fact serves to demonstrate that Peoples Gas is unable to reasonably forecast costs associated with the AMRP work.

In its third statement, Peoples Gas' asserts that it can prudently manage the project but fails to acknowledge its own decisions regarding the curtailed work for 2012 and 2013. The record shows that Peoples Gas is unable to devise any strategy to reduce costs other than stopping the work it planned to complete by the end of 2012 and reducing the amount of work it planned to complete in 2013. (NS-PGL IB, pp. 32-33) Given not only the curtailment of work discussed above, but that the end of 2012 already has passed and not even all of the 2011 projects are completed (*see* Staff IB, p. 24), Peoples Gas' statement that the Company can prudently manage projects when unforeseen costs arise has no merit.

Finally, Peoples Gas' misinterpretation of Mr. Seagle's basis for proposing this adjustment demands clarification. People Gas' inaccurately states: "[…] at no time has Staff testified that these costs were not prudent, reasonable, or used and useful in providing customer service." Mr. Seagle explains his reliance on the prudence standard in his direct testimony. (Staff Ex. 6.0, p. 6) Mr. Seagle explains why it is important for a utility to demonstrate that it completes all work it budgets for in the amount of time the utility states it will complete the work. In particular, Mr. Seagle stated: "Those additions [AMRP associated rate base additions] must be in service and used and useful in providing service to utility customers and the costs associated with the rate base addition must be *prudently incurred*. A utility must demonstrate through documentation that the additions will be used and useful by the end of the test year it selects at its own discretion. The utility must show that the additions are or will be built and in service by the end of the test year in order for Staff to make a used and useful determination. *Peoples Gas, in this case, has failed to do so*." (*Id*., p. 40, emphasis added) Therefore, Peoples Gas' statement that Mr. Seagle did not make a finding of imprudence is an erroneous interpretation of Mr. Seagle's basis for proposing this adjustment and an improper attempt to shift the burden of proof from Peoples Gas to Staff. The Commission should disregard Peoples Gas' claims.

For the reasons stated above it is Staff's position that the Commission should adopt Mr. Seagle's recommendation to exclude certain costs associated with Peoples Gas' AMRP from its base rates. Specifically, the exclusion of $95,794,000 in 2012 and $122,804,000 in 2013 from Peoples Gas' requested rate base addition for ARMP costs.

c. Construction Work in Progress (PGL)

The AG recommends reducing Peoples Gas' Construction Work in Progress ("CWIP") to the amount of $4,639,000 to exclude AMRP projects that will not be used and useful in providing service in the 2013 test year. (AG IB, p. 29) Staff maintains its position that the Commission should only accept Mr. Effron's net adjustment if the Commission does not adopt the adjustment of Staff witness Seagle that disallows CWIP in rate base because none of CWIP will be placed in service within 12 months of the date of the rate determination (Staff IB, pp. 28-29) The Commission should not adopt both adjustments because the level of duplication between Staff's adjustment and Mr. Effron's proposed adjustment has not been established (Staff IB, p. 28).

Staff notes that the Company, in response to the AG, also points to the lack of evidence that plant will not be placed in service within the 12-months allowed by 220 ILCS 5/9-214(e). The Company points out that Section 9-214(e) of the Act, 220 ILCS 5/9-214(e), is specifically applicable to CWIP, and provides that "the Commission may include in the rate base of a public utility an amount for CWIP for a public utility's investment which is scheduled to be placed in service within 12 months of the date of the rate determination" without any necessity that the short-term CWIP be shown to be used and useful. (NS-PGL IB, p. 39)

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

e. Capital Costs for Non-AMRP Gas Services

Staff maintains its position on this issue. (Staff IB, pp. 29-30) As explained in Staff's Initial Brief, Peoples Gas' request to include a last minute $12,122,000 rate base increase should be rejected primarily due to the fact that the Company's request took place when Staff and the intervening parties to the proceeding had no opportunity to investigate or respond to the change and had no time to verify that the proposed cost would be prudently incurred or used and useful as required by the PUA. (Staff IB, p. 30) In response, Peoples Gas repeats the same argument made by Mr. Hoops in his surrebuttal testimony that for the test year, 2013, that is, that People Gas incorrectly estimated Non-AMRP Gas Services to be $4,359,396 and proposes to increase Non-AMRP Gas Services to $16,073,896. (NS-PGL IB, p. 40) Staff continues to disagree with the Company's basis for its request. Staff's response is set out in detail in Section IV. C. (d), *supra* and will not be repeated here. (Staff IB, pp. 29-30)

3. Cash Working Capital

a. Pass-Through Taxes

Staff has not changed its position on this issue. The Commission should not allow a revenue lag for pass-through taxes for the reasons set forth in Staff's Initial Brief. (Staff IB, p. 30) Consistent with that position Staff accepted the Companies' proposal offered in their surrebuttal testimony to use zero lag days for pass-through taxes. (Staff IB, p. 30) (CUB-City IB, pp. 23-24) (AG IB, pp. 30-32)

The Companies, in their surrebuttal testimony, proposed an alternative using zero lag days for pass-through taxes for purposes of this proceeding. The Companies' proposal includes using the actual number of days that pass-through taxes are held by the Companies for lead days as detailed below in Section c, All Other. (NS-PGL IB, p. 43)

In spite of having offered this proposed alternative, the Companies still argue in briefs that pass-through taxes are a payment for utility service and are not funded by ratepayers. (NS-PGL IB, pp. 47-48) Both are invalid arguments.

Pass-through taxes are not a payment for utility service. For rate setting purposes, utility service revenue and expense are determined in the revenue requirement. Pass-through taxes are not included in the revenue requirement because the taxes are not a utility service. The inclusion of pass-through taxes on customer bills defines the method through which pass-through taxes are collected, but does not magically transform pass-through taxes into operating expenses. (Staff Ex. 2.0, p. 14; Staff Ex. 12.0 Revised, p. 17) (AG IB, p. 30)

The Companies do request ratepayer funding for pass-through taxes. The Companies' assertion that including a revenue lag for pass-through taxes does not request funding from ratepayers is misleading. (NS-PGL IB, pp. 48-49) It is true that, if the Companies use an expense lead which is greater than revenue lag for a pass-through tax, the net lag is negative. The Companies' assertion, however, ignores that the proper lag for pass-through taxes is zero. The Companies' original position uses their operating revenue lag for pass-through tax lag instead of the proper lag of zero days. As a result, the negative effect of the pass-through tax lead is partially eliminated causing the Companies' requested Cash Working Capital ("CWC") requirement to be overstated (more positive) which would cause ratepayers to fund an amount equal to the Companies' calculated pass-through tax revenue lag.

b. Pension/OPEB

Staff has not changed its position on this issue. The Commission should assign an expense lead of negative 33.91 days for pension and OPEB expenses in North Shore's CWC calculation and negative 35.23 days for pension and OPEB expenses in Peoples Gas CWC calculation. (Staff IB, p. 31)

The Companies create a straw man argument when they assert that Staff contends that pension and OPEB liabilities are actually driven by an operating expense component in the revenue requirement. (NS-PGL IB, p. 50) Concerning CWC, this is a misrepresentation of Staff's position. It is Staff's position that the CWC requirement is driven by utility operations as represented by the revenue requirement. (Staff IB, p. 31) The Companies admit that ratepayers provide recovery of the cost of the pension plan through pension expense which is reflected in the revenue requirement and, in turn is recovered from ratepayers through rates. (Staff IB, p. 36) It is the operating expense component of pension and OPEB expense that generates the CWC lead that Staff proposes. (Staff IB, p. 31)

The Companies assert that Staff's proposal should be rejected because intercompany billing payments have no relation to the cash flows related to pension and OPEB expenses. (NS-PGL IB, p. 50) The Companies make this assertion in spite of their admission that, in the Companies' prior CWC calculations, pension and OPEB expenses were included in intercompany billing. (Staff IB, p. 31) (AG IB, pp. 37-38) (CUB-City IB, pp. 24-25) While the Companies' assertion should be ignored, if the Commission were to conclude that pension and OPEB operating expenses should have an expense lead of zero days because pension and OPEB operating expenses do not impact cash flows; then the Commission should also conclude that an amount equal to pension and OPEB expenses in the CWC calculation should be separated from revenue in the CWC calculation and be given the same zero days for revenue lag by the same reasoning. (AG IB, pp. 38-39)

But, if, alternatively, the Commission were to conclude that an amount equal to pension and OPEB expenses in the CWC calculation should not be separated from revenue in the CWC calculation with zero days for revenue lag, then the Companies' proposal to use zero lag days for pension and OPEB operating expenses should be rejected. The Companies' proposal includes, in the CWC calculation, ratepayer revenue which funds the recovery of pension plan costs, but effectively excludes the pension and OPEB expenses that are recovered by using a zero expense lead. The Companies' proposal overstates CWC, and thereby rate base, by the amount of Staff's calculation of CWC related to pension and OPEB expense lead.

The Companies' approach to justifying their proposal to assign OPEB operating expenses an expense lead of zero also includes an attempt to latch onto the coattails of Commonwealth Edison Company ("ComEd") in Docket No. 11-0721. (NS-PGL IB, pp. 50-51) The Companies refer to Mr. Kahle's response to NS-PGL Data request 4.02 (a) but ignore part (c) in which Mr. Kahle explained his rationale for a treatment different in this proceeding from the treatment he proposed in the ComEd proceeding. The Company also fails to note that this issue was not contested in the ComEd proceeding, and that Mr. Kahle, since the ComEd proceeding, has had the opportunity to further consider this issue and has, in this proceeding, set forth his rationale as to why the approach and corresponding adjustments that he proposed in this proceeding are reasonable. (Staff Ex. 12.0 Revised, p. 22)

c. All Other

Staff has not changed its position on this issue. Staff continues to endorse the Companies' proposal offered in their rebuttal and surrebuttal testimony that the lead days for pass-through taxes should be the number of days that each pass-through tax is actually held. (Staff IB, pp. 31-32) The lead days to be used should be the following:

Pass-Through Tax	**Lead Days– Peoples Gas**	**Lead Days– North Shore**
Gross Receipts/Municipal Utility Tax (MUT)	(24.200)	(60.520)
Energy Assistance Charges (EAC)	(18.360)	(19.550)
Gas Revenue/Public Utility Tax (GRT)	10.630	9.440
City of Chicago Gas Use Tax (CITY GUT)	(24.310)	N/A
(North Shore and People's Gas Cross Exhibit No. 1)		

4. Retirement Benefits, Net

The Staff position on the disallowance of an alleged "pension asset" from rate base remains unchanged. The Utilities even concede that the Commission, in the Utilities' three most recent requests for rate increases—2007, 2009, and 2011—found that Peoples Gas' *pension asset* **should not be included** in the calculation of rate base and *OPEB liabilities* nonetheless **should be included** in the calculation of rate base. They also concede, as they must, that Peoples Gas 2009 Order was affirmed by a ruling of the Appellate Court (Peoples v. Illinois Commerce Commission, Nos. 1-10-0654,1-10-0655,1-10-0936,1-10-179, and 1-10-1846 and 01-10-1852, Consolidated, Appellate Court (First District-Fifth Division) September 30, 2011, pp. 42 – 43, par. 69 - 71). (NS-PGL IB, p. 51)

In spite of these orders and court decision, which are not contested by any party to this proceeding, the Utilities again requested to include alleged "pension assets" in utility rate base along with Other Post Employment Benefits ("OPEB") liabilities. The fact pattern in the instant proceeding is no different than it was in the previous three cases and the Utilities have not provided any new evidence that should compel the Commission to reach a different conclusion than it has three times before. Nevertheless, the Utilities again request that the Commission include the alleged (and in Staff's opinion, non-existent) "pension asset" in the instant cases, and alternatively, whether to [allow recovery of specific North Shore pension contributions][2] or exclude the OPEB liabilities. The Companies note that the Commission has based its prior decisions to exclude the alleged "pension asset" from rate base on the finding that it is the product of customer-supplied funds. (NS-PGL IB, p. 52) The Utilities allege five reasons why they believe the Commission should reconsider inclusion of the alleged "pension asset" in rate base. Staff refutes each one, as follows:

[2] This proposal (NS-PGL IB, p. 52) was not supported in North Shore's testimony; accordingly, it should not be considered by the Commission as there are no facts in the record to support the proposal. The Company's alternative position (as stated in the rebuttal testimony of Ms. Christine M. Phillips (NG-PGL Ex. 31.0, p. 3)) was that the pension asset and OPEB liabilities should also be treated consistently in rate base; i.e., either both included or both excluded. The Company's alternative position (as stated in the surrebuttal testimony of Ms. Christine M. Phillips (NG-PGL Ex. 47.0, p. 2)) was if Peoples Gas' pension asset is excluded from rate base, and North Shore has a pension liability (because the year-end methodology is used), the North Shore pension liability should also be excluded.

1. The Utilities argue that the premise that customers, by paying utility bills, should be treated as if they had paid for the utility's assets is incorrect *as a matter of law*. They assert that customers pay for service, not for the property used to render it. *Bd. of Pub. Utility Commissioners, et al. v. New York Tel. Co*., 271 U.S. 23 (1926). *(Emphasis added)*

The Companies argue that the Commission should reconsider and reject Staff's adjustment to not include the "pension asset" in rate base because it is contrary to the law. (NS-PGL IB, p. 53) Once again the Companies resort to an eighty-five year old case, *Bd. Of Pub. Utility Commissioners, et al. v. New York Tel. Co*., 271 U.S. 23 (1926), to support their position. The Commission considered this same eighty-five year old case and rejected the same argument in the Companies' last rate cases in Docket Nos. 11-0280/0281 (Cons.[3]) and should do so again here. The case cited by the Companies, *Bd. Of Pub. Utility Commissioners,* is essentially a retroactive ratemaking case. Staff is aware of the issue of retroactive ratemaking as well as Illinois case law on the issue. (*See*, *Mandel Brothers, Inc. v. Illinois Commerce Comm'n*, 2 Ill. 2d 205, 210 (1954) and a number of subsequent decisions, (*Citizens Utilities Co. v. Illinois Commerce Comm'n*, 124 Ill. 2d 195, 206-211 (1988)). The Companies have not argued that Staff's position is retroactive ratemaking, which it is not; therefore the eighty-five year old case is not relevant to the issue in this case. The Companies are seeking to collect monies from ratepayers and then charge those ratepayers with a return on investment of those monies. What is relevant, which the Companies have not disputed, is that under Illinois law for ratemaking purposes a public utility may not receive a return on investment from ratepayers for ratepayer-supplied funds. (*City of Alton v. Illinois Commerce Comm'n,* 19 Ill. 2d 76, 85-6 and 91 (1960); *DuPage Utility Co. v. Illinois*

[3] Order, Docket No. 11-0280/0281 (Cons.), January 10, 2012, p. 30

Commerce Comm'n, 47 Ill. 2d 550, 554 and 558 (1971); and *Central Illinois Light Co. v. Illinois Commerce Comm'n*, 252 Ill. App. 3d 577, 583-3 (3rd Dist., 1993). *See also Business and Professional People for the Public Interest v. Illinois Commerce Comm'n ("BPI II"),* 146 Ill. 2d 175, 258 (1991)) Staff Witness Pearce testified that the Companies failed to show that the "pension asset" was provided by discrete shareholder contributions and, as a result, "[t]he pension asset should not be included in rate base because it was not created with funds supplied by shareholders." (Staff Ex. 4.0, p. 4)

The Commission has consistently rejected the attempts of other utilities to receive a return on ratepayer-supplied funds and should do so again here. (*Central Illinois Light Co. d/b/a AmerenCILCO, et al.,* Order, Docket Nos. 06-0070, 06-0071, and 06-0072, (cons.), November 21, 2006, pp. 27-28; *Northern Illinois Gas Company d/b/a Nicor Gas Company*, Order, Docket No. 04-0779, September 20, 2005, pp. 22-23; *Northern Illinois Gas Co. ("Nigas"),* Order, Docket No. 95-0219, April 3, 1996, pp. 9-10, 1996 Ill. PUC LEXIS 204, *19-*23, *affd. sub nom*. *Nigas, et al. v. Illinois Commerce Comm'n,* Order of June 23, 1997, Appeal Nos. 3-96-0473, etc. (cons.); and *GTE North Inc*., Order, Docket Nos. 93-0301 and 94-0041 (cons.), October 11, 1994, pp. 8-13, 1994 Ill. PUC LEXIS 436, *16-*26, *affd. sub nom. Citizens Utility Board, et al. v. Illinois Commerce Comm'n,* Order of July 12, 1995, Appellate Court Docket Nos. 4-94-1103, 4-94-1104 and 4-94-1122 (cons.), *cert den*. December 6, 1995, Sup. Ct. Docket No. 79931, Petition of GTE North. *See also Citizens Utility Board v. Illinois Commerce Comm'n,* 166 Ill. 2d 111, 132 (1995) [Commission is unauthorized to depart drastically from practices established in earlier orders] and *Mississippi River Fuel Corp. v. Illinois*

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

2. The Utilities assert that the pension asset is part of the utility's balance sheet and the utility owns the assets via the pension trust.

Staff already addressed the argument (NS-PGL IB, p. 53) that ownership of the pension asset is not determinative of ratemaking treatment. (Staff Ex. 14.0, pp. 5 – 6; Staff IB, pp. 33-34) Furthermore, Staff's position is (and has been) that first, there is no "pension asset"; second, the "pension asset" is a mathematical derivation of the underfunded status of the plan (a liability) offset against the regulatory asset, which can only be reflected on the Company's books to the extent *it is expected to be collected from ratepayers through future rates*. Therefore, the alleged "pension asset" is created with monies that will be collected from ratepayers, not shareholders. A regulatory asset, by its definition in the Uniform System of Accounts for Gas Utilities Operating in Illinois[4], only exists due to the rate actions of this Commission and represents costs that would have been included in net income in one period but for purposes of developing rates, is collected in the costs for utility services in a different period.

3. The Utilities assert that customers, by paying their bills, do not pay for the pension asset. The rates on which their bills are based reflect the accrual of pension expense.

The Companies' argument that customers, by paying their bills, do not pay for the pension asset (NS-PGL IB, p. 53) is without merit. The alleged "pension asset" represents funds that will be provided through future revenue streams from ratepayers

[4] 83 Ill. Adm. Code 505.10 adopted 18 CFR 101, as of June 15, 2006. 18 CFR 101 provides Definition 31 – Regulatory Assets and Liabilities

paying their bills; the alleged "pension asset" does not represent any investment from investors. Staff has repeatedly addressed the fact that ratepayers pay the ongoing cost of pension and OPEB benefits through the operating statement, therefore, they—not shareholders—supply the monies used to fund the pension. As Staff witness Pearce testified in direct testimony,

> The mere fact that cash collected from ratepayers is later remitted to the pension trust fund does not somehow make those funds "supplied by investors," as Ms. Phillips seems to imply. The Companies must show specific contributions to the pension trust fund that come directly from shareholders. (Staff Ex. 4.0, pp. 5 – 6)

4. The Utilities assert that Staff witness Ms. Pearce has acknowledged, normal operating revenues of a utility include amounts collected through rates to repay the utility's cost of capital, and the portion of amounts collected from customers that ends up as net income is retained earnings, and thus is part of shareholder's equity, to the extent it is not paid out in dividends.

The Utilities further allege, 'In particular, point 4, above, first was raised by the Utilities in *Peoples Gas 2011*, but Staff and the applicable intervenors did not refute it there, nor have they done so here. They have ignored point 4 here without even attempting to refute it.'

As the Companies acknowledge, the Commission has considered and rejected the argument that a portion of amounts collected from customers that ends up as net income is retained earnings, and thus is part of shareholder's equity. (NS-PGL IB, pp. 53-54) Putting that aside, the implication appears to be that since some of the monies that ratepayers pay to utilities ultimately gets paid to shareholders as dividends or is made part of retained earnings that such monies, therefore, are not ratepayer funded. This claim is obviously illogical and flawed and is not supported by the evidence in the record. The Companies fail to recognize that they have offered no evidence in this record that they are not paying dividends to shareholders. In fact the evidence in the record suggests the exact opposite. The Companies' rate of return witness Mr. Moul and Staff's rate of return witness Mr. McNally both assume in their cost of equity analysis that for the foreseeable future the Companies will be making streams of dividend payments to shareholders[5]. (NS-PGL IB p. 140; Staff IB, p. 73) Since dividends are being paid to shareholders, the Companies argument that a portion of rates representing a cost of capital has somehow created the alleged "pension asset" is without support in the record. In addition, this argument by the Companies does not address the fact that ratepayers should not have to provide a return on an asset that represents future collections from ratepayers.

5. The Utilities assert that cumulative pension contributions to the trust have exceeded cumulative pension expense recognized pursuant to Generally Accepted Accounting Principles ("GAAP"). Utilities further assert that this data was not presented in the prior cases, although somewhat similar points sometimes were made. Thus, they argue, the Commission has sufficient grounds for reconsidering this issue.

The Companies' assertion that pension contributions exceeded expense by $77,546,609 during the period October 1, 1995 – December 31, 2013 (NS-PGL IB, p. 54) presents a misleading assessment of the impact on ratepayers. The $77,546,609 difference between total pension expense of ($24,080,194) and total pension contributions of $53,466,415 for the 18-year period (1995 – 2013) (Staff Ex. 14.0, Att. A, p. 7) is due to negative amounts of pension expense in the years 1996 – 2003. Negative pension expense typically results when the expected return on plan assets exceeds other elements that make up pension expense. However, ratepayers did not

[5] Both the Companies and Staff used a DCF analysis among other analysis to estimate cost of common equity. DCF analysis assumes that the market value of common stock equals the present value of the expected stream of future dividend payments. Since a DCF model incorporates time-sensitive valuation factors, it must correctly reflect the timing of the dividend payments that stock prices embody. (Staff IB, p. 73)

receive the benefit of these negative expenses, because no rate case was filed that reflected the negative amounts in the revenue requirement. (Staff IB, pp. 36-38) Moreover, Peoples Gas filed several rate cases since its rate case in Docket No. 07-0242. As shown in the table below, in the overwhelming majority of these rate cases, the Companies' pension expenses recovered from ratepayers through base rates exceeded actual pension contributions—the reverse of what the Companies claim. (Staff Ex. 14.0, p. 11) On a total basis pension expense of $84,257,459 exceeds pension contribution of $17,164,995 by $67,092,464. In terms of magnitude, total pension expense is almost five times greater than the pension contributions.

General Rate Case	Test Year	Pension Expense	Pension Contribution
Docket No. 07-0242	Historic test year ended 9/30/06	$ 11,507,532	$ 16,207,282
Docket No. 09-0167	Future test year ended 12/31/10	$ 8,015,677	$ 121,123
Docket No. 11-0281	Future test year ended 12/31/12	$ 26,311,141	$ 499,673
Docket No. 12-0512	Future test year ending 12/31/13	$ 38,423,109	$ 336,917
Total		**$ 84,257,459**	**$ 17,164,995**

Source: Companies Response to DR BAP 23.01, Staff Ex. 14.0, Att. A.

Shareholders did not provide a higher level of contributions than the amount of pension expense that was reflected in rates in three of the four years shown above. The table above supports Staff's contention that ratepayers-- not shareholders-- have supplied the funds and will continue to supply the funds for employee pension benefits. The Commission should reject this unsubstantiated and highly inaccurate claim that the

Companies have used to justify inclusion of the alleged "pension asset" in rate base. (Staff Ex. 14.0, pp. 10 – 12)

As noted by Staff previously, it is unreasonable for the Utilities to net the pension liability with a regulatory asset that reflects the recognition of assured future recovery from ratepayers of the pension expense, in order to reflect an alleged "pension asset" in rate base. This novel treatment leads to the absurd result of making ratepayers pay utility shareholders a return on amounts that ratepayers will pay the utility in the future. (Staff Ex. 14.0, pp. 7 – 9)

The Companies have never established that the so-called "pension asset" was not created with funds collected from or to be collected from ratepayers. It is an uncontested fact that ratepayers pay for ongoing, periodic pension expense and other post-retirement benefits—not the shareholders. The Companies admit this fact. (*Id.*)

Accordingly, the Commission should adopt Staff's proposal to remove the alleged "pension asset" from the Companies' rate base regardless of whether a year end or average rate base is adopted. In so doing, the Commission is appropriately rejecting the novel argument that ratepayers today should be forced to pay utility shareholders a return on amounts that ratepayers will pay the utility again in the future. Moreover, the Companies have presented no new facts or evidence in the instant proceeding that would warrant a different conclusion from the Commission in this proceeding than it has reached in its orders for the previous three rate cases, one of which, 09-0166/0167 (Cons.), was upheld on appeal as discussed above. (*Id.*)

5. Net Operating Losses

Staff's position on this issue has changed from that set forth in Staff's Initial Brief. The timing of the inclusion of the 2012 and 2013 NOLs has complicated this issue. Staff recognizes that the American Taxpayer Relief Act of 2012 was not enacted until January 2013. (NS PG IB, p. 57) This was a factor in Staff's original acceptance of the Companies' surrebuttal adjustment. However, Staff has now come to realize that the late inclusion of the 2012 NOL in the case due to the closing of the Companies' books has overly complicated the calculation of the revenue requirement in order to present precise calculations of all contested adjustments with the effect of the 2012 NOL. (See III. A. and B. Revenue Requirement) To date, the Companies have only presented schedules reflecting the 2012 NOL at present rates. (PGL/NS Ex. 43.0 at 26, PGL/NS Ex. 43.2, p. 2 and AG IB, pp. 42-43) The Companies in their initial brief could have presented schedules reflecting the effect of the 2012 NOL at proposed rates but did not do so.

The parties have not had ample time to develop the full evidentiary record to calculate the full effect of the 2012 NOL on every contested adjustment nor to challenge the Companies' claim that disallowance of the 2012 NOL would cause a normalization violation, requiring the Companies to be denied 2013 bonus depreciation. (NS PG IB, p. 57; Staff IB, p. 41) Therefore, Staff now agrees with the AG's position that it is appropriate to remove the 2012 NOL's effect from the revenue requirement. (Staff RB, Appendix C, p. 15)

6. Accumulated Deferred Income Taxes

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

See Section V.E.1.

b. Repairs Deduction Related to AMRP projects

c. Bonus Depreciation

d. Derivative Adjustments from Contested Adjustments

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

V. OPERATING EXPENSES

A. Overview/Summary/Totals

1. North Shore

2. Peoples Gas

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

1. Administrative & General

   a. Interest Expense on Budget Payment Plan

   b. Interest Expense on Customer Deposits

   c. Lobbying expenses

   d. Social and Service Club Dues

   e. Executive Perquisites

   f. Consulting Expense – SIG Consulting

   g. Employee/Retiree Perquisites – Awassa Lodge

   h. Update to Pension and Benefits

   i. Updated IBS Return on Investment

   j. Costs to Achieve Amortization

2. Uncollectible Account Expense Included in Base Rates

3. Depreciation Expense

   a. WAM System

   b. CNG Plant

4. Income Tax Expense – Changes in Interest Expense on Debt Financing

5. Revenues

   a. Sales and Revenue Adjustment by Service Classification

6. Interest Synchronization (methodology on derivative adjustments)

C. Potentially Contested Issues (All Subjects Relate to NS and PGL Unless Otherwise Noted)

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

While Staff and the Companies are in agreement on the dollar cost recovery of the Companies' Non-Executive Incentive Compensation Plans' ("NEICP") costs (Staff IB, p. 48; NS-PGL IB, p. 78) Staff does take issue with the implication or suggestion in the Companies' initial brief that the Commission's standard for incentive compensation cost recovery is different than the standard under well established case law. The Companies initially argue in their brief that "[i]t is a well established principle that a utility is entitled to recover its prudent and reasonable costs of service. See, e.g., *CUB*, 166 Ill. 2d at 121, 651 N.E.2d at 1095" and that "employee salaries are operating expenses and, as such, are recoverable in full so long as they are prudent and reasonable. See, e.g., *Village of Millford v. Illinois Commerce Comm'n*, 20 Ill. 2d 556, 565 170 N.E.2d 576, 581 (1960)" The Companies then state that "[w]ith respect to incentive compensation costs, <u>the Commission's standard for recovery</u> is whether the incentive compensation expenses 'can reasonably be expected to provide net benefits to ratepayers.'" The Companies do note that the first District Appellate Court held that the Commission's use of a customer benefit standard for the recovery of incentive compensation costs was appropriate. (NS-PGL IB, pp. 77-78) (Emphasis added)

The Companies' overview of both the case law and the Commission's standard gives the false impression that (1) the Commission's standard is different than the well established case law standard and (2) the Companies are entitled, as a matter of law, to rates that allow them the opportunity to recover fully their prudent and reasonable costs of service. (NS-PGL IB, p. 77) The Commission's standard and the true well established case law's standard are not different and the Companies are not entitled, as a matter of law, to rates that allow them the opportunity to recover fully their prudent and reasonable costs of service. With regard to the second point, it has long been established that ratepayers are not required to pay any part of costs unless the utility shows that such costs directly benefit either ratepayers or the services the utility renders. (*Illinois Bell Telephone Company v. Illinois Commerce Comm'n*, 55 Ill. 2d 461, 482-483 (1973)) The Second District, in examining the very issue of the recoverability of incentive compensation costs, concluded that case law and the Public Utilities Act expressly make room for the Commission to consider factors "beyond simply whether an expenditure is reasonable and prudent." (*Commonwealth Edison Co. v. Ill. Commerce Comm'n*, 398 Ill. App. 3d 510, 516-517 (2nd Dist. 2009)) In fact, the Court noted that there is ample precedent making a benefit to ratepayers a condition upon which the recovery of salary-related expense depends. (*Commonwealth Edison Co.*, 388 Ill. App. 3d at 517) Given that the Commission's standard is identical to the well established case law standard, Staff cautions the Commission against accepting the Companies' false suggestion that the Commission's standard is somehow different than the standard under case law. The standards are not different; the standards are the same. In this case, nonetheless, it is Staff witness Ostrander's position that the Companies' NEICP costs have met the standard articulated above for cost recovery. (Staff Ex. 13.0, p. 25; Staff IB, p. 48)

2. Wage Increase Corrections

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

Staff maintains its position on this issue. (Staff IB, p. 49) The Companies incorrectly contend that a proposed cumulative non-union wage increase of 3.45% is reasonable and should be approved by the Commission. The Companies' proposal includes a general wage increase (2.60%), a pool of funds to provide for merit-based increases (0.45%), and a pool of funds to provide for costs attributable to pay increases commensurate with promotions and market adjustments (0.40%). (NS-PGL IB, p. 83) The Companies continue to rely upon market data provided by the World At Work 2012-2013 Salary Budget Survey for its proposed general wage increases. (NS-PGL IB, p. 85) This source is the same source that was used by the Companies in the 2011 rate cases, which was rejected by the Commission. (Staff Ex. 13.0, p. 10) The Commission should reject the World at Work Survey again for the reasons set forth in Staff's IB. (Staff IB, p. 83)

Regarding the proposed merit increases, the Companies mischaracterized Staff witness Ostrander's testimony on cross-examination in that he had no objection to a public utility giving a larger pay increase to individual employees who perform at a higher level than other employees. (NS-PGL IB, p. 86) Mr. Ostrander testified on cross-examination that he would not object to a merit increase as long as an employee had earned such an increase. (*Tr.*, February 5, 2013, p. 250) Mr. Ostrander's response was based on the specific human resource (employee evaluation) scenario that was presented to him. His testimony should not be misconstrued as an endorsement for ratemaking purposes of merit increases for ratemaking purposes that might occur at an unknown point in the future at a currently unknown rate for future employees that might be hired.

The third component of the Companies' proposal is a pool of funds that is equal to 0.40% of the Companies' total non-union wage base to pay increases commensurate with promotions and market adjustments. The Companies admit that this promotional fund is discretionary in nature. (NS-PGL IB, pp. 88-89) This admission supports Staff's assertion that promotional wage increases are dependent upon the premise that employees will earn such increases in 2012 and 2013, which may or may not occur. (Staff Ex. 13.0, p. 15) The Companies do offer an alternative to the Commission that would award an amount less than originally requested. (NS-PGL IB, p. 89) This alternative proposal does not sway Staff from maintaining its position to limit total non-union wage increases to a more reasonable 2.28%.

Lastly, the Companies claim that using a CPI rate to forecast utility wage increases is insufficient because "wages in the utility industry have been increasing at a faster pace than overall wages generally (2.3% versus 1.5% for the twelve months ended September 2012)." (NS-PGL IB, p. 84) The Companies do not, however, provide any evidence or reasoning to explain why wages have increased or should continue to increase at such a significant rate when compared to other industries. There is no evidence in this proceeding that shows that utility employees are more intelligent or work harder than employees in other industries and are thus entitled to a higher than average wage. As Staff has proposed, the CPI is a sufficient rate to increase wages for employees in the utility industry to include in charges to be recovered from ratepayers.

The Companies' proposed methodology of a cumulative non-union wage increase proposal based on multiple data sources is the same methodology and data sources that were proposed by the Companies in their last rate case, which was rejected by the Commission. (Staff IB, p. 49) Therefore, the Commission should accept Staff's adjustment to reduce the amount of non-union wage increases to a more reasonable amount.

4. Vacancy Adjustment (Falls in Multiple Categories of O&M)

Staff maintains its position on this issue. (Staff IB, p. 50) AG witness Brosch and CUB-City witness Smith continue to propose reductions to the Companies' test year payroll expenses for an average vacancy factor which is based on actual versus authorized, but unfilled, employee positions during the first nine months of 2012. (AG IB, p. 66; CUB-City IB, p. 43) The Companies contend that they have filled or are hiring to fill the budgeted positions and have fully explained and supported their headcounts that will be equivalent to the headcounts reflected in their test year operating expenses. (NS-PGL IB, p. 89) Staff did not adjust the union wages for a vacancy factor; however, Staff did adjust the increase to non-union wages for a vacancy factor as discussed in its Initial Brief. (Staff IB, *Id.*) Staff continues to believe that its adjustment to decrease non-union wages to a more reasonable amount is appropriate and should be adopted by the Commission.

5. Distribution O&M

a. Plastic Pipefitting Remediation Project

Staff maintains its position on this issue. (Staff IB, pp. 51-52) As explained in Staff's Initial Brief, Staff witness Brett Seagle recommended that the Commission reject

Peoples Gas' request to include $2,000,000 of O&M expenses due to a remediation project involving the replacement of plastic pipe fittings that, when installed, did not comply with certain industry standards referenced in Part 192 of Title 49 of the Code of Federal Regulations ("CFR"). (Staff Ex. 16.0, p. 1; Staff IB, p. 51) Mr. Seagle determined that the Company failed to demonstrate that the costs associated with the project were just and reasonable. (Staff Ex. 16.0, p. 7)

In response, Peoples Gas makes the same argument made by Mr. Hoops in his rebuttal testimony that although an industry-recognized expert concluded the fittings were safe, the reasonable course of action was to replace them at the time that they did for convenience purposes, regardless of the fact that the Company could have sought a special permit to allow the pipe fittings to remain in service. (PGL Ex. 28.0, p. 12) Staff continues to disagree with the Company's basis for its request. Staff responded to this argument in its Initial Brief in detail in Section V, C, 5, a, *supra* and will not repeat those arguments here. (Staff IB, pp. 51-52)

b. Legacy Sewer Lateral Cross Bore Program

Staff maintains its position on this issue. (Staff IB, pp. 52-54) As explained in Staff's Initial Brief, Staff witness Brett Seagle recommended that the Commission reject Peoples Gas' request to include $5,700,000 of O&M expenses due to a remediation project involving the Legacy Sewer Lateral Cross Bore Program. (Staff Ex. 16.0, p. 9) Mr. Seagle recommended a similar adjustment of $2,600,000 for North Shore. (*Id.*, p. 1) Mr. Seagle states that the Companies failed to demonstrate that the costs associated with this Program were prudent and reasonable. Staff witness Darin Burk provided additional testimony in support of Mr. Seagle's adjustment. (Staff Ex. 6.0, pp. 12-13)

(See, generally, Burk Reb., Staff Ex. 19.0) In response, Peoples Gas repeats the same argument made by Mr. Hoops in his surrebuttal testimony that because Peoples Gas allegedly provides detailed training to its employees and "has learned and continues to learn about the complexity of the City of Chicago's underground sewer system," the costs related to the Legacy Sewer Lateral Cross Bore Program are prudent and reasonable and that the Utilities have sound procedures and practices. (NS-PGL Ex. 44.0, pp. 4-5) (NS-PGL IB, p. 92)

In its Initial Brief, Staff already provided arguments detailing why Peoples Gas' request for the O&M expenses described above should be denied. (Staff IB, pp. 52-54) Staff will not repeat those arguments here.

c. New Chicago Department of Transportation Regulations

6. Productivity Adjustment

Staff maintains its position on this issue. (Staff IB, p. 55) AG witness Brosch continues to recommend a one-half of one percent productivity adjustment to reduce the Companies' 2012 and 2013 test year non-fuel O&M expenses. (AG IB, p. 77) Staff continues to agree with the Companies that Mr. Brosch has not provided sufficient support for the proposed productivity adjustment. (NS-PGL IB, pp. 94-100) Therefore, Staff continues to recommend that the Commission should not accept Mr. Brosch's proposed productivity adjustment. (Staff IB, *Id.*)

7. Administrative & General

a. Adjustments to Integrys Business Support costs

Staff's position remains unchanged regarding its adjustment to disallow IBS costs in excess of the five-year average. Although Staff's calculation of the adjustment to IBS costs differs from AG witness Brosch's calculation, the general reduction to operating expense is comparable. (Staff IB, p. 59) Thus, by two different methodologies it has been determined that the Companies' level of forecasted 2013 IBS costs is too high.

The Utilities' in their IB simply summarize each argument the Companies made in rebuttal and surrebuttal testimonies to Staff's direct and rebuttal testimonies on the issue. (NS PGL IB, pp. 101 – 104) Thus, the Staff position is fully addressed in Staff's IB and the arguments will not be repeated here. Staff will respond to the erroneous and unsupported assertions by the Utilities regarding Staff's adjustment to: (a) increased costs for benefits and injuries and damages expenses beyond the Utilities' overall inflation rate of 2.2%; (b) the impact of annualizing 2012 actual expenses; and, (c) changes in management of intercompany expenses by IBS since 2008. First and foremost, the Utilities did not support the increase in IBS costs as claimed in the testimony of Utilities' witnesses Christine Gregor and Christine Phillips and contrary to the Utilities' assertions Staff did in fact propose to disallow the costs as set forth in Ms. Pearce's analysis. (NS-PGL IB, p. 101) The Commission should reject the Companies' arguments as the Utilities have not provided sufficient evidence for the increase in IBS costs. Staff's adjustment is based upon a five-year average for the period 2008 – 2012 compared to the intercompany charges as reflected in the 2013 test year filing on Peoples' Schedule C-13 in the direct case. Furthermore, the Utilities did not update their benefits costs for the most recent actuarial valuation until the rebuttal testimony phase of this proceeding. The amount of Ms. Pearce's adjustment is based on the amount the Companies included in their filing *before* the actuarial update, to reflect the most recent actuarial valuation that occurred in the rebuttal phase of this proceeding. Therefore, the increased cost of benefits associated with the actuarial update that the Company included in its rebuttal position is not part of Staff's adjustment.

Despite the Companies' claims to the contrary Staff is challenging the testimony of Companies witnesses Gregor and Philips. Staff witness Pearce is challenging the reasonableness of the numbers Ms. Gregor and Phillips testify to. It is Staff's position that after considering Ms Pearce's testimony the Commission should not find the Companies to have supported those amounts for inclusion in Peoples Gas' rates. It is the Companies' burden to show the costs at issue are just and reasonable. ("… the burden of proof to establish the justness and reasonableness of the proposed rates or other charges, classifications, contracts, practices, rules or regulations, in whole and in part, shall be upon the utility. .." (220 ILCS 5/9-201(c))

The Utilities found fault with Staff's rebuttal proposal to substitute the IBS cost increase level with a general inflation rate of 2.2%, however, the Company itself utilized a 2.2% overall inflation rate to forecast the 2013 operating expenses (Staff Ex. 14.0, Schedule 14.02 P, p. 1, line 5). The Utilities fail to recognize that the difference in an inflation rate would only explain $3,198,000 (Staff Ex. 14.0, Schedule 14.02 P, p. 1, line 6, $148,543,000 minus line 4, $145,345,000), not the difference of $15,524,676. Thus, the difference in the inflation rate is not the explanation for the increase in projected 2013 IBS costs over the average.

Moreover, Staff's calculations did account for changes in injuries and damages expenses that had occurred during the 2008 – 2013 period, (Id., pp. 101-102), since each year the reserve for injuries and damages was adjusted to the level necessary to cover the anticipated liabilities from injuries and damages incurred during a given year. Since the 2013 test year is a future test year, it is unclear why the 2013 level of the injuries and damages reserve would be significantly higher than the level of the 2012 injuries and damages reserve. Given that Staff's analysis utilized 11 months of actual data through November 2012, the only unknown would be the accrual related to December 2012. If an event that gave rise to claims for injuries and damages occurred during the months prior to December 31, 2012, that accrual should already be reflected in the reserve, even if based on an estimate. Allowing for year-end closing adjustments to the final reserve balance, limited to the month of December, the impact would be $677,000 according to the Company. A $677,000 impact from recording December costs in the injuries and damages account does not explain an increase in 2013 intercompany expenses of $15,524,676, or more than ten percent more than the five year average of intercompany costs. (ICC Staff Ex. 14.0, Sch. 14.02 P, p. 2) Thus, the increased cost of injuries and damages does not support the Company's requested increase in IBS costs over the five-year average calculated by Staff. The amount of $677,000 purported by the Utilities is insignificant (i.e., 0.42%, or less than half of one percent) when compared to the overall amount of intercompany charges the Company reflected in its intercompany test year forecast of $160,870,000.

The next erroneous assertion by the Utilities is that Staff's analysis using annualized costs for 2012 has a significant impact on the adjustment. The Utilities make the false claim that Staff's calculation presented in direct testimony was flawed because it annualized the results for first nine months of 2012 which overstated the adjustment (Id., p. 102) and could not be supported because Staff presented an updated calculation in rebuttal testimony to annualize 2012 expenses based on the first eleven months of actual expenses for 2012. Staff's analysis showed that the result was not significantly different than Staff's adjustment using annualized results from the first nine months. For example, Staff calculated annualized 2012 expenses of $141,223,045 based on 9 months of actual expenses in direct testimony, (Staff Ex. 4.0, Sch. 4.02 P, p. 2, line 14), versus annualized 2012 expenses of $142,321,671 based on 11 months of actual expenses in rebuttal testimony. (Staff Ex. 14.0, Sch. 14.02 P, p. 2, line 14) The difference of $1,098,626 represents less than one percent of the total annualized 2012 expenses. Staff also increased the 2012 annualized expense total in rebuttal testimony to reflect a 2.2% overall inflation rate for O & M expenses that was used by the Company in its forecast.

The next erroneous assertion by the Utilities is that Staff's analysis does not take into account that management of the expenses changed during the 2008 – 2013 period with management moving to IBS in 2009. The Companies fail to acknowledge that Staff's calculations rely on the invoices provided by the Company in accordance with the Master affiliated interest agreement ("AIA"). Staff notes that each monthly invoice includes a section for "Direct Charges and Credits", along with allocated charges and invoices processed by IBS. (ICC Staff Exhibit 4.0, Attachment A) Additionally, the Companies made it clear that IBS was managing costs after 2008, therefore, Staff is not persuaded that the 2013 forecast is so much different (i.e., based on all charges, including those previously paid directly by Peoples Gas) from the previous years' intercompany results that the increase of more than 10% is justified. The Company seems to contendn that the reason for a forecast which is so obviously out of line with experience is not that the forecast is too high, but that the Company suddenly used a different way of forecasting its costs for 2013 and Staff failed to take that into account. The Companies provided no means for Staff to verify the alleged costs that were "paid directly by Peoples Gas" during the years 2009 through 2012. By utilizing a different methodology to estimate the 2012 test year forecast expenses, the Company risked the possibility that its estimates would not be comparable and the test year level of expense would appear unreasonable. Even the Companies' witness, Christine M. Gregor, agreed the increases in IBS costs were not clearly explained by the Companies, but she declined to accept Staff's adjustment claiming the amount of disallowed expense consists mainly of increases in benefit costs and injuries and damages expenses. (NS-PGL Ex. 25.0)

In addition Staff performed another analysis that demonstrated that excluding 2008 charges, as the Companies argue Staff should do, would produce a four-year average with an even greater disparity to the 2013 test year forecast for intercompany charges from IBS to Peoples Gas. Thus, an even larger adjustment than Staff proposed in rebuttal testimony would have been warranted if the Companies' argument that 2008 should not be included in the calculation of the average were accepted. Specifically, the five-year average that Ms. Pearce calculated, (Staff Ex. 14.0, Sch. 14.02 P, p. 2), produced an average annual total intercompany charge of $145,345,324 versus $141,349,998 for a four-year average without 2008. (*Id.*, p. 3) Using the four-year average would result in an adjustment even greater than Staff recommended since the adjustment would be derived by taking the 2013 test year forecast for intercompany charges of $160,870,000, (*Id.*, p. 2), less the smaller four-year average annual total intercompany charge. Given that the five-year average is less than three percent greater than the four-year average, the impact of 2008 does not seem to be significant to the estimate overall. Thus, the Utilities' argument is not valid.

Moreover, in describing 2008 as a non-representative year for comparative purposes, the Utilities did argue that later years were not comparable. However, in the rebuttal phase, the Utilities asserted that the test year forecast was estimated on a different basis than the actual results that were reflected in prior years' intercompany charges. This is a convenient way of precluding Staff from making a meaningful analysis as to the reasonableness of test year expenses. If the test year forecast appears to be unreasonable in comparison to the previous 4 year average and the previous 5 year average, then the future test year forecast may be overstated unless the Company can provide justification as to why the test year is not comparable. To date, this justification has not been provided.

In conclusion, Peoples Gas has attempted to justify an unreasonably high level of intercompany charges in the future test year by selectively addressing increases in two areas of expense. Given the reasons articulated above and in Staff's IB, as well as the magnitude and variety of costs that flow through the intercompany charges (from IBS to Peoples Gas), Ms. Gregor's explanation does not support the overall level of increase, 10.68%. (Staff Ex. 14.02 P) For example, even if expenses increased in the areas of benefits costs and injuries and damages, other intercompany charges may have also declined that would offset the two increases selectively chosen by Ms. Gregor. Furthermore, the updated employee pension and benefits costs that resulted from the updated actuarial study were reflected in the Utilities' rebuttal testimony. Therefore, they are not part of the difference calculated in Staff's analysis, which is based on the Utilities' initial filing and actual invoices from IBS to Peoples Gas for the period 2008 through November 2012.

Accordingly, Staff urges the Commission to adopt Staff's adjustment to reduce intercompany charges from IBS to Peoples Gas. This will cause intercompany charges to align more closely with the five-year average calculated on Staff Exhibit 14.0, Schedule 14.02 P, page 2 of 3, as adjusted for the overall rate of inflation utilized by the Utilities in the 2013 test year, 2.2%, discussed on Peoples Gas' Schedule G-5, page 10 of 12, Note G.

b. Advertising Expenses

Staff maintains its position on this issue. (Staff IB, p. 60) The Companies argue that event sponsorships should be recoverable from ratepayers because the expenses in question were charitable in nature (and therefore allowed for recovery under Section 9-227 of the Act) and/or involved promotion of safety, energy efficiency, and heating assistance information. (NS-PGL IB, p. 107) The Companies' argument is misleading and, therefore, should be rejected. The Companies filed their rate cases requesting that these costs be recovered as advertising costs (subject to Sections 9-225 and 9-226) and not as charitable contributions (subject to Section 9-227). The Commission should not allow recovery of these advertising costs because the Companies have decided in the middle of this proceeding that these costs are now charitable contributions. (Staff IB,

p. 62) The Companies have failed to demonstrate in the record that the costs in question are valid advertising costs allowed in recovery under Section 9-225. (Staff IB, pp. 61-62) The Companies contend that when a contribution is made to a charity by sponsoring an event, where information about energy efficiency and/or safety is provided, the expense should be allowable regardless of whether it is recorded as a charitable contribution or as an advertising expense. (NS-PGL IB, p. 107) The fact that the expense of sponsorships *could* be recorded in certain accounts, does not guarantee that the Commission *will* allow such expenses in rates. (Staff IB, pp. 62-63)

The Companies attempt to refute Staff's argument regarding the fact that the Commission does not guarantee recovery of expenses that could be recorded in certain accounts by referring to the Commission's conclusion in Commonwealth Edison Co. ("ComEd"), ICC Docket No. 99-0117 (Order on Rehearing March 9, 2000). (NS-PGL IB, p. 109) In that order, the Commission allowed expenses that were erroneously recorded as generation marketing expenses to be included as costs for the provision of delivery services. Such conclusion occurred only after the Commission reopened the record and adduced that ComEd had sufficiently demonstrated the prior error and appropriate classification. (Order on Rehearing, p. 23) There has been no such showing in evidence here.

The Companies had ample time to consider and substantiate in the record the substance of the expense and proper classification for ratemaking purposes. They have failed to do so. Only after Staff proposed disallowing goodwill advertising expenses did the Companies attempt to re-classify any expense of a perceived charitable nature, advertising sponsorship costs, and institutional events sponsorship costs as allowable under Section 9-227, rather than as advertising under Section 9-225. The Commission should accept Staff's recommended disallowance to remove advertising expenses that are promotional, goodwill, or institutional in nature.

c. Charitable Contributions

Staff proposed an adjustment to reduce test year charitable contributions by $8,000 for the disallowance of contributions made by Peoples Gas to organizations outside the Company's service territory, since there is no tangible evidence that these contributions provide any benefit to Peoples Gas' ratepayers. (Staff Ex. 3.0, p. 21; Sch. 3.09 P; Staff IB, p. 63) Staff maintains its position on this issue. Peoples Gas points out that Section 9-227 of the Act allows the recovery of donations made for educational purposes provided that such donations are reasonable in amount. (NS-PGL IB, p. 110) Staff does not dispute that the subject contributions were for educational purposes and were reasonable in amount. Staff's adjustment is to disallow the contributions made by Peoples Gas to organizations outside the Company's service territory, since Peoples Gas provided no tangible evidence that these contributions provide any benefit to Peoples Gas' ratepayers. (Staff IB, p. 63) Tellingly, Peoples Gas merely contends that "there is such evidence" with no cite to the evidentiary record. (NS-PGL IB, p. 110) Peoples Gas has had ample opportunity to provide the evidence for the Commission to rule in their favor, but has failed to do so.

Despite the Company's allegation that Staff's position is unlawful (NS-PGL IB, p. 113), Staff's adjustment is consistent with the Commission's recent orders (Docket Nos. 12-0321, 10-0467, 11-0721, and 12-0001) that disallow contributions to organizations outside a utility's service territory. (Staff IB, p. 63) The Companies go on to criticize

Staff for relying on these four recent Commission decisions from 2011-2012 because Section 9-227 was added to the Act in 1987. ((NS-PGL IB, p. 111) The Company's reasoning that this Commission should ignore its most recent, on-point decisions which are not inconsistent with Section 9-227 of the Act, belies common sense. The Commission should accept Staff's recommended disallowance to test year charitable contributions for contributions made by Peoples Gas to organizations outside the Company's service territory, since Peoples Gas provided no tangible evidence that the contributions provided any benefit to Peoples Gas' ratepayers.

d. Institutional Events

Staff maintains its position on this issue. (Staff IB, p. 64) As with advertising sponsorship expenses discussed above, the Companies argue that institutional events fund-raising support should be recoverable from ratepayers because the expenses support local charities. (NS-PGL IB, p. 113) The Companies' argument, however, omits mention of a key point: the Companies filed their rate cases requesting that these costs be recovered as miscellaneous operating expenses and not as charitable contributions. This Commission should not allow recovery of these costs because the Companies have decided in the middle of this proceeding that these costs are now charitable contributions.

The Companies had ample time to consider the substance of the expense and proper classification for ratemaking purposes. They have failed to do so. Only after Staff proposed disallowing institutional events fund-raising support did the Companies attempt to classify these expenses as charitable contributions. The Companies argue that "[w]hether the Utilities make charitable contributions to some of the same institutions is irrelevant, as long as the total contributions are not unreasonable in amount." (NS-PGL IB, p. 114) The Companies' argument fails. Costs must be lawful for cost recovery under the Act. A reasonable amount of expense for "promotional, political, institutional or goodwill advertising" or "political activity or lobbying" expenses for that matter, is never recoverable in rates. (220 ILCS 5/9-225 and 9-224) The Commission should accept Staff's recommended disallowance of institutional events fund-raising support which is promotional, goodwill or institutional in nature.

8. Depreciation

a. Bonus Depreciation

b. Derivative Adjustments from Contested Adjustments

9. Rate Case Expenses

There are no contested adjustments to the recommended amount of rate case expenses for the current rate cases. (Staff IB, p. 67; NS-PGL IB, p. 115; CUB-City IB, p. 51 and AG IB, p. 89) The Companies have no objections to Staff's recommended language for the Commission's conclusion regarding rate case expenses (NS-PGL IB, p. 127):

> The Commission has considered the costs expended by the Companies to compensate attorneys and technical experts to prepare and litigate these rate case proceedings and assesses that the amounts included as rate case expense in the revenue requirements of $2.286 million and $3.334 million for North Shore and Peoples Gas, respectively, are just and reasonable.

It is Staff's understanding that the Companies will recommend suggested language in their Draft Proposed Order regarding the Commission's consideration of the evidence determining that the Companies' rate case expenses are just and reasonable in light of a recent Illinois American decision by the First District Appellate Court. (*Id.*)

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

1. Invested Capital Tax Computation and Derivative Adjustments

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

1. Appropriate Methodology to Reflect Change in State Income Tax Rate (see also Section IV.C.6.a.)

The Staff position on the appropriate methodology to reflect change in state income tax rate remains unchanged. Staff did not take issue with the Companies' position, noting that based on Staff's understanding of the order in Docket No. 83-0309, the methodology appears reasonable and Intervenors did not demonstrate sufficient cause for changing it. (Staff Ex. 14.0, pp. 21 – 22)

Intervenor witnesses Smith (CUB-City Ex. 2.0) and Brosch (AG Ex. 4.0 – 4.2) proposed changes in the Companies' methodology to account for ADIT to reflect the scheduled decrease in the state income tax rate effective 2015 and a further decrease in 2025. Both witnesses assert that deferred tax expense should be reduced to reflect savings associated with this change.

The Utilities disagreed with the Intervenors' proposed adjustment, partly because they assert it might lead to a normalization violation. (NS-PGL IB, p. 63) This argument is moot however, because at issue is a change in state tax rate and not the federal tax rate. A normalization violation could only occur if there were a change in the federal income tax rate, according to Utilities' witness Mr. Stabile. (NS-PGL Ex. 46.0, p. 11) Utilities' witness Mr. Stabile conceded that Mr. Smith's proposal is not a violation of the Federal income tax normalization rules. (NS-PGL Ex. 30.0, p. 12)

The Utilities raise a valid argument that the change in income tax rates should be treated consistently among the utilities to avoid uneven results that vary as to when a rate case is filed. *Id.* at 21:494-496. For example, Northern Illinois Gas Company ("Nicor"), as a result of its merger, agreed to not file a rate case for three years. (NS-PGL IB, IV C. 6. A., p. 66) If in Nicor's next rate case, Nicor chooses a 2015 future test year, the test year would occur after the *temporary* state tax rate increase ends. Thus, Nicor customers would be precluded from receiving any of the "flow-through" benefits of the temporary schedule rates. *Id.* at 22:511-525.

F. Gross Revenue Conversion Factor

1. Methodology

2. Late Payment Charge Ratio

G. Net Operating Loss (Derivative Adjustment based on NOL Tax Asset)

VI. RATE OF RETURN

A. Overview

B. Capital Structure

C. Cost of Short-Term Debt

D. Cost of Long-Term Debt

E. Cost of Common Equity

1. Overview

The Companies' IB emphasizes the Commission's obligation to grant a fair return and describes possible ramifications if they are authorized a rate of return below their cost of capital. (NS-PGL IB, pp. 137-138) However, no one disputes that the Commission must grant a fair return or that there could be negative consequences, **if** the Companies are not given the opportunity to earn their investor-required rate of return. But the Companies' general truism fails to address the truly critical issue, which is determining what the Companies' investor-required rate of return is.

The Companies conclude that "a modest increase of the utilities' ROE would…comport with Staff's economic models, which show a 55-basis-point increase from the Utilities' last rate case."[6] (NS-PGL IB, p. 132) That argument is illogical, as there is no consensus on the direction of change of the investor-required return on common equity in this case. Indeed, using the Companies' reasoning, Staff could argue that an even larger *decrease* of the utilities' ROE would be warranted based on the *Companies'* analysis, which show an 85-basis-point *decrease* from the Utilities' last rate

[6] If the Companies' proposed increase of 55 basis points relative to the current authorized ROE (10.00% - 9.45% = 0.55%) is "modest," then Staff's proposed decrease of only 39 basis points (9.45% - 9.06% = 0.39%) is surely at least as modest, yet the Companies refuse to characterize Staff's proposal as "modest."

case (from 10.85% to 10.00%). (Order, Docket No. 11-0280/11-0281 (Cons.), January 10, 2012, p. 139)

The above notwithstanding, the primary issue in this proceeding is that the unadulterated market results of established cost of equity models indicate a much lower cost of common equity than the Companies propose. The difference between the Companies' and Staff's cost of common equity recommendations is due almost entirely to Mr. Moul's inclusion of a leverage adjustment and a risk premium model. (Staff Ex. 15.0, p. 8) In fact, when Mr. Moul's results are corrected to remove his leverage adjustment and risk premium model, both of which have been repeatedly rejected by this Commission, the Companies' result would be lower than Staff's (8.94% compared to 9.16%, before adjustment for Rider UEA). (Staff Ex. 5.0, pp. 30, 40-41) This fact appears to be lost on the Companies since their IB does not defend those aspects of Mr. Moul's analyses, but rather focuses almost exclusively on criticisms of the analyses that Staff and the Companies have in common: the DCF model and CAPM. When it comes down to it, market prices, interest rates, authorized ROE trends, and even the corrected ROE resulting from the Companies' inputs in this proceeding <u>all</u> support a cost of common equity similar to Staff's estimate. None support the Companies' recommended ROE.

Ultimately, the Companies' IB is really an attack on the DCF model and CAPM generally, rather than Staff's implementation of those models, since, the Companies' unadjusted results for those models are similar to, or lower than, Staff's. Staff believes such criticism is misplaced and maintains its belief that Staff's 9.06% ROE estimate is a reasonable estimate of the Companies' investor-required rate of return on common equity. Nevertheless, since the Companies also employed both the CAPM and DCF model in their own analysis and are obviously dissatisfied with Staff's results for those models, Staff would not object, if, in an effort to narrow its focus on this matter, the Commission were to adopt an ROE based solely on the Companies' unlevered CAPM and DCF model results. This would produce a base ROE of 8.94%, as detailed below.

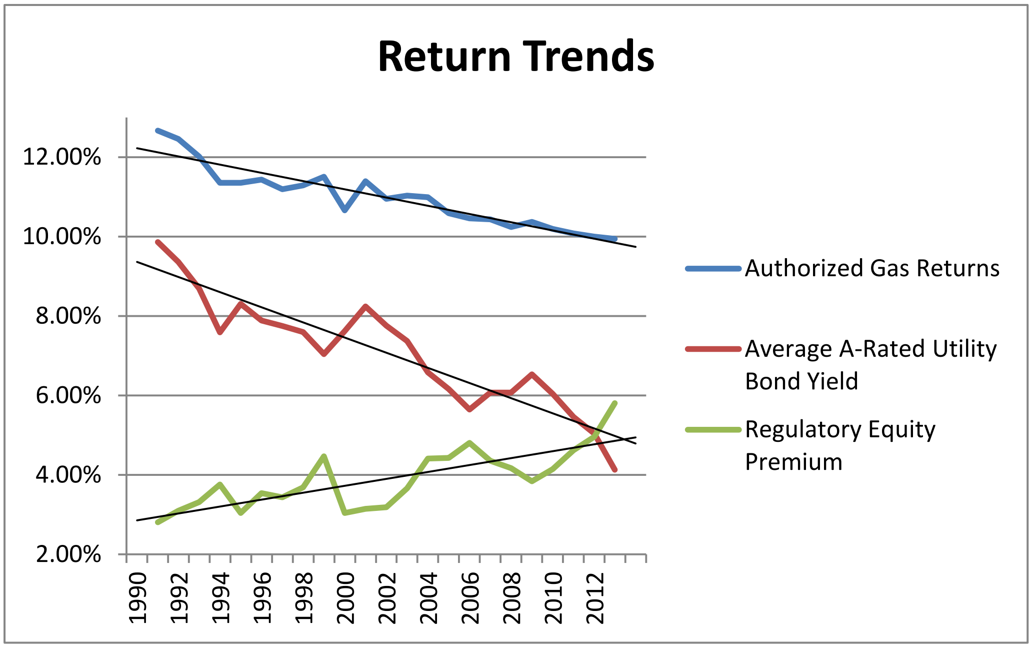
	dividend yield		growth rate		ROE estimate
DCF	3.99%	+	4.50%	=	8.49%
	risk-free rate		ß x (Rm-Rf)		ROE estimate
CAPM	4.00%	+	0.68 x (7.93%)	=	9.39%
Average					8.94%

(PGL Ex. 3.0, pp. 30, 39, and 43; NS Ex. 3.0, pp. 30, 39, and 43) Staff would maintain its recommendation that the base ROE be adjusted downward by ten basis points to reflect the reduction in risk associated with Rider UEA, which would result in an ultimate ROE of 8.84%.

2. ROE Trend

Staff concluded that the fact that interest rates are near all-time lows and have clearly been trending downward for over 20 years supports the adoption of a lower authorized return. (Staff Ex. 15.0, pp. 9-10) Although Mr. Moul acknowledged the falling interest rates Staff cited, he disputed Staff's conclusion, stating that interest rates provide "an incomplete picture of how authorized returns have reacted to that trend." He claimed to "complete that picture" by calculating and presenting equity risk premiums from authorized gas returns and A-rated utility bond yield from 1990-2012. (NS-PGL Ex. 39.0, pp. 3-4) The Companies' IB presents a graph of the equity risk premiums Mr. Moul calculated, which demonstrate an upward trend. They conclude quite firmly that "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 IB, p. 131) Ironically, the Companies present a picture that is not only incomplete, but false. Below is a graph of the true "complete picture" from the Companies' own work paper:



(Staff IB, pp. 77-78; Staff Cross Ex. 8) The top line presents the 1990-2012 authorized rate of return data Mr. Moul began with (but chose not to present); the middle line presents A-rated interest rates; and the bottom line depicts the equity risk premiums Mr. Moul calculated from the data graphed in the other two lines.[7] The unmistakable downward trend of the top two lines demonstrates that the movement of authorized returns has had a strong, direct correlation with that of interest rates – both have been steadily trending downward for over 20 years and are at the lowest they have been in that time, which clearly validates Staff's conclusion that falling interest rates suggest a lower ROE. In fact, Mr. Moul's own authorized rate of return data proves the Companies' statement that "the Utilities' cost of equity is increasing because the 'equity

[7] With trend lines added. The bottom line is the same data graphed on page 131 of the Companies' IB.

premium'...is rising" to be unequivocally false; indeed, the exact opposite has been true – the cost of equity has been falling despite a rise in the equity premium. Therefore, it is not surprising that the Companies want the Commission to focus on that equity premium data rather than the authorized rate of return data.

Furthermore, not only is the conclusion about the proper authorized return that the Companies attempt to draw from estimates of the equity premium false, but their argument is highly disingenuous. Despite Mr. Moul's claim that he was providing the "complete picture" regarding the proper authorized return, he failed to present for the record the very authorized return data with which he started. Instead, he used that data to derive a single component of the authorized return, the equity premium, to suggest a completely contradictory conclusion than the original authorized return data supports.

Mr. Moul then misapplied the Companies' embedded costs of long-term debt to manufacture a contrived ROE estimate of 10.36%, which the Companies now present to suggest their 10.00% recommendation is modest. (NS-PGL Ex. 39.0, p. 4; NS-PGL IB, pp. 131-132) However, the cost of equity Mr. Moul cobbled from the equity premium he derived is incorrectly calculated in several respects. First, the equity premium itself is overstated, as it reflects an average of all A rated utility bond yields, including A+, A, and A- utilities, rather than just A- utilities like the Companies. Due to their lower risk, the bond yields for A+ and A rated utilities are lower than those of A- rated utilities, all else equal. Thus, the inclusion of A+ and A utilities produces an understated average yield relative to that of an A- utility. Subtracting an understated bond yield from the authorized ROE produces an overstated equity risk premium. Second, a company's embedded cost of debt is not equivalent to its current investor-required return on long-term debt. For example, North Shore's embedded cost of long-term debt reflects costs of debt issued in 2003, 2008, and 2012. (Staff Ex. 15.0, Schedule 15.02N) The current investor-required return on debt would be the yield on a current debt issuance, not debt costs from a year ago, five years ago, and certainly not ten years ago. Third, Mr. Moul inappropriately mixes data from different years, as his equity premium was derived from 2012 data, but the long-term debt costs represent 2013 embedded costs. He has not demonstrated that the 2012 equity premium can be properly applied to a 2013 cost of long-term debt. In fact, to the contrary, if interest rates and ROEs were to rise in 2013, as Mr. Moul suggests, one would expect the equity premium to fall, given their inverse relationship shown in the graph above.[8] As such, Mr. Moul would be combining the higher 2012 equity premium with the higher 2013 cost of long-term debt and, thus, overstating the cost of equity. Given these severe flaws in the calculation of his 10.36% ROE estimate, any comparison to that estimate is uninformative.

3. Spot data

The Companies continue to criticize Staff's reliance on the most recently-available spot data, claiming that the use of spot data is subject to market inefficiencies that cause stock to trade at prices different than its true economic value.[9] Absurdly, the Companies state that Mr. McNally "admits" that stock prices change daily, as if to suggest that reflecting all known data is somehow inappropriate and it is preferable to

[8] Mr. Moul notes that the equity risk premium for 2012 represented an all-time high. (NS-PGL Ex. 39.0, p. 4) In contrast, interest rates in 2012 were the lowest they have been in at least 22 years.

[9] This, of course, raises the question of who determines the "true economic value," if it is not the investors in the marketplace, who "put their money where their mouth is." The Companies' argument seems to suggest that the analyst should substitute his judgment for that of investors, which are reflected in current stock prices. That would clearly be subjective and truly "invite all sorts of problems."

use outdated data. (NS-PGL IB, pp. 141-142) Staff addressed this issue in its IB. (Staff IB. pp. 79-80) As Staff explained, the most recent spot price will always be more timely than a historical average and is, thus, preferable. An analysis using the most current data reflects all information that is available and relevant to the market at the time of that analysis, including the number of days until the next dividend payment,[10] while analyses using older data reflect information that the market no longer considers relevant, including the number of days to dividends that have already been paid (and thus are unavailable to stock purchasers), a fact Mr. Moul has acknowledged. Therefore, use of a historical average requires the analyst to subjectively determine what data is no longer relevant, needlessly and inappropriately replacing the collective judgment of all investors with his own. (Staff Ex. 15.0, p. 15)

The Companies also continue their misguided efforts to label Staff's analysis as "historical." (NS-PGL IB, pp. 141-142) Contrary to the Companies' claims, Staff's analysis was <u>not</u> historical. Rather, Mr. McNally's analysis was a current analysis, relying on the most recent data available at that time. (Staff Ex 15.0, p. 15) This contrasts with the Companies' use of truly historical data, which was outdated by up to <u>five years</u> by the time of Mr. Moul's analysis, which was performed several months *before* Staff's analysis. (Staff Ex. 5.0, p. 34) Thus, the Companies' criticism of Staff's use of spot data as "historical" is curious, for even if one does accept that then-current

[10] Significantly, stock prices change with the approach of dividend payment dates and fall by the amount of the dividend on the ex-dividend date, as both Mr. McNally and Mr. Moul acknowledge, making consistency between the measurement dates for the stock price, growth rate, and dividend data critical. However, Mr. Moul inconsistently mixed and matched data from different points in time in his analysis. (Staff Ex. 5.0, pp. 16-17; PGL Ex. 3.13C, p. 4; Staff Ex. 15.0, pp. 15-16)

data should be considered historical, their criticism would still more clearly apply to their own analysis.

The Companies note that the Commission has voiced concerns with the use of spot data in recent decisions and has suggested that parties should provide context regarding the market conditions or financial climate at the time of such analyses. (NS-PGL IB, pp. 142-143) Mr. McNally directly addressed the Commission's concern in this proceeding by replicating his analysis every day for an entire week to demonstrate the normalcy of his analysis date. In fact, "the use of an alternative sample date" was one of the ways proposed by the Commission to provide context regarding the market conditions or financial climate at the time of such analyses. (Order, Docket Nos. 07-0241/07-0242 (Cons.), February 5, 2008, p. 92) Staff provided not just an alternative sample date, but four of them. That the results of those five analyses were all within five basis points demonstrates that the November 12, 2012 analysis was <u>not</u> the anomaly the Companies imply. (Staff Ex. 15.0, pp. 17-18) In contrast, the Companies have not even attempted to demonstrate that November 12, 2012 was anything other than a normal day.

The Companies claim that "Staff provided no evidence that information from a single day in the past provides a more accurate prediction than forecasts do." (NS-PGL IB, p. 141) That is simply a false statement. Staff showed that the April 1, 2012 Blue Chip forecasts Mr. Moul cited were less accurate than the actual interest rate as of that time. In contrast, the Companies provided nothing to demonstrate that either their historical data or their forecasts are superior to the most-recently available spot data. As Staff explained, it is impossible to accurately forecast interest rates. Academic research has shown that forecasters' predictions of future movements of interest rates are inaccurate. Indeed, as one financial text states, "forecasting interest rates is a perilous business. To their embarrassment, even the top experts are frequently wrong in their forecasts." Forecasts are frequently wrong even in the direction, let alone the magnitude and timing, of future interest rate changes. Security returns, including interest rates, closely approximate a type of time series called a random walk, making the current return the best estimate going forward. Moreover, if forecasting could be done with a reasonable degree of accuracy, there would be little divergence among the various sources. However, Staff showed that a 61% variance existed among even a small sampling of forecasts just a few months in advance of the forecast period, which demonstrates the difficulty in accurately predicting future movements of interest rates. These differences among forecasts lead to the further problem of selecting a forecast, since it is unknown which of these disparate results will ultimately be closest to realized rates. (Staff Ex. 15.0, pp. 3-5)

The Companies suggest that Staff's analysis and criticism of the use of forecasts in determining the ROE is inconsistent because Mr. McNally "relied on…forecasts for real GDP growth in his DCF model, but ignored the interest rate forecasts that the same sources publish that are relevant to his CAPM model." (NS-PGL IB, p. 146) This argument demonstrates a fundamental misunderstanding of the facts on the Companies' part. Contrary to the Companies' statement, Mr. McNally did not use GDP forecasts in his DCF model, as the DCF model does not call for GDP growth estimates of any sort. In fact, although Mr. McNally did *review* GDP growth forecasts in the process of assessing the appropriateness of the inputs for both his DCF and his CAPM analyses, he did <u>not</u> *apply* GDP growth forecasts in either of his models. Rather, he applied company-specific growth rate estimates in his DCF model and the actual 30-year U.S. Treasury bond yield for the risk-free rate in his CAPM. Thus, not only is the Companies' statement incorrect, but the consistency demonstrated in Staff's approach directly refutes the Companies' implication that Staff is inconsistent in its analysis and its criticism of the use of forecasts in determining the ROE.

The Companies' arguments against the use of spot data continuously shift, demanding of Staff an increasingly higher standard of proof, all the while providing no evidence to support their vague, hypothetical speculations. The Companies argue that market prices <u>may</u> be affected by unspecified market inefficiencies, but provide no evidence to suggest such inefficiencies have affected the market prices Staff used, despite the opportunities afforded to them during the evidentiary phase of this proceeding. (NS-PGL IB, p. 142) Nonetheless, Staff explains that it used a sample to mitigate the effects of those potential inefficiencies. The Companies, in turn, argue that use of a sample does not mitigate the effects of inefficiencies <u>if</u> all stock prices are affected by the same inefficiencies or the use of a sample does not cancel out the inefficiencies. This suggests a widespread problem in the market for which they provide no evidence despite the opportunities afforded to them during the evidentiary phase of this proceeding, but once again demand Staff disprove. As Staff explained, Mr. McNally replicated his analysis every day for a week to demonstrate that the November 1, 2012 analysis date was not anomalous. Still not satisfied, the Companies respond that "at most, all that Mr. McNally's cost of equity measurements demonstrate with any confidence is what the Utilities' market cost of equity was in one week in November

2012." (NS-PGL IB, p. 142) Accordingly, they once again shift their argument to now suggest that the issue at hand is not estimating the current cost of equity, but the cost of common equity investors will expect during the future test year. However, as Staff explained, it is difficult enough to estimate the current investor-required return when actual data is available on which to base such an analysis, as the high degree of contention on the subject during rate cases demonstrates. To attempt to project what investors will demand at some point in the future is pure speculation. Thus, the Commission should continue to rely on the current investor-required return on common equity rather than rely on a forecast. (Staff Ex. 15.0, p. 10) Indeed, contrary to the Companies' latest suggestion in their ever-changing argument, their own cost of equity witness never claimed to be estimating a future cost of common equity. Even if he had, that would leave the Companies defending the absurd position that looking backward (approximately six months for his DCF price data and more than five years for his risk premium) to outdated data provides a better estimate of the future cost of common equity than Staff's more recent November 2012 analysis.

4. DCF model selection

The Companies maintain that Staff's DCF result should be rejected, continuing to argue that Staff selected its version of the DCF model based on a "lower of" approach, which they claim is "intended to generate lower ROEs." (NS-PGL IB, pp. 143-144) The Companies' attempt at character assassination is gratuitous, unfounded, and patently false, as Staff explained in its IB. (Staff IB, pp. 80-81) Unfortunately, their willingness to assert that "the Commission can infer" that their claim is true when it was already established to be false only serves to demonstrate their willingness to engage in character assassination and the factual weakness of their position. Mr. McNally irrefutably established, in his rebuttal testimony, that use of a constant growth DCF in this proceeding produced a higher result than if he had used the non-constant growth DCF methodology used in the 2009 proceeding. (Staff Ex. 15.0, p. 12) Moreover, Mr. Moul's surrebuttal response did nothing to refute that truth, but merely presented an alternative growth rate for the non-constant DCF that would still produce a lower result than Mr. McNally's DCF model produced in this proceeding. Thus, even if one accepted Mr. Moul's alternative growth rate, Staff's conclusion would still be the same and the Companies' statement would still be false.[11] (Staff IB, p. 81)

The Companies also continue to argue that Staff's DCF model does not produce reliable results, which Staff addressed in its IB. (Staff IB, pp. 81-82) However, despite citing to the same surrebuttal conclusion, the Companies have modified their argument. They now suggest that the variance among Staff's individual DCF results for the companies in the sample "illustrates the volatility that can result when the DCF model is used to measure cost of equity based on a single day's data." (NS-PGL IB, p. 144) Once again, the Companies confuse the issue. Volatility and variance are not the same thing.[12] Thus, their conclusion that variance among ROE estimates illustrates volatility is unsound. Further, variance is not a result of the use of spot data. Rather, the

[11] Remarkably, while Mr. Moul stated that his alternative growth rate is "based upon the well accepted premise that long-term growth in a multi-stage DCF model should be linked to long-term GDP growth" (NS-PGL Ex. 39.0, p. 4), the Companies argued <u>the exact opposite</u> in their 2009 rate case, stating, "GDP is not an appropriate measure of long term natural gas utility growth." (Order, Docket Nos. 09-0166/09-0167 (Cons.), January 21, 2010, p. 99) Clearly, when it comes to rate of return, the Companies will say anything regardless of how wrong, how contradictory, how misleading, or how defamatory.

[12] Variance, as they use the term, is the difference between observations across a sample of companies. Volatility would be the dispersion of results for a single company over time. While the Companies point to variance between the DCF ROE estimates, they provide no evidence regarding volatility.

variance the Companies note is an unavoidable imperfection in the models that afflicts all such analyses, including their own. That is precisely why a sample is used – to reduce the effects of measurement error in any single estimate to make the final estimate more accurate. The Companies have not provided, indeed cannot provide, an alternative approach that avoids variance among estimates.

5. Other authorized ROEs

The Companies continue to defend their use of other authorized returns as a benchmark for determining the reasonableness of ROE estimates. (NS-PGL IB, pp. 147-148) However, as Staff explained in its IB, reliance on authorized ROEs for *other* companies, in *other* jurisdictions, at *other* times during *other* market environments is not useful when critical aspects of those decisions, such as the relative risk of the utilities involved, any common stock flotation cost adjustment that were included in those decisions, and the market environment in which those decisions were made, are entirely unknown. (Staff Ex. 15.0, pp. 8-9; Staff IB, p. 77)

The Companies claim that Mr. Moul addressed those concerns regarding unidentified critical information. They claim that he demonstrated that the bond ratings of the utility industry are currently tightly clustered, that adjustments for flotation costs are small if made at all, that the 2011-2012 measurement period was limited. (NS-PGL IB, p. 148) However, those claims completely fail to address the concerns Staff raised. First, Mr. Moul's discussion of the credit ratings of the overall utility industry does not reveal the risk of the specific subset of companies represented in the authorized ROEs he cited. Simply put, if we do not know the risk level of the companies represented in the authorized ROEs Mr. Moul cited, we cannot conclude, as Mr. Moul suggests, that those authorized ROEs are "representative of returns investors can earn on other investments of comparable risk."[13] (NS-PGL Ex. 24.0, p. 22) Second, Mr. Moul did not truly address the flotation cost issue at all, but instead, simply suggested it can be ignored. Just because Mr. Moul claims, without any documentation, that flotation costs have small effect on the average authorized ROE does not mean such information can be ignored. Indeed, the Companies certainly have not ignored the relatively small (i.e., ten basis points) adjustments Staff proposes for Rider UEA and they propose for Rider VBA. Third, that the authorized ROEs were limited to rulings made in 2011-2012 does nothing to address the current market environment the Commission must assess in making its ROE decision, as those determinations reflect the market environment from one to two years ago. As the authorized ROE trend graph presented earlier indicates, a year or two can make a significant difference in the market environment. Moreover, given the clear downward trend over the last 22 years, 2011 and 2012 authorized ROEs

[13] Furthermore, it does not matter how "tightly clustered" the credit ratings of a group of companies are if they do not reflect the same risk as North Shore and Peoples Gas. The average credit rating for the overall utility industry – the only risk metric Mr. Moul presented – was BBB+. (PGL Ex. 3.5, p. 3) That is a notch below the Companies' credit rating of A–, indicating a higher degree of risk for those companies, rendering them inappropriate for use as a benchmark for the Companies. The average credit rating for the companies whose authorized ROEs Mr. Moul cited may be even lower – we do not know. Moreover, even if a tight clustering was significant, the credit ratings for the utility industry companies were, in fact, not tightly clustered. Their credit ratings spread across eight credit rating notches, all the way from A down to BB– (junk bond status), with the credit ratings for 23 of those 32 companies below that of North Shore and Peoples Gas and only two above. Given their criticism of the variance amongst individual company DCF estimates, one would be expect the Companies to shy away from relying on a group of companies with bond ratings of such a range, particularly one that extends well into the "junk" status. However, as the Companies repeatedly demonstrate throughout their IB, consistency is one of their hobgoblins. Also, lost on the Companies is the irony that such "tightly clustered" credit ratings come from companies with Value Line betas that range from 0.55 to 1.20, which would produce CAPM ROE estimates that are far from tightly clustered – ranging all the way from 8.36% up to 14.52%, based on the Companies' risk-free rate and market risk premium estimates. (PGL Ex 3.5, p. 3; PGL Ex. 3.0, p. 43) That range of results is considerably higher than the range of Staff's DCF results that the Companies criticize as unreliable.

produce an overstated benchmark for the Companies' current ROE, let alone for the future test year ROE the Companies now appear to advocate.

Nonetheless, the Companies suggest that other authorized returns are the type of "general financial market information" the Commission should consult to assess the consistency of the various ROE proposals with the "real-world" conditions surrounding their current decision. (NS-PGL IB, p. 147) However, looking at historic regulatory data to judge current return requirements ignores the current real-world financial data. That data, including market prices, interest rates, authorized ROE trends, and even the corrected ROE resulting from the Companies' inputs in this proceeding indicate that a return of 9.06% is appropriate, as Staff's analysis demonstrated. In fact, the analysis presented by the Companies' own witness provides a lower result, when adjusted to remove his leverage adjustment and risk-premium analysis, both of which have been repeatedly rejected by the Commission. (Staff Ex. 5.0, pp. 40-41) Despite all the current real world data indicating a falling ROE, the Companies not only seek to look backward to justify their ROE recommendation, but, in fact, demand an ROE above the 2012 average of the historical authorized ROEs they cite. (NS-PGL IB, p. 147)

The Companies also defend their use of other authorized returns on the grounds that they represent a large sample. In fact, the Companies suggest that any observation derived from a sample is "relevant and useful," and once again stoop to questioning Mr. McNally's integrity because he allegedly only "relied on samples when it suited his analysis." (NS-PGL IB, p. 146) However, Mr. McNally's "refusal" to rely on the sample of authorized ROEs the Companies cite was warranted and is in no way indicative of a character flaw. The Companies' suggestion that a sufficiently large sample cures all ills would be like using the average weight of all men in the world to estimate the weight of a given woman. Clearly that would be folly, for although it would be a very large sample, it measures the wrong target. Similarly, the authorized ROE the Companies cite, for *other* companies, in *other* jurisdictions, at *other* times during *other* market environments, were not intended to measure the cost of common equity for the Companies.[14] Indeed, even the limited information Mr. Moul provided to defend his use of those authorized returns suggests they are <u>not</u> appropriate for use as a benchmark for the Companies' ROE.

6. Betas

The Companies claim that Staff's regression beta estimate is biased downward. (NS-PGL IB, p. 145) The Companies' conclusion that the regression beta is biased downward is results-based, stemming solely from a comparison to Value Line beta estimates, which illogically assumes the conclusion that the Value Line beta estimates are correct and differing estimates are incorrect. Obviously, one could just as easily conclude that it is the Value Line betas that are biased upward. The fact is, there is no reason to believe either is "biased"; they are simply calculated differently (i.e., weekly vs. monthly return observations). That is precisely why Staff used multiple approaches to estimating beta. (Staff Ex. 5.0, pp. 27-28) In fact, this highlights an inconsistency with the Companies' arguments, as they advocate the use of multiple sample companies, models, and growth rate estimates, and malign Mr. McNally for using samples "when it suited his analysis," yet Company witness Moul only utilized a single

[14] Relying on authorized rates of return in other jurisdictions also creates a circularity problem: the authorized rate of return in the first jurisdiction becomes the standard for the second jurisdiction, which in turn, becomes the basis for the rate of return in the first jurisdiction.

source for his beta estimates. Moreover, this argument has been litigated numerous times, and numerous times Staff's beta has been accepted by the Commission. In fact, this was litigated in the Companies' last rate case in which the Commission's Final Order stated:

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

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

Further committing to their accusation of Staff bias, the Companies state that "published betas are not adequate for Staff's purposes." (NS-PGL IB, p. 145) Their continued attempt to disparage Staff is once again gratuitous, unsupported, and false. Unlike the Companies, who advocate solely on their own behalf, Staff's "purpose" is to derive an accurate estimate of the true investor-required return, in order to balance the interests of rate payers and shareholders. As explained in Staff's IB, it is unknown which beta source more accurately estimates the unobservable, true beta; thus, a combination of betas was used for a more balanced approach. (Staff IB, pp. 82-83) If Staff was truly avoiding published betas in an attempt to <u>minimize</u> the ROE estimate, as the Companies imply, Staff would not have included the <u>higher</u> Value Line beta and certainly would not have adjusted the published Zacks beta <u>upward</u> to reflect the findings of academic studies. Moreover, if, as the Companies imply, the purpose of Mr. McNally's inclusion of Staff's non-published regression beta estimate was to minimize his ROE estimate, Mr. McNally would not have gone out of his way to average that beta estimate with the Zacks beta estimate before combining them with the Value Line beta estimate, in order to avoid overweighting monthly return betas, which, of course, had the effect of *reducing* the influence of the lower regression and Zacks betas on his CAPM ROE estimate. (Staff Ex. 5.0, pp. 28-29) The Commission should not tolerate the Companies' personal attacks on Staff, especially when they are so obviously fallacious.

7. Effect of Riders

The Companies argue that the existence of bad debt trackers for some of the companies in the proxy sample render the Rider UEA adjustment that has been made in the Companies' last two rate cases unwarranted. (NS-PGL IB, p. 149) This was fully addressed in Staff's IB. (Staff IB, p. 85) As Staff explained, the Companies have not provided any data regarding the percentage of the revenues affected by bad debt trackers for the sample companies that have them. Simply put, that bad debt trackers apply to some unknown portion of the sample's revenues does not warrant the elimination of Rider UEA, particularly when it is known that a large portion of those revenues are not affected.

The Companies also argue that a 10-basis point upward adjustment to the Companies' authorized ROE is warranted due to the possibility that Rider VBA may be rejected by the Appellate Court. (NS-PGL IB, pp. 149-150) This was fully addressed in Staff's IB. (Staff IB, pp. 90-91) As Staff explained, the Companies' proposal is premature because, although it would very definitely increase rates beginning this July, it is not yet known *when*, or even *if*, Rider VBA will be overturned. Moreover, we do not know whether the Commission would adopt alternative means of recovering fixed costs if the Courts find Rider VBA violates statute. The Companies argue that Staff is trying to "have it both ways," since Staff is contesting the Companies' alternative SFV rate proposal while also contesting their upward ROE adjustment. The Companies are wrong. Staff did not argue against the upward ROE adjustment if Rider VBA were to be immediately overturned without a comparable replacement, such as SFV. Rather, Staff clearly explained that it is <u>premature</u> to make such an adjustment at this time because, as of yet, those things have not happened. In fact, it is the Companies that are attempting to have it both ways by seeking to have Rider VBA or SFV rates in place while, <u>at the same time</u>, having a higher ROE as though Rider VBA or SFV rates were not in place.[15]

F. Weighted Average Cost of Capital

VII. WEATHER NORMALIZATION (Uncontested)

VIII. COST OF SERVICE

A. Overview

B. Embedded Cost of Service Study – Uncontested

[15] After being subjected to so many invalid examples of alleged inconsistency in the Companies' IB, a valid example of an inconsistency is in order to return one's logic processor to its factory state. For example, one would be seeking "to have it both ways" if one were to oppose an upward adjustment to the authorized ROE because the utility still has Rider VBA while simultaneously arguing that Rider VBA should be eliminated without replacement with an alternative means of de-coupling fixed costs from sales levels. Staff is not advocating the cancellation of rider VBA in this proceeding. (See, Section IX., D. of this reply brief)

IX. Rate Design

A. Overview

B. General Rate Design

1. Allocation of Rate Increase

2. Uniform Numbering of Service Classifications

3. Bifurcation of S.C. No. 1 class

4. Terms and Conditions of Service

C. Service Classification Rate Design

1. Uncontested Issues

a. Service Classification No. 2, General Service (Straight Fixed Variable Rate Design Addressed in IX.C.2)

b. Large Volume Demand Service

c. Service Classification No. 8, Compressed Natural Gas Service

d. Contract Service for Electric Generation

e. Contract Service to Prevent Bypass

f. Rider SSC, Storage Service Charge

2. Contested Issues – North Shore and Peoples Gas

a. Service Classification No. 1, Small Residential Non-Heating

Staff has not changed its position on this issue. The Commission should accept Staff's proposal to recover 80% of non-storage related fixed costs through the Companies' customer charge, which the Companies accepted in their rebuttal testimony. (Staff IB, pp. 101-105) The AG's proposed flat monthly charge for the Companies' S.C. No. 1 Non-Heating ("NH") customers should be rejected.

AG witness Scott Rubin is proposing that both NS and PGL implement a monthly flat rate with no distribution charge for non-heating customers. (AG IB, p. 118) Mr. Rubin states that the non-heating class is much more homogeneous compared to the heating class, with 85% of bills for PGL and 75% of bills for NS that are ten therms or less per month. (*Id.*) (Section 285.5130, Schedule E-8, Page 3 of 8 identifies 71% of bills for NS are for 10 therms or less not 75% as identified by Mr. Rubin) Also, Mr. Rubin indicated that the difference between typical winter and summer usage for the residential non-heating class is small. (*Id*., p. 119)

The AG's proposed flat monthly charge for S.C. No. 1 NH customers, while not labeled as a SFV rate, has the same effect as a 100% SFV rate. It charges customers the same rate regardless of the different demands each customer places on the system. Thus, the same criticism the AG makes against a 100% SFV rate also applies to the AG's own flat rate proposal. Regarding the Companies' proposed 100% SFV rate, AG witness Rubin argued:

> "The fundamental flaw in SFV rates is that they treat demand-related costs as "fixed" even though they are incurred based on the amount of gas customers use. It is grossly unfair to spread demand-related costs among all customers irrespective of the amount of gas used by those customers."
> (*Id.*, p. 110)

The AG's proposal fails to consider the differences in demand among the S.C. No. 1 NH customers. Staff witness Johnson explained that even though 85% of bills for PGL and 71% of bills for NS are for ten therms or less that still leaves 15% for PGL (199,802 bills) and 29% NS (6,585 bills) that are above 10 therms. In fact, there are

2,633 bills for PGL usage above 200 therms, ranging from 200 therms to over 1,000 therms. Likewise, there are 142 bills for NS usage above 200 therms, ranging from 200 therms to approximately 900 therms. (Staff IB. pp. 103-104) So even though there are a high percentage of total bills that are for 10 therms or less, there are still customers that use more therms and place different demands on the system. Second, even though the difference between typical winter and summer usage for the residential non-heating class is small, (*see* AG Exhibits 3.01 and 3.04), there is a distinct pattern of increased usage in the winter months. This indicates that the non-heating residential class is placing greater demands on the system in the winter compared to the summer months. So even though a large percentage of non-heating customers may be using 10 therms or less, there are some customers in the non-heating class that are using more therms and should be charged for the different demands they place on the system. Third, as Staff pointed out in its Initial Brief, the Commission in Docket No. 07-0585 et al. (Cons.) and Docket No. 08-0363 has stated that it believes that leaving a portion of fixed costs to be recovered through the volumetric rate (20%) would encourage companies to seek ways to improve efficiency and otherwise cut costs. The Commission also has noted if all of their fixed costs were recovered through the monthly charge, companies may arguably over-recover their fixed costs through the monthly charge. (Staff IB, pp. 103-104)

b. Service Classification No. 1, Small Residential Heating

Staff has not changed its position on this issue. The Commission should reject the Companies' proposal to increase fixed cost recovery to 80% for the S.C. No. 1 Heating ("HTG") class. The Commission should accept Staff's proposal to increase fixed cost recovery for North Shore to 68%, from its current 67%, and increase fixed cost recovery for Peoples Gas to 61%, from its current 54%. (Staff IB, pp. 105-107)

The Companies argue that Staff's proposed fixed charge increase from 67% to 68% for North Shore and 54% to 61% for Peoples Gas is too modest in light of Commission policy on this matter. (NS-PGL IB, p. 159) However, as Staff has discussed throughout the proceeding, the Commission should proceed gradually and cautiously in the movement towards greater fixed cost recovery. Staff explained that if too much emphasis is placed on ensuring revenue requirements are met through higher fixed charges, other basic rate objectives will be inadvertently overshadowed. (Staff IB, p. 113) For example, Peoples Gas customers under present rates currently pay 25.963 cents per therm for the first 50 therms and 11.806 cents per therm for anything over 50 therms. Peoples Gas' shifting of the distribution charge costs to the customer charge shifts the price signal customers receive from the distribution charge. Approximately 48% of total bills are attributed to 50 therms or less which, currently, is charged at the 25.963 cents per therm. Decreasing the current distribution charge from 25.963 cents per therm to 10.054 cents per therm, as Peoples Gas' proposed in rebuttal testimony in order to recover 80% of fixed costs in the distribution charge, will not encourage customers to use less gas. Leaving the non-storage related demand costs in the distribution charge will ease the move to a flat rate while still encouraging conservation. (*Id*., pp. 106-107)

Additionally, the Companies are proposing to bifurcate the S.C. No. 1 class and that split will affect the two customer groups differently. For example, the bifurcation produces the counter-intuitive result that the customer charge for the non-heating class decreases even though the percentage of fixed costs recovered through that customer charge increases under both Staff's and the Companies' proposals. Even under Staff's proposed 80% fixed cost recovery for the S.C. No. 1 non-heating class there is a dramatic decrease in the customer charge compared to the current combined S.C. No. 1 class. The decrease in the customer charge for non-heating customers, even at 80% fixed cost recovery, is a clear indication of the cost differences between heating and non-heating customers that was not apparent when the heating and non-heating customers were combined. Using the Companies' proposed direct testimony revenue requirement, the customer charge for the non-heating group would decrease from $22.00 per month to $14.48 for North Shore and from $22.25 per month to $13.63 for Peoples Gas. (*Id*., p. 102) This occurs because the bifurcation produces a reduction in the customer charge for the non-heating class that more than offsets the increase that would result from either Staff's or the Companies' fixed cost recovery proposals. This is not the case for the heating class. The Commission should first wait and observe what effects the S.C. 1 split has on all of the Companies' residential customers before moving forward on significantly greater fixed cost recovery through the customer charge for the C.C. No. 1 HTG classes.

c. Service Classification Nos. 1 and 2, Alternative Conditional Straight Fixed Variable Rate Design

Staff has not changed its position on this issue. The Commission should reject the Companies' proposal to include a second set of rates for S.C. No. 1 and S.C. No. 2 customers as a contingent backup in the event Rider VBA is overturned in court.

The Companies argue in their initial brief that were the Illinois Appellate Court to reverse the Commission's approval of decoupling, customer charges recovering anything less than 100% of fixed costs would not result in the level of decoupling approved by the Commission in the 2011 rate cases. Absent full decoupling, adequate fixed cost recovery would need to be accomplished through rate design, leaving fixed monthly charges, as the only viable alternative to fully decouple fixed cost recovery from the volume of gas consumed. (NS-PGL IB, p. 160)

Staff disagrees. First, Staff does not believe the Commission's intent is to put rates in place for utilities so that a certain revenue requirement is guaranteed. Section 1-102(a)(i) of the Act states: "tariff rates for sale of various public utility services are authorized such that they accurately reflect the cost of delivering those services and allow utilities to recover the total costs prudently and reasonably incurred." (220 ILCS 5/1-102(a)(i)) The Commission recognized this in the Companies' last rate case when the Commission's final order stated that "[u]nder long established federal and Illinois constitutional law, and Illinois ratemaking law, a utility's rates must be set so as to allow it the opportunity to obtain full **recovery** of its prudent and reasonable costs of service, including its costs of capital. (Final Order, January 10, 2012, Docket Nos. 11-0280/0281 (Cons.), p. 5) (Emphasis added) The Companies have historically filed rate cases when they believed their rates were inadequate to cover their costs. They are not precluded from continuing to do so. (Staff IB, pp. 113-114)

Second, Rider VBA and SFV rates are not equivalent substitutes for one another because they recover fixed costs in different proportions from different customers resulting in different rate impacts on customers. Rider VBA recovers any under or over recovery of fixed costs on a per therm basis. SFV rates would recover fixed costs on a per customer basis, which would affect small use customers greater than larger use customers. (*Id*., pp. 108-109)

Third, even if the Illinois Appellate Court reverses the Commission's Order in Docket Nos. 11-0280/11-0281 (Cons.) Staff is still proposing greater fixed cost recovery through fixed charges. If the Commission believes greater fixed cost recovery is warranted, then Staff's proposed non-SFV rates would meet that requirement in a way that is more consistent with prior Commission orders and that considers gradualism and conservation. (*Id.*)

Fourth, if events occur that lead the Companies to believe that a different rate structure would be more appropriate, the Companies are able to file rate cases when they deem it necessary to do so. In fact, according to the Companies' own testimony, Peoples Gas and North Shore are currently required to file biennial rate proceedings in 2014 and 2016 under Section 9-220(h-1) of the Act. (*Id.*)

Fifth, the Companies used customer demand forecasts for the 2013 test year which should minimize some of the Companies' concerns about adequate cost recovery. In fact, Companies' witness Kevin R. Kuse testified that the Companies have used this same model in the past three rate cases and the model has performed well historically. (*Id.*)

Sixth, having two rates in place will cause confusion for ratepayers or anyone else examining the tariff books. Tariffs are confusing enough for typical customers without presenting two sets of rates, one of which is not actually in effect. The Companies' proposal to present two different rates for the same service, one of which, the proposed SFV rate, takes two separate paragraphs to explain and has no effective date, would be very confusing to customers. It is in the best interest of the Commission and customers to have rate tariffs that are, to the greatest extent possible, easy to understand. In fact, the Act indicates that one of the goals and objectives of regulation is to ensure "the fair treatment of consumers and investors in order that…the application of rates is based upon public understandability and acceptance of the reasonableness of the rate structure and level." (220 ILCS 5/1-102(d)(ii)) Including two rates on a tariff sheet whereby one of the rates will become effective only if a court determines that the other rate is illegal is not only confusing but premature. In fact, there is no known effective date in the Companies' proposed tariff language. Even if Rider VBA is not allowed by the court to continue, there may be legal disputes over what the correct effective date of the new customer charges and distribution charges should be. (*Id.*)

Seventh, Rider VBA is still in effect and it is speculative as to whether it will be overturned.

Eighth, the Commission has already declined to approve 100% fixed cost recovery through a fixed charge. In fact, the Commission explained why it is important to leave a portion of fixed costs to be recovered through the volumetric rate:

> The Commission does not at this time approve recovery of all fixed costs in the monthly charges for two reasons. First, it is expected that leaving a portion of fixed costs to be recovered through the volumetric rate will encourage AIU to see ways to improve efficiency and otherwise cut costs. Second, as the number of AIU's customers grows, AIU should experience growing revenue. If all of its fixed costs were recovered through the monthly charge, AIU may arguably over-recover its fixed costs through the monthly charge.

(Order, Docket No. 07-0585 et al. (Cons.), September 24, 2008, p. 237)

The Commission was clear that it did not want 100% fixed cost recovery through a fixed charge

Even if the Commission rejects Staff's arguments against the Companies' conditional tariff proposal which it should not, the Companies' proposal should be rejected as a matter of law. The Companies' conditional tariff proposals are inconsistent with Section 9-201 of the Act. Section 9-201(a) provides in part that:

> Unless the Commission otherwise orders, and except as otherwise provided in this Section, no change shall be made by any public utility in any rate or other charge or classification, or in any rule, regulation, practice or contract relating to or affecting any rate or other charge, classification or service, or in any privilege or facility, except after 45 days' notice to the Commission and to the public as herein provided. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules or supplements stating plainly the change or changes to be made in the schedule or schedules then in force, *and the time when the change or changes will go into effect*, and by publication in a newspaper of general circulation or such other notice to persons affected by such change as may be prescribed by rule of the Commission. The Commission, for good cause shown, may allow changes without requiring the 45 days' notice herein provided for, by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

(220 ILCS 5/9-201(a)) (Emphasis added) Under the Companies' proposal, the tariff only takes effect if it ever does at some unknown date in time depending on events outside the Commission's control. This proposed conditional tariff is contrary to the plain language of Section 9-201(a) that a tariff must state "plainly the change or changes to be made in the schedule or schedules then in force, and *the time when the change or changes will go into effect*" (220 ILCS 5/9-201(a))(Emphasis added) Since no one knows when the conditional tariff will take effect, if it ever does, the conditional tariff fails to comply with the requirement of Section 9-201(a) that an effective date be

provided in the tariff. Accordingly, the conditional proposed tariffs of North Shore and Peoples Gas should be rejected as a matter of law. (*Id.*)

D. Fixed Cost Recovery and Rider VBA

Staff has not changed its position on this issue. Staff's proposed fixed cost recovery proposals are more consistent with past Commission rulings and should be approved. With respect to Rider VBA the Commission should reject the argument made by the AG and CUB-City to terminate Rider VBA.

The Companies argue the risk from the Court reversing the Commission's approval of full decoupling means that more movement to fixed cost recovery through fixed charges is appropriate. (NS-PGL IB, p. 162) Staff opined that the Commission should proceed gradually and cautiously in the movement towards greater fixed cost recovery. Staff witness Johnson explained that if too much emphasis is placed on ensuring revenue requirements are met through higher fixed charges, other basic rate objectives will be inadvertently overshadowed. (Staff IB, p. 113) Staff noted that the Commission's Order in Ameren's Docket No. 07-0585 et al. (Cons.) made it clear that caution should be used recovering greater fixed costs in setting rates in order to meet certain rate objectives such as encouraging Ameren to improve efficiency and cut costs. Additionally, the Commission was concerned that Ameren could possibly over-recover its revenue requirement if too many fixed costs were recovered through the monthly charge. (*Id*.)

The Companies also opined that the 80% fixed cost recovery proposed for S.C. No. 1 would be consistent with the partial decoupling approved for Ameren and Nicor

Gas. (NS-PGL IB, p. 162) However, Staff succinctly pointed out that the Companies' belief that fixed cost recovery should not be set at anything below that of Ameren's and Nicor's 80% level of fixed cost recovery for the S.C. No. 1 HTG classes is misguided. The Companies currently have a true-up mechanism in place through Rider VBA that guarantees recovery of all of its fixed costs in the approved revenue requirement. Even if Rider VBA is eventually overturned by the court, Staff's rate design proposal still provides movement towards greater fixed cost recovery through fixed charges. (Staff Ex. 17.0, p. 7)

The Companies also stated that Staff's proposal to set the customer charge for the Companies' S.C. No. 1 NH customers at 80% of fixed costs leaves the Companies' S.C. No. 1 HTG classes as the only small residential rate class with lesser fixed cost recovery among the state's large gas utilities. (NS-PGL IB, p. 162) However, Staff has explained why Staff's proposed 80% fixed cost recovery for the S.C. No. 1 NH customers should not be applied to the S.C. No. 1 HTG classes' fixed cost recovery at this time. Staff has repeatedly discussed how the proposal to bifurcate the S.C. No. 1 class will affect the two S.C. No. 1 customer groups differently. For example, the bifurcation produces the counter-intuitive result that the customer charge for the non-heating class decreases even though the percentage of fixed costs recovered through that customer charge increases under both Staff's and the Companies' proposals. Even under Staff's proposed 80% fixed cost recovery for the S.C. No. 1 non-heating class there is a dramatic decrease in the customer charge compared to the current combined S.C. No. 1 class. The decrease in the customer charge for non-heating customers, even at 80% fixed cost recovery, is a clear indication of the cost differences between heating and non-heating customers that was not apparent when the heating and non-heating customers were combined for COS purposes. This occurs because the bifurcation produces a reduction in the customer charge for the non-heating class that more than offsets the increase that would result from either Staff's or the Companies' fixed cost recovery proposals. This is not the case for the heating class. The Commission should first observe what effects the S.C. 1 split has on all of its residential customers before moving forward on significantly greater fixed cost recovery through the customer charge for the S.C. No. 1 HTG classes.

The AG and CUB-City argue that the Commission should order the Companies to terminate Rider VBA. (AG IB, p. 138; CUB-City IB, p. 79) AG and CUB-City argue in part that Rider VBA is unlawful because it violates the Act's prohibition against retroactive ratemaking. (AG IB, p. 135; CUB-City IB, pp. 75-76) The Commission decided to move forward with Rider VBA on a permanent basis just over a year ago in Docket No. 11-0280/0281 (Cons.). Rider VBA was initially in place on a pilot basis following the Commission's decision in Docket Nos. 07-0241/0242 (Cons.). In Docket Nos. 11-0280/0281 (Cons.) the Commission after considering the evidence decided to direct the Companies to continue Rider VBA on a permanent basis. (Order, Docket No. 11-0280/0281 (Cons.), January 10, 202, p. 164) The Commission's order stated in part the following:

> The Commission agrees with Staff that Rider VBA has operated as the Commission intended. The annual reconciliation proceedings have disclosed no issues with the operation of the rider. The Commission also agrees with Staff and the Companies that Rider VBA stabilizes the Companies' revenues and ensures that the S.C. Nos. 1 and 2 customers neither over- nor under-pay the approved revenue requirements. While the Commission supports increased recovery of fixed costs through fixed charges, it prefers, at this time, decoupling rather than a switch to an SFV

> rate design. For these reasons the Commission is convinced that there has been a compelling and sufficient showing that a permanent Rider VBA is reasonable and justified. The Commission directs that Rider VBA shall continue on a permanent basis. Subject to that limitation, the Commission approves the tariff changes as set forth in NS-PGL Ex. 45.5 and NS-PGL Ex. 45.6 except for those which provide consideration for customer switching between S.C.2, S.C. 3, and S.C. 4

(*Id*.) AG and CUB-City acknowledge that the Commission's order in Docket Nos. 11-0280/0281 (Cons.) is currently under appeal in the Second District, Docket Nos. 2-12-0243 and 2-12-0349. (AG IB, p. 130) Staff's understanding is that the matter has been fully briefed and that oral argument was held on March 4, 2013. The only thing left as part of that appeal process is for the Second District Appellate Court to issue its decision.

Staff recommends that the Commission not terminate Rider VBA in this proceeding as the AG and CUB-City suggest, but rather await the Second District Appellate Court's decision on Rider VBA. If the Commission were to terminate Rider VBA as the AG and CUB-City argue, which it should not, the appeals in the Second District, Docket Nos. 2-12-0243 and 2-12-0349, would become moot and those appeals would likely be dismissed. (*Illinois Bell Telephone Co. v. Illinois Commerce Comm'n*, 67 Ill. App.3d 616, 617 (1979) "A case is moot where there is no existing controversy and nothing remains for the court to decide. An appellate court will not review a case for the sole purpose of establishing a precedent. (*Phillips v. Board of Education* (1974), 23 Ill.App.3d 124, 318 N.E.2d 687) An exception to the rule is stated in *People ex rel. Wallace v. Labrenz* (1952), 411 Ill. 618, 104 N.E.2d 769, Cert. denied, 344 U.S. 824, 73 S.Ct. 24, 97 L.Ed. 642, for cases of great public concern if an authoritative determination is desirable, and if there is a likelihood of a future recurrence of the question." Presumably the Companies would then appeal a Commission finding in this proceeding that Rider VBA was illegal which would add even more years of litigation in pursuit of the ultimate fundamental issue of whether Rider VBA is consistent with the law as the Commission determined it to be in Docket Nos. 11-0280/0281 (Cons.) and Docket Nos. 07-0241/0242 (Cons.). Based upon the above, Staff recommends that the Commission reject the AG's and CUB-City's proposal that Rider VBA be terminated.

X. Transportation Issues

A. Uncontested Issues

1. Purchase of Receivables (Withdrawn)

2. Commission Authority to Order Investigation on Provider of Last Resort

Both IGS and the Utilities commented on the issue of whether the Commission had the authority to order an investigation into ending the Utilities' role as a provider of last resort. The Utilities took no position. (NS-PGL IB, p. 163) IGS asserted that the Commission's ability to investigate could be broadly interpreted to include such an investigation. (IGS IB, pp. 10-11) Staff, as noted in its IB, does not disagree. (Staff IB. p. 116)

B. Contested Issues

1. Cost Allocation Between Sales Customers and Small Volume Transportation Customers

IGS devotes a considerable part of its IB decrying the alleged poor status of retail competition in Peoples Gas and North Shore Gas' territories. (IGS IB, pp. 2-5) IGS apparently intends to convince the Commission that immediate steps to correct cost allocations are required to make the Choices For You ("CFY") successful. (*Id*., pp. 5-8) One, it is asking the Commission to change the allocation of costs to base rates, so that CFY customers are no longer allocated costs that they allegedly do not cause. (*Id*., pp. 13-20) Two, especially if the Commission denies a change in cost allocations, it requests that the administrative charges that currently only apply to CFY customers, instead, be allocated to all eligible CFY customers. (*Id*., pp. 20-27)

IGS starts its argument by including a graph which it believes shows the following:

> Over the last three years, the number of customers participating in both of the Companies' Choices For You programs has dropped by more than one-third; only a handful of competitive suppliers are even registered to provide service in the Companies' service areas.

(*Id*., pp. 2-3) In support of its statements, IGS refers to IGS Energy Cross Exhibits 25 and 26. However, there is no North Shore Gas information appearing in IGS Cross Exhibits 25 and 26. IGC Cross Exhibits 25 and 26 only contain data for Peoples Gas. While IGS cross examined Companies' witness Ms. Egelhoff concerning the number of customers in Peoples Gas CFY program, no such questions were posed to Ms. Egelhoff with respect to North Shore. (*Tr*., February 13, 2013, pp. 910 and 933) Thus, there is no evidence in the record for IGS to suggest that the number of North Shore's CFY customers has declined by more than a third as IGS suggests. (IGS IB, p. 3) Staff's understanding is that the percentage change for North Shore is only 11.4%.[16] With

[16] As of March 31, 2010 NS had 10,844 CFY customers and as of December 31, 2012 NS had 9,608. (10,844-9608/10,844 equals 11.4%. Source: Quarterly Reports filed in Docket No. 01-0469. Staff acknowledges that these figures are not in evidence. To the extent the Commission finds it necessary to (continued…)

respect to Peoples Gas the percentage change is a decline of 22.1% not 33% as IGS argues.[17]

Another metric that IGS relies upon to convey the picture of a "badly functioning market" is the number of suppliers operating under the program. IGS states that "only a handful of competitive suppliers are even registered to provide service in the Companies' service areas." (IGS IB, p. 12) According to the IGS Cross Exhibits, eight suppliers provide service in Peoples Gas territory and there are six in North Shore Gas' service area. In contrast, there are 22 suppliers to Nicor small volume customers. (IGS Cross Exhibits 21-23) IGS' simplistic analysis ignores several factors that differentiate the three gas utilities. First, and most obviously, Nicor has a much larger customer base than either North Shore or Peoples Gas. For example, Nicor has almost 2.2 million customers that are eligible for its small volume transportation program. (IGS Cross Exhibit 20) In contrast, Peoples Gas has approximately 42,288 ÷ 0.051 ≈ 830,000 eligible customers.[18] (IGS Cross Exhibit 19 and 20) There are approximately 2.6 times as many eligible customers in Nicor territory relative to the Utilities and 2.75 times as many suppliers. Taking into account that Nicor has a larger customer base the 2.75 number of Nicor choice suppliers vs. the Companies' choice suppliers does not suggest a large difference in supplier interest.

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rely upon these figures, the Commission could take administrative notice of the filings referenced in Docket No. 01-0469.

[17] As of March 31, 201 PGL had 54,288 CFY customers and as of December 31, 2012 PGL had 42,288 CFY customers. (IGS Cross Ex. 25 and 26) (54,288-42,288/54,288 equals 22.1%)

[18] The estimated number of eligible customers is derived from the percentage participating (5.1%) and the number of CFY customers (42,288), since % participating = # CFY customers ÷ customers # eligible.

Further, IGS does not address whether or how conditions in the wholesale gas market affect the numbers of CFY suppliers. (Staff Ex. 18.0, pp. 5-6) Instead of focusing on the effect that wholesale market conditions have on CFY participation, IGS cites cost misallocation as a large factor for the decline in the number of CFY customers. (IGS IB, pp. 3-5) IGS cites to the cost allocations that the Commission approved for Nicor as a reason for Nicor's allegedly more competitive market. (IGS IB, p. 13) However, in the 2009 Peoples Gas-North Shore Gas rate case, IGS as part of an ad hoc group of Retail Gas Suppliers ("RGS") proposed incorporating various key aspects of the more successful Nicor CFY program, Customer Select SVT. (Final Order, January 21, 2010, Docket Nos. 09-0166/7 (Cons.), pp. 253-254) The Commission agreed, and ordered workshops which were held during the fall of 2010. The Companies filed the resulting tariffs on January 27, 2011, and they took effect on March 13, 2011. But the trajectory of participation in the CFY program did not change after these changes were made. That is, even after the Commission ordered some of the changes sought by suppliers, customers continued to switch back to sales service. (IGS IB, p. 2, IGS Energy Chart 1.0)

Peoples Gas and North Shore Gas charge suppliers $200 per group per month Aggregation Charge, and a $0.40 per-customer charge per month. (*See* Rider AGG in Peoples Gas's tariffs: Ill. C.C. No. 28, Seventh Revised Sheet No. 110) While IGS does not discuss this amount, this charge was $0.83 prior to January 28, 2010, (Peoples Gas' tariffs; Ill. C. C. No. 28, First Revised Sheet 110), and $1.02 from January 28, 2010 until January 21, 2012. (*See* Peoples Gas' tariffs; Ill. C. C. No. 28, Fifth Revised Sheet 110) Thus, it is difficult to see the correlation between the amount of the per customer charge and customer interest in transportation service. In fact, customer numbers continued to decline even after the administrative charges fell by 61%.

In conclusion, IGS fails to include any facts or argument in its brief that contradicts Staff's position expressed in Staff's Initial Brief. Data necessary to clarify cost causation of the existing customer charges simply is not available. (Staff IB, p. 116) However, in the case of the CFY program's administrative costs, those costs are tracked and are clearly caused by the transportation customers. (*Id*., pp. 115-116) IGS's attempt to paint the Utilities' CFY market as a failure is not a fair characterization of the market. There is no urgent need for the Commission to reform a market that is not dysfunctional.

2. Recovery of Supply-related Costs from Small Volume Transportation Program (Choices for You^{SM} or "CFY") Customers

See Section X.B.1.

3. Recovery of Small Volume Transportation Program (Choices for You^{SM} or "CFY") Administrative Costs

See Section X.B.1.

4. Provider of Last Resort Investigation

Consistent with Staff's position set forth in its Initial Brief, Staff continues to believe that if the Commission is interested in the topic at a theoretical level, it could order an investigation, even though North Shore and Peoples Gas are not currently in a position to surrender their provider of last resort responsibilities. (*Id*., p. 116)

XI. CONCLUSION

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

Respectfully submitted,

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JESSICA A. CARDONI
JOHN C. FEELEY
NICOLE LUCKEY
ANGELIQUE PALMER
Office of General Counsel
Illinois Commerce Commission
160 North LaSalle Street, Suite C-800
Chicago, IL 60601
Phone: (312) 793-2877
Fax: (312) 793-1556
jcardoni@icc.illinois.gov
jfeeley@icc.illinois.gov
nluckey@icc.illinois.gov
apalmer@icc.illllinois.gov

Counsel for the Staff of the
Illinois Commerce Commission

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