STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

North Shore Gas Company	**:**	
	:	**12-0511**
Proposed general increase in natural gas rates. (Tariffs filed on July 31, 2012)	**:**	
	:	
The Peoples Gas Light and Coke Company	**:**	**12-0512**
	:	
Proposed general increase in natural gas rates. (Tariffs filed on July 31, 2012)	**:**	**Cons.**

PROPOSED ORDER

[Draft Proposed Order Submitted by North Shore Gas Company and The Peoples Gas Light and Coke Company]

[Please note that this Draft Proposed Order does not address any new calculations, contentions, or positions in the Reply Briefs of Staff and intervenors as such, although some material herein regarding prior calculations, contentions, and positions in effect may do so to some degree in some instances. The Utilities do not waive, and instead expressly reserve the right to make in subsequent filings, and in oral argument if any, any and all responses and/or objections as they may have to any and all such new material in the Reply Briefs of Staff and intervenors.]

_____ ___, 2013

TABLE OF CONTENTS

				Page
I.	INTRODUCTION			1
	A.	Procedural History		1
	B.	Nature of Operations		6
		1.	North Shore	6
		2.	Peoples Gas	6
II.	TEST YEAR (Uncontested)			6
III.	REVENUE REQUIREMENT			6
	A.	North Shore		7
	B.	Peoples Gas		7
IV.	RATE BASE			8
	A.	Overview/Summary/Totals		8
		1.	North Shore	8
		2.	Peoples Gas	8
	B.	Uncontested Issues (All Subjects Relate to NS and PGL Unless Otherwise Noted)		8
		1.	Cushion Gas Calculation	8
		2.	Plant	9
		a.	Forecasted Test Year Capital Additions – Utility Plant in Service (PGL)	9
		b.	Advanced Metering Infrastructure Project	
		c.	LNG Control System Upgrade and Related Project	9
		d.	Calumet System Upgrade	9
		e.	CNG Fueling Station	9
		f.	Incentive Compensation – Capitalized Amounts Disallowed in Prior Cases	9
		g.	Original Cost Determination as to Plant Balances as of December 31, 2011	10
		3.	Budget Plan Balances	10
		4.	Accumulated Deferred Income Taxes – 50/50 Sharing Related to Tax Accounting Method Change	10

C. Potentially Contested Issues (All Subjects Relate to NS and PGL Unless Otherwise Noted) 10
1. Year End Rate Base or Average Rate Base 10
2. Plant 18
a. Forecasted Test Year Capital Additions – Utility Plant In Service (NS) 18
b. Accelerated Main Replacement Program Projects (PGL) 19
c. Construction Work In Progress (PGL) 26
d. Non-Union Wages (see also Section V.C.2) 28
e. Capital Costs for Non-AMRP Gas Services 28
3. Cash Working Capital 29
a. Pass-Through Taxes 29
b. Pension/OPEB 32
c. All Other 33
4. Retirement Benefits, Net 33
5. Net Operating Losses 36
6. Accumulated Deferred Income Taxes – 39
a. Appropriate Methodology to Reflect Change in State Income Tax Rate 39
b. Repairs Deduction Related to AMRP Projects 43
c. Bonus Depreciation 45
d. Derivative Adjustments from Contested Adjustments 46

D. Accumulated Depreciation (Uncontested Except for Derivative Adjustments from Contested Adjustments) 46

V. OPERATING EXPENSES 46

A. Overview/Summary/Totals 46
1. North Shore 46
2. Peoples Gas 46

B. Potentially Uncontested Issues (All Subjects Relate to NS and PGL Unless Otherwise Noted) 47
1. Administrative & General 47
a. Interest Expense on Budget Payment Plan 47
b. Interest Expense on Customer Deposits 47
c. Lobbying Expenses 47
d. Social and Service Club Dues 48
e. Executive Perquisites 48
f. Consulting Expense – SIG Consulting 48
g. Employee/Retiree Perquisites – Awassa Lodge 48
h. Update to Pension and Benefits 48
i. Update to IBS Return on Investment 48
j. Costs to Achieve Amortization 48
2. Uncollectible Account Expense Included in Base Rates 49

3. Depreciation Expense – 49
   a. WAM System 49
   b. CNG Plant 49
4. Income Tax Expense – Changes in Interest Expense On Debt Financing 49
5. Revenues 49
   a. Sales and Revenue Adjustment by Service Classification 49
6. Interest Synchronization (methodology on derivative adjustments) 50

C. Potentially Contested Issues (All Subjects Relate to NS and PGL Unless Otherwise Noted) 50
1. Incentive Compensation (Falls in Multiple Categories of O&M) 50
2. Wage Increase Correction 56
3. Non-union Base Wages (Falls in Multiple Categories of O&M) 57
4. Vacancy Adjustment (Falls in Multiple Categories of O&M) 63
5. Distribution O&M 64
   a. Plastic Pipefitting Remediation Project 64
   b. Legacy Sewer Lateral Cross Bore Program 65
   c. New Chicago Department of Transportation Regulations 66
6. Productivity Adjustment 67
7. Administrative & General 69
   a. Adjustments to Integrys Business Support Costs 69
   b. Advertising Expense 71
   c. Charitable Contributions 73
   d. Institutional Events 74
8. Depreciation 75
   a. Bonus Depreciation 75
   b. Derivative Adjustments from Contested Adjustments 75
9. Rate Case Expenses 75

D. Taxes Other Than Income Taxes and Invested Capital Taxes (Payroll) (Uncontested Except for Invested Capital Tax and Derivative Adjustments from Contested Adjustments) 84
1. Invested Capital Tax Computation and Derivative Adjustments 85

E. Income Taxes (Including Interest Synchronization) (Derivative Adjustments from Contested Adjustments) 86
1. Appropriate Methodology to Reflect Change in State Income Tax Rate (see also Section V.C.6.a.) 86

F. Gross Revenue Conversion Factor 86
1. Methodology 86
2. Late Payment Charge Ratio 86

G. Net Operating Loss (Derivative Adjustment based on NOL Tax Asset) 87

VI. RATE OF RETURN 87

A. Overview 87

B. Capital Structure 88

C. Cost of Short-Term Debt 89

D. Cost of Long-Term Debt 89

E. Cost of Common Equity 91
1. Overview 91
2. Proxy Group Analysis 93
3. DCF 93
4. CAPM 96
5. Risk Premium 97
6. Effect of Riders UEA & VBA 98
7. Commission Analysis and Conclusions 99
a. The Context 99
b. The DCF Model 100
c. The CAPM Model 101
d. Risk Premium Analysis 101
e. Adjustments for Riders UEA & VBA 102
f. Conclusion 102

F. Weighted Average Cost of Capital 103
1. North Shore 103
2. Peoples Gas 103

VII. WEATHER NORMALIZATION – AVERAGED PERIOD (Uncontested) 104

VIII. COST OF SERVICE 104

A. Overview 104

B. Embedded Cost of Service Study – Uncontested 104

IX. RATE DESIGN 105

A. Overview 105

B. General Rate Design 105
1. Allocation of Rate Increase 105
2. Uniform Numbering of Service Classifications 106
3. Bifurcation of S.C. No. 1 class 107
4. Terms and Conditions of Service 108

C. Service Classification Rate Design 109

1. Uncontested Issues 109

a. Service Classification No. 2, General Service (Straight Fixed Variable Rate Design Addressed in IX.C.2) 109
b. Large Volume Demand Service 110
c. Service Classification No. 8, Compressed Natural Gas Service 111
d. Contract Service for Electric Generation 111
e. Contract Service to Prevent Bypass 111
f. Rider SSC, Storage Service Charge 112

2. Contested Issues – North Shore and Peoples Gas 112

a. Service Classification No. 1, Small Residential Non-Heating 112
b. Service Classification No. 1, Small Residential Heating 114
c. Service Classification Nos. 1 and 2, Alternative Conditional Straight Fixed Variable Rate Design 118

D. Fixed Cost Recovery and Rider VBA 122

X. TRANSPORTATION ISSUES 124

A. Uncontested Issues 124
1. Purchase of Receivables (Withdrawn) 124
2. Commission Authority to Order Investigation on Provider of Last Resort 124

B. Contested Issues 125
1. Cost Allocation Between Sales Customers and Small Volume Transportation Customers 125

2. Recovery of Supply-related Costs from Small Volume Transportation Program (Choices for You^{SM} or "CFY") Customers 125
3. Recovery of Small Volume Transportation Program (Choices for You^{SM} or "CFY") Administrative Costs 126
4. Provider of Last Resort Investigation 126

XI. FINDINGS AND ORDERING PARAGRAPHS 127

STATE OF ILLINOIS

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	:	
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ORDER

By the Commission:

I. Introduction

A. Procedural History

On July 31, 2012, North Shore Gas Company ("North Shore" or "NS") filed with the Illinois Commerce Commission ("Commission"), pursuant to Section 9-201 of the Public Utilities Act (the "Act") (220 ILCS 5/9-201), the following revised tariff sheets: ILL. C.C. No. 17, Title Sheet and ILL. C. C. No. 17, Sheet Nos. 6-11, 17, 27, 28, 58, 124, 135.1. This tariff filing embodied a proposed general increase in gas service rates, and revisions of other terms and conditions of service. The tariff filing was accompanied by direct testimony, other exhibits, and other materials required under Parts 285 and 286 of Title 83 of the Illinois Administrative Code (the "Code"), 83 Ill. Adm. Code Parts 285 and 286.

On July 31, 2012, The Peoples Gas Light and Coke Company ("Peoples Gas" or "PGL") filed with the Commission, pursuant to Section 9-201 of the Act, the following revised tariff sheets: ILL. CC. No. 28, Title Sheet and ILL. C. C. No. 28, Sheet Nos. 4-10, 16, 18, 28, 29, 59, 130-140, 151.1. This tariff filing embodied a proposed general increase in gas service rates and revisions of other terms and conditions of service. The tariff filing was accompanied by direct testimony, other exhibits, and other materials required under Parts 285 and 286 of the Code.

Notices of the proposed tariff changes reflected in these rate filings were posted in North Shore's and Peoples Gas' (the "Utilities" or "Companies") business offices and published in secular newspapers of general circulation in the Utilities' respective service

areas, as evidenced by publishers' certificates, in accordance with the requirements of Section 9-201(a) of the Act and the provisions of 83 Ill. Adm. Code Part 255.

The Commission issued a Suspension Order for North Shore's tariff filing on September 6, 2012, which suspended the tariffs to and including December 27, 2012, and further initiated Docket 12-0511. On December 19, 2012, the Commission issued a Resuspension Order that suspended these tariffs to, and including, June 27, 2013.

The Commission issued a Suspension Order for Peoples Gas' tariff filing on September 6, 2012, which suspended the tariffs to and including December 27, 2012, and initiated Docket 12-0512. On December 19, 2012, the Commission issued a Resuspension Order that suspended these tariffs to, and including, June 27, 2013.

On September 24, 2012, the Administrative Law Judges ("ALJs") held an initial status hearing and, on the oral motion of Commission Staff ("Staff"), consolidated these cases and also orally approved a case schedule and data request response time schedule.

On September 26, 2012, North Shore and Peoples Gas (collectively, the "Utilities") each filed motions for protective orders in each Docket, pursuant to 83 Ill. Adm. Code §200.600.

On October 5, 2012, the Utilities filed a motion for entry of case management plan and schedule, pursuant to Section 10-101.1 of the Act and 83 Ill. Adm. Code §§ 200.190, 200.370, and 200.500.

On October 29, 2012, the ALJs issued a notice of schedule.

On January 23, 2013, the Attorney General of the State of Illinois (the "Attorney General" or "AG") filed a motion to strike and deny The Peoples Gas Light and Coke Company's and North Shore Gas Company's request for a conditional SFV Tariff and certain associated testimony.

On January 29, 2013, the AG filed a motion to strike certain portions of the surrebuttal testimony of the Utilities' witnesses Mr. Hengtgen and Mr. Stabile.

On January 29, 2013, Staff filed a motion to strike certain portions of the surrebuttal testimony of the Utilities' witness Mr. Hoops.

On March 11, 2013, the Utilities filed a motion to correct the transcript of the February 4-8, 13, 2013 Hearings.

Rulings on motions are discussed further below.

Petitions to Intervene

Petitions to Intervene were filed or appearances were entered on behalf of the AG; the Citizens Utility Board ("CUB"); the City of Chicago (the "City") (collectively, CUB

and the City are "CUB-City") the Utility Workers Union of America, Local Union No. 18007 ("UWUA Local 18007"); and Interstate Gas Supply of Illinois, Inc. ("IGS Energy").

The Evidentiary Hearing

The evidentiary hearing was held February 4, 2013, through February 8, 2013, and February 13, 2013, at the offices of the Commission in Chicago, Illinois. At the evidentiary hearings, the Utilities, Staff, and the Intervenors entered appearances and presented testimony. The following witnesses testified on behalf of the Utilities: James F. Schott, Vice President and Chief Financial Officer, Integrys Energy Group, Inc., North Shore and Peoples Gas (NS Exhibit ("Ex.") 1.0 Revised ("REV"), PGL Ex. 1.0 REV., NS-PGL 22.0 Second Revised ("2REV"), NS-PGL Ex 37.0); Lisa J. Gast, Manager, Financial Planning and Analysis, Integrys Business Support, LLC (NS Ex. 2.0, PGL Ex. 2.0, NS-PGL Ex. 17.0, NS-PGL Ex. 23.0, NS-PGL Ex. 38.0); Paul R. Moul, Managing Consultant, P. Moul & Associates (NS Ex. 3.0, PGL Ex. 3.0, NS-PGL Ex 24.0 REV, NS-PGL Ex. 39.0); Kevin R. Kuse, Senior Load Forecaster, Integrys Business Support, LLC (NS Ex. 4.0, PGL Ex. 4.0, NS-PGL Ex. 40.0); Christine M. Gregor, Director, Operations Accounting, North Shore and Peoples Gas (NS Ex. 5.0 REV, PGL Ex. 5.0 REV, NS-PGL Ex. 16.0, NS-PGL Ex. 25.0, NS-PGL Ex. 41.0 Corrected ("CORR")); Sharon Moy, Rate Case Consultant, Regulatory Affairs, Integrys Business Support, LLC (NS Ex. 6.0, PGL Ex. 6.0, NS-PGL Ex. 18.0, NS-PGL Ex. 26.0, NS-PGL Ex. 42.0 REV); John Hengtgen, Consultant, Stafflogix Corporation (NS Ex. 7.0, PGL Ex. 7.0, NS-PGL Ex. 19.0, NS-PGL Ex. 27.0, NS-PGL Ex. 43.0); Kyle Hoops, General Manager, District Field Operations, The Peoples Gas Light and Coke Company (NS Ex. 8.0, PGL Ex. 8.0, NS-PGL Ex. 20.0, NS-PGL Ex. 28.0 REV, NS-PGL Ex. 40.0); Noreen E. Cleary, Assistant Vice President, Total Compensation, Integrys Energy Group, Inc. (NS Ex. 9.0, PGL Ex. 9.0, NS-PGL Ex. 29.0, NS-PGL Ex. 45.0); John P. Stabile, Tax Director, Integrys Business Support, LLC NS Ex. 10.0, PGL Ex. 10.0, NS-PGL Ex. 30.0 REV, NS-PGL Ex. 46.0); Christine M. Phillips, Manager, Benefits Accounting, Integrys Business Support, LLC (NS Ex. 11.0, PGL Ex. 11.0, NS-PGL Ex. 31.0, NS-PGL Ex. 47.0); Valerie H. Grace, Consultant, Stafflogix Corporation (NS Ex. 12.0 REV, PGL Ex. 12.0 REV, NS-PGL Ex. 32.0, NS-PGL Ex. 48.0 REV), Joylyn C. Hoffman-Malueg, Rate Case Consultant, Regulatory Affairs, Integrys Business Support, LLC (NS Ex. 13.0, PGL Ex. 13.0, NS-PGL Ex. 33.0); Philip M. Hayes, Director, Project Management, Integrys Business Support, LLC (PGL Ex. 14.0, NS-PGL Ex. 21.0, NS-PGL Ex. 34.0, NS-PGL Ex. 49.0 CORR); Thomas L. Puracchio, Manager, Gas Storage, Integrys Business Support, LLC (PGL Ex. 15.0, NS-PGL Ex. 35.0), Debra E. Egelhoff, Manager, Gas Regulatory Policy, Integrys Business Support, LLC (NS-PGL Ex. 36.0, NS-PGL Ex. 50.0).

The following witnesses testified on behalf of Staff: Dianna Hathhorn, Accountant, Accounting Department, Financial Analysis Division, Illinois Commerce Commission (Ex. 1.0, Ex. 11.0), Daniel Kahle, Accountant, Accounting Department Financial Analysis Division, Illinois Commerce Commission (Ex. 2.0, Ex. 12.0 REV, Ex. 23.0, Ex. 24.0); Mike Ostrander, Accountant, Accounting Department, Financial Analysis Division, Illinois Commerce Commission (Ex. 3.0, Ex. 10.0, Ex. 13.0 REV, Ex. 25.0); Bonita Pearce, Accountant, Accounting Department, Financial Analysis

Division, Illinois Commerce Commission (Ex. 4.0, Ex. 14.0), Michael McNally, Senior Financial Analyst, Finance Department, Financial Analysis Division, Illinois Commerce Commission (Ex. 5.0, Ex. 15.0), Brett Seagle, Gas Engineer, Engineering Department, Energy Division, Illinois Commerce Commission (Ex. 6.0, Ex. 16.0), Christopher Boggs, Rates Analyst, Rates Department, Financial Analysis Division, Illinois Commerce Commission (Ex. 7.0), William Johnson, Economic Analyst, Rates Department, Financial Analysis Division, Illinois Commerce Commission (Ex. 8.0, Ex. 17.0), Alicia Allen, Rate Analyst, Fates Department, Financial Analysis Division, Illinois Commerce Commission (Ex. 9.0), David Rearden, Senior Economist, Policy Program, Energy Division, Illinois Commerce Commission (Ex. 18.0), Darin Burk, Pipeline Safety Program Manager, Safety and Reliability Division, Illinois Commerce Commission (Ex. 19.0), Philliph Buxton, Program Manager, Energy Engineering Program, Safety and Reliability Division, Illinois Commerce Commission (Ex. 20.0), David Sackett, Economic Analyst, Policy Program, Policy Division, Illinois Commerce Commission (Ex. 21.0), Rochelle Phipps, Senior Financial Analyst, Finance Department, Financial Analysis Division, Illinois Commerce Commission (Ex. 22.0).

The Attorney General's witnesses were: Michael Brosch, Principal, Utilitech Inc. (AG Ex. 1.0, AG Ex. 4.0), David J. Effron, Consultant (AG Ex. 2.0, AG Ex. 5.0); Scott Rubin, Consultant (AG Ex. 3.0 REV, AG Ex. 6.0).

CUB-City's witness was: Ralph Smith, Consultant (CUB-City Ex. 1.0, CUB-City Ex. 2.0).

The Utility Workers Union of America's witness was: Richard Passarelli, Business Manager, Local Union Number 18007, Utility Workers Union of America, AFL-CIO (UWUA Ex. 1.0).

Interstate Gas Supply of Illinois' witness was: Vincent A. Parisi, General Counsel, Interstate Gas Supply of Illinois, Inc. (IGS Ex. 1.0, IGS Ex. 2.0).

The above references to testimony are intended to include the attachments thereto, whether given separate exhibit numbers or not.

All parties were given the opportunity to cross-examine witnesses. On _____ __, 2013, the ALJs marked the record "Heard and Taken".

Rulings on Motions

A status hearing was held September 24, 2012, where the ALJs granted Staff's motion to consolidate these Dockets.

On October 16, 2012, after considering all of the parties' arguments, the ALJs entered a Protective Order for these dockets.

On October 29, 2012, the ALJs granted the Utilities' Motion for Entry of an Order Regarding Case Management Plan and Schedule.

On December 13, 2012, the ALJs granted Staff's motion for leave to file supplemental rebuttal testimony of Mr. Ostrander.

On January 29, 2013, the ALJs granted Staff's motion for leave to file supplemental rebuttal testimony of Mr. Kahle.

During the Hearing of February 6, 2013, the ALJs denied both Staff's motion to strike portions of Utilities' witness Mr. Hoops' surrebuttal testimony and the AG's motion to strike to deny the Utilities' request for a conditional SFV tariff and certain associated testimony.

During the Hearing of February 7, 2013, the ALJs granted Staff's oral motion for leave for the parties to file surrebuttal testimony on the issue of Net Operating Loss Adjustments. Also during the Hearing of February 7, 2013, the ALJs denied the AG's motion to strike certain portions of the surrebuttal testimony of the Utilities' witnesses Mr. Hengtgen and Mr. Stabile.

On March 13, 2013, the ALJs granted the Utilities' motion to correct the transcript of the Feb. 4-8, 13, 2013 Hearings.

Post-Hearing Briefs

On March 8, 2013, the Utilities, Staff, the AG, City-CUB, and IGS, each filed Initial Briefs ("Init. Br.").

On March 26, 2013, the Utilities, _____, and _____ each filed Reply Briefs ("Rep. Br.").

On March 28, 2013, per direction of the ALJs, the Utilities submitted a draft Proposed Order and _____ submitted draft position statements.

On _____ __, 2013, the ALJs issued their Proposed Order.

On _____ __, 2013, Briefs on Exceptions ("BOE") were filed by _____.

On _____ __, 2013, Reply Briefs on Exceptions ("RBOE") were filed by _____.

This Order considers all of the positions and arguments set out in the exceptions briefs and reply briefs on exceptions listed above.

* * *

B. Nature of Operations

1. North Shore

North Shore is engaged in the business of transporting, purchasing, storing, distributing and selling natural gas at retail to approximately 158,000 residential, commercial, and industrial customers within 54 communities in Lake and Cook Counties, Illinois. This service territory covers about 259 square miles. The company owns approximately 2,303 miles of gas distribution mains and approximately 96 miles of transmission lines. North Shore employed approximately 163 people at the time these cases were filed. North Shore is a wholly owned indirect subsidiary of Integrys Energy Group, Inc. ("Integrys"). NS Ex. 1.0 Rev. at 8.

2. Peoples Gas

Peoples Gas is engaged in the business of transporting, purchasing, storing, distributing and selling natural gas at retail to approximately 826,000 residential, commercial, and industrial customers within the City of Chicago. This service territory covers about 237 square miles and has a population of approximately three million people. The company owns approximately 4,119 miles of gas distribution mains and approximately 419 miles of transmission lines. Peoples Gas also owns a gas storage field, Manlove Field. Peoples Gas employed approximately 1,162 people at the time these cases were filed, nearly all within the City of Chicago. Peoples Gas is a wholly owned indirect subsidiary of Integrys. PGL Ex. 1.0 Rev. at 8-9.

II. <u>TEST YEAR (Uncontested)</u>

The Utilities proposed calendar year 2013, the twelve months ending December 31, 2013, as the test year. NS Ex. 6.0 at 4-5; PGL Ex. 6.0 at 4-5. The 2013 test year data were based on the Utilities' forecasted 2013 revenues, expenses, and rate bases, subject to appropriate adjustments. The proposed test year is reasonable (NS Ex. 6.0 at 2; PGL Ex. 6.0 at 2), is uncontested, and is approved.

III. <u>REVENUE REQUIREMENT</u>

"Under 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." *North Shore Gas Co., et al.*, ICC Docket Nos. 11-0280, 11-0281 Cons. (Order Jan. 10, 2012) ("*Peoples Gas 2011*"), p. 5. The legal standards governing a utility's right to a fair and reasonable rate of return, in particular, are well-established and familiar. A public utility has a constitutional right to a return that is "reasonably sufficient to assure confidence in the financial soundness of the utility and [is] adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties." *Bluefield Water Works & Improvement Co. v. Public Service Comm'n of the State of West Virginia*, 262 U.S. 679, 693 (1923). The authorized return on equity "should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover,

should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944). The Commission "fully embraces the principles set forth" in the *Bluefield* and *Hope* cases. *In re Consumers Ill. Water Co.*, ICC Docket No. 03-0403 (Order April 13, 2004), p. 41; *Peoples Gas 2011* Order, p. 5. Allowing a utility the opportunity to recover fully its costs of service, including its costs of capital, is in the long-term interests of customers, because this is necessary in order for the utility to be able to provide adequate, safe, and reliable service over time at the least long term cost. *Peoples Gas 2011* Order, p. 5.

The Commission, in a rate case, is required to set just and reasonable rates. 220 ILCS 5/9 201(c). The rates must be just and reasonable to the utility and its stockholders as well as customers. *Bus. and Prof. People for the Pub. Interest v. Illinois Commerce Comm'n*, 146 Ill. 2d 175, 208, 585 N.E.2d 1032, 1045 (1991).

The formula for determining a utility's costs of service -- its revenue requirement is well-established and uncontested. RR = OE + (ROR x RB). A utility's revenue requirement ("RR") equals: (1) its operating expenses ("OE") plus (2) a reasonable rate of return ("ROR") on its rate base ("RB"). *Commonwealth Edison Co. v. Illinois Commerce Comm'n*, 322 Ill. App. 3d 846, 849, 751 N.E.2d 196, 199 (2d Dist. 2001).

A. <u>North Shore</u>

North Shore's final proposed base rate revenue requirement is $85,703,000, or $87,313,000 if costs recovered as Other Revenues ($1,610,000) are included, and North Shore states that its proposed revenue requirement is just and reasonable based on the testimony and other exhibits in evidence. *E.g.,* NS PGL Ex. 42.0 Rev. at 3; NS-PGL Ex. 42.1N, lines 1, 5, 10, and 11, col. [H].

At each of the direct, rebuttal, and surrebuttal testimony stages, each of the Utilities presented pie charts showing the drivers of their cost increases over the levels approved in the Utilities' 2011 rate cases (*Peoples Gas 2011*) and summary information regarding those drivers. NS-PGL Init. Br. at 10-13.

[PLEASE NOTE THAT THE REVENUE REQUIREMENT FIGURES IN THIS SECTION III OF THIS DRAFT PROPOSED ORDER AND IN THE REMAINDER OF THIS DRAFT PROPOSED ORDER ASSUME THE FIGURES FOUND IN ALTERNATIVE (2) FOR FINDINGS AND ORDERING PARAGRAPHS (9) AND (10), SET FORTH IN SECTION IX HEREIN. IF ALTERNATIVE (1) FOR PARAGRAPHS (9) and (10) IS ADOPTED, THEN THE AFFECTED FIGURES HERE AND IN THE REMAINDER OF THIS DRAFT PROPOSED ORDER SHOULD BE REVISED ACCORDINGLY.]

B. <u>Peoples Gas</u>

Peoples Gas' final proposed base rate revenue requirement is $628,894,000, or $645,089,000 if costs recovered as Other Revenues ($16,195,000) are included, and Peoples Gas states that its revenue requirement is just and reasonable based on the

testimony and other exhibits in evidence. *E.g.,* NS PGL Ex. 42.0 Rev. at 3; NS-PGL Ex. 42.1P, lines 1, 5, 10, and 11, col. [H].

As noted above, the Utilities' presented information on the drivers of their cost increases over the levels approved in *Peoples Gas 2011*.

IV. RATE BASE

A. Overview/Summary/Totals

1 and 2. North Shore and Peoples Gas

North Shore's surrebuttal presented a year-end rate base of $209,116,000, reflecting adjustments proposed by Staff and intervenors that the utility agreed with or accepted in whole or in part, certain updates, and the correction of certain prior calculation errors. NS-PGL Ex. 43.0 at 26; NS-PGL Ex. 43.1N at Sched. B-1; NS-PGL Ex. 43.2N at Sched. B-2. North Shore's Schedules also presented average rate bases for 2013 and for the last six months of 2013.

Peoples Gas' surrebuttal presented a year-end rate base of $1,659,271,000, reflecting adjustments proposed by Staff and intervenors that the utility agreed with or accepted in whole or in part, certain updates, and the correction of certain prior calculation errors. NS-PGL Ex. 43.0 at 26; NS-PGL Ex. 43.1P at Sched. B-1; NS-PGL Ex. 43.2P at Sched. B-2. Peoples Gas' Schedules also presented average rate bases for 2013 and for the last six months of 2013.

North Shore's and Peoples Gas' rate bases are supported by extensive, detailed evidence, including the testimony of John Hengtgen (overall rate base and the underlying calculations and supporting various components of rate base); Kyle Hoops (key components of Gross Utility Plant); Christine Gregor (the test year forecast, including the Capital Budget); Noreen Cleary (capitalized incentive compensation costs); Christine Phillips (updating the pension and OPEB liability figures and the pension assets/liability); and, as to Peoples Gas in particular, Thomas Puracchio (certain capital projects) and Philip Hayes (certain capital projects). NS-PGL Init. Br. at 14-15.

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

1. Cushion Gas Calculation

The Utilities and Staff agree that a 3.0% estimate should be used in calculating cushion gas. PGL Ex. 15.0 at 8; Staff Ex. 6.0 at 30-31. This proposed estimate is not contested. Therefore, the Commission approves the 3.0% estimate and the cushion gas in rate base reflected in the rate base figures in this Order.

2. Plant

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

Staff has withdrawn its proposed adjustment to Peoples Gas' rate base based on a comparison of budget to actual expenditures for three previous years. Staff Ex. 12.0 Rev. at 13. This is not contested. Therefore, the Commission approves Staff's withdrawal of this proposed adjustment to Peoples Gas' rate base.

b. Advanced Metering Infrastructure Project

The Utilities and Staff have agreed upon inclusion in rate base of the Advanced Metering Infrastructure Project. PGL Ex. 8.0 at 12; NS-PGL Ex. 28.0 Rev. at 8; Staff Ex. 6.0 at 16; Staff Ex. 16.0 at 6. This is not contested. Therefore, the Commission approves inclusion in rate base of the Advanced Metering Infrastructure Project.

c. LNG Control System Upgrade and Related Project

Peoples Gas has withdrawn the LNG Control System Upgrade project and the related project to construct a new control building from this rate case. NS-PGL Ex. 35.0 at 2-3. This is not contested. Therefore, the Commission approves the withdrawal of the LNG Control System Upgrade project and related project to construct a new control building from rate base.

d. Calumet System Upgrade

The Utilities and Staff have agreed upon inclusion in rate base of the Calumet System Upgrade Project. PGL Ex. 8.0 at 10; NS-PGL Ex. 28.0 Rev. at 9; NS-PGL Ex. 44.0 at 8; Staff Ex. 6.0 at 24; Staff Ex. 16.0 at 10; NS-PGL Cross Ex. 13. This is not contested. Therefore, the Commission approves inclusion in rate base of the Calumet System Upgrade Project.

e. CNG Fueling Station

Peoples Gas has withdrawn the CNG Fueling Station project from rate base. NS-PGL Ex. 44.0 at 2. This is not contested. Therefore, the Commission approves the withdrawal of the CNG Fueling Station project.

f. Incentive Compensation – Capitalized Amounts Disallowed in Prior Cases

Only for the purposes of narrowing the issues in this proceeding and without waiving any rights to contest such amounts in future proceedings, the Utilities do not object to removing the previously disallowed amounts related to incentive compensation from rate base. NS-PGL Ex. 27.0 at 4-5. This is not contested. Therefore, the Commission approves removing the previously disallowed amounts related to incentive compensation from rate base.

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

The Utilities and Staff agree that consistent with Part 510 of the Commission's rules, the Commission's order should state the following concerning the Original Cost Determination as to plant balances as of December 31, 2011:

> It is further ordered that the $3,016,429,000 original cost of plant for Peoples Gas at December 31, 2011, reflected on Peoples Gas' NS-PGL Ex. 27.14P, Line 19, Column B, is unconditionally approved as the original cost of plant. It is also ordered that the $424,299,000 original cost of plant for North Shore at December 31, 2011, reflected on North Shore's NS-PGL Ex. 24.14N, Line 17, Column B, is unconditionally approved as the original cost of plant.

NS-PGL Ex. 27.0 at 36; Staff Ex. 12.0 Rev. at 26-27. This is not disputed. Therefore, the Commission approves the above proposed language concerning the Original Cost Determination as to plant balances as of December 31, 2011.

3. Budget Plan Balances

The Utilities and the AG have agreed to a methodology for determining budget plan balances. NS-PGL Ex. 27.0 at 13-14; NS-PGL Ex. 43.0 at 4; AG Ex. 2.0 at 13; AG Ex. 5.0 at 3-4. This is not disputed. Therefore, the Commission approves the methodology for determining budget plan balances and approves the balances reflected in the rate base figures in this Order.

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

The Utilities are withdrawing their proposal for a 50/50 sharing with respect to a tax accounting method change related to the capitalization of certain types of indirect and overhead charges. NS-PGL Ex. 30.0 Rev. at 16. This is not disputed. Therefore, the Commission approves the withdrawal of the Utilities' proposal for a 50/50 sharing with respect to a 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

North Shore and Peoples Gas

The Commission is charged with establishing just and reasonable rates for utilities, their stockholders, and their customers. Rates must be set so as to allow the utility the opportunity to obtain full recovery of its prudent and reasonable costs of service. NS-PGL Init. Br. at 2-3. In the instant case, the Commission must decide if the

year end rate base methodology proposed by the Utilities or the average rate base methodology proposed by Staff, the AG, and CUB-City is more appropriate.

The Utilities submit that the evidence demonstrates that a year end rate base calculation is more appropriate than the average rate base methodology proposed by Staff, the AG, and CUB-City, on the specific facts of the instant cases.

The average versus year end rate base issue is a critical issue, because it has a very large impact on the Utilities' ability to recover the costs of plant investments, including Peoples Gas' Accelerated Main Replacement Program ("AMRP"). The Commission's prior findings in the Utilities' 2009 rate cases, *North Shore Gas Co., et al.*, ICC Docket Nos. 09-0166, 09-0167 Cons. (Order Jan. 21, 2010) ("*Peoples Gas 2009*"), *aff'd in part and rev'd in part*, *People ex rel. Madigan v. Illinois Commerce Comm'n*, 2011 IL App (1st) 100654, 958 N.E.2d 405 (2011), *appeal denied*, 963 N.E.2d 246 (Ill. 2012), and the testimony of the Utilities and of Local Union No. 18007, Utility Workers Union of America, AFL CIO ("Union Local 18007") in the instant cases, have established, without refutation, that the AMRP has numerous important benefits for customers and has created hundreds of jobs. The Commission previously has found that the long-term benefits of the AMRP include, among other things, enhancements of reliability and safety, significant long-term reductions in operating expenses, and, as to customers served by the legacy low pressure system, the ability to use more energy efficient appliances and equipment. *Peoples Gas 2009* Order, pp. 164-173. The Utilities and the Union, moreover, submitted evidence of the AMRP's benefits, which no witness challenged. *E.g.,* PGL Ex. 14.0 at 4, 7-8; Union Local 18007 Ex. 1.0 at 2. The AMRP also involves a new apprentice training program and 500 highly skilled jobs that are at risk if the AMRP is put at risk, including hundreds of union jobs. NS-PGL Ex.22.0 2nd Rev. at 7; Union Local 18007 Ex. 1.0 (entire).

The plant investment cost recovery reductions under the average rate base method that is advocated by Staff, the AG, and CUB-City are very large.

- Per Staff's revised calculations in its Initial Brief, the average rate base method will reduce Peoples Gas' gross plant in rate base by $151,242,000, including $61,402,000 of "AMRP investment costs. Staff Init. Br., App. B, p. 6, col. (c), line 1 (citing Kahle Reb., Staff Ex. 12.0 Rev., Sched. 12.01P Rev., col. (C), line 4)); Kahle Reb., Staff Ex. 12.0 Rev., Sched. 12.07P Rev, p. 2, col. (D), line 8.
- When all impacts are taken into account, per Staff's calculations, the average rate base method would reduce Peoples Gas' rate base by $98,890,000. Staff Init. Br., App. B, p. 6, col. (c), line 23. The Utilities note that Staff's calculations for this adjustment use data from Peoples Gas' rebuttal exhibits even though the starting point for Staff Initial Brief App. B is Peoples Gas' surrebuttal rate base. The calculations should be based on Peoples Gas' surrebuttal exhibit NS-PGL Ex. 43.1P, page 1 of 2, by comparing column (F) to column (H). Based on that comparison, the Staff average rate base adjustment would reduce rate base by

$95,687,000 (col. (H), line 15, less col. (F), line 15, or the difference between $1,563,584,000 and $1,659,271,000).

- Per Staff's calculations, the average rate base method will reduce North Shore's gross plant in rate base by $11,235,000. Staff Init. Br., App. A, p. 6, col. (c), line 1.
- When all impacts are taken into account, per Staff's calculations, the average rate base method would reduce North Shore's rate base by $5,353,000. Staff Init. Br., App. A, p. 6, col. (c), line 23. The Utilities note that Staff's calculations for this adjustment use data from North Shore's rebuttal exhibits even though the starting point for Staff Initial Brief App. A is North Shore's surrebuttal rate base. The calculations should be based on North Shore's surrebuttal exhibit NS-PGL Ex. 43.1N, page 1 of 2, by comparing column (F) to column (H). Based on that comparison the adjustment would reduce rate base by $4,176,000 (col. (H), line 15, less col. F, line 15, or the difference between $204,940,000 and $209,116,000).

The AG and CUB-City's average rate base calculations are similar to those of Staff.

While the use of the average rate base methodology will not instantly end the program, the AMRP is not sustainable over time absent timely and adequate cost recovery. NS-PGL Init. Br. at 5-6; *see also, e.g.,* Tr. 2/6/13, at 442–445. The Staff, AG, and CUB-City positions are not grounded in a real world assessment.

The Utilities have advocated use of a year end rate base calculation in these Dockets on the grounds, in brief, that:

(1) the Commission's rules (83 Ill. Adm. Code § 285.2005(e)) permit use of a year end rate base in a future test year rate case;
(2) the rates being set in these cases will not go into effect until July 2013, which means that the Utilities will experience the revenue impact of any rate increase for at most half of 2013; and
(3) use of a year end calculation will result in setting rates that better match the Utilities' cost of service during the period in which the rates will be in effect and come closer to giving them the opportunity to recover fully their costs of service.

E.g., PGL Ex. 1.0 Rev. at 13; NS Ex. 1.0 Rev. at 11-2; PGL Ex. 7.0 at 4-6; NS Ex. 7.0 at 4-5; NS-PGL Ex. 22.0 2nd Rev. at 7-10; NS PGL Ex. 27.0 at 5-9. The Utilities also presented the alternative of a calculation as of September 30, 2013, the midpoint of the last six months of the year, which reflects the logic of the Staff and intervenor position discussed below but also takes into account the fact that the rates being set will not go into effect until the second half of 2013. NS-PGL Ex. 43.0 at 10-11; NS-PGL Ex. 43.1N, p. 2; NS PGL Ex. 43.1P, p. 2.

The Utilities' points (1), (2), and (3), above, are not really disputed. As to the Utilities' point (1), Staff witness Mr. Kahle's direct testimony noted that 83 Ill. Adm. Code

§ 285.2005(e) does not expressly state that year end rate base is permitted, but he also acknowledged that the rule indicated average rate base was not the only permitted method. *See* Staff Ex. 2.0 at 9-10. Mr. Kahle agreed, during cross-examination, that the Commission's rules do not prohibit use of year end rate base in a future test year case. Tr. 2/4/13 at 167. Intervenors also did not deny that the Commission's rules permit use of a year end rate base here.

As to the Utilities' point (2), neither Staff nor any intervenor denied that the rates being set in these cases will not go into effect until July, and, as a result, that the Utilities will experience the revenue impact of any rate increase for at most half of 2013. The Utilities' existing rates are based on a forecasted 2012 test year (*Peoples Gas 2011* Order, p. 5), and thus their rates in effect for the first half of the year will not include any recovery of the plant investment costs incurred by the Utilities in that period. Staff witness Mr. Kahle agreed the rates being set will become effective around July 1, 2013. Staff Ex. 2.0 at 5.

As to the Utilities' point (3), Staff, the AG, and CUB-City essentially shrug off that point, on the theory that it is irrelevant. For example, Staff witness Mr. Kahle acknowledged that the Utilities have increasing levels of plant investment, but he asserted that this was "normal" and that past Commission Orders, including the Orders in the Utilities' 2009 and 2011 future test year rate cases, approved use of the average rate base method. Staff Ex. 2.0 at 10-11. The Utilities did not propose end of year rate base, however, in their 2009 and 2011 cases. They did so in the instant Dockets because of changed circumstances, in particular, the timing of when the rates being set will go into effect and the loss of their infrastructure cost recovery rider due to an appellate decision. *E.g.*, NS-PGL Ex. 27.0 at 6. Moreover, Staff elsewhere argues for proposed adjustments on the ground that they better match costs during the period when rates will be in effect. *See* Staff Init. Br. at 49, 68.

Staff, the AG, and CUB-City in the aggregate present two "matching" arguments and one related theoretical argument in support of use of the average rate base method in all future test year rate cases: (1) the use of the average rate base method better matches the costs of plant investments in the test year; (2) the use of the average rate base method better matches the determination of expenses in the test year; and (3) a future test year is sufficiently forward looking that there is no need to use the end of year method to reduce regulatory lag. None of those points warrants their proposal.

Their first point is limited to calculating costs as such as if a utility had perfect rates, or a reconciliation process, that allows it to exactly capture its costs incurred during the test year. That concept takes no account, however, of when the rates being set will go into effect, and thus of whether use of the average rate base will result in rates that give the opportunity to recover fully its costs of service. Indeed, CUB-City are emphatic that the matching principle they invoke is about calculation of costs and is separate from analysis of rates. *See* CUB-City Init. Br. at 13-15. Use of the average rate base method here would result in rates that under-recover costs, as discussed above.

The second point of Staff, the AG, and CUB-City is wrong. Their proposal is not actually a calculation of any sort relating to revenues, it is just about costs. *E.g.,* Tr. 2/4/13, 156-164; CUB-City Init. Br. at 13-15. In any event, revenues and expenses generally are measured on a cumulative basis as of December 31st of the test year. *See, e.g.,* combination of PGL Ex. 6.1, Sched. C-1, and PGL Ex. 5.1, Sched. C-4; *see also* Tr. 2/4/13 at 157- 158. That is not an average. The AG suggests that Utilities witness Mr. Schott on cross examination agreed that depreciation expense is calculated on an average basis (AG Init. Br. at 10), but the cross examination was based on the presentation in a particular document in Peoples Gas' Part 285 filing. Depreciation expense is calculated on a cumulative basis as of December 31st of the test year in the Utilities' revenue requirements. *See, e.g*., PGL Ex. 5.1, Sched. C-4, p. 1, col. [C], line 9 (forecasted depreciation expense figure of $90,903,000 as of December 31, 2013); PGL Ex. 6.1, Sched. C-1, line 24 (using that figure in the revenue requirement). The AG and CUB-City point to the Utilities' use of an average to calculate the cost of long-term debt (AG Init. Br. at 12; CUB-City Init. Br. at 14, 15), but that is a net income item, not an operating expense item, and the issues are distinct and the Utilities' calculation of that item is proper under 83 Ill. Adm. Code § 285.4000(b). NS-PGL Init. Br. at 134-136. CUB-City throws in the assertion that the Utilities' proposal is based on "matching rates with costs from outside the test year" (CUB-City Init. Br. at 14), but that assertion is unexplained and has no supporting citation. The end of year figures, by definition, are from the test year.

Staff and the AG argue that use of a future test year is sufficiently "forward looking", although the AG is inconsistent about whether this results in regulatory lag. *See* Staff Init. Br. at 12; AG Init. Br. at 13,14, 15, 17,18. That method does cause lag, as discussed above. That Staff and AG conceptual argument again disregards the facts regarding how the method would affect the sufficiency of cost recovery here. Staff witness Mr. Kahle testified in part that revenues should equal the rate base investment of the test year plus the expenses of the test year. Tr. 2/4/13 at 156. That can only occur if rates are set such that they yield revenues matching those costs. The AG argues that end of year rate base is used in historical test year rate cases because it is more representative of the investment that the Utilities will have in their rate bases at the time that the rates go into effect. AG Init. Br. at 10. The AG once again is ignoring the facts regarding when the rates will go into effect here.

Staff and the AG deny that the average rate base method "disallows" any costs, but that is semantics and in any event it is incorrect. Costs are incurred to build plant, including the time value of the capital used to pay for the plant investment, plus, once plant goes into service, depreciation expense. For example, when a new meter is installed on January 5th, the utility has paid for the meter, and it starts to depreciate, even if it is not in the rate base used to set existing rates. *E.g*., Tr. 2/4/13 at 158–159. With new rates not going into effect until July 2013, customers will not start paying any of the costs of those investments until up to six months after they are made. *E.g*., Tr. 2/4/13 at 166–167. The average rate base method never makes up for the cost recovery foregone during that period when, as here, the new rates do not go into effect until the second half of the year, and Staff and the AG do not and cannot point to any means by which those costs ever will be recovered.

Staff and intervenors argue that under the end of year method, when the rates being set go into effect, they will reflect plant investment costs not to be incurred until the second half of 2013. *E.g.,* Staff Ex. 2.0 at 5. However, that argument does not change the reality of what the average rate base method means for cost recovery in the instant cases. Moreover, the Staff and intervenor argument has at least three other flaws. First, this is a future year rate case. Thus, there is nothing inherently inappropriate about rates that include future costs, as long as the utility complies with the future test year selection rule, 83 Ill. Adm. Code § 287.20(b). In this instance, the Utilities, under the rule, could have selected a future test year ending as late as July 31, 2014, 24 months from the tariff filing date, 83 Ill. Adm. Code § 287.20(b), although as a practical matter preparing and filing a test year that is not the calendar year or the utility's fiscal year is difficult. NS-PGL Ex. 22.0 2nd Rev. at 8-9. Indeed, if the test year were a future test year ending July 31, 2014, use of the average rate base method would yield a rate base that approximates a rate base as of January 31, 2014, which is one month further out in time than the year end rate base that the Utilities propose. NS-PGL Ex. 43.0 at 6.

Second, that Staff and intervenor point applies as a conceptual matter to the average rate base method, too. The average they advocate is the average of the amounts as of December 31st of the prior year and December 31st of the test year. So, the average also includes in its computation the costs of plant investment in the second half of the test year, although it cuts in half the recovery of those costs.

Third, the flip side of Staff and intervenor point is that, as to costs of plant investments in the first half of the year, customers will not start paying any of the costs of those investments until up to six months after they are made (*e.g.,* Tr. 2/4/13 at 166–167), and the average rate base method never makes up for the cost recovery foregone during that period when, as here, the new rates do not go into effect until the second half of the year, as discussed above.

Staff, the AG, and CUB-City cites past Commission Orders approving the average rate base method in future test year rate cases, but that discussion cannot change what the evidence in the record shows about whether in these cases, use of a year end rate base calculation or an average rate base calculation is more appropriate in order to establish just and reasonable rates. The Commission, in meeting its duty to set just and reasonable rates, must base its decision exclusively on the applicable law and the evidence in the record here. 220 ILCS 5/10 103; 220 ILCS 5/10 201(e)(iv)(A).

The Utilities are not arguing that the past Commissions Orders on this subject are irrelevant. Past Commission Orders involving similar issues and evidentiary records generally are relevant, absent a change in law. However, in only two of the past Commission Orders that Staff and intervenors cite was the question of average versus end of year rate base contested: the 1990 Central Illinois Public Service Company rate case, *Central Illinois Public Service Co*., ICC Docket No. 90-0072, 1990 Ill. PUC Lexis 625 (Order Nov. 28, 1990) ("*CIPS*"); and Nicor Gas Company's 2004 rate case, *Northern Illinois Gas Co*., ICC Docket No. 04-0779 (Order Sept. 20, 2005) ("Nicor 2004"). *See also* Tr. 2/4/13 at 167 (Staff witness Mr. Kahle acknowledging that the

issue was not disputed in the other past Commission Orders that Staff and Intervenors cite). The *CIPS* decision expressly stated that the question was "a close issue". *CIPS*, 1990 Ill. PUC Lexis 625 at *6. Moreover, the *Nicor 2004* decision expressly stated that the *CIPS* decision was not dispositive, and that subsequent cases where the issue was not contested contributed little to the analysis. "However, the above quoted language cited from 90-0072 does not clearly state a general rule. Instead, it addresses the question for that case, finds it to be a close issue, and ultimately decides in favor of the average rate base. Subsequent cases, in which this issue was not litigated, contribute little toward this discussion." *Nicor 2004* Order, p. 7.

Staff and intervenors are right that the *Nicor 2004* decision, in particular, does provide support for their argument for use of an average rate base calculation, but that past Order is not dispositive and the same result should not be reached here. The reality here is that, because the rates being set will not go into effect until July 2013, using the average rate base method would mean that the Utilities would under recover their 2013 plant investment costs in 2013, and the rates set here would not match the costs of service in the period in which they will be in effect as well as would rates set using a year end rate base. The Commission found against Nicor Gas, but the Utilities contend that the Commission should choose here the method that the evidence shows is most appropriate to set just and reasonable rates, which is the end of year method. Finally, the *Nicor 2004* decision did not involve any alternative, such as the September 30, 2013, alternative raised here by the Utilities.

The AG also discusses the four recent Orders in the Ameren and ComEd electric formula rate cases. AG Init. Br. at 9. Those Orders do not support use of the average rate base method here, and, if anything, do the opposite. There, the Commission agreed that, when setting rates, the end of year rate base method should be used. *E.g., Commonwealth Edison Co*., ICC Docket No. 11-0721 (Order May 29, 2012), pp. 17-18. The Commission decided to use the average rate base method only in reconciling the revenue requirement used to set rates for the "rate year", *i.e.*, the year in which the rates were in effect, with actual costs of the rate year. *Id*., p. 18. The Utilities, in contrast, have no means to reconcile the revenue requirements being set in the instant cases with the actual costs they will incur in the period in which the rates being set are in effect.

The Utilities legally could have chosen a future test year with a later ending date, as late as July 31, 2014, 24 months from the tariff filing date. (83 Ill. Adm. Code § 287.20(b)), but as a practical matter, preparing and filing a test year that is not the calendar year or the utility's fiscal year is difficult. NS-PGL Ex. 22.0 2nd Rev. at 8-9. Staff identified only one utility, Illinois American Water Co., which has filed recent rates cases with test years other than its fiscal year. Staff Ex. 12.0 Rev. at 11. Even more importantly, in any event, the fact that the Utilities could have chosen a test year with a later ending date is not a reason to reach a wrong decision in the rates cases that they did file. The right decision here is use of the end of year method.

The Commission has a duty to set rates that are just and reasonable and allow the utility the opportunity to recover fully its costs of service. The Commission should approve use of the year end rate base method on the facts of the instant cases.

In the alternative, the Utilities propose that a calculation based on a rate base as of September 30, 2013, the midpoint of the last six months of the year, should be used. This alternative is a compromise as it recognizes concerns of Staff, the AG, and CUB-City, but it also recognizes when the rates being set will go into effect. *See* NS-PGL Ex. 43.0 at 10-11; NS-PGL Ex. 43.1N, p. 2; NS-PGL Ex. 43.1P, p. 2.

Staff, the AG, and CUB-City complain about the timing of the alternative proposal, but their complaints lack merit. The alternative calculation was proper surrebuttal and and its component figures were provided in NS-PGL Ex. 43.1N, p. 2, and NS-PGL Ex. 43.1P, p. 2. Discovery was allowed and occurred with respect to surrebuttal. Staff and intervenors point to no related fact that needed to but could not be developed in discovery or at the hearing. Moreover, Staff, the AG, and CUB-City are inconsistent. They accepted surrebuttal revisions with new calculations by the Utilities that reduced rate base based on the availability of "bonus depreciation" in 2013 under the American Taxpayer Relief Act of 2012 (the "fiscal cliff" legislation, enacted January 2, 2013). *See* Section IV.C.6.c of this Order. Staff also accepted an alternative proposal of the Utilities in surrebuttal for a new calculation of pass-through taxes in determining cash working capital. *See* Section IV.C.3.a of this Order. The compromise proposal is more than fair, because it only reduces, but does not eliminate, the under-recovery of the Utilities' costs.

Other Parties

[Insert]

Commission Analysis and Conclusion

[ALTERNATIVE ONE]

The Commission has reviewed the evidence and its past decisions, particularly that in *Nicor 2004*. The Commission finds that a year end rate base calculation is more appropriate than an average rate base calculation on the facts of the particular cases before us. The Commission is tasked with setting rates that are just and reasonable, not just for customers and utility stockholders, but also for the utility, and that allow the utility the opportunity to recover fully its prudent and reasonable costs of service. The selection of an average rate base calculation, on the specific facts before us, would cause an extremely detrimental impact on the Utilities and compromise their ability to recover their costs of service. The *Nicor 2004* decision was decided based on its facts and while it indicated a preference for the average rate base method, here we conclude on the specific facts before us that the very large resulting reductions in plant cost recovery that would result from using the average rate base method, including the large AMRP cost recovery reductions, are not warranted, are not in the long-term best interests of customers, and are not consistent with our legal duty to set rates that are

just and reasonable and allow the Utilities the opportunity to recover fully their prudent and reasonable costs of service.

[ALTERNATIVE TWO]

The Commission has reviewed the evidence and its past decisions, particularly that in *Nicor 2004*. The Commission has reviewed the competing considerations and arguments and finds that a rate base calculation based on September 30, 2013, approximating the average of the six months of 2013 in which the rates being set will be in effect, is more appropriate than an average rate base calculation or a year end rate base calculation on the facts of the particular cases before us. The Commission is tasked with setting rates that are just and reasonable, not just for customers and utility stockholders, but also for the utility, and that allow the utility the opportunity to recover fully its prudent and reasonable costs of service. The selection of an average rate base calculation, on the specific facts before us, would cause an extremely detrimental impact on the Utilities and compromise their ability to recover their costs of service. The *Nicor 2004* decision was decided based on its facts and while it indicated a preference for the average rate base method, here we conclude on the specific facts before us that the very large resulting reductions in plant cost recovery that would result from using the average rate base method, including the large AMRP cost recovery reductions, are not warranted, are not in the long-term best interests of customers, and are not consistent with our legal duty to set rates that are just and reasonable and allow the Utilities the opportunity to recover fully their prudent and reasonable costs of service. We also do not approve the year end method, however, finding the alternative proposed by the Utilities to best fit the facts in evidence. *Nicor 2004* did not involve and does not preclude, either by its reasoning or its ruling, the conclusion we have reached here, which best balances the applicable concerns.

2. Plant

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

North Shore

North Shore presented extensive evidence supporting its Utility Plant in Service in rate base, as referenced in Section IV.A.1, *supra*. However, despite such evidence, North Shore states that Staff proposes an adjustment to reduce North Shore's forecasted additions to plant-in-service for the test year ending December 31, 2013, based on the historical spending pattern for budgeted capital expenditures for 2010, 2011 and 2012. Staff Ex. 23.0 at 2-3. Staff's adjustment is improper as it does not reflect North Shore's experience with public improvement projects. NS-PGL Ex. 28.0 Rev. at 4-5. The variance between North Shore's budget and actual expenditures is primarily due to public improvement projects, which have been rescheduled or delayed. These circumstances are not within North Shore's control. If the Commission determines that an adjustment is necessary, North Shore states that the last five years (2008 through 2012) would be more appropriate to determine the adjustment as it is

more reflective of current spending patterns, particularly public improvement projects. NS-PGL Ex. 44.0 at 3. Further, a five-year period is a long enough period so that it does not inappropriately skew the average high or low based on an unusual year, such as 2009 data. North Shore cites the Commission's Order in *North Shore Gas Co., et al.*, ICC Docket Nos. 07-0241/0242 (cons.) (Order Feb. 5, 2008) ("*Peoples Gas 2007*") to support its proposal.

Other Parties

[Insert]

Commission Analysis and Conclusion

[ALTERNATIVE ONE, IF NORTH SHORE'S PROPOSED LEVEL OF FORECASTED PLANT ADDITIONS ARE APPROVED:] The Commission finds that the North Shores' level of forecasted plant additions for the 2013 test year is appropriate. Based on the record in this proceeding, the amount of North Shore's forecasted plant additions are based upon the best available information and any resulting variance will be outside of North Shore's control. Thus, the Commission declines to approve Staff's proposed adjustment.

[ALTERNATIVE TWO, IF COMMISSION DETERMINES THAT AN ADJUSTMENT IS REQUIRED USING FIVE YEARS OF DATA:] The Commission finds that North Shore's level of forecasted plant additions for the 2013 test year should be adjusted based on the budget to actual variance it has experienced in past years. However, Staff's use of a three year period is arbitrary and does not reflect historical spending patterns. It is perceived that something is inherently wrong in the selection of years to average when the results change so drastically when either 3 or 5 year data is considered. The Commission agrees with North Shore that by incorporating five years of data smooths out the impact of an unusual year and is more reflective of North Shore's actual experience.

b. <u>Accelerated Main Replacement Program Projects (PGL)</u>

People Gas

The Commission previously has found that Peoples Gas' Accelerated Main Replacement Program has long-term benefits that include, among other things, enhancements of reliability and safety, significant long-term reductions in operating expenses, and, as to customers served by the legacy low pressure system, the ability to use more energy efficient appliances and equipment. *Peoples Gas 2009* Order, pp. 164-173. The Utilities and the Union, moreover, submitted evidence of the AMRP's benefits, which no witness challenged. *E.g.,* PGL Ex. 14.0 at 4, 7-8; Union Local 18007 Ex. 1.0 at 2. The AMRP also involves a new apprentice training program and 500 highly skilled jobs that are at risk if the AMRP is put at risk, including hundreds of union jobs. NS-PGL Ex.22.0 2nd Rev. at 7; Union Local 18007 Ex. 1.0 (entire).

Peoples Gas explains that in approving Rider ICR, the Commission acknowledged that Peoples Gas had submitted the AMRP plan with its surrebuttal testimony, which was filed on e-Docket on August 17, 2009. AMRP is a 20 year program to be completed by 2030. AMRP is designed to include a five-year ramp up period and a two-year ramp down period. NS-PGL 49.0 Corr. at 8. In fact, the Commission acknowledged Peoples Gas' ability to manage AMRP in Peoples Gas' 2009 rate case. *Peoples Gas 2009* Order, p. 195. Peoples Gas states that there are four main system upgrade goals for AMRP: (1) to retire 1,870 miles of cast iron/ductile iron gas distribution mains; (2) to upgrade approximately 300,000 service pipes; (3) to relocate gas meters from inside of customer facilities to outside; and (4) to upgrade the gas distribution system from low pressure to a medium pressure system. Further, to achieve the conversion of the gas distribution system to a medium pressure system, approximately 50 miles of new high pressure interstation main will have to be installed in total. NS-PGL 49.0 Corr. at 6. Since 2009, the following main replacement projects have been completed:

	2009	**2010**	**2011**	**2012**
New Gas Mains Installed (miles)	43	33	155	132
Old Mains Retired (miles)	27	23	24	118
Miles Restored	Not Available	Not Available	85.3	141.6
New Service Pipes	Not Available	Not Available	10,330	13,289
New Meter Regulator Sets	Not Available	Not Available	14,004	28,168
High Pressure Steel Interstation Main Installed (miles)	Not Available	Not Available	0.7	3.5

NS-PGL Ex. 49.0 Corr. at 7 – 8.

To achieve these results, Peoples Gas states that it engaged in extensive planning in 2010 and into 2011. Construction production has increased during the first two years of construction, namely 2011 (which was a partial year) and 2012 (the first full year of construction). The AMRP goal to schedule work to upgrade the distribution system is through the zonal approach as explained in the 2009 rate cases. The zonal approach targets geographic areas (neighborhoods) which allows efficiencies in design, permitting, and construction while minimizing disruption to the impacted customers and improved coordination with the City of Chicago. Peoples Gas' Five Year Construction White Paper documents the assumptions, attributes and inputs into analyzing and ultimately ranking the zones in terms of prioritizing system upgrades. The time frame for upgrades or the target period is broken down over the time frame 2013 to 2030. On page 18 of the White Paper, the first five year target period is 2013 to 2017 and the

following detail is identified by year: neighborhood, total main retired, total number of services, and the number of vulnerable services. The intent of the Five Year Plan is to provide a road map of completing AMRP in the remaining years of the 20 year program.

Peoples Gas also explained the primary benefits of replacing the cast and ductile iron main are enhancing the safety and reliability of service for customers. Considering that the cast iron and ductile iron mains were installed between 50 and 150 years ago and the corrosion associated with cast iron pipes, it is necessary that they be replaced with plastic or cathodically protected steel main. The Commission recognized this in approving Rider ICR. *Peoples Gas 2009* Order, pp. 170-173, 192-196. Not only are the new mains more reliable, but they also prevent ground water infiltration. The added benefits of accelerating this program include increased public safety for both Peoples Gas' customers and crews, construction and Operating and Maintenance cost savings, job creation, reduced environmental impact and increased functionalities with the higher pressure system. PGL Ex. 14.0, 7-8.

Staff's Adjustments

Peoples Gas argues that Staff's adjustments to reduce rate base by $95.7 million for 2012 AMRP projects and $122.8 million for 2013 AMRP project costs are not only unsupported by the record but the adjustment "calculations" are seriously flawed. The Utilities note that CUB-City may now be adopting these adjustments but offer no new arguments to save them. Peoples Gas not only demonstrated that it has met the scheduled work for 2012 and can reasonably forecast costs, but that it can prudently manage AMRP projects when unforeseen costs arise. Despite proposing these adjustments, Peoples Gas notes that at no time has Staff testified that these costs were not prudent, reasonable, or used and useful in providing customer service. If these punitive adjustments are approved, Peoples Gas argues that it will be unable to sustain its investments in AMRP resulting in a major loss for customers as well as in a loss of significant number of good-paying construction jobs that have already been created. NS-PGL Ex. 22.0 2nd Rev. at 2.

Peoples Gas states that the law applicable to this circumstance is clear. Management acts prudently when it makes decisions exercising a:

> standard of care which a reasonable person would be expected to exercise under the circumstances encountered by utility management at the time decisions had to be made. In determining whether or not a judgment was prudently made, only those facts available at the time the judgment was exercised can be considered. Hindsight review is impermissible. Imprudence cannot be sustained by substituting one's judgment for that of another. The prudence standard recognizes that reasonable persons can have honest differences of opinion without one or the other necessarily being 'imprudent'.

Illinois Commerce Comm'n v. Commonwealth Edison Co., ICC Docket No. 84-0395 (Order Oct. 7, 1987), p. 17, 1987 Ill. PUC Lexis 68 at *34. There is no doubt or

difference of opinion about this standard. *See, e.g., Illinois Power Co. v. Illinois Commerce Comm'n*, 339 Ill. App. 3d 425, 790 N.E.2d 377 (5th Dist. 2003). This same standard is quoted by Staff witness Mr. Seagle in his testimony. Staff Ex. 6.0 at 5.

Peoples Gas states during 2012, after the direct filing in this proceeding, Peoples Gas determined that certain unforeseen items would affect the capital spend for 2012, including (1) rock was encountered at depths that interfered with the placement of pipe and valve clusters, coupled with the City's atypical requirement for deep shoring for certain excavations; (2) AMRP unexpectedly incurred additional costs complying with new City of Chicago Department of Transportation ("CDOT") Regulations and Peoples Gas' cross bore program; and (3) the depths, sizes, and configurations of other exiting utilities were often not as indicated on as-built documents. NS-PGL Ex. 21.0 at 2-6. Peoples Gas states that not knowing this condition at the time of design or bidding, extra work was required of AMRP contractors as well as Peoples Gas engineering, and often required plan changes and re-permitting and Chicago Office of Underground Construction ("OUC") approval. *Id.* Peoples Gas states that no party contested that all of these circumstances were unforeseen and to assert otherwise would be impermissible hindsight review. NS-PGL Init. Br. at 32; NS-PGL Rep. Br. at 38. Peoples Gas states it took action to curtail costs to limit the increase in the 2012 budget to $20 million (resulting in a total 2012 budget of $220 million), which included suspending work on several projects, work on lower priority projects, and overtime costs on non-critical AMRP work. NS-PGL Ex. 21.0 at 2-6. Taking no action in light of these unforeseen circumstances would have been imprudent. NS-PGL Init. Br. at 33.

Despite these unforeseen obstacles, Peoples Gas states that it still installed 132 miles of new main, retired 118 miles of old main, restored 141.6 miles, installed 13,289 new service pipes, installed 28,168 new meter regulator sets, and installed 3.5 miles of new high pressure steel interstation main. NS-PGL Ex. 49.0 Corr. at 7-8. Staff agreed these facilities already are or will be used and useful in serving customers. Tr. 2/7/13 at 622-627; Tr. 2/5/13 at 340-345 In addition, Staff agreed that the 2012 AMRP costs included in rate base (unadjusted by his proposal) is reflective of the work performed. Staff also acknowledged that Peoples Gas revised the 2012 AMRP budget to $220 million in supplemental direct testimony and then actually achieved that target. Tr. 2/7/13 at 620. Thus, Peoples Gas concludes that not contesting that the revised 2012 AMRP work was prudent, reasonable in amount, and used and useful in providing customer service, Staff's adjustment to rate base for 2012 AMRP project costs is punitive. NS-PGL Init. Br. at 33.

Peoples Gas also states that it has demonstrated that it has appropriately developed a schedule for AMRP for the short term as well as the long term. Peoples Gas developed a detailed AMRP Construction Strategy and a 20-year deployment plan based on 5-year rolling periods. NS-PGL Ex. 49.0 Corr. at 14-15. Based on the zonal approach, Peoples Gas' service territory is delineated into three shops with a breakdown of AMRP projects per shop. *Id.* at 14-15, 22-25. Projects are then scheduled based on known drivers such as system needs, public improvement opportunities, community events, and street resurfacing projects. *Id.* Peoples Gas then sets project milestones upon which it works closely with winning contractors to establish

a detailed block by block schedule. Id. Thus, Peoples Gas states that Staff's claims that construction work is left to the discretion of the contractors is incorrect. In fact, Peoples Gas has final approval over the contractor schedules to ensure they remain in line with the established milestones. Id. Given variables such as coordination with the City's public improvement and resurfacing projects and community events, it is impractical and impossible for Peoples Gas to create a detailed 20-year schedule for every street in its service territory. NS.PGL Rep. Br. at 36. Peoples Gas explained that it intentionally set more aggressive installation goals in the first two years of construction in order to gain the necessary momentum that is critical to success. NS-PGL Ex. 49.0 Corr. at 9-10.

Further, contrary to Staff's claims, Peoples Gas does have a process in place to track the progress of AMRP and that there is oversight of its contractors. NS-PGL Ex. 49.0 Corr. at 22-25. Under Peoples Gas plan, each contractor submits weekly updates to the PMO progressing all the activities on their portion of the detailed schedule. Id. In turn, the PMO then does a schedule analysis on each contractor to see if the milestone dates will be impacted. Id. Peoples Gas' 2011-2012 AMRP Construction Strategy White Paper and its Five Year Construction Plan White Paper identify the plan of work to be accomplished in future years. Id. at 14-15, 22-23. Each year that construction work is bid and awarded will follow the very detailed planning process explained by Utilities witness Mr. Hayes. Id at 22-25. Peoples Gas demonstrated that it has appropriately developed a schedule for AMRP deployment for the short term as well as the long term. Furthermore, Peoples Gas appropriately tracks contractor work. Id at 22-25.

Moreover, Peoples Gas has demonstrated its ability to schedule work by actual experience as well. In 2012, Peoples Gas actually installed 132 miles of new main (170 miles forecasted), actually retired 118 miles of main (110 miles forecasted), restored 141.6 miles, installed 13,289 new service pipe, 28,168 meter regulator sets, and 3.5 miles of high pressure main. NS-PGL Ex. 49.0 Corr. at 7-8. Except for new mains installed, all of these totals exceed 2011 construction totals, the first year of construction. NS-PGL Init. Br. at 33-34. Peoples Gas states that it is clear that it is ramping up AMRP as the Commission acknowledged in the 2009 Rate Case. Id. Additionally, Peoples Gas has demonstrated that it can appropriately forecast costs. NS-PGL Ex. 34.0 at 9-11; NS-PGL Ex. 49.0 Corr., 25-29.

Finally, Peoples Gas states that Staff's calculation of its adjustments to rate base for 2012 and 2013 AMRP costs is seriously flawed. Particularly, Staff's analysis is based on outdated information as he does not use the revised 2012 work plan, he fails to account for a large volume of work completed, and he fails to account for the fact that costs of removal are not included in rate base. NS-PGL Ex. 34.0 at 4-5; NS-PGL Ex. 49.0 Corr. at 30; Tr. 2/7/13 at 617-618. Staff also does not consider costs associated with design, engineering, project management, construction management, construction inspection, materials, *etc*. NS-PGL Ex. 34.0 at 5. Further, the various categories of work that Staff excludes from its analysis is work he agrees should be done and yet he did not correct his calculation. Id. at 5-6; NS-PGL Cross Exs. 11 and 12. Finally, and most importantly, Staff's analysis is incorrect as the evidence

demonstrates that the 2012 costs included in rate base are reflective of the work actually completed in 2012. NS-PGL Ex. 49.0 Corr. at 7-8, 30. In fact, Staff agrees that the 2012 AMRP amounts reflected in rate base represent work actually performed. Tr. 2/7/13 at 627. Furthermore, there is no evidence that Peoples Gas will not effectively and efficiently manage AMRP in 2013.

Therefore, Peoples Gas concludes that Staff's adjustments for 2012 and 2013 AMRP costs are without merit as they disallow costs that were or will be prudently incurred, reasonable in amount and used and useful in providing customer service. Peoples Gas avers that adopting these improper adjustments would cause Peoples Gas not to sustain its investments in AMRP resulting in a major loss for customers and in a loss of a significant number of good-paying construction jobs that have already been created. NS-PGL Ex. 22.0 2nd Rev. at 2. This conclusion is supported by Local Union No. 18007, Utility Workers Union of America, AFL-CIO ("UWUA"). See UWUA Local 18007 Ex. 1.0 at 4-5, 6-7.

Section 8-102 Investigation

Staff has argued that the Commission initiate a proceeding under Section 8-102 of the Act because AMRP has accomplished little and has been mismanaged. Further, for the first time in its Initial Brief, the AG supports Staff's recommendation. CUB-City recommend that the Commission consider Staff's recommendation. Peoples Gas argues that the recommendation should be rejected. Peoples Gas argues that the underlying premise to Staff's proposed Section 8-102 investigation, namely that AMRP has accomplished little and has been mismanaged is false. The evidence demonstrates that significant work has been completed since construction began in the spring of 2011. Furthermore, the record demonstrates that Staff is not aware of the specifics of the AMRP plan, the goals of AMRP, or the actual work that has been completed. Therefore, Peoples Gas concludes that Staff's recommendation should be denied.

Peoples Gas explained that when the Commission approved Rider ICR, the AMRP plan was not submitted until August 2009, with surrebuttal testimony in that case. In fact, the Commission noted that only some of the activities had begun for the 20-year program, which should be completed by 2030. At December 31, 2009, 20 full calendar years remained until 2030, so contrary to Staff's assertion, AMRP began in 2010. Further, in approving Rider ICR, the Commission understood that implementation of AMRP would begin in 2011 and there would be a five-year ramp up period, a period which ends in 2015. In 2010 and the beginning months of 2011, Peoples Gas engaged in planning that included (1) system studies assessing the areas of the gas distribution system to be targeted for replacement, partnering with Jacobs Consultancy as the Project Management Office consultant; (2) identification of resource needs; (3) development of staffing plans; and (4) engineering planning. NS-PGL Ex. 49.0 Corr. at 5. In fact, in early fall 2010, detailed engineering plans were being submitted to the City's OUC. *Id.* Implementation of AMRP began Spring 2011 and Staff noted, Peoples Gas encountered certain permitting, coordination, and material delivery issues. However, this is not new information as it is part of the record in the Utilities' 2011 rate

cases. In the first full year of construction, 2012, these issues have not reoccurred. NS-PGL Ex. 49.0 Corr. at 10-11.

Based on its detailed planning and expert management of AMRP, Peoples Gas states much has been accomplished in less than two years as depicted by the chart above. NS-PGL Init. Br. at 35-36. As demonstrated by the evidence, as AMRP is ramping up, significant work is being accomplished. Id. at 37. In 2012, more main was retired than in the last three calendar years. NS-PGL Ex. 49.0 Corr. at 7-8. In fact, in each category of work except for new main installed, Peoples Gas states that it has surpassed the work completed in 2011 and in one instance doubled the work. NS-PGL Init. Br. at 37. Further, at December 31, 2010, averaging the work to be completed over the 20-year period, Peoples Gas meets or exceeds the average in many key categories. Tr. 2/5/13 at 340-345. Significant work has been accomplished even in 2012 when Peoples Gas had to react to rising costs due to unforeseen circumstances. Peoples Gas argues that Staff appears unaware of key parts of the AMRP plan, the main goals of the plan, and the actual work that was completed. Tr. 2/5/13 at 327 – 351. Peoples Gas states that it is unclear on what Staff bases its assertions that "little has been accomplished" or that AMRP has been "poorly managed." NS-PGL Init. Br. at 37-38. Also, the scope of the recommended investigation further demonstrates Staff's unfamiliarity with AMRP. NS-PGL Ex. 49.0 Corr. at 17-20. Finally, Peoples Gas demonstrated that it can manage costs when faced with unforeseen events as in 2012. NS-PGL Rep. Br. at 36.

Finally, Peoples Gas argues that the AB and CUB-City arguments regarding its commitment to AMRP are without merit. Peoples Gas states that these arguments are dispelled based on the level of investment Peoples Gas has made in 2012 and plans to make in 2013. Peoples Gas states that it cannot afford to maintain such large investments if its rate base is reduced based on unsupported adjustments as proposed by Mr. Seagle and Staff as well as intervenors positions regarding year-end rate base. Peoples Gas cannot keep to its planned levels of investing in its system without a cost recovery that, over time, meets the costs of those investments. This cannot occur if costs that are prudently incurred, reasonable in cost, and used and useful in providing utility service are excluded from rate base as Staff proposes. Significant under-recoveries also can erode the ability of a utility can raise capital at a reasonable cost.

Peoples Gas also states that the CUB-City argument that the Utilities cannot assure the safety of the system is a red herring and disingenuous since CUB-City also apparently are adopting Staff's adjustments to AMRP. AMRP is a program that enhances safety and reliability to its customers. It identifies and replaces those segments of main that may have the highest risk. CUB-City appears to be seeking a 100% guarantee in the safety of Peoples Gas system. However, there can be no absolute guarantee as there are inherent risks in any system. Tr. 2/5/2013 at 197. Finally, Peoples Gas states that without the ability to recover its AMRP investments, at risk are (1) 500 recently created highly skilled jobs; (2) the employment of 120 Gas Workers Union Local 18007 field personnel to offset the added AMRP manpower support; and (3) the new apprenticeship program. NS-PGL Ex. 22.0 2nd Rev. at 7.

Failure to allow Peoples Gas to adequately recover these costs, as it is allowed to do for all plant investment, would jeopardize such an important program.

Other Parties

[Insert]

Commission Analysis and Conclusion

Consistent with our Order in the Utilities' 2009 rate cases, which originally approved Rider ICR, AMRP is a 20-year program to be completed by 2030. The acceleration of main replacement was to begin in 2010 and the first five years would constitute a ramp up of AMRP activities. First, to address Staff's proposed adjustments to reduce rate base for 2012 and 2013 AMRP costs, we find that they are unsubstantiated. Staff's adjustments with respect to 2012 AMRP projects would disallow costs that have been prudently incurred, are reasonable and are used in useful in providing customer service. There simply is no evidence indicating otherwise. In fact, Staff's adjustment is contrary to well established law as to when it is appropriate to recover utility plant. Furthermore, there the evidence demonstrates that the 2013 Project costs will be also prudently incurred, reasonable and use and useful in providing customer service. The Commission observes that if we adopted Staff's adjustments without any supporting evidence, the program that Peoples Gas has continued despite the reversal of Rider ICR would be jeopardized and the associated benefits, including the highly skilled jobs lost.

Peoples Gas has established that it has a 20-year plan in place based on 5-year rolling schedules. Based on its ability to schedule work and maintain costs, the Commission cannot say based on the record evidence that "little has been accomplished" in the first 20 months of construction. Therefore, the Commission declines to adopt Staff's proposed Section 8-102 investigation. At best it is premature. The Commission also observes no "commitment issues" as indicated by the AG. CUB-City arguments also lack merit as the Commission cannot conclude that Peoples Gas will not complete AMRP by 2030.

c. <u>Construction Work In Progress (PGL)</u>

People Gas

Peoples Gas presented extensive evidence supporting its Utility Plant in Service in rate base, as referenced in Section IV.A.1, supra. Peoples Gas argues that the AG's proposed disallowance of the amount of Construction Work In Progress ("CWIP") associated with AMRP projects is improper as it rests on an incorrect legal premise and is otherwise wrong and not likely to benefit customers. First, the AG's argument that CWIP is not "used and useful" is not applicable to this CWIP investment. *See, e.g., Citizens for a Better Env't v. Ill. Commerce Comm'n*, 103 Ill. App. 3d 133, 430 N.E.2d 684 (4th Dist. 1981) (affirming inclusion in rate base as CWIP of $97 million of investment in unfinished generating station over objection that the unfinished station was not used and useful). Peoples Gas argues 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. Peoples Gas states that these CWIP investments will be providing service and be used and useful in 2013. NS-PGL Ex. 34.0 at 12-14; NS-PGL Ex. 49.0 Corr. at 30-32. Furthermore, no one contends that the 12-month limitation in Section 9-214(e) (*i.e.*, that the plant will be placed in service by July 2014) is not met by the CWIP in question. Peoples Gas states that AMRP is a capital intensive program that will necessarily require a large amount of costs to move in and out of CWIP as mains are gassed and placed into service. As Peoples Gas moves to the zonal approach of implementing AMRP, the execution of the installation and follow-on gassing process will be easier to manage and facilitate. This is demonstrated by the fact that the CWIP balances related to AMRP projects have been steadily decreasing from $95.9 million at September 30, 2012 to $38.1 million at December 31, 2012. NS-PGL Ex. 34.0 at 13; NS-PGL Ex. 49.0 Corr. at 31-32.

Peoples Gas argues that the AG's proposal regarding AMRP-related CWIP, as well as Staff's adjustments to rate base for 2012 and 2013 AMRP costs, are contrary to the law in each instance and punitive. As to CWIP, it is allowed under Section 9-214 and Commission precedent and there is no evidence that these facilities will not be placed in service in 2013 or as required by the Section 9-214. However, the impacts of the AG and Staff proposals if approved are severe. If approved, Peoples Gas will be unable to sustain its investments in AMRP resulting in a major loss for customers as well as in a loss of significant number of good-paying construction jobs that have already been created. NS-PGL Ex. 22.0 2nd Rev. at 2-3. This conclusion is supported by the UWUA. See UWUA Local 18007 Ex. 1.0 at 4, 6. Peoples Gas notes that if the Commission determines an adjustment is appropriate, which it should not, adopting the Staff and AG adjustments to AMRP costs would be duplicative. NS-PGL Ex. 43.0 at 14.

Other Parties

[Insert]

Commission Analysis and Conclusion

Section 9-214 of the Act provides in pertinent part, that

> Notwithstanding the provisions of paragraphs (b) and (d) of this Section, 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. . . . (220 ILCS 5/9-214(e)).

As long as there is a preponderance of evidence that the projects that are being funded by CWIP will be placed in service within 12 months from June of 2013, inclusion in rate base of CWIP-funded projects is proper. The Commission therefore disagrees

with the AG's argument that AMRP-related CWIP should not be included in rate base. The Commission finds that the record indicates that CWIP will be based in service in 2013 or early 2014. This is in compliant with Section 9-214(e). As such, the Commission refuses to adopt the AG's proposal.

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

See Section V.C.2. (This is discussed in the Operating Expenses section, but I am not sure of the exact section.)

e. Capital Costs for Non-AMRP Gas Services

People Gas

Peoples Gas states that in preparing surrebuttal testimony, Peoples Gas discovered that test year amounts for Non-AMRP Gas Services were significantly understated.[1] NS-PGL Ex. 44.0 at 10. These costs include the capital work on Peoples Gas' system that adds new services for customers for Non-AMRP projects as well as other capital replacements for existing services. For the test year, 2013, People Gas incorrectly estimated Non-AMRP Gas Services to be $4,359,396. This is demonstrated by the fact that for the last three years Non-AMRP Gas Services were: $26 million in 2010, $18.5 million in 2011, and $24.5 million in 2012. Peoples Gas proposes to increase Non-AMRP Gas Services to $16,073,896. Peoples Gas states that this amount is conservative and more reflective of its actual experience. The costs will be prudently incurred, reasonable in cost and used and useful in providing customer service. Therefore, Peoples Gas concludes that the Commission should approve this revised amount. Furthermore, Peoples Gas states that Staff and intervenors did have an opportunity to review and respond to the corrected Non-AMRP Gas Services amount as robust discovery continued after the Utilities filed surrebuttal, and the opportunity to cross examine the appropriate Utilities' witness existed at hearing. For example, the Utilities note that Staff witness Seagle reviewed Utilities witness Mr. Hoops testimony concerning the Calumet System Upgrade and agreed that the project should be included in rate base. Both discovery and cross-examination occurred. Furthermore, Staff's argument is somewhat hypocritical. Staff did not take a similar position with respect to Staff's motion for leave to file the Supplemental Rebuttal Testimony of Daniel Kahle, Staff Ex. 23.0, which revised a proposed adjustment to North Shore's Plant in Service to reflect actual 2012 data, served approximately 25 *hours* before the Utilities' surrebuttal testimony was due. Therefore, Staff and intervenors have not been precluded from reviewing such data.

Other Parties

[Insert]

[1] Note that this item does not apply to North Shore.

Commission Analysis and Conclusion

The Commission finds that it is appropriate to reflect $16,073,896 in rate base for Non-AMRP Gas Services. The Commission does not agree that parties were prejudiced when this change occurred in surrebuttal testimony as discovery was still active and cross-examination of Utilities' witness Mr. Hoops available.

3. Cash Working Capital

a. Pass-Through Taxes

North Shore and People Gas

The Utilities explain how they believe that the Commission Order in their last rate case, Docket No. 11-0280/0281 (cons) incorrectly concluded that the revenue lag days for pass-through taxes and energy assistance charges ("EACs") should be set to zero. NS Ex. 7.0 at 25; PGL Ex. 7.0 at 27; NS-PGL Init. Br. at 41-43. In a lead-lag study, the Utilities explain that the revenue lag measures the number of days from the date service was rendered by the Utilities until the date payment was received from customers and such funds become available to the Utilities. NS Ex. 7.0 at 21; PGL Ex. 7.0 at 22. Pass-through taxes and EACs are included on the monthly bills and payments are received for these amounts at the same time as all other cash from its customers, therefore the lag for the collection of such taxes and charges is identical to the revenue lag. NS Ex. 7.0 at 23, 24; PGL Ex. 7.0 at 25, 26. Staff agrees. NS-PGL Ex. 27.0 at 16. Staff also agrees that pass-through taxes are part of the Utilities' day-to-day cash flows (cash in-flows and out-flows). Staff Ex. 2.0 at 15; NS-PGL Ex. 27.0 at 16. However, Peoples Gas states that Staff and the AG incorrectly argue that the revenue lag for pass-through taxes (except the ICC Gas Revenue Tax ("GRT")) and EACs should be set at zero. Peoples Gas concludes that the Staff and AG proposals are without merit for a number of reasons and should be rejected. NS-PGL Init. Br. at 44.

First, Peoples Gas states that Staff's and AG's position to substitute zero for the lag for pass-through taxes and EACs effectively eliminates the cash in-flow for such taxes and charges in the lead-lag study even though Staff has acknowledged that they are part of the Utilities' day-to-day in-flows. For Peoples Gas, the payment of pass-through taxes is governed by an agreement with the City of Chicago ("City Agreement"). The Utilities have demonstrated through examples for each tax and charge that they do not hold the amounts collected as long as the Staff and AG claim. NS-PGL Ex. 27.0 at 17-22. For example, for Peoples Gas' Gross Receipts/Municipal Utility Tax ("MUT") and the City of Chicago Gas Use Tax ("City GUT"), NS-PGL Ex. 27.12P shows the possible collection dates for an example month (September 2012) and when those amounts would be due based on all of the possible collection dates in that month. The MUT and the City GUT are due by the 15th of the month following the month of collection, or in the example, October 15th. Based on the Utilities' analysis, if Peoples Gas collected all of the MUT and City GUT on September 1, 2012, the longest period of time those funds would be held (the revenue lag) is 44 days. If all the funds were collected on September 30, 2012, the longest period of time such funds would be held is 15 days.

However, Peoples Gas explains that the reality is that the amounts are not collected on the first day or last day of any given month but are collected over the course of the month. Thus, on average, Peoples Gas would have access to those funds on average for 30 days. Peoples Gas' proposed lead-lag study reflects that these amounts are held for 24.2 days (MUT) and 24.31 days (City GUT). These lags are slightly lower than average discussed above as a result of the City Agreement, which governs how these taxes are paid (except for the GRT). The Utilities state that North Shore also follows this process for submitting pass through taxes (except for the GRT). However, the Staff and AG proposal reflects Peoples Gas holding those amounts for 73.79 days for the MUT and 73.90 days for the City GUT. Thus, Staff and the AG inaccurately have the Utilities holding these collected amounts longer than they actually do.

Further, Peoples Gas argues that the AG's arguments regarding the terms of the agreement with the City lack merit. The City Agreement sets forth a formula by which Peoples Gas calculates the *estimated* collection percentages for the various taxes. NS-PGL Ex. 43.0 at 18-21; NS-PGL Init. Br. at 46. Nothing in how the estimated amounts are calculated changes the fact that the pass-through taxes are to be remitted the 15th day in the month following the month of collection. Id. Failure to do so would result in penalties to the Utilities. Id. Thus, as demonstrated by their analysis and supported by the City Agreement, the Utilities' proposed lead-lag study correctly reflects the appropriate lags associated with pass-through taxes and EACs.

Second, Peoples Gas states that Staff and AG both rely on the Orders in the rate cases for other utilities, including Docket No. 08-0363, Northern Illinois Gas Company; Docket Nos. 09-0306/0307/0311 (cons.) and 11-0282, Ameren Illinois; and Docket Nos. 10-0467 and 11-0721, Commonwealth Edison Co. However, it is a factual question as to when a utility must make certain payments, such as taxes, and when it receives cash from customers to make payments, thus the decisions in other utilities' rate cases are not controlling here. NS-PGL Init. Br. at 46-47. Note that the Commission acknowledged that the determination is factual in both the Utilities' 2009 rate cases and 2011 rate cases. *Peoples Gas 2009* Order, p. 24; *Peoples Gas 2011* Order, p. 27. The Utilities acknowledge that the companies in the other dockets are utilities, a gas utility, a combination gas and electric utility, and an electric utility, respectively. NS-PGL Ex. 27.0 at 27-28. However, the Utilities argue that (1) electric utilities have some different types of taxes imposed on them or their customers with different requirements; (2) these utilities operate in different parts of the State subjecting them to different municipal utility taxes; and (3) not all utilities remit these types of taxes on the same basis. Id. For example, there is no evidence that the utilities in the cited cases have similar agreements as Peoples Gas has with the City, including Commonwealth Edison Company, which operates in the City. Id. The Utilities note that Staff and AG also both err in stating that the Order in Docket No 11-0721 includes no lags for pass-through taxes as a lag is included for both the Illinois Excise Tax and the City of Chicago Infrastructure Tax. NS-PGL Init. Br. at 47.

The Utilities also argue that Staff incorrectly concludes that cash received from customers for pass-through taxes and energy assistance charges is not a payment for utility service, therefore, there should be no revenue lag. NS-PGL Init. Br. at 47-48.

The types of pass-through taxes and EACs at issue are taxes or charges imposed by law on either the Utilities or their customers and were either collected through a separate charge prescribed by law or described within the statute as a charge for utility service. Id. For example, with respect to the energy assistance charge, the Utilities are required by State statute to include in their charges for utility service an amount that will be remitted to fund State programs related to energy assistance and renewable energy. 305 ILCS 20/13(e). *Id*. In particular, the statute states: "The Energy Assistance Charge assessed by electric and gas public utilities shall be considered a charge for public utility service." *Id*. The Utilities add that Staff is placing the form of how these taxes and charges are recorded in the Utilities' books and concluding that because they are not recorded as revenue the lag should be set at zero over the substance. *Id*. The amounts collected for the taxes and charges are not recorded as revenue or as expense. NS Ex. 7.0 at 23; PGL Ex. 7.0 at 25. The intent of the cash working capital analysis is to determine cash inflows and out flows and not what is recorded as revenue. NS-PGL Ex. 43.0 at 17. Furthermore, the revenue lag is comprised of a service lag, a billing lag, a collection lag and bank float, which do not vary for pass-through taxes and energy assistance charges. *Id*.

Finally, the Utilities argue that both Staff and the AG incorrectly conclude that the Utilities are merely collection agents with respect to pass-through taxes and EACs, and as such there is nothing for shareholders to finance. This argument is a red herring and must be rejected. The implication that the Utilities are requesting a positive CWC in this proceeding is incorrect. The Utilities have included in rate base a negative amount of CWC for pass-through taxes; thus, there is no customer funding. NS-PGL Ex. 27.0 at 29. Staff agrees. Id. Further, if the Utilities are merely collection agents and as such cash inflows should not be reflected in the lead-lag study, then it not reasonable to assume that there would be cash outflows. Id. In other words, the Utilities state that Staff and the AG argue that the Utilities are only collection agents when collecting the amounts for pass-through taxes but they are not collection agents when making the payments. This is not logical. If the Utilities are collection agents, then neither the collection of pass-through taxes nor the payment of such taxes should be included in the lead-lag study. The Utilities add that this assertion also ignores that the Utilities still require cash on hand to pay the tax by the due date, whether collected or not. NS-PGL Ex. 27.0 at 25.

<u>Proposed Alternative Approach</u>

Even though the record in this proceeding demonstrates that a lag related to pass-through taxes and EACs is proper, the Utilities have proposed an alternative approach which would allow for the lag to be set at zero for pass-through taxes (except the ICC Gas Revenue Tax) and EACs. In the proposal, the expense leads would be reduced by the same value. The alternative proposal reflects customer financing of these amounts and as such customers are benefitting through lower rate base. NS-PGL Ex. 43.0 at 23-24. Staff agrees with this alternative approach. NS-PGL Cross Ex. 1. Therefore, if the Commission rejects the Utilities' proposed revenue lags for pass-through taxes and energy assistance charges, it should adopt this alternative proposal and reflect the leads as shown on NS-PGL Ex. 43.8N and 43.8P.

Other Parties

[Insert]

Commission Analysis and Conclusion

[ALTERNATIVE ONE, IF THE UTILITIES' PROPOSED REVENUE LAG FOR PASS-THROUGH TAXES AND EACS ARE APPROVED:] The Commission declines to adopt Staff's and Intervenors' use of zero revenue lag days for pass-through taxes and EACs as there is no support in the record for this conclusion or result. Based on the record evidence in this proceeding, by not reflecting the revenue lag for pass-through taxes and EACs in the lead-lag study, the results do not reflect the Utilities' actual experience in collecting these amounts from its customers and the ultimate payment of the taxes and charges. Moreover, Staff's theory about what is or is not a utility service by some definition does not alter the reality of the Utilities' cash flows in light of their legal obligations relating to these items, and is erroneous in any event. Further, the Staff and Intervenor argument that the Utilities function as merely collection agents is one-sided as collection agents both collect and remit amounts collected. Further, this argument does not rebut the fact that the Utilities require cash on hand to pay the taxes and charges. The Commission recognizes that while Staff's methodology might or might not have been appropriate in some other utilities' rate cases, it does not reflect the Utilities' facts here.

[ALTERNATIVE TWO, IF COMMISSION APPROVES THE ALTERNATIVE PROPOSAL FOR PASS-THROUGH TAXES AND EACS:] The Commission concludes that the lag for pass-through taxes and EACs, except for the ICC Gas Revenue Tax, should be zero in the Utilities' lead-lag study. However, we find that the alternative approach proposed by the Utilities to reduce the expense leads by the revenue lag value. This approach strikes the right balance as it reflects customer financing of these amounts and reflects the Utilities' actual experience in collection and payment of the taxes and charges.

b. <u>Pension/OPEB</u>

North Shore and People Gas

In their lead-lag studies, the Utilities have proposed to include a zero expense lead for Pension and Other Post-Employment Benefits ("OPEB") because to include a lead time would be duplicative since Pension and OPEB are already included in rate base. NS Ex. 7.0 at 31; PGL Ex. 7.0 at 34. The Utilities argue that Staff's argument that a lead value reflecting the intercompany billing amount be used for Pension and OPEB should be rejected. Intercompany billing payments have no relation to the cash flows related to Pension and OPEB. NS-PGL Ex. 43.0 at 24-25. The Utilities' proposal is the same recommendation made by Staff witness Mr. Kahle in Docket No. 11-0721, ComEd's 2011 formula rate case, and approved by the Commission. NS-PGL Ex. 27.0 at 31–32. The Utilities note that Staff incorrectly claims that his position in this proceeding is supported by the fact that Staff is recommending removal of the pension

asset and OPEB liabilities from rate base. However, Staff is only recommending that Peoples Gas' pension asset be removed from rate base and that North Shore's pension liability, and the Utilities' OPEB liabilities be included in rate base. Further, Staff's argument that Pension and OPEB liabilities are actually driven by an operating expense component in the revenue requirement and not rate base is equally without merit. The Utilities also note that Staff witness Mr. Kahle claims that the ComEd Pension and OPEB had an operating expense component but proposed zero lead days in that proceeding. In this proceeding, he is taking an inconsistent position.

The Utilities argue that the AG's proposal that the lead value for other operations and maintenance expense be used for Pension and OPEB should also be rejected. The Utilities state that the AG proposes to use lead value for other operations and maintenance expense because it is how the Utilities schedule and pay for many types of routinely incurred expenses. However, there is nothing routine about the cash flow related to Pension and OPEB, which the AG acknowledges. NS-PGL Ex. 27.0 at 30. Further, the alternative treatment offered by the AG incorrectly subtracts from revenues associated with Pension and OPEB is incorrect as such revenues are appropriately included in the cash working capital calculation. Id. at 30. The Utilities note that the Commission has previously rejected the AG's proposals in both Docket No. 10-0467, ComEd's 2010 rate case, and Docket No. 11-0721.

Other Parties

[Insert]

Commission Analysis and Conclusion

The Commission finds that the Utilities' proposal to set lead values for Pension and OPEB at zero in the lead-lag study is appropriate. Staff's proposal is not appropriate as the record indicates that intercompany billings have no relation to the cash flows for Pension and OPEB. Therefore, it is not a valid proxy to use in the lead-lag study. As to the AG's proposals, the AG has offered no new arguments or evidence that use of either methodology its proposes is valid. As such, the AG's proposal and alternative proposal are rejected.

c. <u>All Other</u>

There are no other issues related to cash working capital

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

North Shore and Peoples Gas

The Utilities recognize that the Commission, in the Utilities' 2007, 2009, and 2011 rate cases, found that: (1) the Peoples Gas pension asset (and the North Shore pension liability) should not be included in the calculation of rate base; and (2) the Utilities' OPEB liabilities nonetheless should be included in the calculation; and, further, that the Order in their 2009 cases was affirmed on appeal on these subjects. *North Shore Gas*

Co., et al., ICC Docket Nos. 09-0166, 09-0167 Cons. (Order Jan. 21, 2010), *aff'd in part and rev'd in part*, *People ex rel. Madigan v. Illinois Commerce Comm'n*, 2011 IL App (1st) 100654, 958 N.E.2d 405 (2011), *appeal denied*, 963 N.E.2d 246 (Ill. 2012). While the Utilities agree with the Commission's past findings that, if pension assets are excluded, then pension liabilities also should be excluded, the Utilities do respectfully request that the Commission reconsider whether to include the pension asset(s) in the instant cases, and, alternatively, whether to allow recovery of specific North Shore pension contributions or exclude the OPEB liabilities. The Commission should reject Staff's proposal to exclude the Peoples Gas pension asset, but include the North Shore pension liability, if the year end rate base method is chosen.

The Utilities use the term "pension asset(s)" above because, if the end of year rate base method is used, then Peoples Gas has a pension asset and North Shore has a pension liability, while, if the average rate base method is used, then both of the Utilities have pension assets. The figures are as follows:

	End of Year Rate Base Method	**Average Rate Base Method**
Peoples Gas	Pension asset $64,662,000	Pension asset $83,705,000
North Shore	Pension liability $865,000	Pension asset $478,500

NS-PGL Ex. 31.2P, p. 2, line 13, col. (F) and (G); NS-PGL Ex. 31.2N, p. 2, line 13, col. (F) and (G).

The Commission's past decisions to exclude the Peoples Gas pension asset from rate base were based entirely on finding that the asset is, or at least has not been shown not to be, the product of customer-supplied funds. *E.g., Peoples Gas 2007* Order, p. 36. Staff and CUB-City advance that same position in the instant cases, while the AG simply proposes to apply the prior Commission decisions. *E.g.,* Staff Ex. 4.0 at 4; CUB-City Ex. 1.0 at 18; AG Ex. 2.0 at 12.

The Commission should reconsider approving inclusion of the pension asset(s) in rate base for several reasons. First, 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. 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). Second, the pension asset is part of the utility's balance sheet and, with respect to defined benefit plans, which is what is involved here, the utility owns the assets via the trust that holds the assets, with the employees being the beneficiaries of the trust. NS-PGL Ex. 31.0 at 12. Third, 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. NS-PGL Ex. 31.0 at 12. Additionally, as Staff witness Ms. Pearce has acknowledged, normal operating revenues of a utility includes 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. PGL Ex. 11.0 at 13; NS Ex. 11.0 at 13; NS-PGL Ex. 31.0 at 13. Finally, cumulative pension contributions have exceeded cumulative recognized

Generally Accepted Accounting Principles ("GAAP") pension expense. NS-PGL Ex. 47.0 at 4; NS-PGL Ex. 47.1, Attachments A and B.

The Commission, in the alternative, should allow recovery on the Utilities' pension contributions in the form of payments into the trusts, specifically, the North Shore contributions of $4.0 million in 2009 and $11.1 million in 2010, which customers did not fund. Further in the alternative, the Commission could exclude the Utilities' OPEB liabilities from rate base to be consistent. PGL Ex. 11.0 at 13; NS Ex. 11.0 at 13; NS-PGL Ex. 31.0 at 14.

Finally, while Staff strongly argues for adherence to prior Orders as to exclusion of Peoples Gas' pension asset from rate base, Staff's rebuttal (Staff Ex. 14.0 at 4) inconsistently argues for subtracting the North Shore pension liability, even though that same Staff proposal was rejected in the prior Orders. More specifically, Staff made the same proposal in the Utilities' 2009 rate cases, and the *Peoples Gas 2009* Order (at pp. 36-37) rejected it, just as had occurred in the Utilities' 2007 rate cases, and Staff has not provided any change in circumstances or really any basis for a different outcome here. NS-PGL Ex. 47.0 at 3. Even CUB-City's witness opposes inclusion of the North Short pension liability in the rate base calculation if the Peoples Gas pension asset is excluded. CUB-City Ex. 2.0 at 49.

Accordingly, the Commission (1) should approve the inclusion of the pension asset(s) in rate base, or (2) should adopt one of the two alternative positions of the Utilities, but (3) should not adopt the Staff proposal to exclude the Peoples Gas pension asset but include the North Shore pension liability (again recognizing that North Shore has a pension liability only in the event year-end rate base is used).

Other Parties

[Insert]

Commission Analysis and Conclusion

[ALTERNATIVE ONE, IF YEAR END RATE BASE IS USED AND INCLUSION OF ASSET/LIABILITY IS APPROVED:] The Commission finds that the Utilities' respective pension asset and pension liability should be included in rate base. The Commission must decide the instant cases based on their record, just as it decided the prior cases based on their records. The prior findings that customers funded the pension assets cannot be made based on the evidence here. Customers paid for pension expense. The pension asset is the excess of amounts funded over accrued pension expense. Moreover, when customers pay their bills, a portion of the bills is return of and on capital invested by the Utilities, and thus use of such funds does not mean customers paid for assets paid for with those funds.

[ALTERNATIVE TWO, IF AVERAGE RATE BASE IS USED AND INCLUSION OF ASSETS IS APPROVED:] The Commission finds that the Utilities' respective

pension assets should be included in rate base. The Commission must decide the instant cases based on their record, just as it decided the prior cases based on their records. The prior findings that customers funded the pension assets cannot be made based on the evidence here. Customers paid for pension expense. The pension asset is the excess of amounts funded over accrued pension expense. Moreover, when customers pay their bills, a portion of the bills is return of and on capital invested by the Utilities, and thus use of such funds does not mean customers paid for assets paid for with those funds.

[ALTERNATIVE THREE, IF ONLY NORTH SHORE CONTRIBUTIONS ARE APPROVED, WITH LANGUAGE IN BRACKETS DEPENDING ON END OF YEAR OR AVERAGE RATE BASE:] The Commission finds that the [pension assets] [pension asset and liability] should not be included in rate base based on its past Orders, but that the North Shore 2009 and 2010 contributions should be included in its rate base because the latter were not customer funded. The Commission must decide the instant cases based on their record, just as it decided the prior cases based on their records. The evidence supports the finding that, in paying their bills, customers did not pay for the North Shore 2009 and 2010 contributions, but, rather, they were investor-funded. [The record here, as in past cases, does not support reducing the North Shore rate base with its pension liability while excluding the Peoples Gas pension asset.]

[ALTERNATIVE FOUR, IF ASSETS OR ASSET/LIABILITY AND NORTH SHORE CONTRIBUTIONS ARE EXCLUDED BUT OPEB LIABILITIES ALSO ARE EXCLUDED:] The Commission finds that the Utilities' [pension assets] [pension asset and liability] and the North Shore 2009 and 2010 pension contributions should not be included in rate base for the reasons stated in its past Orders. The Commission concludes, however, that the OPEB liabilities should be excluded as well, to be consistent with the rulings on the pension asset[s].

5. <u>Net Operating Losses</u>

North Shore and People Gas

The Utilities state that they are included in the consolidated United States income tax return filed by Integrys. NS Ex. 5.1, Schedule G-5, p. 4; PGL Ex. 5.1, Schedule G-5, p. 4. In its direct filing, the Utilities indicated that using their best estimates neither 2012 nor 2013 would result in a Net Operating Loss ("NOL") on a consolidated basis, even though each utility may be in a NOL position on a standalone basis. Id. In fact under "Summary of Significant Assumptions/Items" in Schedule G-5, the Utilities state:

> There is currently no forecasted net operating loss ("NOL") deferred income tax asset. This results from the assumption that while [the Utilities] may be generating taxable losses, the consolidated group is assumed to be able to use those losses. Under the Companies tax sharing agreement, [the Utilities] will be paid cash for the tax benefit of its loss, if any, generated on a standalone basis, and used to reduce consolidated tax

> obligations. [The Utilities] will therefore not have a deferred income tax asset for the NOL. This assumption will be monitored / updated at each step in the case.

NS Ex. 5.1, Schedule G-5, p. 10; PGL Ex. 5.1, Schedule G-5, p. 10-11. As indicated in their Schedules G-5, the Utilities did evaluate at each step. They noted in rebuttal testimony that even though Peoples Gas was now in a NOL position for 2011 and 2012, no deferred tax asset existed for 2012 or 2013 because the consolidated group's income was forecasted to absorb those losses. NS-PGL Ex. 30.0 Rev. at 27, 28. See also Staff Cross Ex. 13. However, prior to when surrebuttal testimony was filed, two major events occurred: (1) the American Taxpayer Relief Act of 2012 was enacted in January 2013; and (2) end of year 2012 books closed. The consequences of American Taxpayer Relief Act of 2012 led to NOLs for 2013 due to the election for bonus depreciation. The closing of the books for 2012 resulted in the consolidated group being in a NOL position for 2012. NS-PGL Ex. 46.0 at 36. As such, NOLs for 2012 and 2013 should **both** be included in rate base.

In response to CUB-City arguments, the Utilities state that as indicated in their Schedule G-5, forecasts are subject to change. This is why the Utilities indicated in Schedule G-5 that no NOL was being forecasted but would be monitored at every step of the case. There is no inconsistency with the position taken here with the position in the Utilities 2011 rate case. Further, the Utilities state that CUB-City arguments that 2012 NOLs were known for months shows a fundamental misunderstanding on how a consolidated group files a tax return. The Utilities are included in the consolidated United States income tax return filed by Integrys. To the extent that the consolidated group can absorb the NOL of Peoples Gas and North Shore, no NOL is needed to be reflected in rate base. CUB-City would have the Utilities include the effects of NOLs in rate base when information available at the time would indicate it would be improper to do so.

Also, the Utilities state that the AG's argument, regarding Section 287.30 of the Commission rules, 83 Ill. Adm. Code § 287.30, is equally without merit and inconsistent with the AG's own position on 2013 bonus depreciation. While the language of Section 287.30 is unclear, the Utilities' understanding, based on the language of Section 287.30 and the absence of invocation of Section 287.30 in their previous rate cases using future test years, in brief, is to prohibit more than one across the board update (perhaps also including a major update resulting in major changes) to a utility's revenue requirement during a future test year rate case. It is not to prevent the use of new data in isolated instances, and as to updating of individual items it only has a specific provision regarding updating the rate of return. In fact, Staff has used actual year-end 2012 data to update one of its adjustments. The AG has not cited any past rulings that support the application of Section 287.30 as the AG proposes. In contrast, updates in surrebuttal are routine. Even assuming that Section 287.30 somehow were to be applied in the novel manner that the AG now proposes to an individual item update in surrebuttal, the rule would not support the AG's argument. With respect to Section 287.30(b)(2), it was *unknown* to the Utilities at the time of their initial filing and rebuttal filing that 2012 consolidated NOLs as of year-end would exist. All facts known

to the Utilities indicated that the Integrys consolidated group would be able to absorb the Utilities' NOLs – Utilities' testimony, schedules, and data request responses support this fact. Second, with respect to Section 287.30(b)(3), Staff and intervenors did have an opportunity to review the 2012 NOLs. There was robust discovery in these consolidated proceedings, which continued after the filing of the surrebuttal testimony. Thus, Staff and intervenors have not been precluded from reviewing such data or unfairly prejudiced. Moreover, if the AG's proposition were true, then, for example, the inclusion of 2013 bonus depreciation to reduce rate base in the Utilities' surrebuttal, based on the recent change in law, should be equally barred. Finally, the Utilities do not believe that Section 287.30 is intended to or can override the Utilities' right to provide proper surrebuttal evidence, which was established in the case.

Finally, the Utilities state that failure to reflect a known 2012 or 2013 NOL in rate base in this proceeding may cause a violation of the normalization rules. The normalization rules for tax purposes address how a company must normalize the effect of accelerated depreciation. NS-PGL Ex. 30.0 Rev. at 30. By recording the effects of an NOL as a deferred tax asset, the tax benefit associated with accelerated depreciation is effectively eliminated until the time the loss is realized. Id. at 33. The result of violating this rule is severe to both the Utilities and their customers. A violation would result in the Utilities not being able to claim the rate base-reducing impacts of accelerated and bonus depreciation. Id.; Tr. 2/8/13 at 777. The consequences of violating the normalization rules are unrebutted. Thus, if either the 2012 or the 2013 NOL is excluded from rate base, the Commission should also remove 2013 bonus depreciation from the computation of ADIT.

Other Parties

[Insert]

Commission Analysis and Conclusion

The Commission finds that the Utilities appropriately set forth its assumptions when it filed their direct case. The Utilities clearly indicated that based on forecasts at the time, while Peoples Gas or North Shore may individually be generating losses, the consolidated group was able to absorb such losses. Both the AG and CUB-City lose sight of the fact that this is the nature of filing a consolidated return. The Commission also finds that through discovery and at its next opportunity to file testimony, the Utilities again updated the status of the NOLs, indicating again that it was forecasting that the consolidated group would be able to absorb the individual NOLs of Peoples Gas and North Shore. It would have been improper at either the direct stage or rebuttal stage to include the NOL as CUB-City argues. Therefore, the Commission finds that the 2012 and 2013 NOLs are appropriate and should **both** be reflected in rate base.

The Commission further observes that two new facts occurred in January 2013: the Utilities closed their books making actual 2012 data available and (2) the American Taxpayer Relief Act of 2012 was enacted. Staff utilized some actual 2012 data when it updated its adjustment to North Shore's forecasted plant additions, further decreasing

North Shore's rate base. All parties agree that the effects of the American Taxpayer Relief Act of 2012 was enacted, which extended bonus depreciation to 2013, be reflected in rate base. This also has the effect of reducing the Utilities' rate base. However, AG and CUB-City argue against 2012 NOL, which is also new information only available in January 2013, which has a positive effect on rate base. It appears to the Commission that certain intervenors only wish to reflect those adjustments which reduce rate base. However, the Commission must weigh all facts in evidence and it finds that it is proper to include both 2012 and 2013 NOLs in rate base. Given the severe effects of a violation of the normalizations rules by arbitrarily excluding appropriate NOLs, the Commission cautions parties in advancing short sighted arguments.

6. Accumulated Deferred Income Taxes –

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

North Shore and Peoples Gas

The Utilities explain that differences between income and deductions recognized for financial statement purposes or "book" purposes as compared to tax return purposes are called "book to tax differences," which can be permanent or temporary. NS-PGL Ex. 30.0 Rev. at 4. One such temporary book-to-tax difference is depreciation; for financial statement purposes, straight-line depreciation is used and for tax purposes, accelerated depreciation is used. Id. at 4, 6. The Utilities also explain the interaction of Accumulated Deferred Income Taxes ("ADIT"), the book to tax differences for depreciation, and the impact of an income tax rate change. NS-PGL Init. Br. at 58-62. The Utilities also state that Docket No. 83-0309, Illinois Commerce Commission, On its Own Motion, Investigation into the appropriate accounting treatment of the deferred tax reserve resulting from changes in statutory income tax rate, dealt with this situation specifically, outside of a rate case, in an investigation in which all Illinois utilities participated. Id. A separate proceeding was initiated to provide a methodology of deferred income tax accounting such that uniform treatment would exist for the effects on ADIT resulting from income tax rate changes. Id. In its order in Docket No. 83-0309 ("83-0309 Order"), the Commission determined that all utilities use the Average Rate Assumption method, specifically finding that:

> the record herein establishes that the **utilization of the so-called weighted average method, <u>requiring reversals or debits</u> to the accumulated deferred tax reserve account by applying a weighted average historical tax rate to the excess of book depreciation for a given asset, appears <u>most appropriate for ratemaking purposes for Illinois utilities</u>** which utilize deferred tax accounting in that (a) it is consistent with generally accepted accounting principles and APB 11, (b) it is consistent with the Commission's Uniform System of Accounts, (c) it appears nonviolative of the IRS's prescription of normalization for utility

> ratemaking purposes, and (d) it is fair and equitable to both utility ratepayers and stockholders, and such uniform treatment for ratemaking purposes of such deferred tax accounts for Illinois utilities which utilize deferred tax accounting should be adopted in each utility's next rate filing, unless sooner prescribed by the Commission; provided, however, that such treatment should be presumptive only and can be rebutted for good cause shown;
>
> ***
>
> IT IS THEREFORE ORDERED by the Illinois Commerce Commission that Illinois utilities subject to the Commission's jurisdiction over rates which utilize deferred tax accounting shall for ratemaking purposes account for reversals **resulting from changes in federal and Illinois corporate income tax rates** for income taxes deferred in prior years at the weighted average rates at which such deferred income taxes were originally recorded (i.e., by applying a weighted average historical tax rate to the excess of book depreciation for given assets); provided, however, that any accounting change required [*31] to conform with the weighted average method shall not be required until each utility's next rate filing, unless sooner prescribed by the Commission; and further provided, however, that such accounting treatment for ratemaking purposes shall be presumptive only and can be rebutted for good cause shown.

83-0309 Order, 1985 Ill. PUC Lexis 5 at *30-31. ARAM allows the return of excess (or recovery of deficient) ADIT over the remaining useful life of the assets, which gave rise to the excess (or deficient) deferred taxes. NS-PGL Init. Br. at 58-62. In the 83-0309 Order, the Commission notes that other jurisdictions at the time opted for a “quick payback” of excess depreciation but the Commission declined to adopt this methodology. Id. The Utilities state that ARAM has been used uniformly by Illinois utilities since 1985 for various tax rate changes, including the Tax Reform Act of 1986 (federal corporate rate reduced from 46% to 35%); the Omnibus Budget Reconciliation Act of 1993 (federal corporate tax rate increased from 34% to 35%); a 1989 Illinois state corporate combined tax increase from 6.4% to 7.18%; and a 2003 Illinois state corporate combined tax increase from 7.18% to 7.3%. NS-PGL Ex. 30.0 Rev. at 12. It appears that in only two instances since the 83-0309 Order was entered did a utility use a method other than ARAM: ICC Docket No. 12-0321, ComEd’s formula rate proceeding and Docket No. 12-0293, Ameren Illinois’ formula rate proceeding. NS-PGL Ex. 46.0 at 19. In the ComEd proceeding, ComEd proposed a different methodology and in Ameren, the utility adopted a different methodology when raised by an intervenor. AG Cross Ex. 3.0; Docket No. 12-0321, Order at 32-33; Docket No. 12-0293, Order at 89-97. The records in those cases are absent any substantive debate on the merits of the methodology used versus ARAM, which all other Illinois utilities use. NS-PGL Ex. 30.0 Rev. at 13. The Utilities also cite *Central Illinois Public*

Service Co. v. Illinois Commerce Comm'n, 243 Ill. App. 3d 421, 610 N.E.2d 1356 (1993), which upheld the use of ARAM.

The Utilities argue that the AG and CUB-City propose a method that is inconsistent with the existing regulations regarding normalization despite the concerns expressed in the 83-0309 Order that the methodology chosen to apply to both federal and state income tax changes be "nonviolative of the IRS's prescription of normalization for utility ratemaking purposes." Full normalization means that the amount of deferred income taxes recorded is the difference between (1) the actual tax liability (computed for example using accelerated depreciation) and (2) the tax liability if book expenses (such as straight-line depreciation) were used in the tax computation. NS-PGL Ex. 46.0 at 9. Utility normalization is prescribed in two places: the federal income tax rules on normalization and the FERC regulation on normalization. Id. The Utilities argue that the intervenors' methodology no longer reflects the difference between the actual tax liability and the tax liability based upon book expenses and thus no longer "nonviolative of the IRS's prescription of normalization for utility ratemaking purposes." The Utilities also note that the AG and CUB-City proposed methodology is inconsistent with Congressional intent allowing utilities to claim accelerated tax depreciation. NS-PGL Ex. 46.0 at 11. The Utilities argue that the AG and CUB-City proposed method is not a direct violation of normalization rules because at issue here is a change in state tax rate and not the federal tax rate. If a federal tax rate were at issue, the Utilities would likely need to seek a private letter ruling from the Internal Revenue Service before setting rates in accordance with the AG and CUB proposed method. Id. The Utilities state that CUB-City's reliance on Accounting Standards Codification ("ASC") 740, which is the Generally Accepted Accounting Principles ("GAAP") method for computing deferred taxes is misplaced. GAAP has no reference to or definition for normalization; thus there is no "proper normalization accounting … as prescribed by GAAP" as CUB-City claim. The liability method described in ASC 740 is inconsistent with both the income tax and FERC regulations regarding normalization. However, GAAP acknowledges the situation where a prescribed regulatory method, such as ARAM, differs from the liability method as described in ASC 740, and under ASC 980, it allows a utility to record the difference between the two methods as a balance sheet adjustment. NS-PGL Ex. 46.0 at 17.

Further, the Utilities argue that the AG and CUB-City proposed partial flow through methodology distorts costs of service and does not balance and protect the interests of all stakeholders. This is contrary to the 83-0309 Order, which approves the ARAM methodology in part because "it is fair and equitable to both utility ratepayers and stockholders." 83-0309 Order, 1985 Ill. PUC Lexis 5 at *29-30. In fact, the proposed methodology unfairly sacrifices future customers in order to provide a benefit to current customers. The Utilities state that by using ARAM, they provide the benefit of accelerated and bonus depreciation taken on an asset, which affects cost of service, over the life of the asset ensuring customers pay a normalized cost of the asset. However, the effect of the AG and CUB-City proposed methodology is that it lowers cost of service through a reduction for an estimated future tax benefit, in the initial year(s) an asset, flowing through a benefit to tax expense that is uncertain and that will actually be realized in a future period. For an asset, this benefit will not be repeated, and there is a

resulting increase in the carrying cost of that asset in each subsequent year the asset is in service. NS-PGL Ex. 30.0 Rev. at 7. In other words, the tax benefit that under ARAM would be returned over the life of the asset that originated the book to tax difference is provided for immediately. The Utilities state that this is improper because future customers who will be paying for the same asset through depreciation are denied the benefit. The Utilities add that ARAM is fair to all customers as it normalizes the tax benefit or tax deficiency into rates over the assets' in-service lives – matching the depreciation expense which originally caused the book to tax difference. NS-PGL Ex. 30.0 Rev. at 8. Under ARAM, customers, current and future, all share in the burden of an income tax rate increase and enjoy the benefits of income tax rate decreases. Id. This is imperative as all these customers are funding the asset that created the book to tax difference and prevents any windfall to anyone group.

Finally, the Utilities note that in its 83-0309 Order, the Commission stressed the importance of establishing a uniform rule and stated that ARAM is presumptive and can be rebutted for good cause shown. 83-0309 Order, 1985 Ill. PUC Lexis 5 at *30-31. The AG and CUB-City propose a methodology that only two Illinois utilities, proposed under a formula rate statute, use. There is no other evidence indicating that any other Illinois utility has adopted a methodology other than ARAM. The AG and CUB-City proposal is inconsistent with the methodology provided under 83-0309 and they have not provided good cause as to why the Utilities must change their methodology. Further, a piecemeal process is not the proper way to ensure Illinois utilities are using a uniform methodology. Change in income tax rates should be treated consistently and not dealt with on a utility-by-utility basis, as this would lead to uneven results to cost of service and would vary as to when a rate case is filed. For example, Northern Illinois Gas Company ("Nicor"), as a result of its merger, agreed to not file a rate case for three years. If 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 ever receiving any of the "flow-through" benefits of the temporary schedule rates. This is just one example. Through initiating a separate docket (Docket No. 83-0309) in which all Illinois utilities were involved, uneven treatment of Illinois ratepayers is avoided.

The Utilities state that AG and CUB-City have provided no good reason why their proposed methodology should be adopted. Staff agrees.

Other Parties

[Insert]

Commission Analysis and Conclusion

The Commission continues to believe that ARAM is fair and equitable to both utility ratepayers and stockholders. Despite the arguments set forth by the AG, the Utilities are not "hiding behind a thirty year old order." Instead the Utilities are complying with a directive that all Illinois utilities have followed since 1985 when our 83-0309 Order was entered. Our 83-0309 order is applicable to income tax rate

changes past and future, and is applicable to both federal and state rate changes, no matter their form. Further, our 83-0309 Order does provide that the use of ARAM can be rebutted for good cause, however, based on the record, the Commission finds no good cause that the Utilities should use a method other than ARAM to account for ADIT.

b. <u>Repairs Deduction Related to AMRP Projects</u>

North Shore and People Gas

In its 2009 tax return, Peoples Gas elected to change its tax method of accounting for the determination of whether an expenditure is a capital asset or repairs and maintenance ("repairs deduction"). PGL Ex. 10.0 at 8-9. In its direct filing, the Utilities reflected the benefit of this election despite continued audit risk. In particular, the Utilities note that based on developments at the time of direct filing, including the issuance of Revenue Procedure 2011-43 and proposed Treasury Regulations, it could make some reasonable assumptions regarding the repairs deduction:

> (1) The Industry Issue Resolution ("IIR") process related to gas distribution property would result in an *electable* safe harbor similar to the electric transmission and distribution ("T&D") safe harbor;
>
> (2) The Utilities will be satisfied with the tax benefit that the safe harbor method provides and will elect the safe harbor method; and
>
> (3) The election to use the safe harbor method will include a similar transition provision in that it will come in the form of a new method change adopted in a future tax year.

Id.. At the time of its direct filing, based on the information available, Peoples Gas believed that only 40% of AMRP costs would qualify for the repairs deduction. NS-PGL Ex. 46.0 at 26. Peoples Gas' position was supported in part by participants engaged in the ongoing Industry Issue Resolution ("IIR") program, which indicated that the guidance for gas utilities would be similar to Revenue Procedure 2011-43 and that such guidance would be issued in time for filing Peoples Gas' 2011 tax return. Id. However, by the time Peoples Gas filed rebuttal testimony, it believed and it continues to believe, that the Internal Revenue Service ("IRS") would not allow a repair deduction for any portion of AMRP projects. This conclusion was based on a number of factors. First, Revenue Procedure 2011-43 was a procedure for *electric* transmission and distribution ("T&D") companies that included safe harbor guidance in determining whether an expenditure for electric T&D constituted a repair for tax purposes. It cannot be relied upon by a gas utility to meet the tax return positions set forth in the Statement on Standards for Tax Services No. 1. NS-PGL Ex. 46.0 at 27-29. What is useful information is the IRS' application of Revenue Procedure 2011-43 to electric T&D. This procedure provides two exceptions to the safe harbor guidance that if contained in the future gas industry guidance, Peoples Gas believed that no portion of AMRP costs would qualify as repairs based on the application of these exceptions to electric T&D companies. NS-PGL Ex. 30.0 Rev. at 18-20. This conclusion is based on the experience of electric T&D

companies in applying Revenue Procedure 2011-43 that came to Peoples Gas' attention after filing its direct case. *Id.*

Further, the nature of AMRP, following the reversal of Rider ICR by the Appellate Court and through the testimony submitted in this proceeding, is clearly becoming part of a plan of rehabilitation, modernization, or improvement, which is an exception to the safe harbor rule set forth in Revenue Procedure 2011-43. Additionally, the IRS has already indicated that additional guidance was needed to make Revenue Procedure 2011-43 work as intended (as differences in interpretation of key provisions exist) and that guidance would not be received until sometime in 2013 at the earliest. Furthermore, the IRS has indicated that there was a delay in the release of the guidance for gas T&D industry, which also would not be expected until sometime in 2013. Finally, Peoples Gas has indicated that it has not taken the repairs deduction related to AMRP projects on its 2011 return and there is no basis for a repair deduction related to AMRP projects in its 2012 return which is due to be filed in September 2013. NS-PGL Ex. 46.0 at 27; Tr. 2/8/13 at 757:9-12. Peoples Gas' cautious behavior based on these facts and circumstances is not imprudent. Peoples Gas' shareholder is not benefitting by not expending the repairs deduction to AMRP projects.

Peoples Gas states that the AG claims that Peoples Gas should claim a repairs expense deduction for AMRP projects even though it has not claimed a deduction on its 2011 return or will not claim a deduction on its 2012 return for AMRP projects. Peoples Gas explains that based on a lack of guidance to the gas industry regarding the repairs election, the experience of the electric industry with similar guidance, and other developments in the industry and in this proceeding, Peoples Gas determined that it will no longer take a repairs deduction regarding AMRP projects. The AG provides little to no evidence to rebut this conclusion. Also, Peoples Gas' position is based upon applying representations it made to the IRS on Form 3115 when making the election and other applicable law to the 2011 AMRP projects, Peoples Gas could not meet the reporting standard as set forth in the Statement of Standards for Tax Services No. 1. As such, Peoples Gas did not claim the deduction as it relates to AMRP projects on its 2011 return. Further the AG's proposal is similar to the situation where AG witness Mr. Effron attempted to impute the repairs election on ComEd in Docket No. 10-0467. The Commission denied it in that docket and it should do so here. Finally, he AG's reliance on The Narragansett Electric Company, d/b/a National Grid Gas ("National Grid") case is without merit. National Grid's Infrastructure, Safety, and Reliability program is not substantially similar to Peoples Gas' AMRP.

Other Parties

[Insert]

Commission Analysis and Conclusion

The evidence demonstrates that even though the Utilities have elected the repairs deduction, there is still substantial uncertainty related to the repairs deduction. Peoples Gas has not claimed the repairs deduction for AMRP-related projects on its

2011 tax return and does not currently expect to claim this deduction on its 2012 tax return to be filed in September 2013. The IRS has not even issued guidance for gas utilities and there appears substantial doubt on how even the guidance issued to electric utilities is applied. Therefore, we cannot conclude that Peoples Gas' cautious behavior with the IRS, without more, is an act of imprudence.

c. <u>Bonus Depreciation</u>

North Shore and People Gas

In January 2013, the American Taxpayer Relief Act of 2012 was enacted and it extended the availability of 50% bonus depreciation into 2013. The Utilities expect to elect to take bonus depreciation in 2013. NS-PGL Ex. 46.0 at 34. There appears to be no dispute that the appropriate adjustments to ADIT for year end rate bases are $47.2 million for Peoples Gas and $3.2 million for North Shore (for an average rate base, the adjustments are $23.618 million for Peoples Gas and $1.625 million for North Shore).

However, The Utilities state that if the Commission determines that the 2012 NOL should not be included in computing rate base as discussed in Section IV.C.5 of this Order, then bonus depreciation should not be included in determining ADIT. Failure to include the 2012 NOL in rate base would likely lead to a violation of the normalization rules. Tr. 2/8/13 at 777. A consequence of such a violation is the loss of accelerated depreciation, which includes bonus depreciation. NS-PGL Ex. 30.0 Rev. at 33. As such, the Utilities state that the inclusion of bonus depreciation at the very least would be improper.

Other Parties

[Insert]

Commission Analysis and Conclusion

[ALTERNATIVE ONE, IF THE 2012 and 2013 NOLs AND YEAR END RATE BASE ARE APPROVED:] The Commission finds that the appropriate adjustments to ADIT for year end rate bases are $47.2 million for Peoples Gas and $3.2 million for North Shore. Having found that the 2012 and 2013 NOLs should be included in rate base, we do not have to reach the normalization issue.

[ALTERNATIVE TWO, IF THE 2012 and 2013 NOLs AND AVERAGE RATE BASE ARE APPROVED:] The Commission finds that the appropriate adjustments to ADIT for an average rate base, the adjustments are $23.618 million for Peoples Gas and $1.625 million for North Shore. Having found that the 2012 and 2013 NOLs should be included in rate base, we do not have to reach the normalization issue.

[ALTERNATIVE THREE, IF COMMISSION DENIES 2012 OR 2013 NOLS IN RATE BASE] The Commission concluded in Section IV.C.5 of this Order that the 2012 NOLs should not be reflected in rate base. Having reached that conclusion, the

Commission acknowledges that the Utilities will likely be in violation of normalization rules and loss of accelerated depreciation, such as bonus depreciation, is a likely consequence. As such, the Utilities will be precluded at some point during or before the test year from claiming accelerated and bonus depreciation. The Commission therefore concludes that, at a minimum, it would be improper to include 2013 bonus depreciation. Therefore, the Utilities' proposal to reflect these amounts for 2013 bonus depreciation is denied.

d. Derivative Adjustments from Contested Adjustments

Apart from the items discussed in Section IV.C.6.a, b, and c, above, this is an uncontested issue that depends on the outcome of other issues discussed elsewhere in this Order. The Commission's conclusions are reflected in the Appendices.

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

This is an uncontested issue that depends on the outcome of other issues discussed elsewhere in this Order. The Commission's conclusions are reflected in the Appendices.

V. OPERATING EXPENSES

A. Overview/Summary/Totals

1 and 2. North Shore and Peoples Gas

North Shore and Peoples Gas

North Shore states that its final properly calculated base rate operating expenses are $72,424,000, reflecting the Staff and intervenor adjustments that it adopted or accepted in whole or in part in order to narrow the issues and certain updates. *E.g.,* NS-PGL Ex. 42.1P, line 33, col. [H]. Peoples Gas states that its final properly calculated base rate operating expenses are $527,779,000, reflecting the Staff and intervenor adjustments that it adopted or accepted in whole or in part in order to narrow the issues and certain updates. *E.g.*, NS-PGL Ex. 42.1P, line 33, col. [H].

The Utilities state their operating expenses are supported by extensive, detailed evidence, including the testimony of six witnesses on the following topics: (1) the test year, the overall revenue requirement, operating expenses, operating income, rate case expenses, and the Gross Revenue Conversion Factor, and underlying calculations and support of numerous components of operating expenses; (2) the test year forecast and associated "Part 285" Schedules, significant variances year over year from prior years to the test year in amounts recorded in operating expense Accounts, bad debt expense, depreciation and amortization expense, taxes other than income taxes expense, and intercompany costs; (3) employee headcounts, expenses associated with the Chicago Department of Transportation regulation changes and the Utilities' cross bore program; (4) incentive compensation program expenses and non-union base wage increases;

(5) income taxes and invested capital taxes; and (6) employee benefits operating expenses, including pensions, OPEB, group insurance, and Integrys Business Support, LLC ("IBS") billed benefits. NS-PGL Init. Br. at 72-73.

Other Parties

[Insert]

Commission Analysis & Conclusion

The Commission approves North Shore's and Peoples Gas' final revised operating expenses, which reflect adjustments proposed by Staff, AG, and CUB-City with which the Utilities agreed or accepted in whole or in part and certain updates. The Utilities are entitled to recover those proven costs through their rates. The detailed evidence in the record warrants this conclusion. The remaining contested adjustments proposed by Staff, AG, and CUB-City are erroneous and are noted adopted, as discussed below.

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

1. Administrative & General

a. Interest Expense on Budget Payment Plan

In surrebuttal testimony, the Utilities accepted Staff's proposed adjustments of interest expense on budget payment plan based on the December 19, 2012, Commission ruling setting the 2013 rate of interest to be paid at 0%. The Utilities clarified that the adjusted amounts should be taken from the Operating and Maintenance ("O&M") ratemaking adjustments included in the Utilities' revenue requirements that were filed in direct testimony as Schedules C-2.9 and C-2.10. Staff Ex. 12.0 Rev. at 24-25; NS-PGL Ex. 42.0 Rev. at 4. Therefore, the Commission approves Staff's recommended adjustment, as clarified by the Utilities, of interest expense on Peoples Gas' and North Shore's budget payment plan.

b. Interest Expense on Customer Deposits

In surrebuttal testimony, the Utilities accepted Staff's proposed adjustments of interest expense on customer deposit based on the December 19, 2012, Commission ruling setting the 2013 rate of interest to be paid at 0%. The Utilities clarified that the adjusted amounts should be taken from the O&M ratemaking adjustments included in the Utilities' revenue requirements that were filed in direct testimony as Schedules C-2.9 and C-2.10. Staff Ex. 12.0 Rev. at 24; NS-PGL Ex. 42.0 Rev. at 4. Therefore, the Commission approves Staff's recommended adjustment, as clarified by the Utilities, of interest expense on Peoples Gas' and North Shore's customer deposits.

c. Lobbying Expenses

In rebuttal testimony, the Utilities accepted Staff's proposed adjustments disallowing expenses inherent with lobbying and related activities. Staff Ex. 3.0 at 16; NS-PGL Ex. 26.0 at 4-5. Therefore, the Commission approves Staff's adjustments.

d. Social and Service Club Dues

In rebuttal testimony, the Utilities accepted Staff's adjustment to social and service club membership dues. Staff Ex. 3.0 at 15; NS-PGL Ex. 26.0 at 4-5. Therefore, the Commission approves Staff's adjustments.

e. Executive Perquisites

In rebuttal testimony, the Utilities accepted Staff's adjustment to executive perquisites. Staff Ex. 3.0 at 17-18; NS-PGL Ex. 26.0 at 4-5. Therefore, the Commission approves Staff's adjustments.

f. Consulting Expense – SIG Consulting

In rebuttal testimony, the Utilities accepted Staff's adjustment to consulting expenses for Strategic International Group, LLC. Staff Ex. 3.0 at 20-21; NS-PGL Ex. 26.0 at 4-5. Therefore, the Commission approves Staff's adjustments.

g. Employee/Retiree Perquisites – Awassa Lodge

In rebuttal testimony, the Utilities accepted Staff's adjustment to expenses related to Awassa Lodge. Staff Ex. 4.0 at 24; NS-PGL Ex. 26.0 at 4-5. Therefore, the Commission approves Staff's adjustments.

h. Update to Pension and Benefits

In rebuttal testimony, the Utilities updated pension and OPEB expenses to reflect the most recent actuarial report, which increased these expenses by $979,000 for North Shore and $7,201,000 for Peoples Gas. NS-PGL Ex. 26.0 at 14. This was not contested, except indirectly and incorrectly as discussed in Section V.C.7.a of this Order. Therefore, the Commission approves the Utilities' pension and OPEB expenses.

i. Update to IBS Return on Investment

The Utilities and the AG agree that the rate of returns for the IBS return on investment included in the Utilities' revenue requirements should reflect the final approved rates of return. AG Ex. 1.0 at 50-51; NS-PGL Ex. 26.0 at 4-5. No other party disagrees. Therefore, the Commission approves this methodology.

j. Costs to Achieve Amortization

In rebuttal testimony, the Utilities updated the amortization of costs incurred to achieve savings. NS-PGL Ex. 26.0 at 13. This was not contested. Therefore, the Commission approves the Utilities' adjustment to the amortization of these costs.

2. Uncollectible Account Expense Included in Base Rates

In rebuttal testimony, the Utilities accepted Staff's adjustment to the base rate uncollectible accounts expense. Staff Ex. 2.0 at 27; NS-PGL Ex. 26.0 at 4-6. Therefore, the Commission approves Staff's adjustment.

3. Depreciation Expense –

a. WAM System

In surrebuttal testimony, the Utilities updated adjustments for IBS depreciation expense on the Work Asset Management ("WAM") system. NS-PGL Ex. 42.0 Rev. at 11; NS-PGL Ex. 41.0 Corr. at 5. The adjustments were not contested, but the amount of the adjustment is potentially contested as discussed in Section V.C.7.a of this Order. Therefore, the Commission approves the Utilities' adjustment.

b. CNG Plant

In surrebuttal testimony, the Utilities accepted Staff's adjustment to CNG Plant for Peoples Gas to reflect the reclassifications of the depreciation expense and income taxes from utility plant in service to a non-utility plant. NS-PGL Ex. 42.0 Rev. at 13; NS-PGL Ex. 43.0 at 4. Therefore, the Commission approves Staff's adjustment.

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

In rebuttal testimony, the Utilities accepted Staff and intervenor adjustments to income taxes that relate to changes in interest expense on debt financing as well as to changes to the forecasted interest rates on short-term and long-term debt. NS-PGL Ex. 26.0 at 15; NS-PGL Ex. 23.0 at 3. Therefore, the Commission approves Staff and intervenor's adjustments to these amounts.

5. Revenues

a. Sales and Revenue Adjustment by Service Classification

North Shore and Peoples Gas

AG witness Mr. Effron proposed to eliminate the Utilities' forecasted sales decreases and to base their forecasted sales for the 2013 test year at their actual 2011 weather normalized sales. This adjustment would increase Peoples Gas' sales to Service Classification ("S.C.") No. 1 – Small Residential Service by 17,361,000 therms and S.C. No. 2 – General Service by 19,481,000 therms and North Shore's sales to S.C. No. 2 – General Service by 1,963,000 therms. AG Ex. 2.0 at 18-20; AG Ex. 2.1, Sched. DJE-2N; AG Ex. 2.1, Sched. DJE-2P. The Utilities did not contest these adjustments. NS-PGL Ex. 40.0 at 3; NS-PGL Exs. 40.1 and 40.2.

The Utilities provided Staff with blocked test year sales for the different meter classes. NS-PGL Exs. 40.3 – 40.5. In rebuttal testimony, AG witness Mr. Rubin provided different blocking based on a different sales adjustment for Peoples Gas S.C. No. 1, but no blocking to reflect the AG's proposed sales adjustments for Peoples Gas S.C. No. 2 or North Shore S.C. No. 2. NS-PGL Ex. 40.0 at 3-4. Furthermore, Mr. Rubin's blocking for Peoples Gas S.C. No. 1 was not consistent with how the test forecast was derived. *Id.* at 4. It is the Utilities' understanding that the AG does not contest the Utilities' blocking for Mr. Effron's sales adjustment.

Other Parties

[Insert]

Commission Analysis and Conclusions

The Commission will adopt the uncontested adjustment proposed by the AG to eliminate the Utilities' forecasted sales decreases and to base their forecasted sales for the 2013 test year at their actual 2011 weather normalized sales. Further, the Commission will adopt the blocking provided by the Utilities for test year sales for the different meter classes as shown in NS-PGL Exs. 40.3 – 40.5.

6. Interest Synchronization
(methodology on derivative adjustments)

In surrebuttal testimony, the Utilities accepted the AG's adjustment to the Utilities' forecasted sales, which would result in an increase of Peoples Gas' sales to Service Classification ("S.C.") No. 1 – Small Residential Service by 17,361,000 therms and S.C. No. 2 – General Service by 19,481,000 therms and North Shore's sales to S.C. No. 2 – General Service by 1,963,000 therms. AG Ex. 2.0 at 18-20; AG Ex. 2.1, Sched. DJE-2N; Ag. Ex. 2.1, Sched. DJE-2P; NS-PGL Ex. 40.0 at 3; NS-PGL Exs. 40.1 and 40.2 Therefore, the Commission approves the AG's adjustment.

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

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

North Shore and Peoples Gas

The Utilities have three different incentive compensation plans: (i) an Executive Incentive Compensation Plan; (ii) an Omnibus Incentive Compensation Plan, consisting of various stock plans; and (iii) a Non-Executive Incentive Compensation Plan. In order to narrow the issues for the Commission's determination, the Utilities agreed not to contest proposed disallowances to portions of their Executive Incentive Compensation Plan expenses as calculated by Staff and to all of their Omnibus Incentive Compensation Plan expenses, without any waiver of their right to assert arguments or

otherwise contest such disallowances in future rate cases or other proceedings. *See* NS-PGL Ex. 29.0 at 3-7, 15-16. The Utilities seek full recovery of the expenses for their Non-Executive Incentive Compensation Plan.

The Utilities' Non-Executive Incentive Compensation Plan sets different annual incentive compensation levels for non-union employees based on North Shore's and Peoples Gas' performance against pre-determined goals in a number of areas designed to provide net customer benefits. The plan uses four specific performance measures to determine incentive payouts for the Utilities' employees that are all focused on operational aspects of the business: cost management weighted at 50%, employee safety (*i.e.*, OSHA recordable incident rates) weighted at 15%, customer satisfaction weighted at 15% and reliability (*i.e.*, reduction in leaks and damages caused by crews) weighted at 20%. NS Ex. 9.0 at 5-8; PGL Ex. 9.0 at 5-8; NS Ex. 9.1; PGL Ex. 9.1.

While no party opposes the recovery of costs related to the Plan's employee safety, customer satisfaction and reliability measures which account for 50% of the Plan's costs (*see* Staff Ex. 13.0 at 24-25; AG Ex. 1.0 at 32; CUB-City Ex. 1.0 at 97), the AG and CUB-City propose the disallowance of the other 50% of the Plan's expenses associated with its O&M cost control measure – $439,071 for North Shore and $2,882,076 for Peoples Gas. AG Ex. 1.0 at 29-32; AG Ex. 4.0 at 28-33; CUB-City Ex. 1.0 at 81-98; CUB-City Ex. 2.0 at 15-22.

The Utilities begin by setting forth the Commission's general standard for approving the recovery of incentive compensation expenses. It is a well-established principle that a utility is entitled to recover its prudent and reasonable costs of service. *See*, *e.g.*, *Citizens Util. Bd. v. Illinois Commerce Comm'n.*, 166 Ill. 2d 111, 121 (1995). It is settled law, moreover, that employee salaries are operating expenses and, as such, are recoverable in full so long as they are prudent and reasonable. *See, e.g., Villages of Milford v. Illinois Commerce Comm'n*, 20 Ill. 2d 556, 565 (1960) ("*Milford*"). With respect to incentive compensation costs, the Commission's standard for recovery is whether the incentive compensation expenses "can reasonably be expected to provide net benefits to ratepayers." *See In re Illinois Power Co.*, ICC Docket No. 01-0432 (Order Mar. 28, 2002), pp. 42-43 ("*Illinois Power Co.*"). *See also People ex rel. Lisa Madigan v. Illinois Commerce Comm'n*, 2011 IL App (1st) 100654, ¶¶ 51, 55 (1st Dist. Sept. 30, 2011) ("*Peoples Gas 2009 Appeal*") (holding that the Commission's use of a customer benefit standard for the recovery of incentive compensation costs was appropriate).

While the AG and CUB-City rely upon the fact that the Commission disallowed the costs of the same O&M cost control metric in *Peoples Gas 2011*, that decision by the Commission was based on a finding limited to the facts and circumstances in that proceeding that the Utilities had failed to present sufficient evidence to establish the metric was reasonably likely to benefit customers. *Peoples Gas 2011* Order, p. 57. That decision, limited to the facts in those proceedings, is not binding on the Commission here. The Commission must base its decision on the evidence in the record of the instant cases. 220 ILCS 5/10-103; 220 ILCS 5/10-201(e)(iv)(A). *See also*

Citizens Util. Bd., 166 Ill. 2d at 125-126 ("However, this past precedent is not controlling, because the Commission is a legislative and not a judicial body, and generally its decisions are not res judicata in later proceedings before it.") (citations omitted); *Mississippi River Fuel Corp. v. Illinois Commerce Comm'n.*, 1 Ill. 2d 509, 513 (1953) ("The concept of public regulation includes of necessity the philosophy that the commission shall have power to deal freely with each situation as it comes before it, regardless of how it may have dealt with a similar or even the same situation in a previous proceeding."). Here, the Utilities argue – and Staff agrees – that the Utilities have adduced specific evidence in the record demonstrating that the O&M cost-control metric does control or reduce O&M expenses that will provide benefits to customers.

The Utilities assert that, as agreed to by Staff, the record evidence contains substantial evidence establishing that the O&M cost control metric can reasonably be expected to provide net benefits to customers as required by the Commission for the recovery of incentive compensation costs. *Illinois Power Co.*, pp. 42-43. The Utilities rely on the conclusion of Staff witness Mr. Ostrander that the Utilities' O&M cost control metric has an established record of reducing or controlling costs since it was adopted by the Utilities starting in the year 2011, resulting in lower O&M expenses for both Utilities in 2011 than in the previous year, and lower O&M expenses than budgeted for the first nine months of 2012 included in the record. Staff Ex. 13.0, 24-25. The Utilities further rely on Staff's conclusion that the AG's and CUB-City's requested disallowance of the costs associated with the Utilities' O&M cost control metric "are not necessary." *Id*. at 25.

The Utilities point the Commission to specific evidence in the record demonstrating that the O&M metric provides net benefits to customers. The record evidence shows that Peoples Gas was able to beat its O&M expense goal in 2011 by $22.8 million, resulting in an amount of O&M expense that was approximately $2.8 million less than the previous year. Likewise, North Shore was able to beat its goal for O&M expense goal in 2011 by $1.7 million, resulting in an amount of O&M expense that was approximately $1.1 million less than the previous year. NS Ex. 9.0 at 9 -10; PGL Ex. 9.0 at 9-10; NS-PGL Ex. 29.0 at 9. Utilities' witness Ms. Cleary testified that, in her opinion, when costs are reduced or controlled in one year such as they were in 2011, that reduction or control carries through to the basis used in planning the following years' budgets, including the O&M costs budgeted for the 2013 test year at issue in these rate cases. NS Ex. 9.0 at 10; PGL Ex. 9.0 at 10.

While admitting that the Utilities are not able to show a direct link to particular dollars in specific line items of the 2013 O&M budget that have been reduced as a result of the O&M cost control metric (*see* NS-PGL Ex. 45.0 at 5), the Utilities illustrated in a hypothetical how these cost reductions in previous years have benefited customers in the test year budget for the current rate case *Id*. at 6-7. The Utilities' hypothetical demonstrates that if actual costs for Peoples Gas had not been reduced in 2011, but instead had come in at the budgeted level, the O&M budget submitted by Peoples Gas in this rate case for the 2013 test year may have been over $32 million higher. The hypothetical assumed that the percentage change between this hypothetical 2011 result

and the O&M budget for 2012 would have been the same as actually occurred between the real 2011 O&M results and 2012 O&M budget, and then assumed that the percentage change between this hypothetical 2012 O&M budget and the 2013 O&M budget would have been the same as actually occurred between the real 2012 O&M budget and the 2013 O&M budget submitted as part of this rate case. NS-PGL Ex. 45.0 at 6-7. This hypothetical shows how costs savings in one year can result in reducing the expenses to be recovered in future rate cases, all else being equal, and supports Ms. Cleary's opinion that without the O&M cost control metric, the amount of O&M budgeted for the 2013 test year likely would have been higher. NS Ex. 9.0 at 10; PGL Ex. 9.0 at 10; NS-PGL Ex. 45.0 at 7-8. The Utilities point out that even the AG witness Mr. Brosch conceded on cross-examination that increased O&M costs in one year may lead to higher O&M costs being forecasted in a subsequent year's rate case, all else being equal. Tr. 2/6/13 at 512-513. The Utilities further argue that this evidence refutes the AG's argument that no direct benefit can be shown to North Shore's and Peoples Gas' customers because the O&M cost control metric payouts are calculated based on a combined Integrys utility basis.

Based on this record evidence, the Utilities conclude that the O&M cost control metric in their Non-Executive Incentive Compensation Plan falls squarely within the types of incentive compensation plans for which the Commission has allowed recovery in a multitude of cases. A review of past Commission orders reveals numerous instances of the Commission specifically ruling that the costs for a metric which encourages the control or reduction of O&M expenses is beneficial to customers and, therefore, recoverable. For example, in the Utilities' 2007 rate cases, the Commission allowed the Utilities to recover 48.4% of an incentive compensation plan's costs "based on controlling O&M expenses," stating that "we consider this as beneficial to ratepayers." *Peoples Gas 2007* Order, pp. 66-67. Similarly, in ComEd's 2005 rate case, the Commission allowed the recovery of expenses for a component of ComEd's incentive compensation plan based on controlling O&M and capital expenses, stating that such a metric "meets the Commission's standard of reducing expenses and creating greater efficiencies in operations," and that "[l]owering O&M expenses, all else being equal, has the obvious effect of reducing the expenses to be recovered in future rate cases." *In re Commonwealth Edison Co.*, ICC Docket No. 05-0597 (Order July 26, 2006) ("*ComEd* 2005"), pp. 95-96. The Commission reached similar conclusions in ComEd's 2007 rate case and other cases. *See Commonwealth Edison Co.*, ICC Docket No. 07-0566 (Order Sept. 10, 2008) ("*ComEd 2007*"), pp. 54-55, 61 (approving recovery of costs for portions of incentive plan identical to those approved in *ComEd 2005*); *Consumers Illinois Water Company*, ICC Docket No. 03-0403 (Order Apr. 13, 2004) ("*Consumers IWC*"), pp. 14-15 (approving recovery of incentive compensation expenses which included a metric for "maintaining or reducing operating costs at or below budgeted levels"); *In re Aqua Illinois, Inc.*, ICC Docket No. 04-0442 (Order April 20, 2005) ("*Aqua Illinois*"), pp. 21-22 (approving recovery of costs for incentive plan similar to the plan approved in *Consumers IWC*).

Nowhere in these decisions, the Utilities argue, has the Commission set a standard requiring a showing of specific line-item cost savings linked to a cost-control

metric in the exacting detail that the AG and CUB-City would require. Further, the record evidence indicated that there was no methodology known to accomplish such a task, a fact that the AG and CUB-City did not counter. *See* NS-PGL Ex. 45.3, sub (a). *Peoples Gas 2011* is an unusual exception to the Commission's routine approval of such metrics, and it is based on the particular record in that case.

The Utilities respond to the AG's attempt to blunt the impact of *ComEd 2005* based on it being an historical test year rate case by noting that the Commission's analysis in *ComEd 2005* was not limited to cases involving only historical test years. In fact, the Utilities contend, the Commission in *ComEd 2005* expressly referred to plural "future rate cases" in which customers would benefit from costs being controlled. *ComEd 2005*, pp. 95-96. Moreover, the Commission has allowed recovery of costs for incentive compensation metrics designed to control O&M expenses in future test year rate cases, as well. *See Consumers IWC,* pp. 14-15; *Aqua Illinois.*, pp. 21-22.

The Utilities also responded to the AG's argument that the costs of the O&M cost control metric should be disallowed based on the fact that the 2013 test year O&M budget included "much higher O&M expenses." *See* AG Init. Br. at 61. Commission decisions have recognized the principle that lowering costs in one year can reduce costs to be recovered in future rate cases "all else being equal." *See ComEd 2005*, pp. 95-96. As the AG's witness testified on cross-examination, however, all things rarely remain equal for a utility year to year. *See* Tr. 2/6/13 at 505, 512-513. Indeed, Utilities witness Ms. Cleary testified that in fact, things had <u>not</u> remained equal for the Utilities since their previous rate cases and those changes caused the test year 2013 O&M budget to increase despite the impact of the O&M cost control metric. Specifically, Ms. Cleary testified that the need for additional compliance work, cross-bore activity and new Chicago Department of Transportation regulations were behind the significant increases in the 2013 test year O&M budget. NS-PGL 45.0 at 8-9. As Ms. Cleary testified and as shown by the hypothetical discussed above, these facts do not change the conclusion that the O&M cost control metric provides net benefits to customers because the 2013 O&M budget likely would have been even higher without the cost-control incentive provided by this metric. *Id*. at 9.

Nor is there any evidentiary support for the suggestion by the AG that the Utilities may "pessimistically" forecast costs for their test year in order to allow shareholders to benefit from expense savings, nor can the AG point to any such attempt by the Utilities in the present dockets. The Utilities argue that, on the contrary, their test year budgets are open to scrutiny from not only the AG, but from Staff, other intervenors and ultimately the Commission, thus eliminating the ability of a utility to profit from such a scheme.

The Utilities also state that the Commission should reject CUB-City's argument that the costs for the O&M cost control metric should be disallowed based on a "double recovery" theory that (a) if costs are controlled or reduced, then the Utilities will over-recover because the costs underlying their revenue requirements would, after the fact, turn out to have been over-stated; or (b) if costs are not controlled or reduced, then the

Utilities will recover the costs of incentive compensation for this metric included in their revenue requirements. *See* CUB-City Init. Br. at 40-41. First, Commission practice and policy clearly allows for the recovery of costs for incentive compensation plan metrics that encourage O&M cost-control, as demonstrated by *ComEd 2005*, *Peoples Gas 2007*, and the other Commission decisions discussed above. Under CUB-City's argument, the costs of an O&M cost control metric could never be recovered, because one of these two events must always be the case with respect to an O&M cost control metric. Thus, the Utilities assert, CUB-City's argument flies in the face of the Commission's policy and practice. Indeed, CUB-City witness Mr. Smith testified that achieving the goal of "cost containment" is a goal "arguably in the interest of ratepayers." CUB-City Ex. 1.0 at 97. Second, CUB-City's argument fails to account for the fact that the benefits from an O&M cost control metric, as explained in *ComEd 2005*, come from controlling or reducing costs in subsequent rate cases.

The Utilities additionally contend that the AG's attempts to support its productivity adjustment based on evidence regarding the O&M cost control metric are of no avail. First, the Utilities note that although the AG had acknowledged that its analysis in its direct testimony relied upon the wrong amount for the Utilities' Non-Executive Incentive Compensation Plan Costs, and thus the costs associated with the O&M cost-control metric, the AG still relied in its briefing upon the wrong, inflated amount for its analysis – referring to "over $5 million" instead of the correct amount of $2.88 million. *See* AG Init. Br. at 62-63; NS-PGL Ex. 29.0 at 14-15; AG Ex. 5.0 at 29-30; AG Exs. 4.1 and 4.2 at Schedule C-5. Second, contrary to the AG's statement in its Initial Brief (at 65-66), Utilities' witness Ms. Cleary did not "argue" that a 1.66% expense savings should be required in test year O&M savings to pay for incentive compensation plan cost controls. Rather, as Ms. Cleary explained in her surrebuttal testimony, her testimony is only that AG witness Mr. Brosch's analysis exaggerated by approximately 100% the ratio of costs related to the O&M cost control metric to Peoples Gas' total O&M expenses in his arguments in support of his proposed productivity adjustment. NS-PGL Ex. 45.0 at 10-11.

The Utilities urge the Commission to agree with its position, and the position of Staff, and reject the AG's and CUB-City's proposed disallowance of the costs related to the Utilities' Non-Executive Incentive Compensation Plan O&M cost control metric.

Other Parties

[Insert]

Commission Analysis and Conclusions

The Commission has stated on numerous occasions, a utility may recover the costs for an incentive compensation program if that program "can reasonably be expected to provide net benefits to ratepayers." *See Illinois Power Co.*, pp. 42-43. As correctly acknowledged by the Utilities and Staff, one of the goals the Commission encourages public utilities to incentivize through their incentive pay programs is the

control or reduction of operating costs. That is because, as we concluded in our *ComEd 2005* and *Peoples Gas 2007* decisions, controlling or reducing a public utility's operating costs will, all else being equal, lower the costs to be recovered by the utility in future rate cases. The existence of a cost-control metric in a utility's incentive compensation plan also may be factored in by a utility when setting its test year budget for purposes of a rate case, causing estimated costs to increase at a lower rate than otherwise might be forecasted.

Our decision not to allow Peoples Gas and North Shore to recover the costs of their Non-Executive Incentive Compensation Plan O&M cost-control metric in their 2011 rate cases did not change our policy or practice in this regard. Our decision was limited solely to the facts and circumstances of those particular dockets, and based on our finding in that case that the Utilities had not presented sufficient evidence establishing a likelihood of customer benefits. The Commission here must base its decision on the evidence in the record of the instant cases. 220 ILCS 5/10-103; 220 ILCS 5/10-201(e)(iv)(A).

Here, after examining the record evidence, we agree with Staff and the Utilities that the additional evidence adduced by the Utilities in this rate case establishes that the O&M cost control metric in the Utilities' Non-Executive Incentive Compensation Plan is reasonably likely to provide net benefits to customers. The Commission will therefore reject the adjustments proposed by the AG and CUB-City to the costs to be recovered for the Utilities' Non-Executive Incentive Compensation Plan, and allow Peoples Gas and North Shore to recover fully the costs associated with that Plan.

2. <u>Wage Increase Correction</u>

North Shore and Peoples Gas

Staff filed revised Schedules 13.02N and 13.02P purporting to "correct" capitalized construction wages to reflect an average year impact and the ADIT Adjustment. Tr. 2/5/13 at 243. With respect to capitalized construction wages, the Utilities take the position that rates should be set using a year-end rate base methodology. Staff's revision to its Schedules 13.02 N and P adds a column (f) for line 8 on the first page of the schedules to show that *if* the Commission adopts an average year methodology as urged by Staff, Staff's proposed downward adjustment for non-union wages should be divided by 2 for the capitalized construction component of non-union wage base (changing the proposed downward adjustment to this component from $61,000 to $31,000 for North Shore and from $1,137,000 to $569,000 for Peoples Gas). The Utilities agree that this would be the correct amount of the adjustment *if* the Commission accepts Staff's proposed disallowances to the non-union wage base increases *and if* the Commission agrees that an average year rate base methodology is appropriate. The Utilities, however, argue that the Commission should reject both of those Staff proposals, as discussed in Section V.C.3, *infra*, with respect to non-union base wages and in Section IV.C.1, *infra*, with respect using a year-end rather than an average rate base methodology.

The Utilities had no objection to Staff's correction of the derivative ADIT adjustment for non-union wages for Peoples Gas (from ($3,000) to $7,000) on line 13 of revised Scheduled 13.02 P.

Other Parties

[Insert]

Commission Analysis and Conclusions

For the reasons discussed in Section V.C.3, *infra*, the Commission declines to accept Staff's proposed adjustments to the Utilities' non-union wage base increases. Likewise, as discussed in Section IV.C.1, *infra*, the Commission agrees with the Utilities that their choice of a year-end rate base methodology is appropriate under the facts and circumstances of this rate case. Accordingly, Staff's "correction" of capitalized constructions wages is unnecessary and not adopted.

The Commission approves Staff's proposed correction of the derivative ADIT adjustment for non-union wages for Peoples Gas (from ($3,000) to $7,000) as shown on line 13 of Staff's revised Scheduled 13.02 P.

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

North Shore and Peoples Gas

North Shore and Peoples Gas propose an increase in their rate bases and operating expenses for the 2013 test year to allow for a general wage increase (2.60%), a pool of funds to provide for merit-based increases to be given only to high-performing employees (0.45%), and a pool of funds to provide for costs attributable to pay increases commensurate with promotions and market adjustments given only to certain employees (0.40%). NS-PGL Ex. 29.0 at 18. The total amount of this requested increase is equal to 3.45% of the Utilities' total non-union base wages. *Id*. at 17-18.

The Utilities oppose Staff's recommendation to reduce the overall amount of this increase to 2.28% of the Utilities' total non-union base wages for 2013 based on reducing the Utilities' proposed general wage increase component using a forecast of the Consumer Price Index ("CPI") and completely disallowing both the amount to be used for merit increases and the amount to be used for raises due to promotions. Staff Ex. 3.0 at 12-14; Staff Ex. 13.0 at 9-13.

The Utilities first dispute Staff's contention that its position is supported by the fact that the Commission accepted a similar adjustment in the Utilities' last rate cases. The Commission's decision in *Peoples Gas 2011* is not determinative of this issue. It is well-established that the Commission is not bound by its past decisions and must make its determination based on the facts and circumstances particular to each case before it. 220 ILCS 5/10-103; 220 ILCS 5/10-201(e)(iv)(A). *See also Citizens Util. Bd.*, 166 Ill. 2d

at 125-126; *Mississippi River Fuel Corp.*, 1 Ill. 2d at 513. The Utilities posit that this principle is exceptionally apt here because the Utilities have submitted new evidence demonstrating the flaws in Staff's position.

The Utilities state that one of the main flaws of Staff's proposal is that it treats the overall increase in the Utilities' non-union wage base as a whole, when in fact it is comprised of three separate components. Staff's approach merely compares a 2012-2016 forecast of consumer inflation of 2.28% to the Utilities' overall non-union wage base increase of 3.45% to make the Utilities' requested increase appear to be unreasonable. The Utilities state that the problem with this approach is that it fails to address the record evidence supporting each of the individual components of the Utilities' non-union wage base increase. The Utilities contend that this divide between the record evidence and Staff's proposed adjustment means that the adjustment lacks the support of substantial record evidence and should fail for this reason alone.

Peoples Gas and North Shore further address each of the three components of their non-union wage base increase individually.

General Wage Increase

The component of the Utilities' non-union wage base increase to which Staff's comparison of forecasted consumer inflation for 2012-2016 of 2.28% potentially could be applicable is the general wage increase component, equal to 2.60% of the Utilities' total non-union wage base. Staff's proposal to reduce the Utilities' general wage increase amount for 2013 from 2.60% to 2.28% is based upon a forecast of the CPI inflation rate for the time period 2012-2016 produced by the Research Department of the Federal Reserve Bank of Philadelphia in its *Survey of Professional Forecasters* (Third Quarter 2012). Staff Ex. 3.0 at 12 and n. 11. The Utilities assert that this proposed adjustment is inappropriate and should be rejected for at least three reasons.

First, the CPI is not a measure designed or intended to predict or be used to set wage increases, but rather, is an economic indicator calculated by the Bureau of Labor Statistics to show a change over time in the prices paid by consumers for a market basket of goods and services. NS-PGL Ex. 29.0 at 19-20 and n. 4; NS-PGL Ex. 45.0 at 12. CPI is thus a measure reflecting consumer spending patterns and not the wage-setting decisions of employers. Moreover, the CPI looks at all urban consumers and is not focused on specific industries, such as energy or utility services, and therefore it paints with a brush that is much broader than and not reflective of the market wages in the energy industry. NS-PGL Ex. 29.0 at 20. Applying the CPI directly to set wage levels in the manner proposed by Staff, the Utilities contend, is analogous to using a bathroom scale to determine whether your car tires have sufficient "pounds" per square inch of air. While both may appear superficially to be measuring the same thing, they clearly do not and are not interchangeable in this manner.

Further, while Staff argues that the CPI forecast upon which it relies is more appropriate than the compensation-specific market data of the World At Work survey relied upon by the Utilities because it covers a five-year period (2012-2016) rather than

the single year of 2013, the Utilities assert that this fact actually cuts against relying upon the forecast of CPI urged by Staff. The test year in this case is 2013, and Staff's position here is inconsistent with some of the arguments made by Staff and intervenors on the average versus year end rate base issue. Staff's reliance upon a measure of CPI for a period of time outside of the 2013 test year to determine what the general wage increase should be in the test year is unwarranted. The Utilities' in contrast have been consistent, in that their end of year rate base calculations are based on data as of the end of the test year. Moreover, the Utilities assert that Staff's statement in its Initial Brief (at 49) that this "forward looking projection is more in line with the period that rates will be in effect" lacks any support in the record evidence, and contradicts the Staff and intervenor arguments on the average rate base issue. This statement also is incorrect as a matter of law, the Utilities argue, in light of the fact that the Utilities will be required to file another rate case no later than the year 2014 pursuant to the requirements of Section 9-220(h-1), 220 ILCS 5/9-220(h-1).

Second, while Staff argues that the Utilities' evidence concerning the Bureau of Labor Statistics' Employment Cost Index supports the reasonableness of relying upon the 2.28% forecast for CPI to set the Utilities' general wage increase, the Utilities state that Staff's position fails to grasp the relevance of this evidence. The Employment Cost Index unlike the CPI – is specifically designed to measure changes in wages and salaries by industry, and it reveals that 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 Ex. 29.0 at 20 and n. 5; NS-PGL Ex. 45.0 at 12-13 and n. 5. The significance of this evidence, the Utilities argue, is that the forecast for CPI, which is a broad measure that is not differentiated by industry or service type, likely will under-predict the level of change that actually will occur in an industry changing at a faster pace than the market on average. That is exactly what the Employment Cost Index shows to be happening in the utility industry. The Utilities conclude that this evidence thus further undermines Staff's proposal.

Third, the Utilities' proposed general wage increase amount of 2.60% for 2013 is based on market data provided by the World At Work 2012-2013 Salary Budget Survey, which is a well-known compensation tool that reports results of annually surveyed information submitted by corporations on their planned wage increases for the following budget year. NS-PGL Ex. 29.0 at 17; Tr. 2/5/13 at 251. The Utilities' general wage increase of 2.60% was also based on the Utilities' own observations as to compensation trends in the utility industry specifically, as well as advice from Towers Watson compensation consultants. NS-PGL Ex. 29.0 at 17. As conceded by Staff witness Mr. Ostrander, the research data from the World At Work 2012-2013 survey shows that average wage increases for 2013 will be in the "high 2% range" – 2.90%. Staff Ex. 13.0 at 13; NS-PGL Ex. 29.0 at 18. The Utilities state that their proposed general wage increase of 2.60% thus is well below the market average shown for 2013 by research data specifically addressing what the market rate for wage increases will be in 2013. The Utilities argue that it does not make sense for the Commission to rely upon a measure that is unrelated to wages and compensation when the record evidence contains market data specifically on point as to what a reasonable range for wage

increases should be in the 2013 test year. The Utilities state that Staff's approach would have the Commission rely upon the less-applicable evidence that is in the record – likening doing so to the installation of a screw with a hammer when there is a screwdriver sitting right at the top of the toolbox.

North Shore and Peoples Gas conclude that the 2.60% general wage increase proposed by the Utilities is supported by the substantial weight of the record evidence as being a just and reasonable market-based amount for a general wage increase for their non-union employees in 2013.

Pool of Funds for Merit Based Increases

The second component of the Utilities' requested non-union wage base increase is a pool of funds that is equal to 0.45% of the Utilities' total non-union wage base to be used to provide pay increases to certain individual employees who have demonstrated exemplary performance (*e.g.*, a Regular Non-union employee who receives an exemplary performance review during the performance review period may receive a set amount of pay increase from this pool in addition to that employee's 2.60% general wage increase). NS-PGL Ex. 29.0 at 18. Utilities' witness Ms. Cleary explained that these merit-based increases, given only to employees who receive exemplary performance reviews, are used to bring the Utilities' top performers into the range shown in the World At Work survey as being appropriate for such employees in 2013 (from 2.90% up to 4.0%). NS-PGL Ex. 45.0 at 14.

The Utilities state that the divergence between the record evidence and Staff's proposal is greatest with respect to this second component of the Utilities' non-union wage base increase. The Utilities introduced new evidence supporting the recovery of this component of non-union wage base increase not considered by the Commission in the Utilities' previous rate cases. The Utilities contend that this evidence demonstrates not only a possible misunderstanding of this component by Staff, but that the purpose of this component is in fact consistent with Staff's opinion as to appropriate wage increases for high-performing employees.

The Utilities note that Staff witness Mr. Ostrander testified on cross-examination that he has no objection to a public utility giving a larger pay increase to individual employees who perform at a higher level than other employees. Tr. 2/5/13 at 250. Mr. Ostrander also acknowledged that the market research data from the World At Work survey demonstrates that top performing employees may receive wage increases of up to 4.0% in 2013, and testified that he has no reason to doubt this conclusion. *Id*. at 250-252; Staff Ex. 13.0 at 13. The Utilities contend that Staff's proposed disallowance of this component of non-union wage base increase is inconsistent with Mr. Ostrander's testimony concerning the compensation of high-performing employees. The Utilities further argue that it seems the two grounds Staff relied upon for its recommended disallowance of this component are based on misunderstandings concerning the facts of how this pool of funds is used to provide individual merit-based increases to the Utilities' high-performing employees.

First, Staff based its position on the assumption that the Utilities may not actually award the full amount of the 0.45% pool of funds to provide merit-based increases to certain of their employees who are top performers, believing that the Utilities only used half of the amount of such funds forecasted in their 2011 rate cases for 2012. Staff Ex. 13.0 at 12. As was clarified at the hearing, however, Staff's assumption was incorrectly based on combining the amounts forecasted for both the merit-based component and the component for providing raises due to promotions. Tr. 2/5/13 at 254-255, 257-258; NS-PGL Cross Ex. 3. The undisputed evidence demonstrated that the full amounts forecasted to be used for merit-based increases to top-performing employees in both 2011 and 2012 (0.3% and 0.45%, respectively) were in fact used by the Utilities. Tr. 2/5/13 at 258-259; NS-PGL Ex. 45.5. This was consistent with the record evidence establishing that the Utilities have no discretion on whether or not these funds will be used because the full amount of this pool of funds is automatically distributed to award individual merit-based increases to high performing employees. NS-PGL Ex. 45.0 at 14; NS-PGL Ex. 45.4.

The second ground relied upon by Staff for disallowing this component of non-union wage base increase was the assumption that all non-union employees received this 0.45% increase. Staff Ex. 13.0 at 12-13. The Utilities state the evidence clearly shows that while the total amount of this pool of funds is calculated based upon an overall percentage (0.45%) of the Utilities' total non-union wage base, those funds are used to award additional increases only to particular individual employees who perform at a high-level by receiving exemplary performance reviews. NS-PGL Ex. 45.0 at 14; NS-PGL Ex. 45.4; Tr. 2/5/13 at 252-254. These merit-based increases are given only to individual employees who receive exemplary performance reviews in order to bring the Utilities' top performers into the range of pay increases shown by the World At Work survey as being appropriate for such employees in 2013. NS-PGL Ex. 45.0 at 14. Indeed, this result is consistent with Mr. Ostrander's view that a higher-performing employee deserves a larger raise relative to an average employee. Tr. 2/5/13 at 250.

The Utilities conclude that all of the record evidence establishes that this component of the Utilities' non-union wage base increase is consistent with Staff's views on employee compensation and appropriate under the facts and circumstances of these dockets. The Utilities thus urge the Commission to reject the proposed elimination of this component from the Utilities' non-union wage base increase.

Pool of Funds for Raises Due to Promotions

The third component of the Utilities' requested non-union wage base increase is a pool of funds that is equal to 0.40% of the Utilities' total non-union wage base that is to be used to provide discrete pay increases to employees who are promoted. NS-PGL Ex. 29.0 at 18. In other words, these funds will be used to cover the differential in pay for an employee who is promoted to a position with a higher market-based rate of pay relative to that employee's previous position with the Utilities. *Id*. The record evidence shows that it is a common market practice for employers to budget for promotions in this manner. *Id*.

Staff recommends disallowing this component of non-union wage base increase on the same grounds as the merit-based wage increase component discussed above. The Utilities state that, as with the merit-based increase component, this pool of funds for promotional-related wage increases is not awarded to all employees, but rather, only to specific employees who have received promotions where a commensurate increase in pay for the new position is appropriate. NS-PGL Ex. 45.0 at 15.

This pool of funds for promotions – unlike the merit-based increase pool of funds – is discretionary in nature. *Id*. at 14-15; NS-PGL Ex. 45.4. Still, the Utilities assert that they are expected to use this entire pool of funds appropriately to keep and maintain a high-quality workforce and ensure that each necessary position is filled by a highly-qualified employee receiving a market-based rate of pay. NS-PGL Ex. 45.0 at 15. Because the use of these funds has been discretionary, however, the Utilities offer an alternative position in which they request that the Commission award recovery for this pool of funds equal only to the amount by which such increases accounted for a percentage of the Utilities' total non-union wages in 2012: 0.154% for Peoples Gas and 0.007% for North Shore. *Id*.; NS-PGL Ex. 45.6.

Other Parties

[Insert]

Commission Analysis and Conclusions

The Commission concludes that the record evidence does not support Staff's proposed reduction of the Utilities' overall non-union wage base increase from 3.45% to 2.28%. We find that Staff's approach does not properly address the varied nature of the three different components that comprise the Utilities' non-union wage base increase.

First, while Staff's examination of a five-year forecast of CPI for the period 2012-2016 of 2.28% was most appropriate with respect to the 2.60% general wage increase component of the Utilities' non-union wage base increase, the Commission concludes that such reliance was misplaced in this context. We agree with the Utilities that CPI is not an appropriate measure to use for forecasting general wage increases. The Commission finds that it is more appropriate to rely upon market-based research such as the World at Work Survey which is both specifically tailored to determine what changes will occur in employee compensation and addressed to the test year period at issue. Moreover, Staff's reliance on forecasts beyond 2013 is not warranted in the context of this future test year rate case.

Second, we agree with the Utilities that the record evidence supports providing additional merit-based increases to individual employees who perform at a high level. Indeed, the Commission finds Staff in agreement with this principle, and with the Utilities' evidence that the market-based data supports providing such employees overall pay increases of up to 4.0% in 2013, which is what the Utilities state the purpose of the merit-based increase component of their non-union wage base increase to be.

Further, we concluded that the evidence supports the conclusion that the Utilities will use the full amount of this non-union wage base increase component. The Commission thus finds that the proposal to remove the component of the Utilities' requested non-union wage base increase equal to 0.45% of the Utilities' total non-union wage base to be used to provide pay increases to certain individual employees who have demonstrated exemplary performance to be erroneous and unreasonable.

Finally, with respect to the third component of the Utilities' non-union wage base increase, Staff's proposal fails to recognize that the 0.40% pool of funds identified by the Utilities would not be used to provide across the board pay raises to all employees, and that an increase granted from this pool of funds does not truly represent a wage increase, per se, but rather an increase in costs related to an employee's change to a position with a market base wage level higher relative to the former position. ***[Alternative 1:*** The Commission, therefore, finds that the Utilities should also be allowed to recover this 0.40% component of their non-union wage base increase to be used to provide wage increases due to promotions.**]** ***[Alternative 2:*** The Commission, however, shares Staff's concern that the Utilities retain discretion in whether or not to use the full amount of these funds in the test year. Accordingly, we believe that rather than allow recovery of the full amount of these funds, it is more appropriate to allow recovery only of an amount consistent with the amount of such funds shown to have actually been used in the previous year: 0.154% for Peoples Gas and 0.007% for North Shore.**]**

Accordingly, the Commission approves the levels of non-union wage base increases submitted by the Utilities in these rate cases, and denies the adjustments proposed by Staff to these figures.

4. <u>Vacancy Adjustment (Falls in Multiple Categories of O&M)</u>

North Shore and Peoples Gas

The Utilities' 2013 payroll expenses should not be reduced as the AG and CUB-City propose for a vacancy factor. The Utilities are filling their budgeted and forecasted positions in order to equal the headcounts reflected in their test year operating expenses. *E.g.,* PGL Ex. 8.0 at 14-16; NS-PGL Ex. 28.0 Rev. at 13-14; NS-PGL Ex. 44.0 at 10-11. Peoples Gas is filling positions that were added to equal the headcounts reflected in its test year operating expenses. NS-PGL Ex. 28.0 Rev. at 13-14. As of November 24, 2012, North Shore was only two positions below its budgeted headcount and was in the process of hiring to fulfill its two empty positions. NS-PGL Ex. 28.0 at 13. In light of these practices, the Utilities are actively filling positions to equal the headcounts budgeted for in their test year operating expenses. Moreover, the AG and CUB-City positions ignore that the Utilities can prepare to fill a position when an employee's departure is known in advance. Furthermore, if the same amount of work is done by a reduced number of employees, increased overtime and/or additional outside labor may be utilized, resulting in an increase of costs. The Utilities do use overtime and outside services as needed. *E.g.,* PGL Ex. 6.0, at 6. Payroll expenses should not be reduced.

Other Parties

[Insert]

Commission Analysis and Conclusion

The Commission finds that because the Utilities have filled, or are in the process of filling, the budgeted and forecasted positions included in their test year operating expenses, their 2013 payroll expenses should not be reduced. Their forecasts are reasonable. Therefore, the Commission rejects the AG and CUB-City proposals.

5. Distribution O&M

a. Plastic Pipefitting Remediation Project

North Shore and Peoples Gas

Peoples Gas explains that its Pipefitting Remediation Project replaces certain plastic fittings within the Peoples Gas system, which may not have been in technical compliance with Part 192 of Title 49 of the Code of Federal Regulations. Staff's recommendation that the costs associated with the Plastic Pipefitting Remediation Project be removed from Distribution O&M Expenses should be rejected as Peoples Gas has presented evidence that the plastic fittings were safe, and that a special permit under the Pipeline and Hazardous Materials Safety Administration ("PHMSA"), if applied for, would have been granted even after installation of the fittings.

Peoples Gas states that an external and industry-recognized expert performed an extensive analysis on the pipe fittings and concluded that they were safe. NS-PGL Ex. 28.0 Rev. at 12. The expert further concluded that Peoples Gas could have sought a permit as allowed under Title 49 of the Federal Rules. Id. Peoples Gas states that this evidence is unrebutted. However, Peoples Gas determined to replace the fitting at this time given its ability to coordinate some of replacement with other scheduled work. Id. at 12. Furthermore, Peoples Gas notes that Staff only cites one violation of the federal rules – that the fittings were not properly marked in accordance with Section 192.63, which does not impact the safety or integrity of the fittings. NS-PGL Ex. 44.0 at 6. Also, while Staff claims that an operator must apply to PHMSA for a Special Permit before installing non-compliant equipment, Peoples Gas explains that Sub-section 194.341(b) of the federal rules does not so require. Id. Sub-section 194.341(b) provides that an operator must submit an application for a Special Permit at least 120 days prior to the effective date of the granting of the Special Permit. Id. Also, the terms and contents of the application for Special Permit also do not support Staff's assertion. Id. In fact, PHMSA has entertained and granted applications for Special Permits after non-complaint work has been installed. Id. at 7.

Other Parties

[Insert]

Commission Analysis and Conclusion

The Commission finds that the replacement of plastic fittings under the Plastic Pipefitting Remediation Project did not violate any safety or compliance standards. As proven by evidence provided by Peoples Gas, the pipe fittings were safe. Moreover, PHMSA has granted a special permit to utilities who have applied for permits after installation of facilities. Consequently, the costs of the Plastic Pipefitting Remediation Project should not be removed from Distribution O&M Expenses. Therefore, the Commission rejects Staff's proposed adjustment.

b. <u>Legacy Sewer Lateral Cross Bore Program</u>

North Shore and Peoples Gas

The Utilities explain that for gas utilities, a cross bore is when a gas facility that has been installed using trenchless technologies intersects with an existing sewer main or sewer lateral. NS-PGL Ex. 20.0 at 5-6. In the 1990's, gas utilities began to use horizontal directional drilling ("HDD") to install natural gas pipes underground. Id. However, because many vintage sewer lines are made of clay and contain no tracer wire, they cannot be located with above ground locating devices. Id. As result, a utility may have come in contact with sewer lines without any knowledge of such contact, which can potentially cause a blockage in the sewer line. Id. If the conventional rodding method is used to address the blockage, the cutter of the sewer rod machine may cut into the plastic main or service line and possibly cause a gas release. Id. Peoples Gas states that the proposed legacy sewer lateral cross bore program will proactively investigate those mains and service lines installed using HDD to determine whether there is a cross bore. Id.

The Utilities argue that Staff's adjustment to remove these costs from O&M expenses should be rejected. The Utilities state that Staff's claims that the Utilities' prociedures were inadequate or not followed are unsubstantiated. The Utilities state that the procedures in place for the use of HDD are well developed and are consistent with industry standards and with the Gas Pipeline Technology Committee ("GPTC") guidelines. NS-PGL Ex. 44.0 at 4-5. The Utilities state that their procedures focus on safety, with specific emphasis on not striking underground utilities. Id. Furthermore, the Utilities provide crews detailed training, supervise crews in the field, and conduct regular safety inspections. Id. However, the Utilities explain that despite best efforts, cross bores occur as acknowledged by the GTPC guidelines. Id. This becomes especially difficult with a complex sewer system like in the City of Chicago. Id.

Finally, the Utilities argue that the AG's argument that there has not been sufficient detailed planning for the project must also be rejected. The Utilities state that the Legacy Sewer Lateral Cross Bore Program is a test year project that has not yet commenced. NS-PGL Ex. 44.0 at 4-5. However, the Utilities have been investigating

cross bores as part of AMRP projects. Id. Thus, contractors are already out in the field as part of inspecting AMRP projects, and permanent assignments to the Legacy Program will be made when it begins in 2013. Id. Therefore, the Utilities conclude that there is sufficient planning in place to support the inclusion of program costs in operating expenses.

Other Parties

[Insert]

Commission Analysis and Conclusion

The Commission finds that the Utilities have provided adequate program planning. Because the HDD procedures are clearly in line with applicable industry standards and with GPTC guidelines, and because the program has adequately planned based on the experience from inspecting AMRP projects, Staff and AG's recommendations are rejected. The Legacy Sewer Lateral Cross Bore program costs are properly included in operating expenses. Therefore, the Commission rejects Staff's and the AG's adjustments.

c. <u>New Chicago Department of Transportation Regulations</u>

North Shore and Peoples Gas

In response to new regulations for Openings, Construction and Repair in the Public Way issued by the Chicago Department of Transportation ("CDOT regulations") issued in July 2012, Peoples Gas has proposed to include $13.9 million in operating expenses as a result of the new CDOT regulations. Staff agrees and concludes that the calculation of these operating expenses are just and reasonable. NS-PGL Ex. 20.0 at 1; Staff Ex. 16.0 at 5-6.

The Utilities argue that the AG's and CUB-City's argument that costs should be based on the Peoples Gas' experience in the fourth quarter of 2012 is without merit. Their position does not reflect the 2013 expense level. Peoples Gas' cost of service has significantly increased in response to the new regulations issued by CDOT; while a number of initial fees applied in 2012, a significant majority of these expenses begin in January 2013. NS-PGL Ex. 44.0 at 8. Moreover, Peoples Gas is able to accurately estimate the costs associated with the new CDOT regulations, as these costs are within the control of the utility. *Id*.

Other Parties

[Insert]

Commission Analysis and Conclusion

The Commission finds that the new regulations issued by the CDOT are accompanied by associated costs and expenses that will be borne by Peoples Gas. Peoples Gas has proposed $13.9 million in operating expenses with respect to these new regulations. Staff agrees with this proposal. Because these expenses will largely be incurred beginning in the first quarter of 2013, it is appropriate to adjust the 2013 operating expenses to reflect these anticipated costs. AG and CUB-City's adjustments are rejected, as Peoples Gas' costs in the fourth quarter of 2012 do not accurately reflect the impact of the new CDOT regulations. Therefore, the Commission rejects the adjustments proposed by AG and CUB-City.

6. Productivity Adjustment

North Shore and Peoples Gas

The Utilities have provided sufficiently detailed evidence supporting their proposed revenue requirements, and the AG's "productivity" adjustment should be rejected. The Utilities are entitled, as a matter of law, to just and reasonable rates that allow them the opportunity to recover fully their prudent and reasonable costs of service, and have provided extensive, detailed direct cases supporting their proposed revenue requirements. The Utilities also provided evidence presenting more than a *prima facie* case that their proposed rates are just and reasonable, which means that the burden of going forward with the evidence shifted to other parties to show that costs are unreasonable because of inefficiency or bad faith. NS-PGL Init. Br. at 94-95. The proposed revenue requirements are based on 2013 budgets and forecasts which were developed by subject matter experts, examined by independent CPA Deloitte & Touche LLP (per 83 Ill. Adm. Code § 285.7010), and have been carefully modified by ratemaking adjustments, revisions, and updates. PGL Ex. 5.0 Rev. at 4-9; NS Ex. 5.0 Rev. at 4-9; NS-PGL Ex. 25.0 at 6.

The AG claims that the Utilities' non-fuel O&M expenses should be reduced by .5% for each year, as the Utilities' original proposed revenue requirements reflected projected 2012 and 2013 costs, but has failed to provide any support for this argument and has failed to show any inefficiency that would necessitate this reduction on the part of the Utilities. *See* AG Ex. 1.0 at 24-25. The AG relies upon testimony cited in a San Diego Gas & Electric Company ("SDG&E") rate case before the California Public Utilities Commission ("CPUC") that discusses the average trend in productivity for gas utilities from 1999-2008 and from 2004-20087. AG Ex. 1.0 at 24. This rate case is inapposite, as it proposed a mechanism through which SDG&E's revenue requirement would be adjusted each year to reflect increases in certain expenses; moreover, the rate case excluded certain expenses from its analysis and failed to quantify separate or utility-specific productivity rates that would identify changes in productivity at the Utilities. NS-PGL Cross Ex. 4. This information failed to identify any inefficient operations at North Shore or Peoples Gas, and failed to present any information that supports a "productivity" adjustment. NS-PGL Init. Br. at 96-97.

Additionally, the AG relied upon a New York Public Service Commission ("NYPSC") "Order Establishing Rate Plan" issued in NYPSC case 09-E-0588; this Order involved a settlement of both gas and electric rates, involved multi-year rate increases, and contained a "productivity" adjustment based on a prior regulatory "austerity" order. NS-PGL Init. Br. at 97. Similarly, the AG referred to rates for Hawaiian Electric Companies; electric utilities with multi-year rate increase mechanisms are irrelevant to the case at hand. *Id*.

Further undermining the validity of the "productivity" adjustment, the AG is unable to rely upon any decision of the Commission, or any other public utility commission, that supports the imposition of an operating expense reduction based on the above-stated rationale. Instead, the AG has only relied upon adjustments made by utilities that are permitted to make multi-year rate increases. The AG is unable to cite any factual or legal basis for applying a "productivity" adjustment to the Utilities' final revenue requirements.

The AG claims that the Utilities have failed to account for expected productivity increases in their budgets and forecasts. AG Ex. 4.0 at 24. However, the Utilities have provided ample evidence of and supported the methodology by which, and review of, their budgets and forecasts were prepared. PGL Ex. 5.0 Rev. at 4-9; NS Ex. 5.0 Rev. at 4-9. Conversely, the AG is required to present specific facts relating to the Utilities' inefficiencies or missed opportunities for improvements in efficiency; the Commission has ruled that it will not consider a productivity adjustment without such specificity. *Illinois Bell Telephone Co.*, ICC Docket No. 02-0864, 2004 Ill. PUC Lexis 339 at *715 (Order June 9, 2004).

The AG proposal also is improper for yet another major reason. The AG as well as CUB-City and Staff examined the Utilities' operating expenses and proposed specific adjustments. Yet, having reviewed all of the expenses as individual items, the AG proposal then makes a further proposed "productivity" adjustment on top of each of the applicable items. For example, the AG proposed specific adjustments to the IBS costs that make up a large portion of the Utilities' operating expenses, and yet, when the AG calculates its "productivity" adjustment, instead of removing IBS costs because they already have been analyzed, the AG applies that adjustment to the remaining IBS costs. AG Ex. 4.1, Sched. C-4; AG Ex. 4.2, Sched. C-4. The specific reviews make the additional layer of "productivity" adjustments improper.

Staff agrees that the AG has failed to provide sufficient evidence to support its proposed adjustments. Staff Ex. 13.0 at 23-24

Other Parties

[Insert]

Commission Analysis and Conclusion

The Commission finds that the AG has failed to provide any substantive support for its argument that a "productivity" adjustment should be applied to the Utilities' O&M expenses. In support of its argument, the AG has relied upon cases relating to utilities that are allowed multi-year rate increases, and has failed to point to any evidence of inefficiency in the Utilities' expenses. The Utilities have established a *prima facie* case that their rates are just and reasonable, and as such, the burden has shifted to the AG to show unreasonableness due to inefficiency or bad faith. The AG has not done so. Moreover, the Commission has held that it will not consider a productivity adjustment without specific facts that demonstrate inefficiency on the part of the Utilities, and the AG has failed to provide such. Therefore, the Commission rejects the AG's proposed "productivity" adjustments.

7. Administrative & General

a. Adjustments to Integrys Business Support Costs

North Shore and Peoples Gas

The Utilities have provided sufficient evidence through testimony and supporting exhibits that support the costs and expenses attributable to IBS. In direct testimony, the Utilities showed portions of their final revenue requirements that are based on costs allocated or charged to them from IBS, including budgeted and forecasted transactions with affiliated interests for 2012 and 2013. PGL Ex. 5.0 Rev. at 18-19; PGL Ex. 5.1, Sched. C-12, pp. 1-2; NS Ex. 5.0 Rev. at 15-16; NS Ex. 5.1, Sched. C-12, p. 1. As shown by the Utilities, IBS bills the Utilities pursuant to a Commission-approved Master Regulated Affiliated Interest Agreement ("Regulated AIA"). PGL Ex. 5.0 Rev. at 18; NS Ex. 5.0 Rev. at 16.

Staff's argument, that the Utilities have failed to support increases in IBS costs, ignores the testimony and data provided by Utilities' witnesses that fully explain the IBS benefits costs and their causes.

Staff originally proposed to disallow $8,123,000. This included $5,353,000 of benefits expenses and $3,018,000 of injuries and damages expenses, with some smaller offsets. The benefits expense was fully supported, in detail, however, and never refuted by any witness. PGL Ex. 11.0; NS Ex. 11.0; NS-PGL Ex. 31.0; NS-PGL Ex. 25.0; NS-PGL Ex. 25.1P. Staff's argument that the injuries and damages expenses are erroneous must also be rejected, as Staff has failed to account for shifts in management and varying sources of expense payment from the 2008-2013 period that fully explain the increase. NS-PGL Ex. 25.0 at 3-4; NS-PGL Exs. 25.1P, 25.2P. Moreover, in calculating the injuries and damages expenses, Staff overstated the proposed adjustment by another $1,022,000. NS-PGL Ex. 25.0 at 3-4.

In rebuttal testimony, Staff presented a reformulated proposal to disallow even more, $12,327,000, but it also was entirely mistaken. The defective proposal continued to disregard evidence provided by the Utilities' witnesses explaining and supporting

higher benefits costs and their causes. Staff's rebuttal testimony also failed to resolve the faulty injuries and damages expenses calculation by accounting for the amounts paid directly by Peoples Gas, and continued to overstate the proposed adjustment to IBS expenses. Staff's rebuttal also failed to factor in certain other IBS costs. NS-PGL Ex. 41.0 Rev. at 3-4; NS-PGL Ex. 41.1P. Staff's errors, together, entirely eliminate the adjustment, and, when corrected, actually would support an increase. NS-PGL Init. Br. at 102-103. Moreover, Staff's speculation that there may have been intercompany charges that declined sufficiently to offset expense increases (Staff Init. Br. at 58) is unsupported and, in fact, directly contradicted by the evidence. That speculation does not present a lawful basis for a disallowance. *Ameropan Oil Cor. v. ICC,* 298 Ill. App. 3d 341, 348, 698 N.E.2d 582, 587 (1st Dist. 1998). Staff's adjustment should not and cannot be adopted.

Staff's Initial Brief also makes the new argument that the AG's analysis of IBS costs somehow validates Staff's proposed adjustment (Staff Init. Br. at 59-60), but that is wrong. Of the $12,166,000 of AG-proposed adjustments that Staff cites for comparison, only $2,085,000 are direct adjustments to the IBS costs allocated and charged to Peoples Gas, with another $40,000 being a placeholder change in the rate of return on IBS plant investments. *See* Staff Init. Br. at 60. See also the discussion of the AG's proposed IBS adjustments, below. The other $10,081,000 of AG proposed adjustments that Staff cites here is the aggregate amount of AG proposed adjustments to (1) overall employee headcounts of both of the Utilities including both utility employees and some IBS employees attributed to the Utilities and (2) overall operating expenses (except for certain categories) of both of the Utilities including non-IBS costs and IBS costs, and thus they include non-IBS costs as well as IBS costs and they include amounts for North Shore as well as Peoples Gas. *See* Staff Init. Br. at 59-60. Thus, the notion that that other $10,081,000 of AG-proposed adjustments somehow validates Staff's proposed IBS cost adjustments is illogical and absurd. In fact, the AG's final proposed adjustments to IBS costs of $2,085,000 reflects the AG's analysis of all eight IBS cost "home centers" and IBS plant investment costs, with the AG's revising its direct testimony proposal and in rebuttal proposing adjustments to only two of the cost home centers and depreciation expense. NS-PGL Init. Br. at 104-106. Thus, if anything, the AG's analysis refutes the Staff proposal. Again, the Staff proposal must be rejected.

In rebuttal testimony, the AG proposed incorrect adjustments to two IBS home centers. The AG also proposed adjustments to IBS depreciation costs; the Utilities agree that these adjustments are correct in theory, but have been incorrectly calculated. The Utilities found that, in direct testimony, the AG identified two minor adjustments that were warranted; the Utilities made these adjustments in rebuttal testimony. The Utilities have provided evidence that the rest of the IBS home center costs are fully supported, and that any variances in the IBS Corporate Controller home center costs are due to increased outside services related to convergence standards and International Financial Reporting Standards ("IFRS"). NS-PGL Ex. 41.0 Rev. at 6; NS-PGL Ex. 41.5. Similarly, the Utilities have provided evidence that, based on 2010-2012 average costs and inflation, the IBS Legal home center costs were not overstated. NS-PGL Ex. 41.0 Rev.

at 6; NS-PGL Ex. 41.6. In contrast, in using 2012 data, the AG did not use it full year data, and also failed to include a factor for inflation. AG Ex. 4.1, Sched. C 8, line 3 and fn. (c); AG Ex. 4.2, Sched. C-8, line 3 and fn. (c).Thus, the AG analysis is specious.

The Utilities agree that the adjustment to IBS depreciation that was proposed in the AG's rebuttal testimony is warranted, but clarify that the adjustment was miscalculated. The IBS costs should include seven months of depreciation, instead of the six months proposed by the AG. NS-PGL Exs. 41.4P, 41.4N. The Utilities have already made adjustments in their surrebuttal testimony. The remainder of the AG adjustments must be rejected.

Other Parties

[Insert]

Commission Analysis and Conclusion

The Commission finds that the Utilities have provided sufficient, detailed evidence supporting the costs allocated or charged to them by IBS, and that with the exception of two minor home center adjustments and the IBS depreciation adjustment made by the Utilities, no adjustments are warranted. The Utilities have shown that the costs charged by IBS are made pursuant to a Commission-approved agreement, and have adequately supported the increase in benefits costs and their causes through testimony and evidence provided by Utilities' witnesses. Additionally, the Utilities have provided evidence that clarifies the miscalculations made by Staff with regards to injuries and damages expenses. With regards to the AG's proposed adjustments, the Utilities have provided sufficient evidence that fully supports the IBS home center costs and any variances therein, subject to the two minor adjustments made by the Utilities. Last, with regard to AG's adjustment to the IBS depreciation, the Utilities have agreed that an adjustment is necessary; however, the Utilities correctly have adjusted the IBS depreciation based on a period of seven months, instead of AG's suggested six month period. Therefore, the Commission rejects Staff's proposed adjustment, rejects the AG's proposed IBS home center cost adjustments, and accepted the adjustments made by the Utilities to the IBS depreciation costs.

b. <u>Advertising Expense</u>

North Shore and Peoples Gas

The Utilities are entitled to recover advertising expenses, subject to the provisions 220 ILCS 5/9-225, and are entitled to recover costs of contributions for the public welfare or charitable scientific, religious or educational purposes under 220 ILCS 5/9-227. NS-PGL Ex. 26.0 at 7-8. In rebuttal and surrebuttal testimony, the Utilities accepted $69,000 of Staff's proposed adjustments to advertising expenses, but rejected the remaining proposed adjustments because the remaining challenged expenses were recoverable under Section 9-225 and also were charitable in nature. Staff's proposed

adjustments must be rejected, as they disallow expenses that were properly incurred in ways that benefit customers and the communities in the Utilities' service territories. Moreover, not only are Staff's adjustments entirely in error, but Staff's proposed adjustment to Peoples Gas is overstated by $10,000, as Staff failed to account for the fact that Peoples Gas removed an additional $10,000 of the challenged costs from its revenue requirement in the Utilities' surrebuttal. Staff Init. Br., App B, p. 3, col. (o); Staff Ex. 13.0, Sched. 13.03 P, p. 1; NS-PGL Ex. 42.0 Rev. at 13; NS-PGL Ex. 42.2P, p. 2, col. [D], reflected in NS-PGL Ex. 42.1P, col. [D], line 23.

The evidence shows that the costs in question are sponsorships that benefit customers and communities and are recoverable under Section 9-227, and Staff does not and cannot argue that Section 9-225 is an exception to recovery under Section 9-227. *E.g.,* NS-PGL Ex. 26.0, at 7-8; NS-PGL Init. Br. at 107-108. Despite Staff's argument that the Utilities' failed to properly list these amounts as charitable contributions on their Schedule C-7's, prior Commission decisions have shown that the Utilities should be able to recover recoverable expenses even in the case that such expenses were recorded incorrectly, and to rule otherwise would be punitive with no justification. NS-PGL Ex. 42.0 at 5-6, 8-9; *Commonwealth Edison Co.,* ICC Docket No. 99-0117 (Order on Rehearing March 9, 2000); NS-PGL Init. Br. at 109. In addition, Staff contradicts itself. Staff elsewhere stated in its Initial Brief that "[w]hether the Companies record institutional events support costs as miscellaneous general operating expense or charitable contributions, should not dictate whether these particular miscellaneous general operating expenses should be recovered from ratepayers." Staff Init. Br. at 65.

The Utilities have provided sufficient support for the expenses in question to be recovered under Section 9-225 in any event, presenting documentation and other evidence that demonstrate that the expenses were incurred pursuant to the statutory requirements. NS-PGL Ex. 42.0 Rev. at 5-7; NS-PGL Ex. 42.3. In claiming that the Utilities cannot recover costs that paint them in a "philanthropic light," Staff attempts to disallow costs that are beyond the scope of Section 9-225 and promotes a reading of Section 9-225 that is wrong on its face and that is inconsistent with the express allowance of charitable costs recovery under Section 9-227. Moreover, Staff does not provide any actual evidence that the sponsorships are for "promotional advertising" or "goodwill or insitutional advertising," in contravention of Section 9-225(1)(c)-(d). Staff also fails to acknowledge that the express language of Section 9-225 provides that the Commission may approve such costs if "the Commission finds the advertising to be in the best interest of the Consumer…." The Utilities have provided overwhelming evidence that the challenged sponsorships benefit customers and communities within the Utilities' service territories. Staff also is inconsistent in its treatment of such expenses, having failed to propose adjustments to similar advertising expenses in previous cases. NS-PGL Init. Br. at 109-110.

In support of its proposed adjustments, Staff refers to four previous Commission orders disallowing advertising expenses of a promotional, goodwill, or institutional nature. Staff Ex. 3.0 at 20. However, these orders discuss cases that are factually dissimilar to the current facts, and, with the exception of the *Ameren Illinois 2012* Order,

fail to discuss the "philanthropic light" theory. The *Ameren Illinois 2012* Order apparently is the first order under which sponsorships were disallowed under the "philanthropic light" theory pursuant to Section 9-225, despite the fact that the review of advertising expenses has been a practice of both Staff and the Commission for decades. In any event, the *Ameren Illinois 2012* Order is legally and factually distinguishable because, as previously discussed, Section 9-225 does not apply to costs recoverable under Section 9-227, plus, there is no evidence that the sponsorships in question in the instant case are properly qualified as goodwill advertising. Last, the *Ameren Illinois 2012* Order fails to address the language of Section 9-225 that promotes advertising done in the best interests of the customers. Here, as noted above, the sponsorships are in the best interests of customers.

Other Parties

[Insert]

Commission Analysis and Conclusion

The Commission finds that the Utilities have provided sufficient evidence in support of the expenses in question, and that such expenses are properly deemed charitable in nature are recoverable under Section 9-227. The Commission further finds that Staff's objections are inconsistent with Staff's treatment of advertising expenses in previous cases, that Staff's arguments are contrary to Sections 9-225 and 9-227 of the Act, and that Staff lacks any factual basis for these challenges. Therefore, the Commission rejects Staff's proposed adjustments.

c. <u>Charitable Contributions</u>

North Shore and Peoples Gas

Peoples Gas has properly made charitable contributions in the amount of $8,150 to nineteen universities outside of the utility's service territory pursuant to Section 9-227 of the Act, 220 ILCS 5/9-227. Although Staff proposes to disallow these charitable contributions based solely on the fact that these universities are outside of the service territory, Peoples Gas has shown that these contributions are charitable in nature and recoverable under Section 9-227. PGL Ex. 6.0 at 14-15; NS-PGL Ex. 26.0 at 8-9; NS-PGL Ex. 42.0 Rev. at 9. Section 9-227 places a limit on the power of the Commission to disallow reasonable charitable contributions, which Staff's proposal violates. NS-PGL Init. Br. at 110-113. Peoples Gas has also provided detailed information regarding its charitable contributions in its Part 285 Schedules that exceeds the statutory requirements. PGL Ex. 6.0 at 14-15; NS-PGL Ex. 26.0 at 8-9; NS-PGL Ex. 42.0 at 9.

Staff relies upon a number of decisions in which the Commission disallowed charitable contributions outside of the utility's service territory, finding that there was no evidence of "any benefit to ratepayers in ComEd's service territory" or that it did not aid

the "public welfare." *Commonwealth Edison Co.*, ICC Docket No. 10-0467 (Order May 24, 2011), at p. 108; *Ameren Illinois Co.*, ICC Docket No. 12-0001 (Order Sept. 19, 2012), at p. 79. However, the Commission has held that donations made outside of the service territory could be recovered if they benefitted customers in the service territory. *See Commonwealth Edison Co.*, ICC Docket No. 12-0321 (Order Dec. 19, 2012). Moreover, Section 9-227 specifically provides for the recovery of contributions "for the public welfare or for charitable scientific, religious or educational purposes…" Peoples Gas has provided evidence demonstrating that the charitable contributions at issue provide benefits to ratepayers in its service territory, that these contributions are made for educational purposes, and that donations made outside of the service are properly recoverable when found to benefit ratepayers within the territory. NS-PGL Init. Br. at 110-113.

CUB-City cites *Ameren Illinois Co.* for the proposition that in difficult economic times, the Commission must closely examine charitable contributions made by Utilities. CUB-City Init. Br. at 48-49. CUB-City fails to note that the *Ameren Illinois Co.* Order also states that economic hardship increases the need for charitable contributions. Moreover, the Order's decision to disallow charitable contributions in an aggregate amount beyond a particular total is factually distinguishable from the case at hand. Order at 31. The only evidence here is that the charitable costs are reasonable.

Other Parties

[Insert]

Commission Analysis and Conclusion

The Commission finds that Peoples Gas has provided evidence demonstrating that the contributions made to universities outside of its service territory were charitable contributions made for an educational purpose, pursuant to Section 9-227. Moreover, Peoples Gas has clearly demonstrated that these contributions benefit ratepayers within the territory, as universities outside of the service territory may still provide educated utility workers to serve customers within the service territory. Therefore, the Commission approves these costs and rejects Staff's adjustment.

d. <u>Institutional Events</u>

North Shore and Peoples Gas

The Utilities have demonstrated that their sponsorship of institutional events: (1) supports local charities, (2) serves as a means for the charities to raise contributions, (3) allows for dialogue between the charities and the Utilities so they can better service the community, and (4) fosters cross-collaboration between the Utilities and the community so that the Utilities can better serve their customers. NS-PGL Ex. 26.0 at 9-10; NS-PGL Exs. 26.3N, 26.3P.

Although Staff argues that these sponsorships are for goodwill advertising, and that the Utilities already make charitable contributions to some of the same institutions, the Utilities are not barred from making multiple contributions as long as the amount of such contributions are not unreasonable, and the Utilities have supported the contribution level and Staff has not shown it unreasonable. 220 ILCS 5/9-227; NS-PGL Init. Br. at 113-114. The Utilities have provided sufficient evidence to support the finding that certain contributions are made as an element of sponsorship of institutional events, and are not barred by Section 9-225. Moreover, as Staff has acknowledged, Staff has not challenged similar sponsorships in previous rate cases and they were approved in those cases. NS-PGL Ex. 42.0 Rev. at 10; Staff Ex. 13.0 at 18.

Other Parties

[Insert]

Commission Analysis and Conclusion

The Commission finds that the Utilities have made contributions as an element of sponsorship of institutional events, have supported these sponsorships, and that Staff has failed to provide any evidence that demonstrates why these expenses should be disallowed. These events are made in support of local charities and communities, and are not made for the purpose of promoting the utility or fostering goodwill towards the utility. These costs are not barred by Section 9-225 of the Act, and are recoverable under Section 9-25 and Section 9-227. Therefore, the Commission rejects Staff's adjustments.

8. Depreciation

a. Bonus Depreciation

The contested issues with respect to bonus depreciation are discussed in Section IV.C.6.c.

b. Derivative Adjustments from Contested Adjustments

This is an uncontested issue that depends on the outcome of other issues discussed elsewhere in this Order. The Commission's conclusions are reflected in the Appendices.

9. Rate Case Expenses

North Shore and Peoples Gas

North Shore and Peoples Gas take the position that the evidentiary record contains substantial evidence demonstrating that their revised proposed rate cases expenses for this rate case – $2.286 million for North Shore and $3.334 million for

Peoples Gas – are just and reasonable. NS-PGL Ex. 42.0 Rev. at 12-13; NS-PGL Exs. 42.4N, 42.4P; Staff Ex. 13.0 at 8-9 and Scheds. 13.01N, 13.01P. The Utilities assert that the record evidence is more than sufficient for the Commission to specifically assess the justness and reasonableness of those expenses as required by Section 9-229 of the Act, 220 ILCS 5/9-229. The Utilities further rely on the fact that the Staff witnesses who examined the voluminous evidence the Utilities introduced into the record to support the recovery of their rate case expenses concluded that the amounts sought by the Utilities were just and reasonable based on that evidence. Staff Ex. 13.0 at 4-9 and Scheds. 13.01N, 13.01P; Staff Ex. 17.0 at 19; Staff Ex. 22.0 at 2. The Utilities further request that these rate case expenses be amortized over two years for ratemaking purposes, based on the Utilities' experience as to the time between its past rate cases and the requirements of the Act relating to the expected timing of the Utilities' next two general rate case filings. NS Ex. 6.0 at 13; PGL Ex. 6.0 at 13.

The Utilities state that it is well-established law that a utility is entitled to recover rate case expenses, which have been found by the Supreme Court of Illinois to be ordinarily, properly and fairly allowable as an operating expense. *DuPage Util. Co. v. Illinois Commerce Comm'n*, 47 Ill. 2d 550, 553 and 561 (1971) ("rate-case expense is ordinarily properly and fairly allowed as an operating expense"). *See also People ex rel. Lisa Madigan v. Illinois Commerce Comm'n*, 2011 IL App (1st) 101776, ¶ 13 (1st Dist. Dec. 9, 2011) ("*Illinois-American Water*"), *appeal denied* (Ill. S. Ct. Sept. 26, 2012) ("Illinois courts have allowed utilities to recover rate case expense because '[t]he costs incurred by a utility to prepare and present a rate case are properly recoverable as an ordinary and reasonable cost of doing business.'") (citations omitted). The guiding standard for the Commission in setting any rates for a public utility – that the rates be "just and reasonable"[2] – extends to a public utility's recovery of rate case expenses in its rates, as well. *See*, *e.g.*, *Northern Illinois Gas Co.*, ICC Docket No. 04-0779 (Order Sept. 20, 2005), p. 51 ("The amortization period for rate case expense is guided by the requirement that the final rates be just and reasonable"); *Consumers Illinois Water Co.*, ICC Docket No. 03-0403, (Order(April 13, 2004), p. 22 ("the components of . . . rates, including rate case expense, must themselves be just and reasonable").

The Utilities' position is that Section 9-229 of the Act did not change this standard, as Section 9-229 expressly mandates that "justness and reasonableness" is the standard by which rate case expenses must be judged. Rather, Section 9-229 places an additional requirement on the Commission to "specifically assess the justness and reasonableness" of a public utility's rate case expenses and expressly address this issue in its final order in a rate case proceeding.[3] The appellate court in *Illinois-American Water* held that this language in Section 9-229 requires the Commission to "expressly address the basis for its findings" – *i.e.*, include "explanation or discussion" –

[2] 220 ILCS 5/9-201(c); *Bus. and Prof. People for the Pub. Interest v. Illinois Commerce Comm'n*, 146 Ill. 2d 175, 208, 585 N.E.2d 1032, 1045 (1991).

[3] Section 9-229's title and text are: "Consideration of attorney and expert compensation as an expense. The Commission shall specifically assess the justness and reasonableness of any amount expended by a public utility to compensate attorneys or technical experts to prepare and litigate a general rate case filing. This issue shall be expressly addressed in the Commission's final order."

as to the justness and reasonableness of a public utility's rate case expenses in its final order. *Illinois-American Water*, 2011 IL App (1st) 101776 at ¶¶ 47-48. With respect to the type of information the Commission should address in making this finding, the appellate court in *Illinois-American Water* in dicta suggested that the Commission could look to cases involving the award of attorney fees in the context of statutory or contractual fee-shifting provisions.[4] *Id*. at ¶ 51. Based on this guidance, the Commission has stated that a public utility must provide detailed information concerning what actual expenses have been or will be incurred, by whom, for what purpose and why such expenses were necessary in order for the Commission to make an informed determination regarding the justness and reasonableness of recovering rate case expenses from customers. *See In re Charmar Water Co., et al.*, ICC Docket Nos. 11-0561 – 11-0566 (consol.) (Order May 22, 2012) at p. 19; *In re Charmar Water Co., et al.*, ICC Docket Nos. 11-0561 – 11-0566 (consol.) (Order on Rehearing Nov. 28, 2012), p. 14.

The Utilities state that the evidentiary record in this rate case contains an abundance of detailed information presented by the Utilities establishing the actual expenses that have been or will be incurred, the persons providing the services for which those expenses were billed to the Utilities, what services were performed and for what purpose, and why those services were necessary. The record also contains evidence concerning the skill and experience of the attorneys and technical experts, the negotiation of rates, the nature and complexity of the work involved, the comparability of those rates to market rates for similar attorneys and technical experts of their skill and experience levels, and the comparability of rates and the amounts charged in other rate cases before the Commission. With respect to their rate case expenses generally, the unrebutted record evidence established that the Utilities: (1) work to achieve efficiencies in rate case expenses from the simultaneous preparation and consolidation of their rate case proceedings, (2) select outside counsel and expert resources with extensive experience both in Illinois rate cases and related proceedings generally and with the Utilities specifically; (3) negotiate appropriate estimated hours of work that would be reasonable for the scope of and matters reasonably expected to be involved in these rate cases, as well as hourly rates that are just and reasonable in light of the market rates for experienced counsel and technical experts in Chicago generally and for practice before the Commission in Chicago specifically; (4) use IBS cost effectively to provide rate case support services; and (5) need outside counsel and technical experts to assist with the extensive procedures involved in prosecuting their rate cases after they were filed, including the discovery process, analysis of Staff and intervenor direct and rebuttal testimonies, assistance with preparation of the Utilities' rebuttal and surrebuttal testimonies, the evidentiary hearing, post-hearing briefs and reply briefs,

[4] "While we make no finding as to the amount of attorney and expert fees requests, we point the Commission to other cases involving an award of attorney fees, in which the party seeking attorney fees must specify (1) the services performed, (2) by whom they were performed, (3) the time expended, and (4) the hourly rate charged. . . . Similar to cases before the trial court, the Commission has the ability to consider the factors presented to establish the amount of attorney fees requested. We believe that these cases regarding an award of attorney fees can provide guidance to the Commission and the parties to comply with Section 9-229." *Illinois-American Water*, 2011 IL App (1st) 101776 at ¶¶ 51-52 (citations omitted).

analysis of the Administrative Law Judges' Proposed Order, briefs and reply briefs on exceptions, preparation and participation in oral argument, analysis of the final Commission Order, and preparation of a compliance filing. NS Ex. 6.0 at 16-18; PGL Ex. 6.0 at 16-18.

The Utilities state that the evidence also demonstrates the justness and reasonableness of the Utilities' rate case expenses in that the Utilities negotiated agreements with their outside legal counsel whereby their bills would not exceed established budgeted amounts estimated for the work necessary to prepare and litigate the rate cases. Further, the Utilities' witness testified that the Utilities review the invoices submitted by their outside legal counsel and consultants to ensure that they describe the work being performed, no unreasonable amounts of time have been billed for particular tasks, and there has not been inappropriate redundancy whereby multiple counsel or consultants unnecessarily bill time for performing the same task on the same project. The Utilities required that both their affiliated IBS employees and outside consultants working on the rate cases provide detailed invoices. With respect to amounts charged by IBS employees, the Utilities review the documentation to ensure that there is no "double-counting" of expenses for rate case work performed by IBS personnel. NS Ex. 6.0 at 18; PGL Ex. 6.0 at 18. Additionally, the Utilities' rate case expenses witness, Ms. Moy, testified during the hearing that based on her experience in prior rate cases and information from persons who deal directly with the attorneys and technical experts involved in the rate cases, the amounts of estimated rate case expenses remaining that had not been incurred by the time of the hearing are likely to be incurred by the end of the suspension period in June, 2013. Tr. 2/4/13 at 103- 104.

Specifically for each law firm and consultant, the Utilities provided voluminous record evidence containing detailed information concerning what actual expenses have been or will be incurred, by whom, for what purpose and why such expenses were necessary, which establishes the justness and reasonableness of their costs that are sought to be recovered as rate case expenses, which the Utilities summarized as follows:

<u>Outside Legal Services</u>

The record evidence shows that the Utilities retained the services of two law firms – Foley & Lardner LLP and Rooney Rippie & Ratnaswamy LLP – to assist in the preparation and prosecution of the present rate cases. The primary attorneys from these firms working on these rate cases are the same attorneys who worked on the 2009 and 2011 North Shore and Peoples Gas rate cases. The Utilities negotiated an appropriate estimate of hours of work that would be reasonable for the scope of and matters expected to be involved in these rate cases. Further, the Utilities negotiated discounted hourly rates with both firms that are comparable to the market rates for experienced counsel in Chicago generally and for practice before the Commission in Chicago specifically. NS-PGL Ex. 26.0 at 17. The Utilities introduced evidence into the record concerning the terms of the Utilities' engagements with the law firms (*i.e.*, engagement letters with each firm), including details regarding discounts and not-to-

exceed fee arrangements, estimated hours, estimated fees and hourly rates for individual attorneys. *Id*. at 17; NS-PGL Ex. 26.6.

The record evidence further contains detailed invoices received and summaries of services performed from Foley & Lardner LLP and Rooney Rippie and Ratnaswamy LLP that identify each attorney or support staff (*i.e.*, paralegal) who billed time to the rate cases, describe the services performed with detailed daily time entries stating the amount of time expended and describing what was done during that time, and the hourly rate charged, as well as descriptions of work performed, work that is expected to be performed prior to the end of the rate cases, and the fees applicable to both categories NS-PGL Ex. 26.0 at 20; NS-PGL Ex. 42.0 Rev. at 15-16; NS-PGL Exs. 26.7, 26.8, 42.5 and 42.6.

In addition, the Utilities rely on the testimony of Staff witness Mr. Ostrander that the law firms and attorneys have extensive history and experience practicing before the Commission, that the hourly rates charged by the attorneys here are consistent with hourly rates approved by the Commission in other similar rate cases, and that the amounts billed to date are consistent with amounts billed at a similar juncture in the Utilities' previous rate cases. Staff Ex. 13.0 at 8.

Stafflogix

The record evidence shows that Stafflogix provides witnesses and other support to assist in the preparation and prosecution of the present rate cases. Mr. John Hengtgen appeared as a witness for the Utilities, providing testimony on rate base and cash working capital issues, as well as overseeing the filing and process management of the rate cases. Ms. Valerie Grace appeared as a witness for the Utilities as a rate design witness. Stafflogix also provides support in preparing the Utilities' cost of service studies and information technology support necessary to implement the new tariffs approved in the rate cases. The evidence shows that Stafflogix's rates are reasonable based on their long experience working in the utility industry generally and with the Utilities specifically. Further, both Mr. Hengtgen and Ms. Grace spent many years working at the Utilities, allowing them to provide their particular knowledge and expertise of the Utilities to their testimony. NS-PGL Ex. 26.0 at 19-20; NS-PGL Ex. 42.0 Rev. at 16. The Utilities introduced evidence into the record regarding the terms of engagement, particular fees, services and qualifications of Stafflogix. NS-PGL Ex. 26.0 at 20; NS-PGL Ex. 26.9.

The record evidence further contains detailed invoices and summaries of services performed from Stafflogix that show services performed, by whom, the amount of time expended and the hourly rate charged, as well as descriptions of work performed, work that is expected to be performed prior to the end of the rate cases, and the fees applicable to both categories. NS-PGL Ex. 26.0 at 20; NS-PGL Ex. 42.0 Rev. at 16-17; NS-PGL Exs. 26.10 and 42.7.

S.FIO Consulting

The record evidence shows that S.FIO Consulting provides strategic consulting and advice on the development and presentation of particular rate case issues based on consultant Mr. Salvatore Fiorella's history and experience in and knowledge of the Illinois natural gas industry in general and the Utilities in particular. Mr. Fiorella was a long-time employee of the Utilities and has particular knowledge of matters related to the Utilities' rate bases, capital expenditures, revenue requirement and capital structure. Mr. Fiorella used his knowledge and experience to provide assistance to the Utilities in the preparation and prosecution of their rate cases. S.FIO's services are necessary because the employees of the Utilities, their affiliates and/or other consultants have assignments and obligations with respect to the present rate cases as well as other matters that do not allow them the time to perform the work that Mr. Fiorella performs for the Utilities with respect to the present rate cases. Further, Mr. Fiorella brings knowledge, experience and perspective that are different than and thus non-duplicative of the employees of the Utilities and their affiliates or other consultants involved in these rate cases. NS-PGL Ex. 26.0 at 21; NS-PGL Ex. 42.0 Rev. at 17. The Utilities introduced evidence into the record regarding the terms of engagement, particular fees, services and qualifications of S.FIO Consulting, including detailed explanations for how its services in these rate cases were non-duplicative, necessary, and different from other rate cases in which recovery for its services as rate case expense was not allowed. NS-PGL Ex. 26.0 at 21-22; NS-PGL Ex. 26.11.

The record evidence further contains detailed invoices and summaries of services performed from S.FIO Consulting that show services performed, the amount of time expended and the hourly rate charged, as well as descriptions of work performed, work that is expected to be performed prior to the end of the rate cases, and the fees applicable to both categories. NS-PGL Ex. 26.0 at 22; NS-PGL Ex. 42.0 Rev. at 17; NS-PGL Exs. 26.12 and 42.8.

Deloitte

The record evidence shows that Deloitte provided services as independent accountants to examine the forecasted statements of financial position – regulatory basis for the Utilities, and the related forecasted statement of operations – regulatory basis and forecasted statements of cash flows – regulatory basis, to comply with Section 285.7010 Schedule G-2 of Part 285 of the Commission's filing and information requirements in connection with the filing of these rate cases. NS-PGL Ex. 26.0 at 22-23; NS-PGL Ex. 42.0 Rev. at 17-18. The Utilities introduced evidence into the record regarding the terms of engagement, particular fees, services, and qualifications of Deloitte. NS-PGL Ex. 26.0 at 23; NS-PGL Ex. 26.13. The record evidence further contains detailed invoices from Deloitte that show the services performed, by whom, the amount of time expended and the hourly rates charged. NS-PGL Ex. 26.0 at 23; NS-PGL Ex. 26.14.

P. Moul & Associates

The record evidence demonstrates that P. Moul & Associates provided expert analysis and testimony concerning return on equity for the Utilities. Mr. Paul Moul has appeared as a witness for the Utilities in this capacity in their last several rate cases, and was able to apply his existing knowledge and expertise with respect to his analysis of and testimony on the Utilities' return on equity. NS-PGL Ex. 26.0 at 23. The Utilities introduced evidence into the record regarding the particular terms of P. Moul & Associates' engagement, its hourly rates, its services and the qualifications of Mr. Moul, including information concerning the change in Mr. Moul's fees from prior rate cases. *Id*. at 23-24; NS-PGL Ex. 26.15. The record evidence further contains detailed invoices from P. Moul & Associates that show the services performed, by whom, the amount of time expended and the hourly rates charged, as well as descriptions of work performed, work that is expected to be performed prior to the end of the rate cases, and the fees applicable to both categories. NS-PGL Ex. 26.0 at 24; NS-PGL Ex. 42.0 Rev. at 18; NS-PGL Exs. 26.16 and 42.9.

Towers Watson

Towers Watson provided actuarial services in support of Utilities' witness Ms. Christine Phillips' testimony regarding items related to Pensions and Benefits, as well as support during the discovery process. NS-PGL Ex. 42.0 Rev. at 18; NS-PGL Ex. 26.17. The record contains detailed invoices provided by Towers Watson for its services. NS-PGL Ex. 42.0 Rev. at 18; NS-PGL Ex. 42.10.

Intercompany Billings from IBS

The record evidence shows that the Utilities rely upon IBS to provide cost-effective rate case support, and ensure that the IBS costs for which they seek recovery as rate case expense are not also included elsewhere in their O&M costs. NS-PGL Ex. 26.0 at 25; NS-PGL Ex. 42.0 Rev. at 19. The Utilities introduced into evidence detailed documentation that shows for each two week period the identity of IBS employees charging time to the rate cases, the time and amounts charged by each such employee, and a description of what services that person performed, along with information regarding overhead loadings billed and descriptions of work performed, work that is expected to be performed prior to the end of the rate cases, and the fees applicable to both categories. NS-PGL Ex. 26.0 at 25; NS-PGL Ex. 42.0 Rev. at 19; NS-PGL Exs. 26.18 and 42.11.

Unrecovered Rate Case Expense Approved in Prior Rate Cases.

The Utilities state that if the Commission approved the recovery of rate case expense in a prior rate case to be amortized over a number of years, and the utility files another rate case before the recovery period has been completed, then it is appropriate for the Commission to include the amount of previously approved but unrecovered rate case expense to be recovered in the subsequent rate case expense amortization period. *See generally Illinois American Water*, 2011 IL App. (1st) 101776 at ¶¶18-37; 83 Ill. Admin. Code § 285.3085(d) ("If amortization of previous rate case expenses are

included within test year jurisdictional operating expense at proposed rates on Schedule C-1, provide the amount of amortization expense associated with each rate case by docket number."). Here, the Utilities have approved but unrecovered prior rate case expense from their 2009 and 2011 rate cases, shown on NS-PGL Exs. 42.4N and 42.4P. NS Ex. 6.0 at 15; PGL Ex. 6.0 at 15; NS-PGL Ex. 26.0 at 15; NS-PGL Ex. 42.0 Rev. at 12-13. The Utilities note that no party submitted testimony opposing the recovery of these expenses, and the Utilities agreed to adjust the 2011 rate case expense amounts as proposed by Staff. NS-PGL Ex. 42.0 Rev. at 12; Staff Ex. 13.0 at 5. The Utilities state that Commission thus should approve the recovery of these amounts over the same two-year amortization period sought for rate case expenses from the current proceedings.[5]

Rehearing and Appeal Costs From Prior Rate Cases.

The Utilities assert that, as the Commission concluded in *Peoples Gas 2011*, "rehearing and appeal expenses are part and parcel of the litigation expenses in most every significant rate case proceeding," and that nothing in Section 9-229 of the Act prohibits the Commission from allowing their recovery in a subsequent rate case. *Peoples Gas 2011* Order, pp. 85-86 (approving amortized recovery of rehearing and appeal costs for the Utilities' 2009 rate cases as part of the Utilities rate case expenses in their 2011 rate cases). The Utilities have incurred rehearing and/or appeal costs related to both their 2009 and 2011 rate cases for which they seek amortized recovery as part of the rate case expenses in the present cases.[6] The record evidence contains detailed invoices introduced by the Utilities related to the rehearing and/or appeals of both their 2009 and 2011 rate cases that identify each attorney or support staff (*i.e.*, paralegal) who has billed time to the rate cases, describe the services performed with detailed daily time entries stating the amount of time expended and describing what was done during that time, and the hourly rate charged. NS-PGL Ex. 26.0 at 15; NS-PGL Ex. 42.0 Rev. at 19-20; NS-PGL Ex. 26.19 (2009 rate cases); NS-PGL Exs. 26.20 and 42.12 (2011 rate cases).

The Utilities note that no party has submitted testimony opposing or challenging the recovery of these rehearing and/or appeal expenses.[7] The Utilities state that, as concluded by the Commission in *Peoples Gas 2011*, recovery of such expenses is appropriate and the Commission should approve recovery of the rehearing and/or appeal costs for the Utilities' 2009 and 2011 rate cases in the same two-year amortization period sought for rate case expenses from the current proceedings.

[5] For the 2009 rate cases (ICC Docket Nos. 09-0166/09-0167 consol.): $161,000 for North Shore and $364,000 for Peoples Gas. For the 2011 rate cases (ICC Docket Nos. 11-0280/11-0281 consol.): $740,000 for North Shore and $1,088,000 for Peoples Gas. NS-PGL Exs. 42.4N and 42.4P.

[6] For the 2009 rate cases (ICC Docket Nos. 09-0166/09-0167 consol.): $118,000 for North Shore and $291,000 for Peoples Gas. For the 2011 rate cases (ICC Docket Nos. 11-0280/11-0281 consol.): $69,000 for North Shore and $104,000 for Peoples Gas. NS-PGL Exs. 42.4N and 42.4P.

[7] The Utilities voluntarily removed certain expenses identified by Staff in discovery with respect to the rehearing and appeal costs for the 2011 rate cases. *See* NS-PGL Ex. 26.0 at 26; NS-PGL Ex. 26.20; NS-PGL Exs. 42.4N and 42.4P, note 5.

The Utilities conclude that for these reasons, the Commission should make a determination pursuant to Section 9-229 of the Act, 220 ILCS 5/9-229, that the $2.286 million and $3.334 million in rate case expenses requested by North Shore and Peoples Gas, respectively, in these dockets are just and reasonable and allow their recovery (as well as recovery of the unamortized amounts of rate case expenses remaining, and rehearing and appeal costs, from previous rate cases) over a two-year amortization period.

Other Parties

[Insert]

Commission Analysis and Conclusions

"The costs incurred by a utility to prepare and present a rate case are properly recoverable as an ordinary and reasonable cost of doing business." *Illinois-American Water*, 2011 IL App (1st) 101776 at ¶ 13 (citations omitted). The guiding standard for the Commission in setting any rates for a public utility – that the rates be "just and reasonable" – extends to a public utility's recovery of rate case expenses in its rates, as well. *See*, *e.g.*, *Northern Illinois Gas Co.*, ICC Docket No. 04-0779 (Order Sept. 20, 2005), p. 51 ("The amortization period for rate case expense is guided by the requirement that the final rates be just and reasonable"); *Consumers Illinois Water Co.*, ICC Docket No. 03-0403, (Order(April 13, 2004), p. 22 ("the components of . . . rates, including rate case expense, must themselves be just and reasonable").

As stated by the Utilities, Section 9-229 of the Act did not change this standard. Section 9-229 provides:

> Consideration of attorney and expert compensation as an expense. The Commission shall specifically assess the justness and reasonableness of any amount expended by a public utility to compensate attorneys or technical experts to prepare and litigate a general rate case filing. This issue shall be expressly addressed in the Commission's final order.

220 ILCS 5/9-229. The appellate court in *Illinois-American Water* held that Section 9-229 requires the Commission to "'expressly address' the basis for its findings" – *i.e.*, include "explanation or discussion" – as to the justness and reasonableness of a public utility's rate case expenses in its final order. *Illinois-American Water*, 2011 IL App (1st) 101776 at ¶¶ 47-48. Based on the guidance provided by the court in *Illinois-American Water*, the Commission has stated that a public utility must provide detailed information concerning what actual expenses have been or will be incurred, by whom, for what purpose and why such expenses were necessary in order for the Commission to make an informed determination regarding the justness and reasonableness of recovering rate case expenses from customers. *See In re Charmar Water Co., et al.*,

ICC Docket Nos. 11-0561 – 11-0566 (consol.) (Order May 22, 2012) at p. 19; *In re Charmar Water Co., et al.*, ICC Docket Nos. 11-0561 – 11-0566 (consol.) (Order on Rehearing Nov. 28, 2012), p. 14.

The Commission here has thoroughly examined the voluminous record evidence supporting the rate case expenses for which North Shore and Peoples Gas have requested recovery in this rate case. The Commission finds that for each of the attorneys and technical experts for which recovery of rate case expense is sought, the Utilities provided detailed information concerning the nature and scope of their engagement, their hourly rates, what services they performed in support of the rate case, why those services were necessary, and what their actual expenses have been or will be incurred. Detailed invoices were provided that identified who was performing the work, what work or tasks were performed, when and for how long, and the fees and costs associated with that work. Further, the record evidence demonstrates that the rates negotiated with the attorneys and experts were reasonable in light of their experience working on rate cases generally and for the Utilities specifically, the market rate for such services, discounts and other cost protections such as "not-to-exceed" provisions provided, and the necessity and level of difficulty of the work to be performed. The record evidence also established that the Utilities review the invoices and have other safeguards in place to ensure that there is no "double-counting" for the costs of work performed by IBS personnel and that the time spent performing work by outside counsel and experts is reasonable and not duplicative. Moreover, while not determinative of the issue, the Commission notes that no party opposed recovery of the final revised amounts of rate case expenses sought by the Utilities, and that Staff testified it had reviewed the record evidence and found the amounts requested to be just and reasonable based on the facts and circumstances of this rate case.

Additionally, the Commission finds that the evidence in the record supports the conclusion that the amounts of rate case expenses not actually shown to have been expended by the time of the hearing are reasonably likely to be expended by the end of the rate case.

The Commission has considered the costs expended by the Utilities 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. The Commission also finds that the recovery of North Shore's and Peoples Gas' unamortized amounts of rate case expenses remaining, as well as rehearing and appeal costs, from previous rate cases to be just and reasonable. The Commission approves the recovery of these expenses over a two-year amortization period.

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

1. Invested Capital Tax Computation and Derivative Adjustments

North Shore and Peoples Gas

The Utilities propose a methodology for computing invested capital tax and its derivative adjustments based upon 2013 invested capital; Staff agrees with this proposed methodology. Staff Ex. 14.0 at 19-21. The Utilities argue that the AG each set forth a proposal that either bases the invested capital tax calculation on 2012 invested capital amounts and balances or based the accruals recorded for the 2013 test year. The Utilities state that their estimated and accrued tax obligation should be based on *2013* invested capital beginning and ending balances as prescribed by law (35 ILCS 615/1 and 615/2a.1) and not be estimated and accrued based on 2012 beginning and ending balances. NS-PGL Ex. 46.0 at 37-38. This should be the application for computing 2013 test year cost of service, as well as computing the Utilities' actual 2013 activity for financial accounting purposes. Id. At December 31, 2013, all events would have occurred that will bind the Utilities to paying this tax obligation based on 2013 invested capital activity and balances. Id. Further, the Utilities argue that the fact that the 2013 invested capital return is not filed until 2014 does not change the Utilities' obligation to calculate 2013 accruals based on 2013 activity and balances. Id. The Utilities also note that accruing a tax expense in 2013 that results from the 2012 taxable period would be inconsistent with GAAP. NS-PGL Rev. 30.0 Rev. at 35.

Finally, the Utilities state that derivative adjustments are necessary as a result of the invested capital tax computation. The Utilities argue that the AG's arguments that derivative adjustments are not necessary are based on the inaccurate assumptions that (1) other adjustments in revenues and expenses related to regulatory disallowances and financing charges were not taken into account by the Utilities; and (2) the Utilities' proposed rate of return and rate base filed in direct testimony are approved. NS-PGL Ex. 26.0 at 10. Throughout the proceeding, the Utilities' common equity and rate of return have changed based on updates to rate base and operating income adjustments. See NS-PGL Exs. 23.1N, 23.2N, 23.1P and 23.2P. Further, the Utilities add that rate base and operating income adjustments reflect the variations in revenues, expenses, financing charges, and proposed disallowances accepted by the Utilities. NS-PGL Ex. 26.0 at 11. Thus, the Utilities conclude that their invested capital changed over the course of the proceeding. As such, these adjustments should be factored into the derivative adjustments for invested capital taxes as it represents. Id.

Other Parties

[Insert]

Commission Analysis and Conclusion

The Commission finds that the Utilities have proposed a methodology for computing invested capital tax and derivative adjustments that correctly use 2013 invested capital balances in their calculation of a 2013 invested capital return. The

Utilities have also provided evidence that derivative adjustments are necessary in light of the Utilities' ongoing adjustments to revenues and expenses and due to the fact that the Utilities' rate of return and rate base have not yet been approved. Therefore, the Commission rejects the adjustments related to invested capital tax proposed by AG and CUB-City.

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 V.C.6.a.)

The contested issues with respect to bonus depreciation are discussed in Section IV.C.6.a

F. Gross Revenue Conversion Factor

1. Methodology

The only contested issue with respect to the Utilities' Gross Revenue Conversion Factors is addressed in Section V.F.2.

2. Late Payment Charge Ratio

North Shore and Peoples Gas

The Utilities have accounted for late payment charges revenues in their direct cases, ensuring that this revenue is accurately reflected in the Utilities' calculations. NS-PGL Ex. 26.0 at 12-13, NS-PGL Ex. 42.0 Rev. at 11. The AG's Initial Brief, as the Utilities understand it, does not contend otherwise. Instead, the AG acknowledges that "it is true that PGL and NSG have accounted for incremental Late Payment Charges revenues arising from the rate increase…." AG Init. Br. at 95.

The AG miscalculated these charges by assuming operating revenues of over 100%, and appeared to propose a change to the Utilities' Gross Revenue Conversion Factors that would result in a double-counting of these charges. NS-PGL Init. Br. at 129-130.

To the extent, however, that the AG's Initial Brief has clarified that the AG proposal is meant not to operate as an adjustment to the Utilities' figures but only within the AG's Schedules, it still is unnecessary and remains incorrectly calculated. The AG's Initial Brief, as the Utilities understand it, contends in essence that, the way the AG presented their schedules and calculated the incremental LPC revenues within the context of the AG schedules has a different form but it ultimately also correctly calculates those revenues. AG Init. Br. at 95-96. Nonetheless, if the AG is suggesting that its different format be used, the AG has given no reason for doing so, and, if it were to be adopted then the Utilities' calculations would need to be modified to avoid

double-counting of the incremental LPC revenues. In addition, the AG calculation is not correct, in any event, because it assumes operating revenues of over 100%. NS-PGL Ex. 42.0 Rev., at 11. The AG proposal as an incremental proposal can and must be rejected as double-counting, there is no reason to substitute it, and, as calculated, it is erroneous.

Other Parties

[Insert]

Commission Analysis and Conclusion

The Commission finds that the Utilities have already accounted for late payment charges revenues in their calculations, and that to allow the AG's miscalculated adjustment to be applied to the Utilities' figures is unnecessary and would result in a double-counting of late payment charges revenues. Therefore, the Commission rejects the AG's proposal.

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

The Commission's conclusions reflected in the Appendices are consistent with its findings in Section IV.C.5 of this Order.

VI. RATE OF RETURN

A. Overview

Peoples Gas proposes a rate of return on rate base of 7.07% based on a capital structure comprised of 50.43% common equity at a cost (a rate of return on common equity or "ROE") of 10.00%, 43.61% long-term debt at a cost of 4.47%, and 5.96% short-term debt at a cost of 1.26%. North Shore proposes a rate of return on rate base of 7.12% based on a capital structure comprised of 50.32% common equity at an ROE of 10.00%, 42.33% long-term debt at a cost of 4.64%, and 7.35% short-term debt at a cost of 1.80%. The Utilities' proposed 10.00% ROE represents a modest increase to their current ROE of 9.45%.

The Utilities' capital structures and short-term debt costs are not disputed. The Utilities and Staff are in agreement on the Utilities' long-term debt costs, but the AG proposes slightly lower costs by assuming that the Utilities' 2013 debt issuances will cost the same as the actual cost of Peoples Gas' new debt issuance in late 2012 instead of current or forecasted costs for the 2013 issuances. (CUB-City did not address long-term debt cost in their initial brief.)

Staff proposes substantially lower rates of return on rate base, 6.60% for Peoples Gas and 6.65% for North Shore, by virtue of its proposal to reduce the Utilities' ROE from 9.45% to 9.06%. The AG and CUB-City support Staff's proposed ROE.

The legal standards governing a public utility's entitlement to a fair and reasonable return on its investment are well established and familiar. The Commission summarized these standards in one of the Utilities' recent rate cases thus:

> A public utility has a constitutional right to a return that is 'reasonably sufficient to assure confidence in the financial soundness of the utility and adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.' The authorized return on equity 'should be commensurate with returns on investments in other enterprises having corresponding risks. That return, however, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.'

Peoples Gas 2009 Order, pp. 89-90 (citations omitted).

B. <u>Capital Structure</u>

North Shore and Peoples Gas (Uncontested)

As shown in their respective cost of capital schedules, the Utilities and Staff agree on the following capital structures. NS-PGL Exs. 38.1N & 38.1P; Staff Ex. 15.0, Sched. 15.01. No party disputed these structures.

	Peoples Gas	**North Shore**
Common Equity	50.43%	50.32%
Long-Term Debt	43.61%	42.33%
Short-Term Debt	5.96%	7.35%

According to the Utilities, these structures comply with Section 9-230 of the Act because they are consistent with and will support the Utilities' current stand-alone credit ratings. NS Ex. 2.0 at 5-7; PGL Ex. 2.0 at 5-7. A strong capital structure is important, the Utilities assert, because it helps insulate the utility from financial shocks and reduces its cost of debt that is passed on to customers. NS Ex. 2.0 at 7; PGL Ex. 2.0 at 7.

Other Parties

[Insert]

Commission Analysis and Conclusions

The Commission finds that the undisputed capital structures agreed to by the Utilities and Staff are reasonable and consistent with the Act, and therefore approves them.

C. Cost of Short-Term Debt

North Shore and Peoples Gas (Uncontested)

The Utilities and Staff agree on a short-term debt cost of 1.26% for Peoples Gas and 1.80% for North Shore. NS-PGL Exs. 38.1N and 38.1P; Staff Ex. 15.0, Sched. 15.01. No other party addressed short-term debt in their briefs.

Because these rates reflect consideration of both recent actual interest rates and recent forecasts of interest rates during the test year, the Commission finds them reasonable and approves their inclusion in the Utilities' 2013 rates.

D. Cost of Long-Term Debt

North Shore and Peoples Gas

The Utilities accepted Staff's 4.47% cost of long-term debt for Peoples Gas and 4.64% for North Shore. NS-PGL Ex. 38.0 at 3-4. Peoples Gas requested that its long-term debt cost be adjusted to reflect the anticipated April 2013 refinancing of its Series KK bonds at lower cost.

The AG proposes slightly lower costs, arguing that the Utilities' rates should reflect the Utilities' 2013 bond issuances at the same cost as Peoples Gas' November 2012 bond issuance (3.98%). AG Init. Br. at 97-98. This approach is not reasonable, the Utilities respond, because (1) their debt costs should be based on analyst forecasts of the cost of A-rated utility debt in 2013 and (2) even if actual costs are considered, the 4.20% cost proposed by Staff is based on more recent actual A-rated utility bond rates, which is more accurate actual cost data than the AG's single historical rate. NS-PGL Reply Br. at 121-122.

The Utilities also object to the AG's proposal to base their long-term debt costs on a year-end measure. Acknowledging that the AG's proposal would not significantly impact their overall rate of return, the Utilities argued that a year-end measure of long-term debt costs would create a mismatch between their rates and their forecasted costs. The Utilities pointed out that measuring these costs on an annual average basis id consistent with the Commission rule that allows long-term debt balances to be established on an annual average basis. Ill. Adm. Code § 285.4000(b). NS-PGL Init.

Br. at 134. Furthermore, where as here, the Utilities anticipate retiring some of their long-term debt and issuing new debt during the test year, using an annual average will result in rates that more accurately represent their forecasted cost throughout the year. *Id.* at 135. By contrast, if the Utilities' rates reflected forecasted year-end balances of long-term debt, they would reflect only the financing employed by the Utilities on that date. *Id.* The resulting cost would be inaccurate because it would not reflect the higher cost debt retired earlier in the year and would reflect the lower cost debt issued during the year as if it were issued at the beginning of the year. *Id.* In each case, the resulting rates would be inaccurate.

Although a year-end measure would result in slightly lower long-term debt costs in this case (because higher cost debt is anticipated to be replaced with lower cost debt during the test year) the Utilities caution that customers would be over-charged if the cost of the replacement debt was anticipated to be higher than retired debt. In either case, the Utilities argue, their rates would not accurately reflect their forecasted costs. *Id.* at 136; *see also* NS-PGL Reply Br. at 123.

Other Parties

[Insert]

Commission Analysis and Conclusion

The Commission finds that the long-term debt costs agreed to by the Utilities and Staff represent a more accurate forecast than the AG's slightly lower rates. The Utilities-Staff costs include consideration of both forecasted interest rates during the test year as well as more recent actual interest rate data, and this provides a superior basis to establish these costs than the cost of a single debt issuance in the more distant past.

The Commission agrees with the Utilities that setting long-term debt costs on an annual average basis is more appropriate in this case than an end of year measure. The annual average approach is authorized by Commission rule, and it is consistent with the manner in which the Utilities' agreed capital structure balances have been calculated. Thus, the Utilities' rates will more accurately reflect their forecasted costs if the Utilities' annual average long-term debt costs are used. Finally, the Commission encourages settlement of disputed issues. Here, the Utilities and Staff are agreed and the AG's proposal would have very little impact on the otherwise agreed rates.

The Commission further agrees that the Utilities-Staff agreed long-term debt cost for Peoples Gas should be adjusted to incorporate the lower refinanced cost of its Series KK bonds. The refinancing was completed in April 2013 and therefore should be reflected in Peoples Gas' 2013 rates.

E. Cost of Common Equity

North Shore and Peoples Gas

1. Overview

Utilities' Overall Position

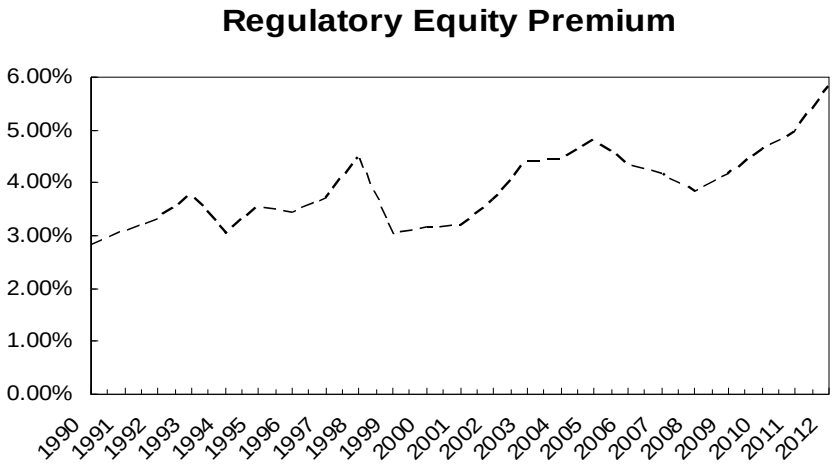
Because the Utilities' common stock is not publicly traded, their cost of equity must be estimated using capital market and financial data relied on by investors to assess the relative risk of other "distribution-only" utilities. Utilities witness Mr. Moul presented three "market" measures of the Utilities' return on equity ("ROE") based on a proxy group of natural gas utilities. Mr. Moul applied the Discounted Cash Flow ("DCF") model, the Capital Asset Pricing Model ("CAPM") and the Risk Premium model. After initially recommending a higher ROE, on surrebuttal, Mr. Moul presented a compromise position on behalf of the Utilities that was intended to reduce the number of disputed issues in the case. The model results that followed from that compromise proposal are as follows:

Model	Equity Cost
DCF	8.98%
CAPM	10.03%
Risk Premium	11.00%
Average	10.00%

NS-PGL Ex. 39.0 at 1-2.

The Utilities assert that Mr. Moul's equity model results as well as general market information about the prevailing cost of utility equity support a modest increase of their current 9.45% ROE to 10.00%. Such an ROE, the Utilities argue, would comport with the 9.94% average ROE for natural gas utilities in 2011-2012. It would also be consistent with 10.30% average forecasted return in 2013 for the "Delivery Group," the proxy group of electric and natural gas distribution-only companies that Mr. Moul and Staff witness Mr. McNally used to estimate the Utilities' cost of equity for the test year. NS-PGL Init. Br. at 130-131.

In response to Mr. McNally's argument that the Utilities' cost of equity should be reduced to reflect historically low interest rates, Mr. Moul showed that the "equity risk premium," the difference in cost between A-rated utility bonds and recent utility authorized ROEs, has increased dramatically since the start of the Great Recession in 2008:



NS-PGL Ex. 39.0 at 3-4.

The current average utility equity risk premium stands at 581 basis points. If that premium is applied to the Utilities' undisputed long-term debt costs in this case, it generates a 10.28% ROE for Peoples Gas and 10.44% for North Shore. *Id.* at 4. Thus, the Utilities assert, their requested ROE of 10.00% is well within the market ballpark of utility returns.

The Utilities find "confounding" Staff's continued refusal to even consider ROEs authorized for other utilities in 2011-2012 on the grounds that individual ROEs cannot be compared without knowing the underlying details. NS-PGL Init. Br. at 147. They note that such returns comprise a large sample and in other contexts Staff acknowledges that the use of samples "mitigates" the "measurement error" that might occur if one relied on a single piece of data. Staff Exs. 5.0 at 28 & 15.0 at 14. The Utilities reason that the same principle applies to the large samples of recent ROEs (146 observations in all) that are readily available to investors, analysts and this Commission. NS-PGL Br. at 148. Furthermore, the evidence shows that Mr. McNally's speculative concerns about comparability issues is unfounded, and that the similarity of the underlying conditions make these sample-based data quite comparable to the Delivery Group. NS-PGL Ex. 39.0 at 2-3. The Utilities also point out that AG witness Brosch relied solely on a sample of recent utility ROEs to arrive at his opinion that the Utilities' ROE should remain at 9.45%, a "recommendation" that CUB-City argued was "fully justified." AG Ex. 1.0 at 61.

CUB-City join Staff in arguing that the Commission should not consider recent ROEs, claiming that it has refused to do so in prior rate cases. CUB-City Init. Br. at 57. But according to the Utilities, they are not asking the Commission to "determine" ROE by comparison to other ROEs or to set their ROE at the average of other ROEs. Rather, they ask the Commission to consider other ROEs and other general market information for context when it assesses the credibility of the parties' various ROE positions. Based on this test, the Utilities' 10.00% ROE is in the ballpark. Staff's

9.06% is far too low, indicating that it is the product of error, bias or both. NS-PGL Reply Br. at 132.

The Utilities argue that all of these considerations support an increase of the Utilities' cost of equity to 10.00%.

Other Parties

[Insert]

2. Proxy Group Analysis

North Shore and Peoples Gas

Because the Utilities' stock is not publicly traded, their cost of equity must be estimated using mathematical models applied to a proxy group of publicly-traded companies with investment risk similar to that of the Utilities. NS Ex. 3.0 at 4. Mr. Moul based his 10.00% ROE recommendation on model runs using a proxy group of publicly traded electric and natural gas distribution-only utilities referred to in the record as the "Delivery Group." *Id.* at 4-6.[8] Mr. McNally, the only other witness to present a cost of equity based on the market models, found the Delivery Group to "provide reasonable proxies for the risk of North Shore and Peoples Gas" and used it for his models. Staff Ex. 5.0 at 13.

Other Parties

[Insert]

3. DCF

North Shore and Peoples Gas

The DCF model expresses the value of an asset as the present value of future expected cash flows discounted at the appropriate risk-adjusted rate of return, which for common stock is the dividend yield plus future price growth. NS Ex. 3.0 at 15. Mr. Moul used a six-month average dividend yield for the Delivery Group, adjusted by three generally accepted methods to reflect investors' expected cash flows, and averaging the three adjusted values. *Id*. at 16. For the investor-expected growth rate, Mr. Moul evaluated an array of historical and forecast growth data from sources that are publicly

[8] Mr. Moul initially included in his analysis the results from an additional proxy group, a "Combination Group" of electric and natural gas utilities. NS Ex. 3.0 at 6. As part of the Utilities' compromise position on ROE, they are not including the ROE results for this proxy group in this case. NS-PGL Ex. 39.0 at 2.

available to, and relied upon by, investors and analysts. *Id*. at 20-21. He focused on forecasts of earnings per share growth because empirical evidence supports it and because that they are most relevant to investors' total return expectations. *Id*. at 22-23. He selected 4.50%, the approximate mid-point for the Delivery Group. *Id*. at 24. Mr. Moul then applied a financial leverage adjustment to his DCF results because they are based on market prices of the Gas Group's stock, which imply a capital structure with more equity and less financial risk, but are applied to utility book values, which imply a capital structure with less equity and more financial risk. *Id*. at 24-30. Mr. Moul's leverage-adjusted DCF result for the Delivery Group was 8.98%. *Id.* at 30. By comparison, Mr. McNally presented a higher DCF result of 9.32% based on forecasted growth rates and stock prices for the Delivery Group on a single day, November 9, 2012. Staff Ex. 5.0 at 14-18.

There are three disputed issues between the Utilities and Staff with respect to DCF methodology: (1) Staff's "lower of" approach to the model, (2) Staff's reliance on historical spot data, and (3) Mr. Moul's leverage adjustment. The Utilities' arguments on each of these issues are presented in turn.

Staff's "Lower Of" Approach Introduces Bias

According to the Utilities, over their last several rate cases Staff has used two different versions of the DCF model depending on certain circumstances. When growth forecasts for the proxy group are at or below Gross Domestic Product (GDP) growth forecasts, Staff uses the "constant growth" version of the model, in which the same growth rate is assumed into the future. When growth rate forecasts for the proxy group are higher than those for GDP, Staff uses a "non-constant growth" version, where near-term and long-term growth rates are assumed, to generate a lower ROE than the constant growth version would generate. Mr. Moul finds this "lower of" approach to be biased against the Utilities. NS-PGL Ex. 24 at 9. The Utilities point out that in their second-to-last rate case, the Commission rejected "Staff's position that the non-constant growth form of the model must be used any time it can be claimed that analyst growth rates are not sustainable." *Peoples Gas 2009* Order, p. 125.

In this case, Staff's witness used the constant growth model after finding the Delivery Group's growth rate of 4.83% comparable to GDP growth rate of 4.3-4.9%. Staff Ex. 5.0 at 15. After the Utilities raised their concern about Staff's "lower of" approach, Staff's witness claimed that had he used the non-constant growth version of the model he would have used a lower long-term growth rate of 3.35%. Staff Ex. 15.0 at 12. The Utilities argue that this is inconsistent with the position of Staff's witness on direct that the 4.83% growth rate for the Delivery Group was "reasonably sustainable," supporting his use of the constant growth version of the DCF model. The Utilities conclude that this only confirms their concerns about bias underlying Staff's methodology. NS-PGL Init. Br. at 144.

Staff's Reliance on Historical Spot Data Is Unjustified

The Commission has in two of the Utilities' recent rate cases admonished Staff that its reliance on data taken from a single day in the past – here, November 9, 2012 – to run its cost of equity models will not be accepted without proof that the results are representative of the Utilities' cost of equity in the test year. In the Utilities' 2007 rate case, the Commission found that "Staff's single data point for use in its DCF is unsatisfactory for the intended purpose in these dockets" because short-term vagaries of the market can affect stock prices and yields on a single trading day." *Peoples Gas 2007* Order, p. 92. Likewise, in the Utilities' 2009 rate case, the Commission observed that:

> it would useful for the Commission to be told the conditions or financial climate of the spot day and whether any of these might cause material market inefficiencies. And, more importantly, we would expect the expert to be acutely attuned to that environment in making a selection. The choice of a spot day may be random or informed and we prefer some combination of both. While the Commission has traditionally accepted spot day analysis, we are not absolutely committed to this approach.

Peoples Gas 2009 Order, pp. 125-126.

The Utilities argue in this case that Staff has once again failed to demonstrate the reliability of its model results based on historical spot data. The Utilities observe that Staff opposes the consideration of forecast data because forecasts are often imprecise in hindsight, but Staff has not shown that historical spot data are better predictors than forecasts. In particular, Staff did not provide evidence that its spot data were immune to short-term market inefficiencies or other measurement errors. The fact that Staff repeated its analysis during a single week in November 2012 does not address this shortcoming. According to the Utilities, "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. They do not answer, and therefore are not relevant to, the issue at hand: what the Utilities' cost of equity will be during the 2013 test year." NS-PGL Init. Br. at 141 (emphasis in original). As a result, the Utilities assert, Staff's DCF and CAPM results are not reliable. In particular, they point to the extreme variance in Staff's DCF results for the individual Delivery Group companies, from 6.52% (clearly too low) to 11.75% (clearly too high). *See* Staff Ex. 5.0, Sched. 5.07.

<u>Mr. Moul's Leverage Adjustment is Methodologically Sound</u>

Mr. Moul applies a "leverage" adjustment to his DCF and CAPM results to correct the mismatch that otherwise occurs when a market-based cost of equity, which is based on the proxy group's average market value capital structure, is applied to the utility's book value capital structure. Currently, the Delivery Group's average market value capital structure has proportionally more equity and less risk than its average book value capital structure. Mr. Moul adjusts the market cost of equity generated by the

mathematical models so that the equity cost reflects the lower amount of equity and higher risk of the book value capital structure. NS Ex. 3.0 at 24-30; NS-PGL Ex. 24.0 REV at 14-16. If the adjustment is not made, the market cost of equity applied to the book value capital structure will prohibit the utility from earning the full return implied by the market cost of equity. NS-PGL Reply Br. at 128-129.

The Utilities refute each of the arguments raised by Staff and CUB-City as to why the Commission should reject Mr. Moul's leverage adjustment. First, the Utilities deny that the adjustment constitutes "fair value" ratemaking, which Staff erroneously claims is prohibited by Section 9-210 of the Act. Staff Init. Br. at 88. The Utilities assert that Staff mischaracterizes fair value ratemaking as involving the application of a market ROE to a market value capital structure. The Utilities cite Illinois case law making clear that the fair value concept gives the Commission great latitude in setting the value of a utility's investment, which can include consideration of both original cost and market value. Further, the Utilities point to Commission decisions applying fair value ratemaking in which it considered non-market factors in setting the utility's return. NS-PGL Reply Br. at 125-128.

Second, the Utilities counter CUB-City's claim that the leverage adjustment runs afoul of Section 9-211 of the Act because it would allow the Utilities to overearn. The Utilities point out that with or without the adjustment, their rates remain based on the return of and on the book value of their investment. *Id.* at 128. The adjustment pertains only to the return on that book value and it is necessary to synchronize a market cost of equity to the book value capital structure used for ratemaking. NS-PGL Ex. 24.0 REV at 14-15; NS-PGL Ex. 39.0 at 8.

Third, although it is true that the Commission has declined to adopt the leverage adjustment for general application in its ratemaking proceedings, the Utilities point out that this did not prevent the Commission from considering Mr. Moul's leverage-adjusted ROE of 10.85% in setting the Utilities' ROE in their last rate case. *Peoples Gas 2011* Order, p. 139.

Other Parties

[Insert]

4. <u>CAPM</u>

North Shore and Peoples Gas

The CAPM determines an expected rate of return on a security by adding to the "risk-free" rate of return a risk premium that is proportional to the non-diversifiable, or systematic, risk of the security. This model requires three inputs: (1) the risk-free rate of return, (2) a "beta" that measures systematic risk, and (3) the market risk premium. For the risk-free rate of return, Mr. Moul used historical and forecast yields on 20-year Treasury bonds and selected a mid-point of 4.25% based on current forecasts and

recent trends. NS Ex. 3.0 at 40; PGL Ex. 3.0 at 39-40. For the beta measurement of systematic risk, he used the average *Value Line* beta for the Gas Group, adjusted using the Hamada formula to reflect the application of this market-based measurement to the utility's book value capital structure used in ratemaking. NS Ex. 3.0 at 38-39; PGL Ex. 3.0 at 38-39. Mr. Moul developed his market premium of by averaging forecast data from *Value Line* and the S&P 500 Composite and historical data from Ibbotson Associates, all of which are sources routinely used by investors, analysts and academics. NS Ex. 3.0 at 40-42; PGL Ex. 3.0 at 40-42.[9]

In its application of the CAPM, Staff estimates the "systematic" risk measurement, or the "beta," for the proxy group by averaging betas published by one or more analytic firms like Value Line with a "regression" beta developed by Staff. Staff Ex. 5.0, at 24-28. The Utilities argue that this additional beta is irrelevant to a determination of their market equity cost because analysts and investors are unaware of and do not consider the Staff betas. NS-PGL Ex. 24.0 REV at 12. A more serious concern, however, is that in each of the Utilities' last four rate cases since 2007 including this one the Staff betas have always been lower than the Value Line betas. *Id.* Thus, the Utilities conclude, the Staff beta methodology is biased and serves to adjust the published betas downward to the Utilities' detriment. Accordingly, Staff's CAPM cost of equity measurement is unsound and should be rejected.

Other Parties

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5. <u>Risk Premium</u>

North Shore and Peoples Gas

The Risk Premium model measures the cost of equity by determining the degree to which equity has more risk than corporate debt, and adding that "equity risk premium" to the interest rate on long-term public debt. NS Ex. 3.0 at 31; PGL Ex. 3.0 at 30-31. Mr. Moul estimated a 5.50% prospective yield on A-rated utility bonds based on historical and forecasted yields. NS Ex. 3.0 at 31-33; PGL Ex. 3.0 at 32-33. Mr. Moul determined a risk premium of 5.50% by analyzing results for S&P Public Utilities and then adjusting those results based upon the results of his fundamental risk analysis in comparing the results for the S&P Public Utilities to the Gas Group. NS Ex. 3.0 at 33-35; PGL Ex. 3.0 at 33-35. Mr. Moul's risk premium analysis thus provided a cost of equity of 11.00%. NS Ex. 3.0 at 36-37; PGL Ex. 3.0 36-37.

The Utilities state that Staff's objection to Mr. Moul's Risk Premium approach – its use of historical data makes it "subject to manipulation" – is precisely why the

[9] Initially, Mr. Moul also adjusted his CAPM result for the relatively small size of the Gas Group, correcting a tendency of the model to understate the cost of equity of smaller companies. NS Ex. 3.0 at 42-43; PGL Ex. at 42-43. As part of the Utilities' compromise on ROE, they are not pursuing this position in this case. NS-PGL Ex. 39.0 at 2.

Commission should reject Staff's DCF and CAPM approaches due to their reliance on historical spot data. NS-PGL Reply Br. at 130. Staff's criticism is also an over-simplification. Although Mr. Moul used historical data, he analyzed the data and concluded they were representative of current market conditions. NS-PGL Ex. 24.0 REV at 13-14.

The Utilities also counter Staff's claim that Mr. Moul did not justify his equity risk premium by pointing out that the Utilities are A-rated and Mr. Moul selected a premium below the premium applicable to the S&P Public Utilities in order to account for differences between (1) that large sample that includes diversified energy companies and (2) distribution-only companies. *Id.* at 12-13.

Other Parties

[Insert]

6. <u>Effect of Riders UEA and VBA</u>

North Shore and Peoples Gas

The Utilities oppose Staff's 10-basis-point downward adjustment to their ROE for Rider UEA because, as Staff concedes, a majority of the Delivery Group companies have similar uncollectible expense trackers. NS-PGL Ex. 24.0 REV at 17-18; Staff Ex. 15.0 at 27. Therefore, an adjustment that assumes none of the Delivery Group companies have such trackers would overstate the Delivery Group's risk relative to that of the Utilities.

The Utilities assert that the Commission should increase their market-based equity costs by 10 basis points to reflect the risk that they will lose Rider VBA. NS-PGL Ex. 24.0 REV at 18-19. In the past, the Commission adjusted the Utilities' ROEs downward by 10 basis points to reflect that the Utilities had a decoupling mechanism. *Peoples Gas 2009* Order, p. 128; *Peoples Gas 2007* Order, p. 99. However, in the Utilities' last rate case, the Commission removed this adjustment in recognition that all of the Delivery Group companies have similar mechanisms. *Peoples Gas 2011* Order, p. 140. The situation is now reversed and the Utilities' Rider VBA is under court challenge. In addition, Staff opposes the Utilities' proposal for straight fixed variable rates if Rider VBA is ruled invalid. Under these circumstances, Staff cannot seriously contend that the Utilities risk is the same as the Delivery Group with respect to decoupling. Because the Utilities have more risk, their ROE should be adjusted upward.

Other Parties

[Insert]

7. Commission Analysis and Conclusions

a. The Context

Traditionally, the Commission has established rates of return on common equity for utilities by employing mathematical models designed to quantify the likely cost of attracting capital investment during the time rates are expected to be in effect. In virtually all cases, we have relied on the DCF and CAPM models. The Utilities urge the Commission also to consider in this case Mr. Moul's Risk Premium model, as well as relevant general market information, including a large sample of recent ROEs approved by this Commission and others, for context in our evaluation of the parties' various ROE proposals.

While we adhere to the position that the Commission does not base utility returns on those approved for other utilities, in Illinois or elsewhere, we do agree that we have an obligation to consider how our decisions will be perceived by the financial markets and what impact those perceptions might have on the Utilities, and thus, ultimately their customers. To this end, the Commission should take notice, through verifiable and well regarded sources, of general market conditions and trends because this information affects directly the decisions that investors make in the market. This information is relevant to our ROE decisions because we determine what investors demand and that requires consideration of the full array of information that investors consider when they effectively set the real cost of capital for a utility. *See Illinois Bell Tel. Co.,* ICC Docket Nos. 92-0448, 93-0239 (Cons.) (Order Oct. 11, 1994), p. 103.

Staff's objections to our consideration of such evidence are not well founded. Our consideration of large samples of recent authorized ROEs answers Staff's concern about comparability. Indeed, Staff itself routinely asks us to consider data averages with the assurance that using a sample mitigates measurement error. *E.g.,* Staff Exs. 5.0 at 28 & 15.0 at 14. Moreover, investors routinely rely on trend analysis and forecasting provided by governmental and commercial analysts. In deciding a utility's market cost of equity, we cannot pretend that such information regularly used by the market does not exist.

It is also important that we are apprised of current market conditions because our decisions affect at least in part the capital costs that the market sets for the Utilities, in particular through the credit rating agencies' evaluation of regulation quality and direction. As we opined in the Utilities' last rate case:

> We are cognizant that the Commission's ratemaking decisions are increasingly important to the Utilities' ability to maintain investment grade credit ratings and reasonable capital costs. Indeed the quality and direction of regulation, in particular the ability to recover costs and earn a reasonable return, are among the most important

> considerations when a credit rating agency assesses utility credit quality and assigns credit ratings. . . . [S]tate commissions play a critical and relevant role in defining the market for utility capital, and we understand that this Commission's decisions play a larger role in setting the Utilities' actual capital costs. The bottom line impact of setting a rate of return too low, unless warranted, could have a deleterious [effect] on a utility's ability to deliver quality service as well as higher credit costs that will make their way to each ratepayer[']s bill.

Peoples Gas 2011 Order, p. 137. Thus, we would be remiss if we ignored altogether, as Staff and CUB-City urge, the potential market reactions to our cost of capital decisions.

Based on the record before us, we find that the average of recent ROEs authorized for natural gas utilities is 9.94%. NS-PGL Init. Br. at 130-131. We also note that A-rated utility equity risk premiums have recently increased to an all-time high even as interest rates remain at historic lows. NS-PGL Ex. 39 at 3-4. This trend supports Value Line's forecasts for the Delivery Group's ROEs in 2013, which average 10.30%. NS-PGL Ex. 24.0 REV at 4-5. These general market data provide relevant comparative information as we assess the parties' various ROE provisions. They do not, however, replace our analysis of the Utilities' specific cost of equity using the traditional tools at our disposal, to which we now turn.

b. <u>The DCF Model</u>

In reviewing the results from the DCF model as performed by the Utilities and Staff, the Commission remains concerned that Staff's approach reflects bias in its choice between the constant and non-constant versions of the model. The Commission further agrees that the results currently being generated by Staff's DCF model for distribution utilities are too variable to provide a reliable estimate of the Utilities' cost of equity. An apparent source of this variation is Staff's continued reliance on historical spot data for its DCF and CAPM models. In this case, Staff has not addressed the Commission's requirement that it be informed of the financial climate at the time Staff collected its data and whether those conditions might cause material market inefficiencies or other measurement errors. *Peoples Gas 2009* Order, pp. 125-126. Accordingly, the Commission determines that the results from Staff's DCF are too anomalous, and in the absence of a check or other supporting information concerning the conditions and financial climate surrounding the data used, they are not a reliable basis on which estimate the Utilities' ROEs.

Although we acknowledge that analysts might disagree as to different variants and ways in which a model might be constructed, we deem Mr. Moul's DCF methodology to be reasoned and sound. Consistent with the Utilities' compromise position, we will consider the Utilities' DCF result for the Delivery Group only.

Turning to Mr. Moul's financial leverage adjustment to his DCF result, we find that it is based on the well-accepted, if not irrefutable, economic theory that there is a direct relationship between a firm's risk and the amount of debt in its capital structure. Currently, there is no dispute that the Delivery Group's average market value capital structure has more equity (and therefore less risk) than its average book value capital structure. In order to make a market cost of equity relevant and applicable to the utility's book value capital structure, an adjustment is required. Otherwise, if the market value cost of equity is applied to the utility's book value capital structure (and all other things are held equal), the utility will not recover its total cost of capital and will not earn its authorized return. NS-PGL Reply Br. at 129.

We reject Staff's argument that the leverage adjustment constitutes fair value ratemaking. That approach does not, as Staff claims, necessarily involve the application of a market return to a market value capital structure. But that is neither here nor there, as the leverage adjustment comes into play when we are applying a market return to a book value capital structure. We also reject CUB-City's claim that the adjustment violates Section 9-210 of the Act. Use of the adjustment does not result in over-earnings, but to the contrary prevents under-earnings.

Using well-accepted formulas, Mr. Moul calculated the Delivery Group's ROEs with an average book value equity ratio and with a market value equity ratio, and determined the ROE of the Delivery Group with a book value equity ratio to be 49 basis points higher than its ROE with a market value equity ratio.

Absent any competing calculation of this adjustment, we find that a 49 basis point upward adjustment to the Utilities' DCF-based cost of equity is necessary to apply that cost of equity to the Utilities' book value capital structures.

c. <u>The CAPM Model</u>

We find that the Utilities' CAPM analyses presents an appropriate basis to determine ROE. Mr. Moul's consideration of historical information in conjunction with current and forecast data is a reasonable approach for this financial model. Consistent with the Utilities' compromise position, we will consider the Utilities' CAPM result for the Delivery Group only, without adjustment for size.

In light of the undisputed evidence in the record that Staff's beta methodology typically generates lower betas than those published and relied upon by investors, we find that Staff's CAPM is biased and will not consider it.

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

We find that Mr. Moul's use of A-rated utility bonds and his development of an equity risk premium based on an analysis of historical data and current market conditions constitute a methodologically sound basis for estimating the Utilities' cost of equity. Thus, the Commission concludes that it is appropriate to include the results from this model in its determination of the Utilities' ROEs.

e. Adjustments for Riders UEA and VBA

With respect to Rider UEA, the Commission finds that Staff's proposed adjustment is not justified when a majority of the Delivery Group companies have similar uncollectible expense trackers. Although a downward adjustment of something less than 10 basis points might be appropriate to reflect the fact that some Delivery Group companies do not have such trackers, insufficient evidence is before us to make a determination. Therefore, we reject Staff's proposed adjustment.

As to Rider VBA, the Commission finds that the Utilities' risk in this regard is greater than that of the Delivery Group due to the pending court challenge, which led this Commission to set the Utilities' collections under the rider subject to refund as may be ordered by the reviewing court. The Utilities are reserving the amounts accrued and billed under the rider, and the Utilities' income statements do not reflect any earnings effect from the rider.

[Alternative 1 if SFV is authorized] However, this increased risk is substantially mitigated by our authorization of the Utilities' straight fixed variable rate proposal in the event that the courts invalidate Rider VBA. Therefore, we conclude that no adjustment to the Utilities' ROE is required.

[Alternative 2 if SFV is not authorized] Because we deny the Utilities' request to implement straight fixed variable rates in the event that the courts invalidate Rider VBA, we conclude that the Utilities' ROE must be adjusted to account for their increased risk relative to the Delivery Group. In the absence of evidence of any other adjustment than the Utilities' proposed 10-basis-points, we adopt it.

f. Conclusions

[Alternative 1 if SFV is authorized] Based on the foregoing discussion, the calculation of ROE will be affected by the following conclusions: (1) the leverage-adjusted DCF analysis performed by the Utilities for the Delivery Group will be included in this calculation; (2) the leverage-adjusted CAPM analysis of the Utilities for the Delivery Group will be included in this calculation; (3) the Utilities Risk Premium analysis for the Delivery Group will be included in this calculation; (4) Staff's adjustment for Rider UEA is rejected; and (5) the Utilities' adjustment for the legal challenge to Rider VBA is not accepted. Based on its review of the record, and consistent with the conclusions above, the Commission finds that an average of the Utilities' DCF, CAPM and Risk Premium models forms an appropriate basis to determine ROE, which results in an ROE of 10.00% for each Utility.

[Alternative 2 if SFV is not authorized] Based on the foregoing discussion, the calculation of ROE will be affected by the following conclusions: (1) the leverage-adjusted DCF analysis performed by the Utilities for the Delivery Group will be included in this calculation; (2) the leverage-adjusted CAPM analysis of the Utilities for the Delivery Group will be included in this calculation; (3) the Utilities Risk Premium analysis for the Delivery Group will be included in this calculation; (4) Staff's adjustment for Rider

UEA is rejected; and (5) the Utilities' adjustment for the legal challenge to Rider VBA is accepted. Based on its review of the record, and consistent with the conclusions above, the Commission finds that an average of the Utilities' DCF, CAPM and Risk Premium models forms an appropriate basis to determine ROE, which when adjusted for the risk to Rider VBA results in an ROE of 10.10% for each Utility.

F. Weighted Average Cost of Capital

1. North Shore

Based on the evidence in the record and the applicable legal principles, the Commission approves as just and reasonable an overall rate of return (weighted average cost of capital) for North Shore of 7.12%, calculated as follows:

North Shore Cost of Capital Summary			
Cost of Capital	**Percent of Total**	**Percent Cost**	**Weighted Cost**
Long Term Debt	42.33%	4.64%	1.96%
Common Equity	50.32%	10.00%[10]	5.03%
Short Term Debt	7.35%	1.80%	0.13
Total Capital			7.12%

2. Peoples Gas

Based on the evidence in the record and the applicable legal principles, the Commission approves as just and reasonable an overall rate of return (weighted average cost of capital) for Peoples Gas of 7.07%, calculated as follows:

[10] The Utilities' updated revenue requirements reflect an ROE of 10.00%. If the Commission adopts the Utilities' proposed adjustment for Rider VBA, the authorized ROE would be 10.10% and North Shore's overall rate of return would be 7.17%.

Peoples Gas Cost of Capital Summary			
Cost of Capital	**Percent of Total**	**Percent Cost**	**Weighted Cost**
Long Term Debt	43.61%	4.47%	1.95%
Common Equity	50.43%	10.00%[11]	5.04%
Short Term Debt	5.96%	1.26%	0.08
Total Capital			7.07%

VII. WEATHER NORMALIZATION – AVERAGED PERIOD (Uncontested)

The Utilities proposed using the average of twelve years of weather data, ending in 2010. PGL Ex. 4.0 at 10; NS Ex. 4.0 at 10. No party disagreed.

The Commission finds that the proposed average is reasonable and appropriate.

VIII. COST OF SERVICE

A. Overview

North Shore and Peoples Gas

Only the Utilities prepared embedded cost of service studies ("ECOSSs"), which they used to develop rate design proposals. NS Ex. 13.0, NS Exs. 13.1-13.8; PGL Ex. 13.0, PGL Exs. 13.1-13.8; NS-PGL Ex. 33.0, NS-PGL Exs. 33.2-33.15.

Other Parties

[Insert]

B. Embedded Cost of Service Study – Uncontested

North Shore and Peoples Gas

Utilities witness Ms. Hoffman Malueg stated that the ECOSS preparation involved three fundamental steps: (1) cost functionalization; (2) cost classification; and (3) cost allocation. NS Ex. 13.0 at 7-9; PGL Ex. 13.0 at 7-9. She explained in detail

[11] The Utilities' updated revenue requirements reflect an ROE of 10.00%. If the Commission adopts the Utilities' proposed adjustment for Rider VBA, the authorized ROE would be 10.10% and Peoples Gas' overall rate of return would be 7.12%.

how she performed each of these three steps and the methodologies to allocate various categories of costs. NS Ex. 13.0 at 9-25; PGL Ex. 13.0 at 9-26. The Utilities' ECOSSs showed their overall rates of return under present and proposed rates. NS Ex. 13.0 at 34-36; PGL Ex. 13.0 at 35-37.

Other Parties

[Insert]

Commission Analysis and Conclusions

Neither Staff nor any party contested the sufficiency of the Utilities' ECOSSs to develop rates in this proceeding nor did they develop ECOSSs of their own. The Utilities' ECOSSs are complete, they systematically functionalize, classify and allocate costs, and they comport with the cost causation principles for preparing such studies that the Commission has approved in many other rate cases. The Commission finds that the Utilities' ECOSSs are sufficient and reasonable for developing rate designs in this proceeding.

IX. RATE DESIGN

A. Overview

North Shore and Peoples Gas

Utilities witness Ms. Grace explained that the Utilities' proposed rate designs were intended to and would accomplish the following six major objectives: (1) recover the revenue requirement, (2) better align rates and revenues with underlying costs, (3) send proper price signals, (4) provide more equity between and within rate classes, (5) reflect gradualism considering test year revenue requirements, and (6) distinguish between low use and high use Service Classification ("S.C.") No. 1, Small Residential Service, customers as the Commission directed. NS Ex. 12.0 Rev. at 6; PGL Ex. 12.0 Rev. at 6.

Other Parties

[Insert]

B. General Rate Design

1. Allocation of Rate Increase

North Shore and Peoples Gas

The Utilities used their ECOSSs to allocate revenue requirements and develop rates. Their ECOSSs and the descriptions of their rate designs, including the supporting exhibits, are detailed and specific enough that it would be straightforward to derive rates from the revenue requirements the Commission approves. NS Ex. 12.0 Rev. at 7-9; PGL Ex. 12.0 Rev. at 7-9. No other party prepared cost of service studies or a comprehensive rate design to meet the full revenue requirements the Commission approves. NS-PGL Ex. 32.0 at 33-34; NS-PGL Ex. 48.0 Rev. at 11-12. To the extent the AG's initial brief suggested a different approach for Service Classification ("S.C.") No. 1, the Utilities stated that the AG's proposal is unclear and unworkable. The Utilities stated that the AG referenced exhibits from its witness' direct testimony, which is only for S.C. No. 1 heating rates. The Utilities will need to develop rates for all their service classifications, including the S.C. No. 1 non-heating and heating classes, following receipt of a final order. At best, the AG's proposal is incomplete. Also, the referenced exhibits are from AG witness Mr. Rubin's direct testimony, yet the AG's proposal appears to be an amalgam of his direct and rebuttal proposals. Moreover Mr. Rubin's proposals rely on the AG's proposed revenue requirement adjustments that the Utilities showed are flawed and problematic for many reasons. NS-PGL Ex. 48.0 Rev. at 13-18.

Other Parties

[Insert]

Commission Analysis and Conclusions

The Commission finds that the Utilities' ECOSSs should be used, together with the rate designs and revenue requirements we approve in this Order, to determine rates.

2. <u>Uniform Numbering of Service Classifications</u>

North Shore and Peoples Gas

In response to a 2011 rate cases directive (*Peoples Gas 2011* Order, p. 169), North Shore proposed changes to its service classifications to establish uniformity with Peoples Gas' service classification numbering to the extent possible. If approved, Utilities witness Ms. Grace stated that North Shore will make the required tariff revisions in its compliance filing. NS Ex. 12.0 Rev. at 25-26; PGL Ex. 12.0 Rev. at 26.

Other Parties

[Insert]

Commission Analysis and Conclusions

The Commission finds that North Shore's proposal to conform its service classification numbering to Peoples Gas' format, to the extent applicable, is appropriate

and meets the directive from the *Peoples Gas 2011* Order. The Commission directs North Shore, in its compliance filing, to make all tariff changes necessary to implement this proposal.

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

North Shore and Peoples Gas

In response to a 2011 rate cases directive (*Peoples Gas 2011* Order, pp. 188-189), Utilities witness Ms. Grace stated that the Utilities proposed to split the S.C. No. 1 class into heating and non-heating classes. They did not create separate service classifications, *i.e*., the customers would continue to receive service under S.C. No. 1 but at different rates. For clarity in the record, the Utilities referred to the heating and non-heating proposals as S.C. No. 1 HTG and S.C. No. 1 NH, respectively. NS Ex. 12.0 Rev. at 11-12; PGL Ex. 12.0 Rev. at 12.

In response to CUB-City, the Utilities first stated that only they and Staff provided comprehensive rate design testimony. The AG offered rate design proposals for S.C. No. 1, and it based those proposals on the heating/non-heating split. CUB-City offered no rate design testimony. The Utilities concluded that the record includes no alternative to the heating/non-heating split for the Commission to adopt, despite CUB-City's reference to the Commission adopting a "superior rate design" to address its low use/high use directive.

Second, the Utilities stated that the reasonableness of their proposal is evident. It is uncontested that non-heating customers' usage is low. CUB-City stated that 85% of Peoples Gas bills and 75% of North Shore bills for the proposed non-heating class are for 10 therms or less. CUB-City Init. Br. at 63. Further, 95% of North Shore non-heating customer bills are for 50 therms or less, and, annually, the average customer uses only 163 therms. NS-PGL Ex. 32.0 at 7-8. For Peoples Gas, 96% of non-heating customer bills are for 30 therms or less, and, annually, the average customer uses only 93 therms. *Id*. at 16. For the proposed heating class, 58% of North Shore and 52% of Peoples Gas bills are for more than 50 therms. *Id*. at 22, 27.

Third, in response to CUB-City's criticism that the Utilities did not study "individual customer usage, the Utilities pointed out that North Shore has more than 145,000 and Peoples Gas has more than 750,000 S.C. No. 1 customers. NS Ex. 13.5, PGL Ex. 13.5. Moreover, the purpose of an ECOSS is to identify the revenues, costs and profitability for each class of service, not for individual customers. NS Ex. 13.0 at 6; PGL Ex. 13.0 at 6; *also see* NS-PGL Ex. 33.0 at 6. The Utilities also noted that the Commission's rules describe the required study as an embedded <u>class</u> cost of service study. 83 Ill. Adm. Code § 285.5110.

Fourth, the Utilities stated that the Commission's Order contemplated that a heating/non-heating split would be a possible outcome of its directive. *Peoples Gas 2011* Order, pp. 188-189. The Utilities presented ECOSSs that distinguished between

high and low use customers in the form of classifying customers as heating or non-heating. As Utilities witness Ms. Hoffman Malueg stated, "[i]t was my understanding that [Peoples Gas] and North Shore did propose a bifurcation of Service Class 1 in the past, and that the distinction kept in our [customer information system] of heating and nonheating followed the same general principles of low use versus high use." Tr. 2/8/13 at 691.

Finally, the Commission's stated purpose of its requirement from the last rate case is to better reflect customer class homogeneity. The Utilities' proposals achieve this purpose. The Utilities explained that some degree of non-homogeneity will necessarily exist in a rate class, but their proposal significantly increases S.C. No. 1 homogeneity. NS-PGL Ex. 33.0 at 6; Tr. 2/8/13 at 684.

Other Parties

[Insert]

Commission Analysis and Conclusions

The Commission, in the *Peoples Gas 2011* Order, required the Utilities "to present an ECOSS to distinguish between low use and high use S.C. No. 1 customers. Such proposals may include, without limitation, a rate design including a demand charge or a bifurcation of the S.C. 1 class into heating and non-heating classes or some other rate structure that better reflects customer class homogeneity to bring each group's bills more into line with their respective costs of service." The Commission finds that the Utilities met this requirement by proposing a rate design that split its S.C. No. 1 into heating and non-heating customer groups, as this split properly distinguishes low and high use customers and will improve homogeneity in the rate class. While other rate designs may exist to accomplish this goal, Staff, the AG and the Utilities each based their proposals on a heating/non-heating distinction and that approach addresses our concerns. No party proposed an alternative method. Moreover, no other party submitted ECOSSs that would provide an alternative proposal for distinguishing between low and high usage customers. The Commission also approves the Utilities' approach of including heating and non-heating rates in S.C. No. 1, rather than creating a new service classification.

4. <u>Terms and Conditions of Service</u>

North Shore and Peoples Gas

The Utilities proposed adding language to address the proposed distinction between heating and non-heating S.C. No. 1 customers in the context of customers applying for service and remaining on the appropriate service classification. They also proposed revising the bill format. NS Ex. 12.0 Rev. at 25; PGL Ex. 12.0 Rev. at 26.

Other Parties

[Insert]

Commission Analysis and Conclusions

The Commission finds that the Utilities' proposed changes to their Terms and Conditions are necessary and appropriate to implement the proposal to split S.C. No. 1 into heating and non-heating rates, which we discuss and approve in Section IX.B.3 of this Order.

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)

North Shore and Peoples Gas

S.C. No. 2 for North Shore and Peoples Gas is General Service. Utilities witness Ms. Grace stated that Peoples Gas proposed to: maintain three meter classes; increase the monthly customer charges for each meter class to move the charges closer to cost, leaving 46% of fixed costs to be recovered through volumetric distribution charges; recover all customer costs and a portion of non-storage related demand costs through the customer charge; and maintain the three declining block distribution charge. Peoples Gas described in detail how it would develop rates based on the Commission-approved revenue requirement. PGL Ex. 12.0 Rev. at 19-21.

North Shore made comparable proposals but its fixed cost recovery through volumetric distribution charges would be 33%. NS Ex. 12.0 Rev. at 19-21.

In response to Staff, the Utilities agreed to examine the number of blocks and the block sizes for S.C. No. 2 in the Utilities' next rate case filings but noted that, under their SFV and modified SFV proposals, this would not be necessary. NS-PGL Ex. 32.0 at 30.

Under the Utilities' proposal, Rider VBA, Volume Balancing Adjustment, a full decoupling mechanism, would remain in effect for S.C. No. 2, with a revised Rate Case Revenue ("RCR") that would arise from the distribution revenues to be set in this proceeding. Ms. Grace explained that the Utilities proposed an alternative SFV rate design if, for specified reasons, Rider VBA is no longer in effect. The Utilities showed that the Rider VBA Percentage of Fixed Costs should be set at 100%. NS Ex. 12.0 Rev. at 21; PGL Ex. 12.0 Rev. at 21.

Other Parties

[Insert]

Commission Analysis and Conclusions

The Commission finds that each of Peoples Gas' and North Shore's S.C. No. 2 rate designs are appropriate and reasonable. Moving greater fixed cost recovery to fixed charges is sound rate design and consistent with long-standing Commission policy. As long as Rider VBA remains in place, the Utilities should move towards fixed cost recovery through fixed charges on a gradual basis and the Commission will not approve, on a primary basis, SFV or modified SFV rate design at this time as Rider VBA will remain in effect.

The Commission addresses the Utilities' alternative SFV proposals in Section IX.C.2.c, *infra*.

As discussed in Section IX.D, *infra*, the Commission makes no changes to Rider VBA and its applicability. The Commission directs the Utilities to file updated Rider VBA RCRs. The Commission also directs each of the Utilities to set the Rider VBA Percentage of Fixed Costs at 100%.

The Commission adopts Staff's proposal and orders the Utilities to examine the number and size of distribution charge rate blocks in their next rate case filings.

b. <u>Large Volume Demand Service</u>

North Shore and Peoples Gas

Utilities witness Ms. Grace stated that Peoples Gas proposed, for its S.C. No. 4, Large Volume Demand Service, setting the monthly customer charge at cost. The demand charge will recover 55% of non-storage related demand costs, and the distribution charge will recover remaining non-storage related demand costs. PGL Ex. 12.0 Rev. at 22.

Ms. Grace stated that North Shore proposed, for its S.C. No. 3, Large Volume Demand Service, setting the monthly customer charge at cost. The demand charge will recover 67% of non-storage related demand costs, and the distribution charge will recover remaining non-storage related demand costs. NS Ex. 12.0 Rev. at 21-22.

Other Parties

[Insert]

Commission Analysis and Conclusions

The Commission finds that each of Peoples Gas' and North Shore's rate designs for their large volume demand service classifications are appropriate and reasonable. It is proper to set these service classifications at cost, and the level of fixed demand cost

recovery in demand charges is reasonable. The proposals are uncontested. The Commission approves the Utilities' proposed S.C. No. 3 (North Shore) and S.C. No. 4 (Peoples Gas) rate designs.

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

North Shore and Peoples Gas

Peoples Gas proposed to set S.C. No. 8, Compressed Natural Gas Service, at cost. PGL Ex. 12.0 Rev. at 22. North Shore does not have a comparable service classification. NS Ex. 12.0 Rev. at 25.

Other Parties

[Insert]

Commission Analysis and Conclusions

The Commission finds that Peoples Gas' rate design for its compressed natural gas service classification is appropriate and reasonable. It is proper to set this service classification at cost. The proposal is uncontested. The Commission approves Peoples Gas' proposed S.C. No. 8 rate design.

d. Contract Service for Electric Generation

North Shore and Peoples Gas

The Utilities proposed no changes to these service classifications. NS Ex. 12.0 Rev. at 22; PGL Ex. 12.0 Rev. at 22.

Other Parties

[Insert]

Commission Analysis and Conclusions

The Commission approves the Utilities' proposals to make no changes to these contract service classes.

e. Contract Service to Prevent Bypass

North Shore and Peoples Gas

The Utilities proposed no changes to these service classifications. NS Ex. 12.0 Rev. at 22; PGL Ex. 12.0 Rev. at 22.

Other Parties

[Insert]

Commission Analysis and Conclusions

The Commission approves the Utilities' proposals to make no changes to these contract service classes.

f. Rider SSC, Storage Service Charge

North Shore and Peoples Gas

The Utilities each proposed revising the Rider SSC Storage Banking Charge, which applies to transportation customers, and the Storage Service Charge, which applies to sales customers to meet their proposed storage-related revenue requirements. For North Shore, the production-related revenue requirement is also included in the calculation. The Commission-approved storage-related revenue requirement will determine the Rider SSC charges that the Utilities will include in their compliance filings. NS Ex. 12.0 Rev. at 23; PGL Ex. 12.0 Rev. at 23; NS-PGL Ex. 32.0 at 32.

Other Parties

[Insert]

Commission Analysis and Conclusions

The Commission directs the Utilities to file Rider SSC charges (Storage Banking Charge and Storage Service Charge) consistent with the revenue requirements it is approving in this Order.

2. Contested Issues – North Shore and Peoples Gas

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

North Shore and Peoples Gas

Utilities witness Ms. Grace stated that the Utilities each proposed, for S.C. No. 1 NH, recovery of 80% of non-storage related fixed costs through the customer charge, with recovery of all remaining costs through a flat distribution charge. NS-PGL Ex. 32.0 at 13-14, 19. Currently S.C. No. 1 has a declining two block structure with a front block of 0-50 therms. As about 95% of North Shore's S.C. No. 1 NH monthly bills are for 50 therms or less and about 96% of Peoples Gas' S.C. No. 1 NH monthly bills are for 30 therms or less, a flat rate structure is more appropriate than a blocked rate structure. NS Ex. 12.0 Rev. at 12; PGL Ex. 12.0 Rev. at 13; *also see* NS-PGL Ex. 32.0 at 7-8, 16.

Ms. Grace further testified that the Utilities would continue to recover storage-related fixed costs through Rider SSC. Rider SSC recovers the cost of storage on a uniform per-therm of capacity basis from transportation customers and on a uniform per-therm of usage basis from sales customers, with an annual reconciliation of revenues and costs. NS Ex. 12.0 Rev. at 8, 14; PGL Ex. 12.0 Rev. at 8, 14; NS-PGL Ex. 32.0 at 11, 18.

The Utilities explained that, increasing the level of costs recovered through the fixed customer charges would better align the charges with their underlying fixed costs and reduce the magnitude of Rider VBA adjustments. NS Ex. 12.0 Rev. at 15; PGL Ex. 12.0 Rev. at 15. It is also consistent with Commission policy. For example, in Docket No. 95-0032 the Commission urged Peoples Gas to increase the customer charge in future rate proceedings to move it closer to cost.[12] In the Utilities' 2007 and 2009 rate cases, the Commission found it appropriate that rates reflect a greater recovery of fixed costs in customer charges.[13] In a Union Electric case (Docket No. 03-0009), the Commission endorsed the utility's efforts to recover all of its fixed customer related costs of serving residential customers through the customer charge component of rates as well as a gradualism approach to doing so.[14] The Commission allowed the Ameren gas utilities and Nicor to recover, for their residential and small commercial rate classes, 80% of their fixed costs through the customer charge.[15] Finally, in the Utilities' 2011 rate cases, in connection with adopting Rider VBA on a permanent basis, the Commission again stated its support for increased recovery of fixed costs through fixed charges. *Peoples Gas 2011* Order, p. 188; NS Ex. 12.0 Rev. at 15-16; PGL Ex. 12.0 Rev. at 15-17.

The Utilities stated that, as the Commission found in the 2011 rate cases (*Peoples Gas 2011* Order, p. 238) and it remains the case, all of the Utilities' S.C. No. 1 costs are fixed. Accordingly, the Rider VBA Percentage of Fixed Costs should continue to be set at 100%. Under the Utilities' proposal, Rider VBA would remain in effect for S.C. No. 1, with a revised RCR and the Utilities proposed alternative SFV rates if Rider

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[12] *Re The Peoples Gas Light and Coke Company*, 1995 WL 17200632 (Ill.C.C. Nov 8, 1995) (Docket No. 95-0032), at 39.

[13] *Peoples Gas 2007* Order, pp. 249-250; *Peoples Gas 2009* Order, p. 218.

[14] *Central Illinois Public Service Company et al.*, ICC Docket Nos. 03-0008 *et al*. (cons.), (Order Oct. 22, 2003), at 115-117.

[15] *Ameren Illinois Utilities*, ICC Docket Nos. 07-0585, *et al.* (cons.), (Order Sept. 24, 2008), at 237; *Northern Illinois Gas Co. d/b/a Nicor Gas Co.*, ICC Docket No. 08-0363, (Order Mar. 25, 2009), at 71, 90-91.

VBA is no longer in effect for specified reasons. NS Ex. 12.0 Rev. at 14, 17; PGL Ex. 12.0 Rev. at 14, 17.

The Utilities stated that AG witness Mr. Rubin's rate design proposal, given his willingness not to contest the applicability of Rider SSC to this rate, is not unreasonable. NS-PGL Ex. 32.0 at 9; NS-PGL Ex. 48.0 Rev. at 4. However, the Utilities accepted Staff witness Mr. Johnson's proposal and, unlike Mr. Rubin, Mr. Johnson does not oppose the continued applicability of Rider VBA to this rate.

The Utilities argued that their proposed S.C. No. 1 non-heating rate design is consistent with the Commission's directive to present a bifurcated S.C. No. 1, shows reasonable and gradual movement towards greater fixed cost recovery through fixed charges, and includes a flat distribution charge, which is appropriate in light of the usage profile of customers who will receive service under this rate.

Other Parties

[Insert]

Commission Analysis and Conclusions

The Commission finds that each of Peoples Gas' and North Shore's S.C. No. 1 NH rate designs, as revised in rebuttal in response to Staff testimony, are appropriate and reasonable. Moving greater fixed cost recovery to fixed charges is sound rate design and consistent with long-standing Commission policy. As long as Rider VBA remains in place, the Utilities should move towards fixed cost recovery through fixed charges on a gradual basis.

The Commission addresses the Utilities' alternative SFV proposals in Section IX.C.2.c, *infra*.

As discussed in Section IX.D, *infra*, the Commission makes no changes to Rider VBA and its applicability. The Commission directs the Utilities to file updated Rider VBA RCRs. The Commission also directs each of the Utilities to set the Rider VBA Percentage of Fixed Costs at 100%.

b. <u>Service Classification No. 1, Small Residential Heating</u>

North Shore and Peoples Gas

The Utilities each proposed, for S.C. No. 1 HTG, recovery of 80% of non-storage related fixed costs through the customer charge, with recovery of all remaining costs through a flat distribution charge. The Utilities showed that moving to a flat distribution charge from the current declining two-block rate produces more favorable bill impacts than those derived from the Staff and AG proposals that retain a blocked distribution charge. Grace Reb., NS-PGL Ex. 32.0 at 23, 27.

The Utilities proposed to continue to recover storage-related fixed costs through Rider SSC. Rider SSC recovers the cost of storage on a uniform per-therm of capacity basis from transportation customers and on a uniform per-therm of usage basis from sales customers, with an annual reconciliation of revenues and costs. NS Ex. 12.0 Rev. at 8, 13-14; PGL Ex. 12.0 Rev. at 8, 12, 14.

The Utilities, citing the Commission's findings in the 2011 rate cases (*Peoples Gas 2011* Order, p. 238), said it remains the case that all of the Utilities' S.C. No. 1 costs are fixed. Accordingly, the Rider VBA Percentage of Fixed Costs should continue to be set at 100%. Increasing the level of costs recovered through the fixed customer charges would better align the charges with their underlying fixed costs and reduce the magnitude of Rider VBA adjustments. NS Ex. 12.0 Rev. at 15; PGL Ex. 12.0 Rev. at 15. It is also consistent with Commission policy, as discussed for S.C. No. 1 NH.

The Utilities stated that their fundamental disagreement with Staff's proposal is the insignificant movement towards greater fixed cost recovery through fixed charges. This is contrary to longstanding Commission policy. The Utilities stated that Staff's S.C. No. 1 proposals produce the incongruous recommendation that, absent Rider VBA, the Utilities' S.C. No. 1 HTG rate would be the only small residential rate class with less than 80% fixed cost recovery among the state's largest utilities. NS-PGL Ex. 32.0 at 35.

Additionally, the Utilities noted that Mr. Johnson cited "price signals" as a reason for leaving non-storage related demand costs in the distribution charge as it will "encourag[e] conservation." Staff Init. Br. at 106-107. Staff did not square its recommendation with the Commission's observation in a Nicor Gas rate case that "[t]he portion of fixed costs that are currently recovered through a volumetric charge are in fact fixed costs, and thus cannot be conserved. Moving a greater percentage of fixed cost recovery to fixed charges rather than volumetric charges provides a more stable revenue stream <u>and</u> <u>sends</u> <u>a</u> <u>better</u> <u>price</u> <u>signal</u> <u>to</u> <u>the</u> <u>consumer</u>." (emphasis added) *In re Northern Illinois Gas Company d/b/a Nicor Gas Company*, ICC Docket No. 08-0363, at 91 (Order Mar. 25, 2009)

To illustrate the flaw in Staff's proposal, the Utilities stated that one example of a type of costs classified as demand is transmission and distribution mains designed to meet customer maximum peak day demand. NS Ex. 13.0 at 8; PGL Ex. 13.0 at 8. Under Staff's proposal, a customer who uses less gas will not pay his share of the costs associated with the main(s) that serve the customer because Staff would place recovery of demand costs in a volumetric charge. Indeed, under Staff's proposal, if a customer's peak day usage increases but usage on non-peak days declines in a greater quantity, the customer pays less than the allocated cost of the main from which it takes service even though its demand on that main increased.

Under the Utilities' proposal, Rider VBA would remain in effect for S.C. No. 1, and as discussed in Section IX.C.2.c, *infra*, the Utilities proposed alternative SFV rates if Rider VBA were no longer in effect for specified reasons. NS Ex. 12.0 Rev. at 14, 17; PGL Ex. 12.0 Rev. at 14, 17.

The Utilities stated that the AG's and CUB-City's disagreement with the Utilities' S.C. No. 1 HTG proposal is largely about the nature of costs classified as "demand." Demand-related costs are fixed costs. As the Commission concluded in the Utilities' 2009 rate cases, "[w]e find compelling Ms. Grace's explanation that demand costs (also known as capacity costs) are fixed costs and not volumetrically based." *Peoples Gas 2009* Order, p. 225. The Utilities stated that in ordering the Utilities to adopt Rider VBA on a permanent basis, the Commission ordered the Utilities to set the percentage of fixed costs at 100% (*Peoples Gas 2011* Order, p. 238), *i.e*., finding that all the Utilities' costs, which would include demand-related costs, are fixed.

The Utilities explained that, although demand-related costs may be spread among rate classes using certain usage based allocation methodologies, demand-related costs do not vary with customers' usage and cost-based ratemaking does not require that they be recovered through distribution charges. The Utilities cited the Gas Distribution Rate Design Manual Prepared by the National Association of Regulatory Utility Commissioners ("NARUC") in support:

> The most controversial issue is deciding where capacity [demand] costs belong in the rate. Because they are fixed costs, it is sometimes argued that they should be part of the customer charge. On the other hand, it can be argued that … those common fixed costs should be recovered evenly from all units of commodity sold. It is even occasionally proposed that these costs be spread between customer and commodity [distribution] charges.

This passage confirms that demand-related costs are fixed, but acknowledges that a few acceptable methodologies exist for recovering such costs. The Utilities showed that, consistent with accepted methodologies and recent Commission policy, such fixed costs should be recovered through a fixed charge such as the customer charge. Nonetheless, in the interest of rate design continuity and gradualism, they proposed, if Rider VBA remains in effect, to spread such costs between the customer and distribution charges for S.C. No. 1 NH and HTG customers. NS-PGL Ex. 48.0 Rev. at 8; *also see* NS-PGL Ex. 33.0 at 8.

The Utilities explained that it is clear from the definition of costs classified to the demand classification that the key is the customer's usage on the peak or the coldest winter day, *i.e*., the customer's maximum peak day demand. NS Ex. 13.0 at 8; PGL Ex. 13.0 at 8; Tr. 2/8/13 at 674. It is not mere day-to-day variations in usage that drive demand costs. By contrast, the commodity-related costs are those that vary with throughput sold or transported to customers. NS Ex. 13.0 at 8; PGL Ex. 13.0, 8; Tr. 2/8/13 at 674.

The Utilities stated that the Commission should reject AG witness Mr. Rubin's proposal. It provides an even lesser amount of fixed cost recovery through fixed charges than Staff's and is inconsistent with sound rate design proposals and Commission precedent. NS-PGL Ex. 32.0 at 21-22, 26-27. The Utilities analyzed the

bill impacts of Mr. Johnson's and Mr. Rubin's proposals and showed that the Utilities' proposals had a more favorable bill impact on customers at varying usage levels. *Id*. at 23-25, 27-29; NS-PGL Exs. 32.7, 32.8, 32.9, 32.10.

The Utilities also responded to CUB-City's and AG's contention, citing diverse home sizes, that the S.C. No. 1 heating class is not homogenous. The Utilities stated that the intervenors implicitly assume that larger homes, in all cases, use more gas than smaller dwellings. However, many factors affect customers' gas usage such as the energy efficiencies of the dwelling and its appliances, the number of people in the household, the ages of household members, individual comfort preferences and employment status, among others. NS-PGL Ex. 32.0 at 23; NS-PGL Ex. 48.0 Rev. at 9.

Finally, the Utilities explained that, in support of its rate design proposal, the AG cites various provisions in Section 1-102 of the Act and describes them as "statutory requirements." AG Init. Br. at 113. Section 1-102 of the Act, Findings and Intent, does not set forth "statutory requirements." "Section 1–102 of the Public Utilities Act is nothing more than prefatory. As such, it is of no substantive or positive legal force." *Monarch Gas Co. v. Illinois Commerce Comm'n.*, 261 Ill. App 3d 94, 99 (5th Dist. 1994) appeal denied 157 Ill. 2d 505 (1994).

Other Parties

[Insert]

Commission Analysis and Conclusions

The Commission finds that the Utilities' proposed S.C. No. 1 heating rate design is consistent with the Commission's directive to present a bifurcated S.C. No. 1, shows reasonable movement towards greater fixed cost recovery through fixed charges, and includes a flat distribution charge, which is appropriate in light of the bill impacts associated with this change. Staff's proposal shows too little movement towards recovering fixed costs through fixed charges, *e.g*., increasing such recovery for North Shore by only 1%. While Staff's proposed increase in fixed cost recovery for Peoples Gas is greater – 54% to 61% -- the 61% is significantly lower than what Staff is recommending for North Shore and much lower than what the Commission approved for Ameren and Nicor Gas. The AG witness' proposals are a large step backwards from the Commission's gradual movement to a rate design that recognizes fixed costs should be recovered in fixed charges. Coupled with the AG's opposition to Rider VBA and an alternative SFV rate design, the AG proposal would substantially and improperly deviate from Commission rate design policy. The Commission approves the Utilities' S.C. No. 1 HTG rate design.

The Commission addresses the Utilities' alternative SFV proposals in Section IX.C.2.c, *infra*.

As discussed in Section IX.D, *infra*, the Commission makes no changes to Rider VBA and its applicability. The Commission directs the Utilities to file updated Rider VBA

RCRs. The Commission also directs each of the Utilities to set the Rider VBA Percentage of Fixed Costs at 100%.

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

North Shore and Peoples Gas

Utilities witness Ms. Grace explained that the Utilities proposed that, under specified circumstances, the S.C. Nos. 1 NH, 1 HTG, and 2 rate designs would be replaced by SFV rate designs and charges that the Commission sets in this proceeding based on the revenue requirements it adopts in this proceeding. NS Ex. 12.0 Rev. at 17; PGL Ex. 12.0 Rev. at 17. Under SFV rate design, all fixed costs related to gas distribution service (those that do not vary with customer usage) are recovered through fixed charges, such as a monthly customer charge, and those costs that vary with customer usage are recovered through a volumetric charge, such as a distribution charge. NS Ex. 12.0 Rev. at 16; PGL Ex. 12.0 Rev. at 17. The Utilities included language in S.C. Nos. 1 and 2 to define the circumstances under which SFV rates would take effect and the specific rates that would take effect. The two specific events that would trigger the implementation of the SFV rates are (1) a Court finds or holds that the Commission lacks or lacked authority to approve Rider VBA, or (2) Rider VBA is otherwise not permitted to remain in effect by action of the Commission. Were either event to occur, then the SFV rates would take effect 90 days after the date of such Court or Commission action, or such other date as ordered by such Court or the Commission. Although the tariff would include the charges and the triggering events such that customers are on notice of the new rates, the Utilities would also provide prior notice to customers of the triggering event and the SFV rates. That additional notice, if possible, would be 30 days. NS-PGL Ex. 48.0 Rev. at 10-11.

Ms. Grace stated that the Utilities' decoupling mechanisms are on appeal. 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. NS Ex. 12.0 Rev. at 16-17; PGL Ex. 12.0 Rev. at 16-17.

The Utilities stated that arguments that their alternative SFV rate design is unlawful rest on contentions that, contrary to Section 9-201 of the Act, the Utilities would (1) place new rates into effect (2) without prior notice. The Utilities stated that the flaw in these arguments is that they rely on mischaracterizations about the proposal. The Utilities, *inter alia*, proposed specific rate designs, including customer charges and distribution charges, for their S.C. Nos. 1 and 2 ("primary proposal"). The primary proposal presumes that Rider VBA remains in effect and, as with the rates that the Commission approved in *Peoples Gas 2011*, provide less than full recovery of fixed costs through fixed charges. The Utilities did not merely propose specific charges stated in dollars and cents but proposed rate design methodologies that, coupled with their ECOSSs, will allow them to calculate specific rates based on the revenue

requirements the Commission approves. Additionally and alternatively, the Utilities proposed specific rate designs and charges that would take effect if Rider VBA were not in effect ("alternative proposal") and would replace the charges developed under the primary proposal. The testimony and exhibits likewise stated those charges and the methodology for deriving them using the revenue requirements the Commission adopts. The Utilities' proposal is that the Commission approve rate designs and charges that are in effect if and while Rider VBA is in effect (*i.e*., the primary proposal) and that the Commission approve an alternative set of rate designs and charges if and while Rider VBA is not in effect (*i.e*., the alternative proposal). NS Ex. 12.0 at 17, 21; NS Exs. 12.4, 12.5; PGL Ex. 12.0 at 17, 21; PGL Exs. 12.4, 12.5; NS-PGL Exs. 32.1, 32.2, 32.3, 32.4; NS-PGL Ex. 48.0 Rev. at 10-11.

The Utilities stated that the approved tariffs would show both sets of charges and their effective dates, either in terms of the effective date stated on the sheet for the charges determined under the primary proposal or the precisely defined events described in the tariff sheet that would result in the charges determined under the alternative proposal taking effect and replacing the first set of rates. Only one set of rates would be in effect at any time.

The Utilities contrasted these facts with the situation in *Citizens Utility Board v. Illinois Commerce Comm'n.*, 275 Ill. App. 3d 329 (1st Dist. 1995) ("*CUB*"). The Court found that a Commonwealth Edison Company tariff (Rate CS) permitting the utility to negotiate rates with a customer as long as the rates exceeded incremental costs was unlawful. The Court's concern was that the tariff contained no charges. Until the utility negotiated a contract, there would be no charges under the tariff. The tariff granted the utility the right to set rates in the future. *CUB* at 339. In contrast, the Utilities filed a tariff that includes specific charges. One set of filed and public tariff charges will take effect with the compliance filing. The alternative set of filed and public tariff charges will take effect upon the occurrence of specific events. The infirmity that the Court identified with Rate CS does not exist. The customers' notice of the alternative charges is identical to the notice of the first set of rates. The Utilities filed this case under Section 9-201 of the Act. The filed tariffs show the primary proposal and the alternative proposal. The Utilities' testimony described the derivation of those charges. The Utilities complied with the Section 9-201 notice requirements applicable to this filing. NS Ex. 12.0 Rev. at 5; PGL Ex. 12.0 Rev. at 5; NS-PGL Ex. 32.17.

The Utilities stated that the AG's argument that it is somehow inappropriate that the alternative proposal charges be based on the same revenue requirement as approved in this case because "a utility's expenses and revenues are dynamic ever-changing" (AG Init. Br. at 120) is puzzling. The AG's observation that costs and revenues are ever-changing is axiomatic. A switch to SFV rates derived from the Commission-approved revenue requirement and set forth in the compliance filing in this proceeding serves no different function than the Utilities' primary proposal – rates that create an opportunity for the Utilities to recover their approved revenue requirements.

The Utilities disputed the AG's claim that the proposal is contrary to the test year rule. The test year for all the Utilities' proposed rates is 2013. The proposal does not

circumvent the test year requirements. The Utilities simply presented two ways of designing rates using the same revenue requirements.

The Utilities also responded to Staff's policy arguments.

First, Staff's concern about the differing impacts of decoupling *versus* SFV on low and high use customers (Staff Init. Br. at 108-109) is addressed by the Utilities' bifurcation proposal. The Utilities' proposed primary and alternative rate designs are designed to recover the same revenue requirements from customers. The bifurcation increases the homogeneity of customer classes within S.C. No. 1 and, thus, addresses concerns about the relatively different impact on low *versus* high use customers.

Second, Staff's proposed increase in fixed cost recovery through fixed charges is minimal, remains far below the modified SFV rate designs the Commission approved for Nicor Gas and Ameren (80% fixed cost recovery in fixed charges) and is far below the full decoupling represented by Rider VBA.

Third, Staff is correct that the Utilities may file a rate case to address a change in circumstances, but that is not a reason to avoid addressing the matter in the instant rate case. Moreover, rates from that filing would not take effect for eleven months, creating an unnecessary lag between the Court or Commission action invalidating Rider VBA and the implementation of appropriate rate designs.

Fourth, the fact that the Utilities are using a forecast test year with forecast customer demand does not bear on the issue. The forecast assumes normal weather. NS Ex. 4.0 at 10; PGL Ex. 4.0 at 10. While more frequent rate cases and a future test year would provide the Utilities timelier cost recovery, that alone will not address the vagaries that occur between rate cases such as weather, gas prices and changes in the economy. Moreover, these factors, which lie outside the Utilities' and customers' control, can lead to over- as well as under-recovery of costs. NS-PGL Ex. 32.0 at 36. The best and most accurate forecast will not prevent over- or under-recovery of a utility's revenue requirement if weather is colder or warmer than normal.

Fifth, possible customer confusion is not a reason to reject the Utilities' proposal. For example, in the 2009 rate cases, the Commission approved Rider FCA, Franchise Cost Adjustment, for North Shore. Due to the nature of the rider and the timing of the implementation of new rates arising from the rate proceeding, North Shore had to implement new rates effective shortly after the compliance filing and again in mid-year after rates from the rider went into effect. Consequently, North Shore's tariffs included two sets of rates that would become effective at different times. The Utilities are not aware of any customer confusion that arose as a result. NS-PGL Ex. 32.0 at 37-38. In any event, to address Staff's concern, the Utilities added an additional form of notice. NS-PGL Ex. 48.0 Rev. at 11.

Sixth, Staff is correct that it is speculative whether Rider VBA will remain in effect, but the pending appeal and the AG and CUB-City's claims in the instant

proceeding that Rider VBA is unlawful are facts that lend uncertainty to the continued viability of Rider VBA.

Seventh, if the Commission is concerned about providing an SFV rate design (100% recovery of fixed costs in fixed charges), then the Utilities proposed modified SFV (80% recovery of fixed costs through fixed charges), which is the rate design that the Commission approved for Ameren and Nicor Gas, as an alternative. NS-PGL Ex. 32.0 at 39. The Utilities noted that Staff finds the 80% recovery to be an acceptable level if the Commission decides to approve the Utilities' SFV proposal. Staff Ex. 8.0 at 18.

The Utilities concluded that their SFV rate design is a reasonable means of addressing the uncertainly associated with Rider VBA. Staff's and the AG's opposition, if endorsed by the Commission, would expose the Utilities and customers to that which is unnecessary -- either over- or under-recovery of the distribution revenue requirement, which is contrary to the Commission's approval of full decoupling (Rider VBA) in the 2007 rate cases and its affirmation in making decoupling permanent in the 2011 rate cases.

Other Parties

[Insert]

Commission Analysis and Conclusions

In the 2011 rate cases, the Commission approved a permanent Rider VBA mechanism and, for all the reasons stated in that Order, full decoupling, which Rider VBA represents, continues to be a sound rate design to address the shortcomings of including any fixed cost recovery in variable charges. Moreover, while the Commission is not bound by the decisions of other public utility commissions, it is notable that decoupling in its various forms is a widely accepted rate design. Taking into account decoupling mechanisms such as Rider VBA and other forms of decoupling such as SFV rates, rate stabilization mechanisms and weather normalization mechanisms, 35 states and 113 companies have decoupling. NS-PGL Ex. 32.0 at 40. ***[ALTERNATIVE 1:*** If Rider VBA is disallowed, by a Court or this Commission, the Commission agrees that SFV rate designs, with recovery of 100% of fixed costs in fixed charges, as proposed by the Utilities, are the functional equivalent of full decoupling and should take effect to preserve the rate design principles that the Commission approved in the 2011 rate cases. The Commission approves the Utilities' alternative SFV rate designs with 100% recovery of fixed costs in fixed charges and the circumstances that would trigger the effectiveness of that alternative.**]** ***[ALTERNATIVE 2:*** If Rider VBA is disallowed, by a Court or this Commission, the Commission agrees that SFV rate designs, but with recovery of 80% and not 100% of fixed costs in fixed charges, as alternatively proposed by the Utilities, are the functional equivalent of partial decoupling and should take effect to partially preserve the rate design principles that the Commission approved in the 2011 rate cases and to match the rate designs that the Commission approved for Ameren and Nicor Gas. The Commission approves the Utilities' alternative SFV rate

design with 80% recovery of fixed costs in fixed charges and the circumstances that would trigger the effectiveness of that alternative.**]**

D. <u>Fixed Cost Recovery and Rider VBA</u>

North Shore and Peoples Gas

The Utilities explained that their primary proposal is that Rider VBA, as approved in the 2011 rate cases, remain in effect for S.C. Nos. 1 and 2 and that fixed cost recovery through fixed charges increase somewhat for these service classes. As discussed in Section IX.C.2.c, *supra*, under certain circumstances, if Rider VBA were no longer in effect, the Utilities proposed that SFV rates would take effect.

Utilities witness Ms. Grace stated that, even if Rider VBA remains in effect, gradually increasing fixed cost recovery through fixed charges is sound rate design and consistent with Commission policy. First, Rider VBA is on appeal. With the risk that the Court may reverse the Commission's approval of full decoupling, more substantial movement to fixed cost recovery through fixed charges is appropriate. Second, the 80% fixed cost recovery proposed for S.C. No. 1 would be consistent with the partial decoupling approved for Ameren and Nicor Gas and would leave a reasonable amount of fixed costs that would be recovered through distribution charges, but still subject to the full decoupling approved under Rider VBA. Third, Ms. Grace stated that Staff witness Mr. Johnson is proposing to set the customer charge for North Shore's and Peoples Gas' S.C. No. 1 NH customers at 80% of fixed costs, leaving the Utilities' 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 if the Commission accepts Mr. Johnson's proposal. Absent decoupling under Rider VBA, a lower fixed cost recovery level would effectively re-couple a large percentage of fixed cost recovery with the amount of gas that customers use, conflicting with prior Commission policy decisions supporting both increased fixed cost recovery and decoupling. NS-PGL Ex. 32.0 at 34-35.

The Utilities stated that Staff's, AG's and CUB-City's arguments that it is inappropriate or radical for the Utilities to have "guaranteed" recovery of fixed costs are flawed. The guarantee that the parties discuss is nothing more than recovery of the approved revenue requirements. It is not a guarantee of profits or that the Utilities will earn their allowed rates of return. As the AG stated in discussing the alternative SFV rate design, the Utilities' expenses are ever-changing. Rider VBA does not address those changing expenses. Thus, if the Utilities' costs are higher than those included in the approved revenue requirements, Rider VBA does nothing to address those higher costs because Rider VBA is linked to the approved revenue requirement.

The Utilities stated that the notion that Rider VBA is unusual or radical or contrary to utility ratemaking is disproved by the prevalence of decoupling in its various forms throughout the country. Decoupling mechanisms, including forms such as SFV rates, rate stabilization mechanisms and weather normalization mechanisms exist in 35 states

for 113 companies. NS-PGL Ex. 32.0 at 40. Decoupling is the norm in utility ratemaking.

Contentions that Rider VBA is unlawful are properly before an Illinois appellate court, and that Court is the proper forum for addressing these arguments. This Commission is defending the lawfulness of its approval of Rider VBA. For all the reasons stated by the Commission in the *Peoples Gas 2007* and *2011* Orders, Rider VBA is lawful.

First, Rider VBA is not single issue ratemaking. The Utilities stated that the decisions the AG cited are inapposite because Rider VBA is not a cost recovery mechanism. Rider VBA isolates no costs and poses none of the risks that concerned the courts in the cited cases. Rider VBA does not take into account costs other than those in the Commission-approved revenue requirements. For example, if the Utilities' actual fixed costs are greater than those the Commission used to set the revenue requirements, Rider VBA does not provide recovery of those higher costs. Rider VBA is essentially a mathematical adjustment to ensure that the Utilities neither over- nor under-recover from customers their Commission-approved distribution revenue requirement.

Second, Rider VBA is not retroactive ratemaking. The Utilities explained that Rider VBA does not change the rates that the Commission found to be just and reasonable. Its entire purpose is to true-up to the revenue requirements that the Commission approved and, thus, to the rates derived from those revenue requirements. Rider VBA is a true-up mechanism predicated on the assumption that the rates derived from the approved revenue requirements are correct and the Utilities should not over- or under-recover those revenue requirement amounts.

Third, the test year issue is essentially the same as addressed in Section IX.C.2.b, *supra*, in connection with SFV rates. The test year 2013 revenue requirements are the basis of Rider VBA calculations.

Finally, Rider VBA is not a "lost revenues" rider. As the Commission correctly found in the 2007 rate cases, "Rider VBA does not seek to recover lost profits." *Peoples Gas 2007* Order, p. 149. Adjustments occur, as with the mechanism approved in the 2007 rate cases, through the application of a mathematical formula (*Peoples Gas 2007* Order, p. 151) that is based on the Commission-approved revenue requirement.

Other Parties

[Insert]

Commission Analysis and Conclusions

For the reasons stated in Section IX.C.2.c, *supra*, the Commission continues to find that Rider VBA is sound rate design policy and should remain in place permanently as approved by the Commission in the 2011 rate cases. For the reasons described at

length in *Peoples Gas 2007*, and with which we continue to agree, decoupling, in the form of Rider VBA, is lawful. Likewise, the Commission finds that the continued movement toward fixed cost recovery through fixed charges is appropriate and a long-standing Commission policy. The Utilities' rate design proposals are consistent with these principles and should be approved.

X. TRANSPORTATION ISSUES

A. Uncontested Issues

1. Purchase of Receivables (Withdrawn)

North Shore and Peoples Gas

The Utilities stated that IGS Energy withdrew its proposal that the Commission require the Utilities to implement a residential purchase of receivables program. The Utilities concluded that no issue remains for the Commission to decide.

Other Parties

[Insert]

Commission Analysis and Conclusions

As no proposal remains for the Commission's consideration, the Commission makes no findings or conclusions on purchase of receivables.

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

North Shore and Peoples Gas

The Utilities took no position on the Commission's authority to conduct an investigation on provider of last resort.

Other Parties

[Insert]

Commission Analysis and Conclusions

As stated in Section X.B.4, *infra*, the Commission declines to open a proceeding to address provider of last resort questions. The Commission need not address whether it has authority to open such an investigation.

B. Contested Issues

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

North Shore and Peoples Gas

Utilities witness Ms. Grace stated that the Utilities significantly revised their transportation programs in 2011 (small volume program) and 2012 (large volume program), including implementing new administrative charges, approved in the 2011 rate cases, for both programs in January 2012. Therefore, Ms. Grace explained that the Utilities proposed no changes in this proceeding. NS Ex. 12.0 Rev. at 23; PGL Ex. 12.0 Rev. at 23-24. In the 2011 rate cases, the Commission concluded that sales customers do not cause the costs that the Utilities recover from Rider AGG, Aggregation Service, suppliers. *Peoples Gas 2011* Order, p. 234. No evidence of changed circumstances exists.

Other Parties

[Insert]

Commission Analysis and Conclusions

IGS Energy raises no new issues and presents no new evidence that was not addressed thoroughly in the Utilities' 2011 rate cases. As Staff explained, cost causation is not a simple issue. Moreover, the Commission agrees with the Staff that participation levels in a program are not necessarily indicative of whether the program is well-designed. The Commission finds that it was reasonable for the Utilities to make no changes to the administrative charges that the Commission so recently reviewed and approved. The Commission makes no other findings about the design of or other aspects concerning the Utilities' programs.

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

North Shore and Peoples Gas

Utilities witness Ms. Grace stated that the Utilities' gas supply personnel provide support for securing and managing the services and assets that underlie storage and balancing services. Although CFY customers buy their gas from alternative suppliers, the Utilities continue to provide delivery service and storage and balancing services so that the transportation programs can exist. Suppliers have no obligation to deliver the precise amount of gas their customers use every day. Moreover, under certain conditions, CFY suppliers buy company-supplied gas through cash-outs. NS-PGL Ex. 48.0 Rev. at 17; *also see* Section X.B.1, *supra.* Thus, CFY customers (and

suppliers) benefit from the Utilities' gas supply functions, and it is appropriate that all customers' base rates include these costs.

Other Parties

[Insert]

Commission Analysis and Conclusions

As the Commission concluded in the preceding section, it was reasonable for the Utilities to make no changes to the administrative charges that the Commission so recently reviewed and approved. The Commission agrees that CFY customers and suppliers benefit from the Utilities' gas supply functions. The fact that CFY customers purchase their gas from an alternative supplier does not mean that no company gas supports the service those customers receive. The Utilities' gas supply function, including hedging, benefits those customers by helping to enable the Utilities to provide a small volume transportation program. The Commission rejects IGS Energy's proposal to remove gas supply functions from rates that CFY customers pay.

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

North Shore and Peoples Gas

The Utilities reiterated their arguments summarized in Sections X.B.1 and X.B.2, *supra*.

Other Parties

[Insert]

Commission Analysis and Conclusions

The Commission finds that IGS Energy raised no issues not already addressed in Sections X.B.1 and X.B.2, *supra*. The Commission declines to order the Utilities to allocate costs differently than they currently do.

4. Provider of Last Resort Investigation

North Shore and Peoples Gas

Utilities witness Ms. Egelhoff stated that, if the Commission chooses to open a proceeding to investigate whether the Utilities should continue to act as the provider of last resort, the Utilities will participate. NS-PGL Ex. 36.0 at 3-4; NS-PGL Ex. 50.0 at 2.

Other Parties

[Insert]

Commission Analysis and Conclusions

The Commission declines, in this rate case for North Shore and Peoples Gas, to open a proceeding to investigate whether North Shore and Peoples Gas should continue to act as the provider of last resort. The Commission notes that, under Section 19-130 of the Alternative Gas Supplier Law, it is submitting a report to the General Assembly, regarding the development of competitive retail natural gas markets in Illinois. As required, the Commission gathered input from interested parties in preparing that report, and it provided a forum for parties to raise the provider of last resort issue.

XI. FINDINGS AND ORDERING PARAGRAPHS

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

(1) Peoples Gas is an Illinois corporation engaged in the transportation, purchase, storage, distribution and sale of natural gas to the public in Illinois and is a public utility as defined in Section 3-105 of the Act;

(2) North Shore is an Illinois corporation engaged in the transportation, purchase, storage, distribution and sale of natural gas to the public in Illinois and is a public utility as defined in Section 3-105 of the Act;

(3) the Commission has jurisdiction over the parties and the subject matter herein;

(4) the recitals of fact and conclusions of law reached in the prefatory portion of this Order are supported by the evidence of record, and are hereby adopted as findings of fact and conclusions of law; the Appendices attached hereto provide supporting calculations;

(5) the test year for the determination of the rates herein found to be just and reasonable should be the 12 months ending December 31, 2013; such test year is appropriate for purposes of this proceeding;

(6) the $424,299,000 original cost of plant for North Shore at December 31, 2011, and the $3,016,429,000 original cost of plant for Peoples Gas at December 31, 2011 are unconditionally approved as the original costs of plant;

(7) for the test year ending December 31, 2013, and for the purposes of this proceeding, Peoples Gas' original cost rate base with adjustments is $1,659,271,000.

(8) for the test year ending December 31, 2013, and for the purposes of this proceeding, North Shore's original cost rate base with adjustments is $209,116,000;

[Alternative 1 for items (9) and (10): With Rider VBA Adjustment]

(9) a just and reasonable return which Peoples Gas should be allowed to earn on its net original cost rate base is 7.12%; this rate of return incorporates a return on common equity of 10.10% and costs of long-term debt of 4.47% and short-term debt of 1.26%, with a just and reasonable capital structure of 50.43% common equity, 43.61% long-term debt and 5.96% short-term debt;

(10) a just and reasonable return which North Shore should be allowed to earn on its net original cost rate base is 7.17%; this rate of return incorporates a return on common equity of 10.10% and costs of long-term debt of 4.64% and short-term debt of 1.80%, with a just and reasonable capital structure of 50.32% common equity, 42.33% long-term debt and 7.35% short-term debt;

[Alternative 2 for items (9) and (10): Without Rider VBA Adjustment]

(9) a just and reasonable return which Peoples Gas should be allowed to earn on its net original cost rate base is 7.07%; this rate of return incorporates a return on common equity of 10.0% and costs of long-term debt of 4.47% and short-term debt of 1.26%, with a just and reasonable capital structure of 50.43% common equity, 43.61% long-term debt and 5.96% short-term debt;

(10) a just and reasonable return which North Shore should be allowed to earn on its net original cost rate base is 7.12%; this rate of return incorporates a return on common equity of 10.0% and costs of long-term debt of 4.64% and short-term debt of 1.80%, with a just and reasonable capital structure of 50.32% common equity, 42.33% long-term debt and 7.35% short-term debt;

[PLEASE NOTE THAT THE REMAINDER OF THIS DRAFT PROPOSED ORDER ASSUMES THE FIGURES FOUND IN ALTERNATIVE (2) FOR FINDINGS AND ORDERING PARAGRAPHS (9) AND (10), ABOVE. IF ALTERNATIVE (1) FOR PARAGRAPHS (9) and (10) IS ADOPTED, THEN THE EFFECTED FIGURES IN THE REMAINDER OF THIS DRAFT PROPOSED ORDER SHOULD BE REVISED ACCORDINGLY.]

(11) Peoples Gas' rate of return set forth in Finding (9) results in approved base rate net operating income of $117,310,000;

(12) North Shore's rate of return set forth in Finding (10) results in approved base rate net operating income of $14,889,000;

(13) Pursuant to Section 9-229 of the Act, the Commission has specifically assessed the amounts expended by the Utilities to compensate attorneys and experts to prepare and litigate this general rate case filing and finds those amounts as adjusted to be just and reasonable, with the Commission's more detailed supporting findings on this subject set forth in Section V.C.9 of this Order;

(14) Peoples Gas' rates, which are presently in effect, are insufficient to generate the operating income necessary to permit Peoples Gas the opportunity to earn a fair and reasonable return on net original cost rate base; these rates should be permanently canceled and annulled;

(15) North Shore's rates, which are presently in effect, are insufficient to generate the operating income necessary to permit North Shore the opportunity to earn a fair and reasonable return on net original cost rate base; these rates should be permanently canceled and annulled;

(16) the specific rates proposed by Peoples Gas in its initial filing do not reflect various determinations made in this Order regarding revenue requirement, cost of service allocations, and rate design; Peoples Gas' proposed rates should be permanently canceled and annulled consistent with the findings herein;

(17) the specific rates proposed by North Shore in its initial filing do not reflect various determinations made in this Order regarding revenue requirement, cost of service allocations, and rate design; North Shore's proposed rates should be permanently canceled and annulled consistent with the findings herein;

(18) Peoples Gas should be authorized to place into effect tariff sheets designed to produce annual base rate revenues of $628,894,000, in addition to $16,195,000 of other revenues, which represents a total base rate increase of $96,996,000 or 18.23% in base rate revenues; such revenues will provide Peoples Gas with an opportunity to earn the rate of return set forth in Finding (9) above; based on the record in this proceeding, this return is just and reasonable;

(19) North Shore should be authorized to place into effect tariff sheets designed to produce annual base rate revenues of $85,704,000, in addition to $1,610,000 of other revenues, which represents a base rate increase of $9,570,000 or 12.57% in base rate revenues; such revenues will provide North Shore with an opportunity to earn the rate of return set forth in Finding (10) above; based on the record in this proceeding, this return is just and reasonable;

(20) It is further ordered that the uncollectibles expense includes in base rates for People Gas is $_____ and for North Shore is $_____;

(21) ***[Alternative 1*:** the determinations regarding cost of service and rate design contained in the prefatory portion of this Order are reasonable for purposes of this proceeding; the tariffs filed by North Shore and Peoples Gas should incorporate the rates and rate designs set forth and referred to herein, including the alternate straight fixed variable rate design with 100% fixed cost recovery] ***[Alternative 2*:** the determinations regarding cost of service and rate design contained in the prefatory portion of this Order are reasonable for purposes of this proceeding; the tariffs filed by North Shore and Peoples Gas should incorporate the rates and rate designs set forth and referred to herein, including the alternate straight fixed variable rate design with 80% fixed cost recovery**]**;

(22) the percentage of fixed costs for purposes of computations under Rider VBA shall be 100% for each of North Shore and Peoples Gas and North Shore and Peoples Gas shall file revised Rate Case Revenues for Rider VBA;

(23) as required in this Order, under the discussion of Uniform Numbering of Service Classifications in Rate Design, North Shore shall conform its service classification numbering to Peoples Gas' format, to the extent applicable, and make all tariff changes necessary to implement this proposal in its compliance filing;

(24) as required in this Order, under the discussion of Service Classification No. 2, General Service, the Utilities shall examine the number and size of distribution charge rate blocks for S.C. No. 2 in their next rate case filings;;

(25) as required in this Order, under the discussion of Rider SSC, Storage Service Charge, North Shore and Peoples Gas shall file Rider SSC charges (Storage Banking Charge and Storage Service Charge) consistent with the approved revenue requirements; and

(26) new tariff sheets authorized to be filed by this order should reflect an effective date consistent with the requirements of Section 9-201(b) as amended.

IT IS THEREFORE ORDERED by the Illinois Commerce Commission that the tariff sheets presently in effect of The Peoples Gas Light and Coke Company and North Shore Gas Company that are the subject of this proceeding are hereby permanently canceled and annulled, effective at such time as the new tariff sheets approved herein become effective by virtue of this Order.

IT IS FURTHER ORDERED that the proposed tariffs seeking a general rate increase, filed by The Peoples Gas Light and Coke Company and North Shore Gas Company on July 31, 2012, are permanently canceled and annulled.

IT IS FURTHER ORDERED that the $3,016,429,000 original cost of plant for Peoples Gas at December 31, 2011, reflected on Peoples Gas' NS-PGL Ex. 27.14P, Line 19, Column B, is unconditionally approved as the original cost of plant. It is also ordered that the $424,299,000 original cost of plant for North Shore at December 31, 2011, reflected on North Shore's NS-PGL Ex. 24.14N, Line 17, Column B, is unconditionally approved as the original cost of plant.

IT IS FURTHER ORDERED that The Peoples Gas Light and Coke Company and North Shore Gas Company are authorized to file new tariff sheets with supporting workpapers in accordance with Findings (18) and (19) of this Order, applicable to service furnished on and after the effective date of said tariff sheets, which date shall be no later than four business days after said sheets are filed.

IT IS FURTHER ORDERED that North Shore shall conform its service classification numbering to Peoples Gas' format, to the extent applicable, and make all tariff changes necessary to implement this proposal in its compliance filing.

IT IS FURTHER ORDERED that Peoples Gas and North Shore shall file revised Rider VBA Rate Case Revenue ("RCR") amounts and set the percentage of fixed costs for purposes of computations under Rider VBA at 100%.

IT IS FURTHER ORDERED that North Shore and Peoples Gas shall file Rider SSC charges (Storage Banking Charge and Storage Service Charge) consistent with the approved revenue requirements.

IT IS FURTHER ORDERED that North Shore and Peoples Gas examine the number and size of distribution charge rate blocks for S.C. No. 2 in their next rate case filings.

IT IS FURTHER ORDERED that any motions, petitions, objections, and other matters in this proceeding which remain unresolved are disposed of consistent with the conclusions herein.

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

By Order of the Commission this ___ day of _____, 2013.

(SIGNED) DOUGLAS P. SCOTT

CHAIRMAN