STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

NORTH SHORE GAS COMPANY	:	No. 12-0511
	:	
Proposed general increase in rates for gas service.	:	(Cons.)
	:	
THE PEOPLES GAS LIGHT AND COKE COMPANY	:	No. 12-0512
	:	
Proposed general increase in rates for gas service.	:	

BRIEF ON EXCEPTIONS OF NORTH SHORE GAS COMPANY AND THE PEOPLES GAS LIGHT AND COKE COMPANY

John P. Ratnaswamy
Carla Scarsella
Rooney Rippie & Ratnaswamy LLP
350 W. Hubbard Street, Suite 600
Chicago, Illinois 60654
(312) 447-2800
john.ratnaswamy@r3law.com
carla.scarsella@r3law.com

Mary Klyasheff
Integrys Energy Group, Inc.
130 E. Randolph Street
Chicago, Illinois 60601
(312) 240-4470
mpklyasheff@integrysgroup.com

Bradley D. Jackson
Foley & Lardner LLP
150 East Gilman Street, Verex Plaza
Madison, Wisconsin 53703
(608) 258-4262
bjackson@foley.com

Theodore T. Eidukas
Foley & Lardner LLP
321 N. Clark Street, Suite 2800
Chicago, Illinois 60654
(312) 832-4913
teidukas@foley.com

May 9, 2013

TABLE OF CONTENTS

			Exception Number	Page
I.	INTRODUCTION			1
	A.	Overview		1
	B.	Fundamental Legal Principles		4
	C.	The Drivers of the Utilities' Cost Recovery Shortfalls		5
	D.	Peoples Gas' AMRP Costs		6
	E.	The Utilities' Costs of Capital		9
	F.	The "Average Rate Base" Issue		10
	G.	Selected Other Issues and Major Calculation Errors		11
IV.	RATE BASE			12
	C.	Potentially Contested Issues (All Subjects Relate to NS and PGL Unless Otherwise Noted)		12
		1. Year End Rate Base or Average Rate Base	1	12
		2. Plant		20
		a. Forecasted Test Year Capital Additions – Utility Plant In Service (NS)	2	20
		c. Construction Work In Progress (PGL)	Tech. 1	20
		e. Capital Costs for Non-AMRP Gas Services	3 and Tech. 2	21
		3. Cash Working Capital		23
		a. Pass-Through Taxes	Tech. 3	23
		b. Pension/OPEB	4	24
		4. Retirement Benefits, Net	5	25
		5. Net Operating Losses	Tech. 4	30
		6. Accumulated Deferred Income Taxes		31
		a. Appropriate Methodology to Reflect Change in State Income Tax Rate	6	31
		(1) The AG and CUB-City Did Not Show Good Cause to Deviate From The 83-00309 Order		32
		A. Accounting for Deferred Income Taxes And Changed Income Tax Rates		32
		B. The Proposed Order's Recommended Methodology Distorts Costs of Service		34
		C. The Proposed Order Methodology Is Inconsistent With Existing Regulations Regarding Normalization		36
		D. ARAM Ensures Consistency Across Illinois Utilities		37
		E. Conclusion		38

	(2) If the Commission Adopts the Proposed Order Proposal, Clarifying Language Is Required		38
V.	OPERATING EXPENSES		39
B.	Potentially Uncontested Issues (All Subjects Relate to NS and PGL Unless Otherwise Noted)		39
	1. Administrative & General		39
	i. Update to IBS Return on Investment	Tech. 5	39
	3. Depreciation Expense		40
	i. WAM System	Tech. 6	40
C.	Potentially Contested Issues (All Subjects Relate to NS and PGL Unless Otherwise Noted)		
	2. Wage Increase Correction	7	41
	3. Non-union Base Wages (Falls in Multiple Categories of O&M)	8	41
	a. The Erroneous Calculation of the Non-Union Base Wages Adjustment Must Be Corrected		42
	b. The Record Evidence Does Not Support Staff's Non-Union Base Wages Adjustment		43
	(1) The Record Evidence Supports Recovery Of the Component to Be Used For Individual Merit-Based Increases		44
	(2) The Record Evidence Supports Recovery Of the Component to Be Used For Individual Promotional Increases		46
	(3) The Proposed Adjustment to the General Wage Increase Based on a Forecast of CPI Is Not Supported by the Record Evidence		47
	5. Distribution O&M		49
	a. Plastic Pipefitting Remediation Project	9	49
	7. Administrative & General		50
	a. Adjustments to Integrys Business Support Costs	10	50
	c. Charitable Contributions	11	53
VI.	RATE OF RETURN		56
E.	Cost of Common Equity	12	56
	1. Overview		56
	2. The Proposed Order Largely Supports the Utilities' Cost of Capital Position		58
	3. The Utilities' Cost of Equity Is Increasing		63
	a. The Staff's and Utilities' Financial Model Results From 2011-2012 Show An Increased Cost of Equity		63

	b. The Regulatory Equity Premium Has Risen Sharply Since 2008		63
	c. Natural Gas Utility ROEs Are Significantly Higher Than the Staff and Proposed Order Positions		66
F.	Weighted Average Cost of Capital	13	68
	1. Peoples Gas		68
	2. North Shore		68
IX.	RATE DESIGN		69
C.	Service Classification Rate Design		69
	2. Contested Issues – North Shore and Peoples Gas		69
	b. Service Classification No. 1, Small Residential Heating	14 and Tech. 7	69
	c. Service Classification Nos. 1 and 2, Alternative Conditional Straight Fixed Variable Design	15	72
X.	TRANSPORTATION ISSUES		73
B.	Contested Issues		73
	3. Recovery of Small Volume Transportation Program (Choices for You^{SM} of "CFY") Administrative Costs	16	73
XI.	FINDINGS AND ORDERING PARAGRAPHS		73
	Finding (7)	17	73
	Finding (8)	18	73
	Finding (9)	19	73
	Finding (10)	20	73
	Finding (11)	21	73
	Finding (12)	22	73
	Finding (18)	23	73
	Finding (19)	24	73
	Finding (20)	25	73
XII.	APPENDICES		75
	Appendix A	Tech. 8	75
	Appendix B	Tech. 9	75
	Appendix B	Tech. 10	75
XIII.	CONCLUSION		75

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

NORTH SHORE GAS COMPANY	:	No. 12-0511
	:	
Proposed general increase in rates for gas service.	:	(Cons.)
	:	
THE PEOPLES GAS LIGHT AND COKE COMPANY	:	No. 12-0512
	:	
Proposed general increase in rates for gas service.	:	

BRIEF ON EXCEPTIONS OF NORTH SHORE GAS COMPANY
AND THE PEOPLES GAS LIGHT AND COKE COMPANY

North Shore Gas Company ("North Shore") and The Peoples Gas Light and Coke Company ("Peoples Gas") (together, the "Utilities"), under Section 10-111 of the Public Utilities Act (the "Act"), 220 ILCS 5/10-111, Section 200.830 of the Illinois Commerce Commission's (the "Commission" or ICC") rules, 83 Ill. Admin. Code § 200.830, and the April 26, 2013, Administrative Law Judges' ("ALJs") Proposed Order ("Proposed Order"), submit: (1) this Brief on Exceptions and (2) separate Exceptions to the Proposed Order with proposed language.

I. INTRODUCTION

A. Overview

These Dockets are 2013 "future test year" rate cases. The Utilities' proposed base rate "revenue requirements" (costs of service) are based on their forecasted costs for 2013, subject to appropriate adjustments and updates, and the forecasts were duly examined by independent Certified Public Accountant Deloitte and Touche LLP per the Commission's rules.[1]

The Utilities' existing base rates, which were set by the Commission in their 2011 rate cases based on forecasted 2012 costs,[2] fall far short of recovering their forecasted 2013 costs,

[1] *E.g.*, Gregor Direct ("Dir."), PGL Exhibit ("Ex.") 5.0 Rev., 4:81 – 9:200; Gregor Dir., NS Ex. 5.0 Rev., 4:81 - 9:189; 83 Ill. Adm. Code § 285.7010.
[2] *North Shore Gas Co., et al*., ICC Docket Nos. 11-0280, 11-0281 Cons. (Order Jan. 10, 2012) ("*Peoples Gas 2011*"), p. 5.

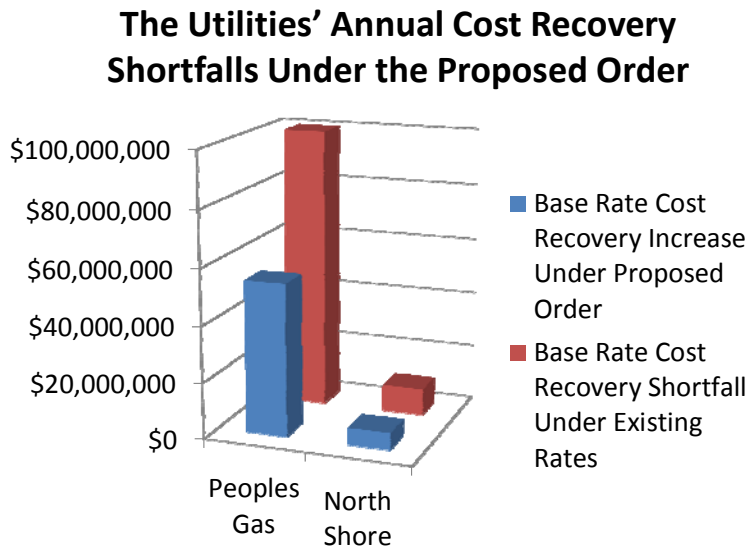
due primarily to increased plant investments and operating expenses. **Peoples Gas' 2013 base rate cost recovery shortfall** (its "revenue deficiency") under existing rates is forecasted (as revised) to be **$96,996,000**, and at **North Shore** it is forecasted (as revised) to be **$9,570,000**.[3]

The Proposed Order, on many issues, correctly applies the applicable law to the evidence. In particular, the ALJs correctly recommend that the Commission reject the unlawful, incorrect, and ruinous proposals of Staff to disallow directly $95,794,000 of the actual costs incurred by Peoples Gas in 2012 under its Accelerated Main Replacement Program (the "AMRP") and $122,804,000 of Peoples Gas' forecasted 2013 costs under the AMRP (Proposed Order, p. 61), as discussed further below in this Introduction.

The Proposed Order, however, in other instances recommends rulings that deny proper cost recovery. The net effect of those recommendations results in large annual cost recovery shortfalls, as illustrated by the following chart.

[3] *E.g.*, NS-PGL Ex. 42.1P, line 1; NS-PGL Ex. 42.1N, line 1.

Please note that, in order to avoid confusion, the revenue requirement and deficiency figures in this Brief on Exceptions and the Utilities' Exceptions language have not been recalculated to reflect the slightly lower costs of long-term debt that are set forth in the Utilities' April 17, 2013, Motion to Admit Evidence on 2013 Debt Costs. Exception Nos. 17, and 18, however, do reflect the lower long-term debt costs. The final Order should use those lower long-term debt costs in calculating the revenue requirements and deficiencies.



Sources: As to Peoples Gas, *see, e.g.,* Proposed Order, Appendix B, p. 1, line 1, versus NS-PGL Ex. 42.1P, line 1.
As to North Shore, *see, e.g.,* Proposed Order, Appendix A, p. 1, line 1, versus NS-PGL Ex. 42.1N, line 1.

This chart reflects that the Proposed Order recommends: (1) a base rate revenue requirement for **Peoples Gas** that would **under-recover** its costs of service by an annual **$45,780,000**; and (2) a base rate revenue requirement for **North Shore** that would **under-recover** its costs of service by an annual **$3,470,000**.

The Utilities further note that the rates being set in this Docket will go into effect in July 2013, and, thus, even if the final Order approves revenue requirements that match the Utilities' 2013 cost levels, the new rates in 2013 will remedy only about half of their cost recovery gaps.[4]

The remainder of this Introduction (1) sets forth the fundamental legal principles governing rate setting; (2) discusses the drivers of the changes in the Utilities' cost levels since *Peoples Gas 2011*; and then (3) discusses the Proposed Order's recommendations on the subject

[4] *E.g.*, Schott Dir., PGL Ex. 1.0 Rev., 13:268-271; Schott Dir., NS Ex. 1.0 Rev., 12:240-243.

of (a) AMRP cost recovery, (b) the Utilities' costs of capital, (c) the "average rate base" issue, and (d) certain other contested revenue requirement issues and major calculation errors.

B. <u>Fundamental Legal Principles</u>

As the Illinois Commerce Commission (the "Commission" or "ICC") held in *Peoples Gas 2011*: "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**."[5] The Commission also recognized that setting such rates "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**."[6] *Accord* Proposed Order, pp. 6-7.

Consistent with the above principles, the Commission, in a rate case, must set rates that are just and reasonable to the utility and its stockholders as well as to customers. *E.g.*, 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) ("*BPI II*"); Proposed Order, p. 7.

The formula for determining a utility's costs of service (its revenue requirement) also is well-established: RR = OE + (ROR x RB). The utility's revenue requirement ("RR") equals: (1) the utility's operating expenses ("OE") plus (2) a reasonable rate of return ("ROR") on the capital investments it makes in order to offer and provide service (its rate base or "RB"). *E.g.*, *ComEd*, 322 Ill. App. 3d at 849, 751 N.E.2d at 199; Proposed Order, p. 7.

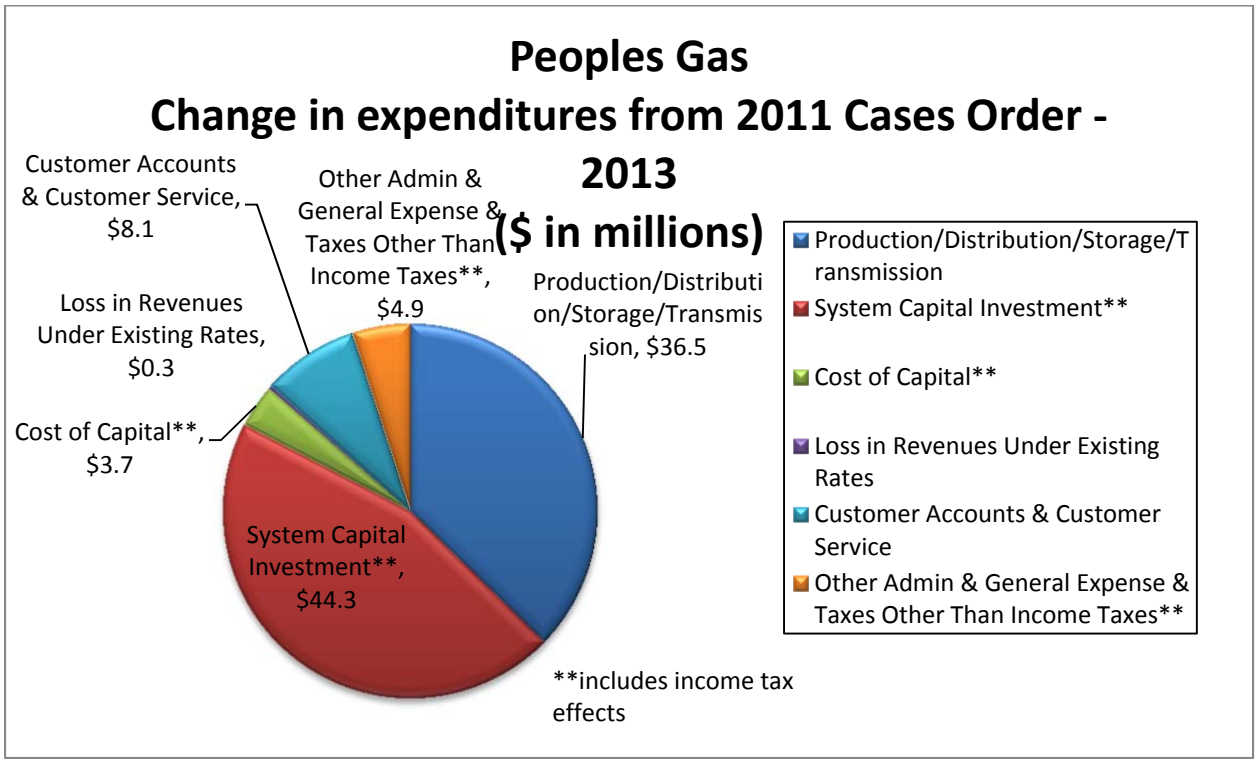
---

[5] *Peoples Gas 2011*, p. 5 (emphasis added). *See also, e.g., Duquesne Light Co. v. Barasch*, 488 U.S. 299, 309-310 (1989); *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) ("*BPI II*"); *Commonwealth Edison Co. v. Illinois Commerce Comm'n*, 322 Ill. App. 3d 846, 849, 751 N.E.2d 196, 199 (2d Dist. 2001) ("*ComEd*"); *In re Consumers Ill. Water Co.*, ICC Docket No. 03-0403 (Order April 13, 2004), p. 41.

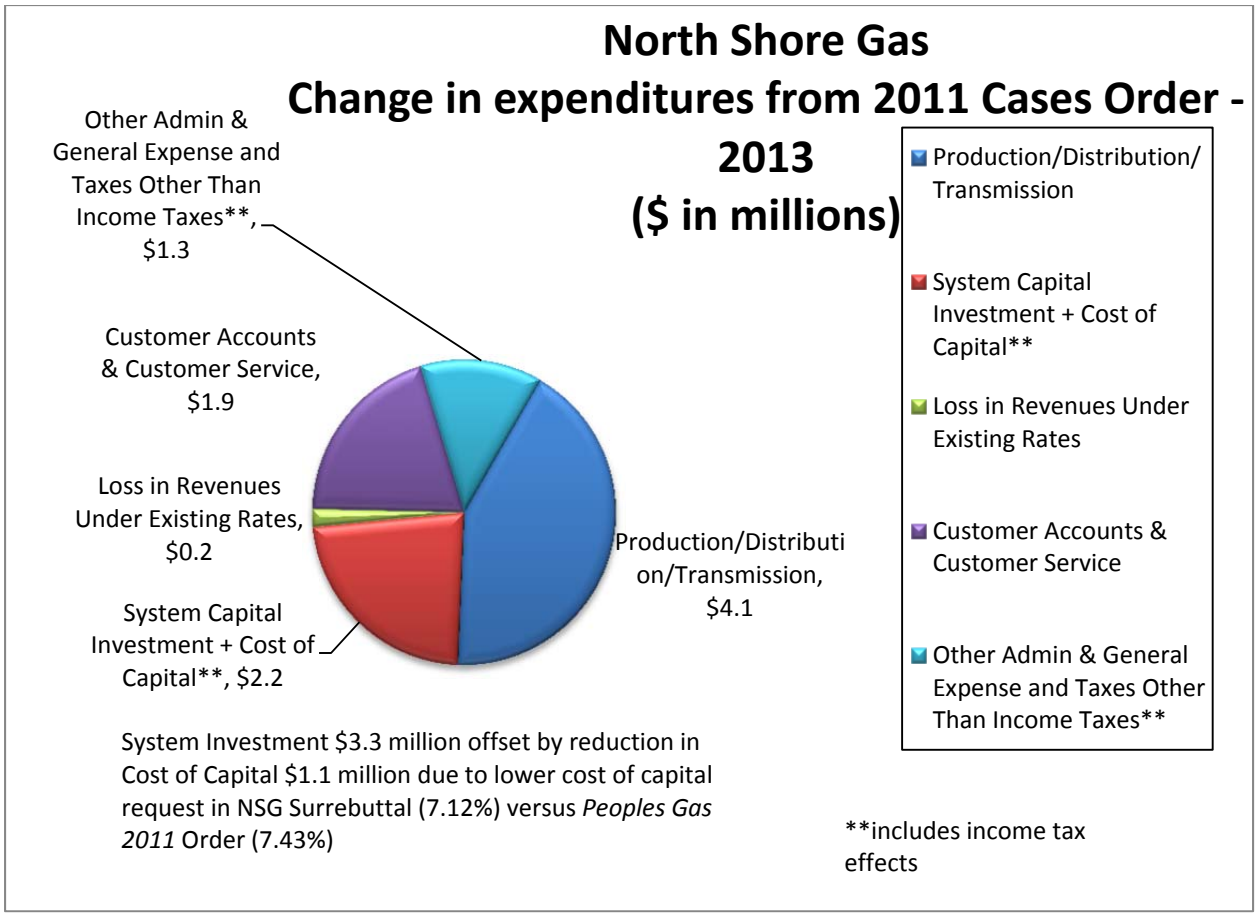
[6] *Peoples Gas 2011*, p. 5 (emphasis added).

C. The Drivers of the Utilities' Cost Recovery Shortfalls

The Utilities' evidence showed, in detail, the drivers of their changes in costs from the levels used to set rates in *Peoples Gas 2011*.[7] The main drivers are higher levels of plant investment and higher operating expenses. The following charts illustrate the drivers.[8]



[7] NS-PGL Initial Brief ("Init. Br.) at 10-13.
[8] The charts are from Schott Surrebuttal ("Sur."), NS-PGL Ex. 37.0, 11:202, 12:214.

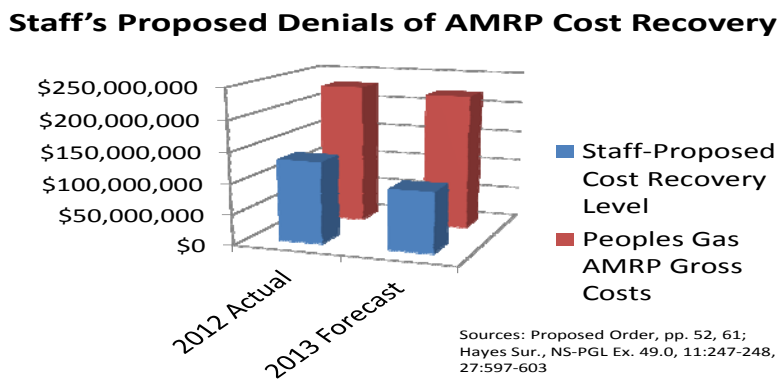


D. <u>Peoples Gas' AMRP Costs</u>

The Commission previously has found that the long-term benefits of Peoples Gas' Accelerated Main Replacement Program -- in which old cast and ductile iron pipe is to be replaced by modern pipe over a 20 year period ending by 2030 (rather than a 50 year period pace ending in 2050) -- include, among other things, significant long-term reductions in operating expenses, enhancements of safety and reliability, and, as to customers served by the utility's

legacy low-pressure system, the ability to use more energy efficient appliances and equipment.[9] The AMRP also involves a new apprentice training program and 500 highly skilled jobs.[10]

The ALJs correctly recommend that the Commission reject the unlawful, erroneous, and devastating proposals of Staff to disallow directly $95,794,000 of the $228,500,000 of actual gross plant costs incurred by Peoples Gas in 2012 under the AMRP and $122,804,000 of Peoples Gas' $220,750,000 of forecasted 2013 gross plant costs under the AMRP, illustrated below. Proposed Order, pp. 52, 61. The ALJs also correctly recommend rejection of the Illinois Attorney General's Office (the "AG") proposal to disallow directly $51,476,000 of Peoples Gas' forecasted 2013 AMRP gross plant costs. *Id*., p. 63-65.[11]



The AMRP disallowances proposed by Staff and the AG are opposed both by the Utilities and by Local Union No. 18007, Utility Workers Union of America, AFL-CIO (the "UWUA").

---

[9] *See North Shore Gas Co., et al*., ICC Docket Nos. 09-0166, 09-0167 Cons. (Order Jan. 21, 2010) ("*Peoples Gas 2009*"), pp. 164-173, *aff'd in part and rev'd in part on other grounds, 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).

[10] *E.g.*, Schott Rebuttal ("Reb."), NS-PGL Ex. 22.0 2nd Rev., 7:127-140; Passarelli Reb., UWUA Ex. 1.0, 4:70- 5:96, 6:121 – 7:133.

[11] The figures in this paragraph are Gross Plant amounts. Plant reductions also affect accumulated depreciation, deferred taxes, and depreciation expense. Under the Proposed Order, a $1,000,000 gross plant reduction reduces revenues by somewhat over $65,000. *See, e.g.*, Proposed Order, Appendix B, p. 6, col. (c), and p. 8, line 9.

The Staff and AG proposals are unlawful and wrong. Staff proposes to disallow recovery of $95,794,000 of 2012 AMRP investments that were prudent, reasonable in amount, and used and useful, based on the contrived theory that Staff's own (erroneous) assertion that the AMRP is significantly behind schedule somehow warrants disallowing amounts actually spent. Staff's own witness who made the proposal agreed on cross-examination that Peoples Gas' 2012 AMRP investments are or will be used and useful in 2013.[12] The impropriety and unfairness of the Staff proposal cannot be over-stated. Even the AG and intervenors the Citizens Utility Board ("CUB") and the City of Chicago ("City") (together, "CUB-City") did not submit any evidence recommending denial of any 2012 AMRP costs. Staff also proposes to deny recovery of $122,804,000 of AMRP investments based on a similar extension of its contrived theory, while the AG in rebuttal jumped partway on to Staff's bandwagon, also with no legitimate cause.[13] The Staff and AG proposals are shown in detail to be unlawful and wrong on pages 26 to 38 of the Utilities' Initial Brief and pages 29 to 41 of their Reply Brief.

The real world risks of the AMRP adjustments proposed by Staff and the AG cannot be ignored. As Utilities witness James Schott, Integrys Energy Group, Inc. ("Integrys") Chief Financial Officer, stated:

> The Staff, AG, and CUB-City proposals to reduce recovery of plant investment costs have real world consequences in utility operations. No utility can sustain its plant investment program over time if its regulator does not afford the utility the real opportunity to recover the costs of those investments. In particular, Peoples Gas cannot sustain its investments in accelerated main replacement if the Commission were to approve Staff's and intervenors' proposed extremely large reductions in AMRP cost recovery. Substantial cost under-recoveries also can reduce, over time, the ability of a utility to raise capital in the capital markets at a reasonable cost.

---

[12] *E.g.*, Seagle Tr. 2/7/13, 627:1-7.

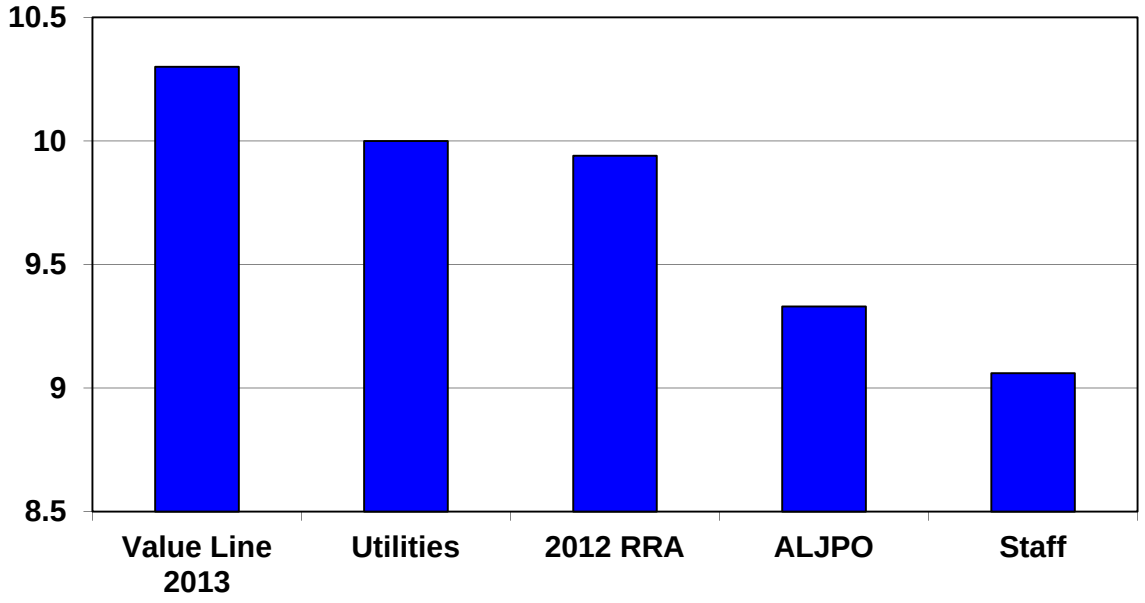
[13] Staff, the AG, and CUB-City also propose large indirect reductions in 2013 AMRP cost recovery through the "average rate base" method, as discussed later in this Introduction and Section IV.C.1.

Schott Reb., NS-PGL Ex. 22.0 2nd Rev., 2:38 – 3:45. The proposed disallowances would not require instant cessation of the AMRP, but the AMRP is not sustainable over time absent timely and adequate cost recovery. Schott Tr. 2/6/13, 442:13 – 445:9.

E. <u>The Utilities' Costs of Capital</u>

The Proposed Order recommends rates of return on investment below the Utilities' real costs of capital, thereby reducing Peoples Gas' cost recovery by $10,755,000 and North Shore's by $1,353,000.[14] Although it appropriately provides for recovery of the Utilities' various costs of debt, which are largely uncontested in this case, the Proposed Order errs, by adopting a rate of return on common equity significantly below the return that the financial markets would expect based on recent authorized returns for natural gas utilities and expected returns in 2013, as illustrated by the following chart (*see* Section IV of this Brief on Exceptions).

Comparison of ROE Positions to Investor Expectations[15]



[14] Proposed Order, Appendix B, p. 8, line 7, and Appendix A, p. 7, line 7.

[15] Value Line's forecasted 2013 ROEs for the Delivery Group used in the Utilities' and Staff's financial models is 10.30%. Moul Reb., NS-PGL Ex. 24.0 Rev., 4:79 – 5:80 (table). The average ROEs for natural gas utilities in 2012 according to Regulatory Research Associates was 9.94%. Staff Cross Ex. 8.

The Commission should authorize a return on equity of 10.00% for each of the Utilities. This return would represent a modest increase over the Utilities' current authorized return of 9.45%. Such an increase would be consistent with the financial model results presented by the Utilities and Staff, which show that the Utilities' cost of equity has increased since their last rate cases. It would also bring the Utilities' authorized return into line with the various indicia of natural gas utility equity costs in the record.

F. <u>The "Average Rate Base" Issue</u>

The Proposed Order recommends use of the "average rate base" method thereby reducing Peoples Gas' rate base by $95,688,000 and its annual revenues (cost recovery) by $9,854,000 and North Shore's rate base by $6,508,000 and its annual revenues by $658,000.[16] The Proposed Order errs, in that on the facts of this case, the "year-end" method should be used or, alternatively, given the Proposed Order's own reasoning, it should have recommended the Utilities' compromise proposal of the average of costs during the last six months of 2013, which reflects the fact that the rates being set in these Dockets will not go into effect until about July 1, 2013 (*see* Section IV.B.1 of this Brief on Exceptions).

The Proposed Order's recommendation has a huge impact on plant investment cost recovery, including AMRP costs. The average rate base method reduces gross plant in Peoples Gas' rate base by $151,242,000, and in North Shore's rate base by $11,235,000. Proposed Order, Appendix B, p. 6, col. (c), line 1, and Appendix A, p. 6, col. (c), line 1. That $151,242,000 includes half of the 2013 AMRP gross plant costs.

The Proposed Order primarily reasons that the average rate base method best calculates the Utilities' investment costs for all of 2013. Proposed Order, p. 38. That reasoning does not

[16] Proposed Order, Appendix B, p. 6, col. (c), line 23, and p. 8, line 9, and Appendix A, p. 6, col. (c), line 23, and p. 7, line 8.

come to grips, however, with the requirement that rates must be set in a manner that allows the opportunity for full cost recovery. The charts and discussion in Section IV.C.1 show that: (1) the average rate base method results in cost under-recovery, whether one looks at all 12 months of 2013 or just the last six months; (2) the end of year method is more reasonable, especially when one looks at all 12 months; and (3) perhaps most importantly, the Utilities' compromise proposal is the approach that both (a) best matches costs during the last six months and (b) results in rates that best match those costs.

The Proposed Order's Commission Analysis and Conclusion section (p. 38) does not expressly discuss the Utilities' alternative compromise proposal. The Proposed Order's failure to recommend the compromise proposal is even more troubling because a different Proposed Order recommendation is based on the theory that rates should be set in a manner that reflects costs during the period the rates will be in effect. *See* Proposed Order, pp. 135, 136. Those two recommendations cannot be reconciled.

G. <u>Selected Other Contested Issues and Major Calculation Errors</u>

The Proposed Order also errs on several other major items, including:

1) reducing non-union wages cost recovery by $5,873,000 as to Peoples Gas and $425,000 as to North Shore, most of which is attributable to an error in how this adjustment was calculated (*see* Section V.C.3 of this Brief on Exceptions);

2) reducing Peoples Gas' recovery of costs for services provided by its affiliate, Integrys Business Support, LLC ("IBS"), by $2,150,000 (*see* Section V.C.7.a);

3) reducing Peoples Gas' recovery on its pension asset (*i.e.*, recovery of carrying costs of prepaid pension expense) by $5,194,000 (*see* Section IV.C.4); and

4) erring in its calculations of the net operating losses in the Peoples Gas and North Shore rate bases, resulting in incorrectly under-stating their rate bases (*see* Section IV.C.5).

The Proposed Order also errs on additional issues, but the above items have been listed here due to the magnitude of their impacts on cost recovery.

IV. RATE BASE

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

1. Year End Rate Base or Average Rate Base

Exception No. 1

As discussed in Section I.B of this Initial Brief, the Commission is required by law to establish just and reasonable rates; the rates must be just and reasonable to the utility and its stockholders as well as customers; and the rates must be set so as to allow the utility the opportunity to obtain full recovery of its prudent and reasonable costs of service.

The Commission, therefore, must decide which of the three approaches that have been presented in these cases best meets those legal principles on the proven facts.[17] The three approaches are: (1) the end of year approach proposed by the Utilities, under which rate base figures are based on the values at December 31st of the test year; (2) the Staff, AG, and CUB-City proposal, under which the averages of the values of January 1st and December 31st of the test year are used (the average rate base method); or (3) the Utilities' compromise proposal, a

[17] The Utilities note that this issue does not involve certain rate base items. All parties agree that certain rate base components should be computed based on 13 month averages. *E.g.*, Hengtgen Dir., NS Ex. 7.0, 4:72-74, 7:136-146; Hengtgen Dir., PGL Ex. 7.0, 4:75-76, 7:139-149. Thus, the dispute does not involve those items. *E.g.*, Kahle, Tr. 2/4/13, 153:3-15. The dispute also does not involve the cash working capital figure in rate base, which is independently calculated. *E.g.*, Hengtgen Dir., NS Ex. 7.0, 7:139-141; Hengtgen Dir., PGL Ex. 7.0, 7:142-144.

variation on the average rate base method, which, because the rates being set will not go into effect until July 2013, uses the average of the last six months of the test year.

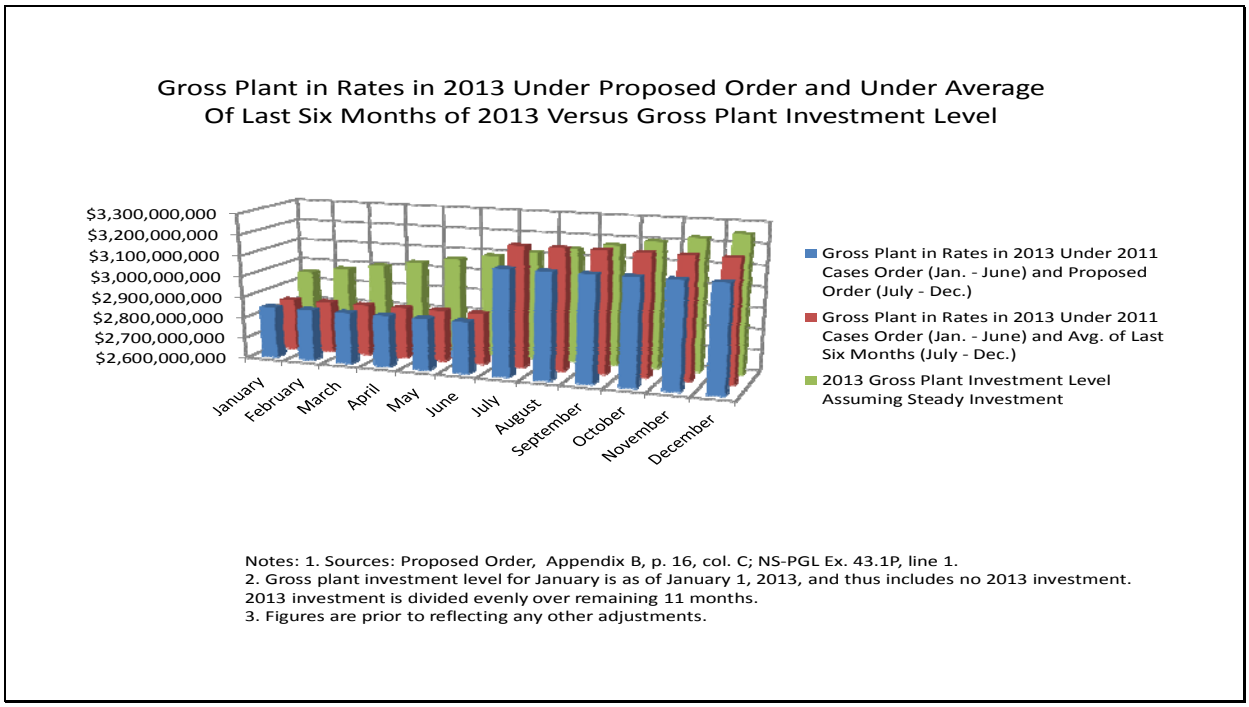
The Proposed Order (at p. 38) recommends the average rate base method, which has a huge impact on rate base, including AMRP costs. The average rate base method reduces Peoples Gas' rate base by $95,688,000 and its annual revenues (cost recovery) by $9,854,000 and North Shore's rate base by $6,508,000 and its annual revenues by $658,000.[18] The average rate base method reduces gross plant in Peoples Gas' rate base by $151,242,000, and gross plant in North Shore's rate base by $11,235,000.[19] That $151,242,000 includes half of the 2013 AMRP gross plant costs. The Proposed Order's Commission Analysis and Conclusion section did not expressly discuss the Utilities' alternative compromise proposal.

The Proposed Order primarily reasons that the average rate base method best calculates the Utilities' investment costs for all of 2013. Proposed Order, p. 38. That reasoning does not come to grips, however, with the legal requirement that rates be set in a manner that allows the opportunity for full cost recovery, and how that principle applies here.

The following chart shows that: (1) the average rate base method results in cost under-recovery, whether one looks at all 12 months of 2013 or just the last six months; (2) the end of year method is more reasonable than the average rate base method, especially when one looks at all 12 months; and (3) perhaps most importantly, the Utilities' compromise proposal is the approach that both (a) best matches costs during the last six months and (b) results in rates

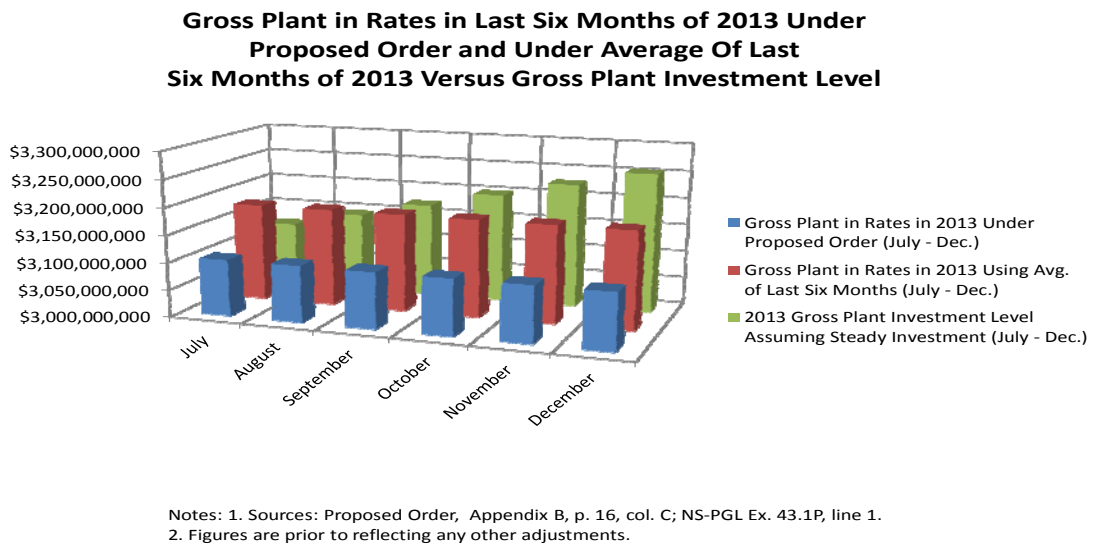
[18] Proposed Order, Appendix B, p. 6, col. (c), line 23, and p. 8, line 9, and Appendix A, p. 6, col. (c), line 23, and p. 7, line 8.
[19] Proposed Order, Appendix B, p. 6, col. (c), line 1, and Appendix A, p. 6, col. (c), line 1.

that best match those costs. In particular, the following chart (as to Peoples Gas) shows the superior accuracy and reasonableness of the compromise proposal in matching costs and rates.[20]



The superiority of the Utilities' compromise proposal also is apparent when costs are compared with rates just for the last six months of 2013, as shown in the following chart.

[20] The Utilities' charts on the average rate base issue present data on Gross Plant amounts, but the same relationships would result if the figures were for net plant or for rate base as a whole, as long as adjustments are corrected for. *See* Proposed Order, Appendix A, p. 15; NS-PGL Ex. 41.1N, line 1. Also, similar charts for North Shore would have different numbers but the same relationships as the Peoples Gas charts. *See* Proposed Order, Appendix A, p. 15; NS-PGL Ex. 41.1N, line 1.



Notes: 1. Sources: Proposed Order, Appendix B, p. 16, col. C; NS-PGL Ex. 43.1P, line 1.
2. Figures are prior to reflecting any other adjustments.

The Proposed Order here analyzes full year 2013 costs but divorces that analysis from the context of the ultimate objective of setting rates that properly tie costs and revenues. The Proposed Order mismatches costs and revenues even though Staff, the AG, and CUB-City argue (ironically) for such a matching when urging the average rate base method. *See, e.g.*, Proposed Order, p. 17 (Staff argument that: "An average rate base derives rates that properly match test year revenues and expenses which will occur throughout 2013 with the level of rate base investment also occurring throughout the year."); *id.*, p. 20 (AG argument that: "Staff witness Daniel Kahle and CUB witness Ralph Smith likewise endorsed the use of an average rate base methodology to ensure that the Companies' revenues match its actual costs.").

Staff witness Mr. Kahle, on cross-examination, testified in part that revenues should equal the rate base investment of the test year plus the expenses of the test year. Kahle Tr. 2/4/13, 156:13-19. That can only occur if rates are set such that they yield revenues matching

those costs. That will not occur here under the average rate base method. That can only occur with either the end of year method or the Utilities' alternative compromise proposal.

The Proposed Order also is inconsistent. The Utilities contended here that the end of year method, and the alternative proposal, better match the Utilities' cost of service during the period in which the rates will be in effect (*e.g.*, NS-PGL Initial Brief ("Init. Br.") at 19), but the Proposed Order disregarded or placed no value on that point. Yet, the Proposed Order's recommendation on the subject of non-union base wages is based on the theory (advanced by Staff) that rates should be set in a manner that reflects costs during the period the rates will be in effect. *See* Proposed Order, pp. 135, 136. The recommendations cannot be reconciled.

The Proposed Order (at p. 38) also suggests that the Utilities' end of year rate base proposal assumes that all 2013 investment is in place all year, but that suggestion misses the point that the rates being set are only for the last six months of 2013. Indeed, as the charts above illustrate, the average rate base method uses the value as of the middle of the year to set rates for the last six months of the year, even though investment levels are rising during those six months, and thus it omits actual costs and causes cost under-recovery. There is nothing wrong, of course, with new rates going into effect that include some plant investment costs that have not yet been incurred, for that is inherent in future test year ratemaking. *See* 83 Ill. Adm. Code § 287.20.

The Proposed Order does not and cannot find that the end of year method or the Utilities' alternative compromise proposal is not permissible. The Commission's rules (83 Ill. Adm. Code § 285.2005(e)) permit use of the end of year method in a future test year case, as the Commission found in Nicor Gas Company's 2004 rate case, *Northern Illinois Gas Co.*, ICC Docket No. 04-0779 (Order Sept. 20, 2005) ("*Nicor 2004*"), p. 7, although it approved the average rate base method in that case. The Proposed Order also recognizes that the Commission's rules allow

use of the end of year method, although it reasons that the Utilities did not provide sufficient showing for use of that method. Proposed Order, p. 38. Staff witness Mr. Kahle acknowledged that the rule indicates average rate base is not the only permitted method. *See* Kahle Dir., Staff Ex. 2.0, 9:201 – 10:213.[21] Also, nothing in the rule or the Proposed Order provides any basis for concluding that the Utilities' alternative compromise proposal is not permitted.

The Proposed Order also does not and cannot find that past Commission decisions legally require use of the average rate base method here, although it notes that the prior decisions did not approve use of the end of year method. The Commission must decide the issues based on the record in these cases. 220 ILCS 5/10-103; 10-201(e)(IV)(a). *See also* NS-PGL Rep. Br. at 68 (further citations on the legal significance of past Commission orders). Even CUB-City (Init. Br. at 26) acknowledge that prior Commission orders are not *res judicata* and that the Commission must decide the issues based on the record here. Staff, the AG, and CUB-City focused much of their arguments on past Commission decisions, and they are right in particular that *Nicor 2004* provides support for their position, but the Utilities' briefs discussed the past decisions in detail, including *Nicor 2004*, and showed that legally, and based on their findings and reasoning, they do not require use of the average rate base method either in all future test year cases or in the instant cases in particular. NS-PGL Init. Br. at 21-24; NS-PGL Reply Brief ("Rep. Br.") at 23-24. The Utilities agree that they did not propose end of year rate base in their 2009 and 2011 rate cases. They did so in the instant Dockets, however, 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.*, Hengtgen Reb., NS-PGL Ex. 27.0, 6:123-141.

[21] Furthermore, the average rate base method includes values as of December 31st, so it includes the same projects in its calculation as do the Utilities' proposals, although the average rate base method then cuts in half the recovery of the costs of those projects.

Furthermore, neither the Proposed Order nor the arguments of Staff, the AG, and CUB-City have identified any prior case in which the Commission has been presented with any proposal similar to the Utilities' alternative compromise proposal. The past decisions provide no on point support against the alternative proposal.

The intervenors make other arguments that were not adopted by the Proposed Order. None of them has merit. CUB-City complain that the Utilities' proposals somehow are based on post-test year data or seek to recover non-test year costs (*e.g.*, Proposed Order, pp. 33-34), but that is false. Both of the Utilities' proposals use only test year data. CUB-City perhaps are referring to the Utilities' argument that increasing levels of investment justify use of an end of year rate base, which is true (NS-PGL Init. Br. at 19, 20-21 (in part noting Staff acknowledgements that the Utilities have increasing levels of plant investment and that that is normal)), but that argument does not change what data the Utilities' proposals actually use.

Staff, the AG, and CUB-City have claimed that they did not have a sufficient chance to "investigate" the Utilities' alternative compromise proposal (*see*, *e.g.*, Proposed Order, p. 19), but that is nonsense. The compromise proposal is based on the logic of the Staff, AG and CUB-City arguments, combined with a recognition of when the new rates will go into effect, and thus it simply averages (1) the averages of the year as using the same figure they used, as a proxy for the amount as of June 30th (which is proper because their own proposal assumes even investment over the course of the year) and (2) the amounts as of December 31st. Hengtgen Sur., NS-PGL Ex. 43.0, 10:218 - 11:240; NS-PGL Exs. 43.1N, 43.1P.

The AG claims that revenues and expenses are measured on an average basis and that there is an inconsistency between the Utilities' position here and the Utilities' position on how long term debt costs should be calculated (Proposed Order, p. 19), but neither claim warrants the

average rate base method here. 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* Kahle Tr. 2/4/13, 157:16 – 158:14.[22] As to long term debt, it is part of calculating net operating income, not operating expenses. In addition, the long term debt calculation is independent of the rate base valuation determination under the Commission's rules (83 Ill. Adm. Code § 285.4000(b)); under the rules the Utilities have a choice between using average or end of period balances for valuing the long-term components of their capital structure; and the Utilities appropriately chose the former in order to reflect the financing employed during the annual business cycle. Gast Sur., NS-PGL Ex. 38.0, 4:74 – 5:93.

Finally, Staff and the AG argue that use of a future test year is sufficiently "forward looking", even with the average rate base method, that the Commission need not be concerned about under-recovery of costs, although the AG is inconsistent about whether it admits there is under-recovery. *See* Staff Init. Br. at 12; AG Init. Br. at 13-14, 15, 17-18. That method does cause cost under-recovery, as shown above, and there is nothing to which Staff or the AG (or CUB-City) points that remedies the recovery shortfalls.

The Proposed Order should be modified as shown in Exception No. 1 in the Utilities' separate Exceptions language document, either to adopt the end of year method (Alternative (1)) or, alternatively, to adopt the Utilities' compromise proposal (Alternative (2)).

[22] The AG has misunderstood the record on the subject of depreciation expense, which is calculated on a cumulative basis as of December 31st of the test year. NS-PGL Rep. Br. at 20.

2. Plant

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

Exception No. 2

The Proposed Order (at p. 40) agrees with Staff that an adjustment to North Shore's forecasted plant additions is warranted but finds that such adjustment should be based on five years of North Shore's historical spending pattern, reducing North Shore's gross plant by $2,343,000.[23] The Proposed Order's adjustment is improper as it does not reflect North Shore's experience with public improvement projects. Hoops Reb., NS-PGL Ex. 28.0 Rev., 4:84-5:99. The variance between North Shore's budget and actual expenditures is primarily due to public improvement projects, which have been rescheduled or delayed. *Id.* These circumstances are not within North Shore's control. *Id.*

The Proposed Order should be amended consistent with the language in Exception No. 2. However, if the Commission determines that an adjustment is necessary, then it should adopt the Proposed Order's recommendation here, which correctly finds (at p. 40) that "by incorporating five years of data (2008 through 2012), it is more reflective of North Shore's actual experience."

c. Construction Work In Progress (PGL)

Technical Exception No. 1

The Proposed Order (at p. 65) correctly rejects the AG's proposed adjustment to Construction Work in Progress ("CWIP") and finds that AMRP-related costs are properly included in CWIP. The AG proposal is contrary to Section 9-214 of the Act, 220 ILCS 5/9-214, and unsupported by and contrary to the record. NS-PGL Init. Br. at 38-40; NS-PGL Rep. Br. at 41-42. However, the Proposed Order contains a typographical error in the Commission

[23] Proposed Order, Appendix A, p. 6, col. (d), line 1.

Analysis and Conclusion section. The amount of the AG adjustment as per the AG's rebuttal is $51,476,000 and not $4,639,000. Therefore, Technical Exception No. 1 should be adopted.

e. <u>Capital Costs for Non-AMRP Gas Services</u>

<u>Exception No. 3 and Technical Exception No. 2</u>

(i) <u>Exception No. 3</u>

The Proposed Order (at p. 67) incorrectly rejects Peoples Gas' surrebuttal's proposed adjustment to correct the amount of Non-AMRP Gas Services in rate base, and thus reduced its gross plant by $11,714,000.[24] The Proposed Order indicates that Peoples Gas did not explain why the error was not discovered sooner. If Peoples Gas was aware of the issue, it would have disclosed it. However, it was not until preparing surrebuttal that Peoples Gas discovered that test year amounts for Non-AMRP Gas Services were significantly understated.[25] Hoops Sur., NS-PGL Ex. 44.0, 10:211-218. 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. *Id.* For the test year, 2013, Peoples Gas incorrectly estimated Non-AMRP Gas Services to be $4,359,396. *Id.* This is demonstrated by the fact that for 2010, 2011, and 2012, Non-AMRP Gas Services were $26.0 million, $18.5 million, and $24.5 million, respectively. *Id.* Peoples Gas' proposal to increase Non-AMRP Gas Services to $16,073,896 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. NS-PGL Init. Br. at 40.

Further, the Proposed Order incorrectly concludes that parties were prejudiced because the correction of the amount occurred in surrebuttal. Staff and intervenors did have an opportunity to review and respond to the corrected Non-AMRP Gas Services amount as robust

[24] Proposed Order, Appendix B, p. 6, col. (d), line 1.
[25] Note that this item does not apply to North Shore.

discovery occurred after the Utilities filed surrebuttal, and there was an the opportunity to cross examine the appropriate Utilities' witness. For example, Staff witness Mr. Seagle reviewed Utilities witness Mr. Hoops' testimony concerning the Calumet System Upgrade and agreed that the project should be included in rate base. *See* NS-PGL Cross Ex. 13; Seagle Tr., 2/7/13, 631:5-16. Staff witness Mr. Kahle reviewed Utilities witness Mr. Hengtgen's surrebuttal and agreed with the alternative proposal for pass-through taxes in the lead-lag study. NS-PGL Cross Ex. 1. Both discovery and cross-examination occurred. *Id.* Furthermore, Staff took a similar position with respect to its 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 that was served approximately 25 *hours* before the Utilities' surrebuttal testimony was due. Therefore, parties were not precluded, much less unfairly precluded, from reviewing such data. Additionally, no party objected to the Utilities' surrebuttal reflecting 2013 bonus depreciation, reducing rate base, based on the passage of the American Taxpayer Relief Act of 2012 enacted in January 2013. Proposed Order, pp. 117-118. Exception No. 3 should be adopted.

(ii) <u>Technical Exception No. 2</u>

If the Commission determines that the Proposed Order's recommendations concerning Non-AMRP Gas Services and average rate base (*see* Section IV.C.1) both should be adopted, then a technical correction needs to be made to Appendix B of the Proposed Order. Column (d) of page 6 of Appendix B reflects the full amount of the proposed Non-AMRP Gas Services adjustment, which is based on an end of year rate base figure. Because the Proposed Order adopts the average rate base method, if that recommendation is adopted, the amount of

Non-AMRP Gas Services removed from rate base should be reduced by 50%. In that scenario, this correction also should be reflected in all affected rate base and revenue requirement figures.

3. Cash Working Capital

a. Pass-Through Taxes

Technical Exception No. 3

Without waiving any rights in future proceedings regarding their original proposal that pass-through taxes and energy assistance charges ("EACs") should be reflected at full revenue lag in the cash working capital ("CWC") calculation, the Utilities do not take exception to the Proposed Order's finding adopting the Utilities' alternative proposal. Proposed Order, p. 75. The Utilities believe that the Proposed Order's conclusion acknowledges both customer financing of these amounts and the Utilities' actual experience in collection and payment of the taxes and EACs. The Utilities note that while the Proposed Order states that Staff and intervenors do not object to this approach, only Staff agrees with the Utilities' alternative approach, which the Proposed Order correctly adopts.

However, the CWC computation in the Schedules of the Proposed Order contains an error. The Proposed Order (at p. 75) correctly finds that the revenue lag for the ICC Gas Revenue Tax should not be set at zero. In fact, neither Staff nor intervenors contest the fact that the ICC Gas Revenue Tax should be reflected at the full revenue lag. Brosch Reb., AG Ex. 4.0, 62:1381-1390; NS-PGL Cross Ex. 1. However, the Appendices attached to the Proposed Order do not reflect the ICC Gas Revenue Tax at full revenue. Thus, in Appendix A (North Shore), page 12 of 19 and Appendix B (Peoples Gas), page 13 of 18, a line needs to be added between line 1, Revenues, and Line 2, Other Pass Through Taxes to include the ICC Gas Revenue Tax. Therefore, page 12 of Appendix A (North Shore) should be adjusted as follows:

Appendix A, Page 12 of 19: CWC Adjustments (in Thousands)						
Line No.	Item	Amount	Lag (Lead)	CWC Factor (D) /365	CWC Requirement (C)x(E)	Column (C) Source
(A)	(B)	(C)	(D)	(E)	(F)	(G)
1	Revenues	$170,171	40.50	0.11096	$18,882	App. A, p. 13, Line 7
2	ICC Gas Revenue Tax	198	40.50	0.11096	22	From Line 21 Below
3	Other Pass-Through Taxes	15,651	0	0.00000		Sum of lines 22 - 24 below
4	Total	$186,020			$18,904	Line 1 + Line2

Page 13 of Appendix B (Peoples Gas) should be adjusted as follows:

Appendix B, Page 13 of 19: CWC Adjustments (in Thousands)						
Line No.	Item	Amount	Lag (Lead)	CWC Factor (D) /365	CWC Requirement (C)x(E)	Column (C) Source
(A)	(B)	(C)	(D)	(E)	(F)	(G)
1	Revenues	$872,584	49.49	0.13586	$118,552	App. A, p. 14, Line 7
2	ICC Gas Revenue Tax	1,058	49.59	0.13586	144	From Line 21 Below
3	Other Pass-Through Taxes	160,721	0	0.00000		Sum of lines 22 - 25 below
4	Total	$1,034,363			$118,696	Line 1 + Line2

These corrections also should be reflected in all affected rate base and revenue requirement figures.

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

<u>Exception No. 4</u>

The second contested aspect of the Utilities' lead-lag CWC study relates to the expense lead for Pension and Other Post-Employment Benefits ("OPEB") expenses. The Proposed Order

(at p. 79) adopts Staff's recommendation to reflect a lead value of the intercompany billing amount. The Proposed Order's lead value for Pension and OPEB expenses should be rejected for several reasons. Intercompany billing payments have no relation to the cash flows related to Pension and OPEB expenses. Hengtgen Sur., NS-PGL Ex. 43.0, 24:549-25:553. Further, to include a lead time would be duplicative because pension and OPEB as balance sheet items are already (or should be) included in rate base. Hengtgen Dir., NS Ex. 7.0, 31:670-674; Hengtgen Dir., PGL Ex. 7.0, 34:726-730. The Utilities note that their recommendation is the same recommendation made by Staff witness Mr. Kahle in *Commonwealth Edison Co*., ICC Docket No. 11-0721 ("*ComEd 2011*") and approved by the Commission in its final Order in that Docket on May 29, 2012. Hengtgen Reb., NS-PGL Ex. 27.0, 31:675-685. However, if the Commission determines that a lead value is appropriate, it should approve the Staff proposal that uses the intercompany billing amount, which the Proposed Order adopts, as it is superior to the AG methodology. Exception No. 4 should be adopted.

4. Retirement Benefits, Net

Exception No. 5

The Proposed Order (at p. 90) recommends exclusion of the Utilities' pension assets (prepaid pension expense) from rate base, reducing Peoples Gas' rate base by a gross $83,706,000 and North Shore's by a gross $479,000, while also reducing rate base by the Utilities' OPEB liabilities. The Proposed Order, for its grounds, relies entirely on the findings of past Commission Orders. *Id*.

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 then 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, furthermore, that the *Peoples Gas 2009* Order was affirmed on appeal on this subject.[26]

The Utilities respectfully request, however, that the Commission reconsider whether to include the Utilities' pension asset(s) in the instant cases, and, alternatively, whether to allow recovery of specific North Shore pension contributions or exclude the OPEB liabilities. As discussed in Section IV.C.1 of this Brief on Exceptions, above, the Commission must decide these cases based on their evidentiary records (220 ILCS 5/10-103; 220 ILCS 5/10-201(e)(iv)(A)), and past Commission decisions, while they should be considered when the circumstances are relevant, are not *res judicata*.

The Utilities use the term "pension assets" here because, if the end of year rate base method (or the average of the last six months of the test year) is used, then Peoples Gas has a pension asset and North Shore has a pension liability, but, if the average rate base method is used, as the Proposed Order recommends, then both of the Utilities have pension assets.[27] The figures for the first two methods are as follows:

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

[26] *Peoples Gas 2007* Order at p. 36; *Peoples Gas 2009* Order at pp. 35-37, *aff'd in relevant 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) ("*Peoples Gas 2009 Appeal*") (finding that the Commission's conclusion was not clearly against the manifest weight of the evidence); *Peoples Gas 2011* Order at p. 33. The Appellate Court upheld the Commission's decision to allow ComEd a debt rate of return on its 2005 pension contribution, *Commonwealth Edison Co*., ICC Docket No. 05-0597 (Order on Rehearing Dec. 20, 2006), p. 28, *aff'd, Commonwealth Edison Co. v. Illinois Commerce Comm'n*, 398 Ill. App. 3d 510, 521, 924 N.E.2d 1065, 180 (2d Dist. Sept. 17, 2009), *reh'g denied*, April 6, 2010, *appeal denied*, 237 Ill. 2d 554, 938 N.E.2d 519 (Sept. 29, 2010). The *Peoples Gas 2009 Appeal* decision contained references to the latter Appellate Court decision but did not discuss its ruling on this subject.

[27] That choice of methods is discussed in Section IV.C.1.

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 last six months average would be the average of the above numbers.)

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 advanced that same position in the instant cases, while the AG simply proposed to apply the prior Commission decisions. *E.g.,* Pearce Dir., Staff Ex. 4.0, 4:72-80; Smith Dir., CUB-City Ex. 1.0, 18:397-399; Effron Dir., AG Ex. 2.0, 12:249 - 13:267.[28]

The Commission should reconsider approving inclusion of the pension assets in rate base on five grounds:

(1) 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).

(2) 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. Phillips Reb., NS-PGL Ex. 31.0, 12:258-261.

[28] Staff witness Ms. Pearce also claimed that a utility does not have a pension asset unless it has fully funded all of its future, unrecognized pension liabilities, but she expressly stated that she was not offering that as a ground for her opposition to inclusion of the pension assets in rate base. Pearce Dir., Staff Ex. 4.0, 3:57-66. Ms. Pearce's claim is contrary to GAAP, and to common sense about what is an asset, is undercut by past testimony of Ms. Pearce and of Staff witness Ms. Ebrey in the Utilities' 2009 and 2011 cases, and simply is incorrect. Phillips Reb., NS-PGL Ex. 31.0, 11:225-230, 13:274 – 14:302; Phillips Sur., NS-PGL Ex. 47.0, 6:111-131. Ms. Pearce's claim also is contrary to past Commission Orders. However, because Ms. Pearce expressly does not base her position on this claim, and the Proposed Order did not adopt it, the Utilities see no purpose in discussing it further in this Brief on Exceptions.

(3) 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. Phillips Reb., NS-PGL Ex. 31.0, 12:262 – 13:263.

(4) As Staff witness Ms. Pearce has acknowledged, normal operating revenues of a utility include amounts collected through rates to repay the utility's cost of capital, and the portion of amounts collected from customers that ends up as net income is retained earnings, and thus is part of shareholder's equity, to the extent it is not paid out in dividends. Phillips Dir., PGL Ex. 11.0, 13:288-289; Phillips Dir., NS Ex. 11.0, 13:294-295; Phillips Reb., NS-PGL Ex. 31.0, 13:264-268.

(5) Cumulative pension contributions, that is direct contributions into the trust, have exceeded cumulative recognized Generally Accepted Accounting Principles ("GAAP") pension expense. Phillips Sur., NS-PGL Ex. 47.0, 4:84 - 5:110; NS-PGL Ex. 47.1, Attachments A and B.

In particular, point 4, above, first was raised by the Utilities in *Peoples Gas 2011*, but Staff and the applicable intervenors did not refute it there, nor have they done so here. They have ignored point 4 here without even attempting to refute it. Moreover, the Commission Analysis and Conclusion in *Peoples Gas 2011* Order (*see* p. 33) did not expressly address it. Nor does the Proposed Order here.

The data in point 5, above, was not presented in the prior cases, although somewhat similar points sometimes were made. Thus, the Commission has sufficient grounds for reconsidering this issue and, of course, the decision should be based on the evidence in the record of the instant Dockets. Exception No. 5 should be adopted. Please note that Exception No. 5 has four alternative versions, depending on which rate base methodology is used (if the

end of year method is used, then North Shore has a pension liability) and the following further alternative scenarios.

In the alternative, the Commission should: (1) 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; or, further in the alternative, (2) exclude the Utilities' OPEB liabilities from rate base to be consistent. Phillips Dir. PGL Ex. 11.0, 13:284-287; Phillips Dir., NS Ex. 11.0, 13:290-295; Phillips Reb., NS-PGL Ex. 31.0, 14:305-306, 15:318-325, 16:335-345.

The *Peoples Gas 2007* Order (at p. 36) did not allow a recovery on the 2006 pension contributions of Peoples Gas and North Shore, but that was based on finding that they were funded by (or had not been shown not to be funded by) customers, which the evidence shows is not the case here. The *Peoples Gas 2009* and *Peoples Gas 2011* Orders in the Commission Analysis and Conclusion sections did not explicitly address recovery of specific contributions of the Utilities. The *Peoples Gas 2009* Order (at p. 36), in discussing the overall pension asset recovery issue, did distinguish the Commission's decision to allow ComEd a debt rate of return on its 2005 pension contribution, *Commonwealth Edison Co*., ICC Docket No. 05-0597 (Order on Rehearing Dec. 20, 2006) at p. 28, *aff'd*, *Commonwealth Edison Co. v. Illinois Commerce Comm'n*, 398 Ill. App. 3d 510, 521, 924 N.E.2d 1065, 1080 (2d Dist. Sept. 17, 2009), *reh'g denied*, April 6, 2010, *appeal denied*, 237 Ill. 2d 554, 938 N.E.2d 519 (Sept. 29, 2010). However, that distinction was based on the finding that Peoples Gas had not shown its pension asset to be funded by shareholders. *Peoples Gas 2009* Order, p. 36. In the alternative, the applicable alternative language of Exception No. 5 should be adopted.

Accordingly, the Commission (1) should approve the inclusion of the pension asset(s) in rate base, or (2) should adopt one of the alternative positions of the Utilities. The applicable language from Exception No. 5 should be used.

5. Net Operating Losses

Technical Exception No. 4

The Proposed Order (at pp. 99-100) correctly determines that both the Utilities' 2012 and 2013 Net Operating Losses should be reflected in rate base. However, Page 11, Appendix A (North Shore) of the Proposed Order contains a couple of errors. If the Commission adopts the Proposed Order's recommendation concerning the average rate base method, the amount on page 11, column (D), line 2 of Appendix A should be ($1,049,000) and the amount on page 11, column (D), line 3 should be $1,074,000. Further, page 11, Column (D), line 5 of Appendix A should be ($1,049,000). The number currently reflected on line 5 is overstated by ($1,049,000). For North Shore, assuming the average rate base adjustment is approved, the proper amount of NOL should be 50% of the 2012 NOL balance. Additionally, page 12, Appendix B (Peoples Gas) of the Proposed Order contains a couple of errors. If the Commission adopts the Proposed Order's recommendation concerning the average rate base method, the amount on page 12, column (D), line 2 of Appendix B should be ($10,330,000) or 50% of ($20,661,000). Further, page 12, Column (D), line 5 of Appendix B should be ($10,330,000). The number currently reflected on line 5 is overstated by ($24,203,000) as it double counts the average rate base adjustment (by $13,872,000) and double counts the "effect of rate increase" adjustment (by $10,330,000). Technical Exception No. 4 should be adopted. These corrections also should be reflected in all affected rate base and revenue requirement figures.

6. Accumulated Deferred Income Taxes

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

Exception No. 6

Even though the Proposed Order correctly affirms the Commission decision in *Illinois Commerce Comm'n On Its Own Motion*, ICC Docket No. 83-0309, 1985 Ill. PUC Lexis 5 (Order Sept. 18, 1985) ("*83-0309 Order*") authorizing the use of the Average Rate Assumption Method ("ARAM") when federal or state tax incomes tax rates change, it incorrectly concludes that the AG and CUB-City have shown good cause that an exception from ARAM is warranted for the state tax rate change at issue in this proceeding. The AG and CUB-City partial-flow through methodology that the Proposed Order adopts is improper because it distorts costs of service and does not balance and protect the interests of all stakeholders – current customers, future customers, and shareholders. Further, it is inconsistent with income tax and Federal Energy Regulatory Commission ("FERC") regulations related to normalization. Finally, the AG and CUB-City have not demonstrated good cause to deviate from the well-established ARAM, as discussed below. Staff agrees. Staff Init. Br. at 42; Staff Rep. Br. at 56-57; Pearce Reb., Staff Ex. 14.0, 21:456 - 22:489. However, if the Commission determines that good cause had been shown to change the methodology to account for deferred income taxes for this particular state tax rate change, then clarifying language should be included in the Commission's Order regarding the implementation of this change in methodology. Exception No. 6, Alternative (1) or (2), should be adopted.

(i) The AG and CUB-City Did Not Show Good Cause To Deviate From the 83-0309 Order

A. Accounting for Deferred Income Taxes And Changed in Income Tax Rates

Generally, any differences between how income and deductions are recognized for financial statement purposes or "book" purposes as compared to tax return purposes are called "book to tax differences." Stabile Reb., NS-PGL Ex. 30.0 Rev., 4:79-81. A book to tax difference can either be permanent, where a deduction is allowed for book purposes but not for tax purposes, or temporary, where a deduction is allowed for both book and tax purposes but the timing of the deduction varies. *Id.* at 81-97. One of these temporary book-to-tax differences is depreciation; for financial statement purposes, straight-line depreciation[29] is used and for tax purposes, accelerated depreciation[30] is used. *Id.* at 6:142-145, *see also 83-0309* Order, 1985 Ill. PUC Lexis 5 at *3. Using accelerated depreciation defers income taxes in the early years of an asset's life by reducing taxable income in those early years (through higher depreciation expense) in exchange for increased taxable income in future years (through lower depreciation expense). Stabile Reb., NS-PGL Ex. 30.0 Rev., 27:667-669. The difference between the amount of taxes a utility pays under book depreciation versus tax deprecation is placed in a reserve account, such as Accumulated Deferred Income Taxes ("ADIT"). S*ee 83-0309* Order, 1985 Ill. PUC Lexis 5 at *3. As it explains in *83-0309 Order*, because the Commission sets rates as if a utility claims book deprecation for tax purposes, when book depreciation begins to exceed tax deprecation (the book to tax difference reverses) the utility will draw upon ADIT to make up the

[29] Straight-line depreciation expenses the cost of an asset evenly over its useful life. Stabile Reb., NS-PGL Ex. 30.0 Rev., 28:676-678.
[30] Accelerated depreciation expenses more of the cost of an asset in the early years of its useful life. Stabile Reb., NS-PGL Ex. 30.0 Rev., 27:665-667.

difference between the larger tax liability actually owed and the smaller liability used for ratemaking purposes. *83-0309 Order*, 1985 Ill. PUC Lexis 5 at *3.

The Commission initiated Docket No. 83-0309 in order to determine present accounting treatment of deferred tax changes in light of statutory income tax rate changes. After evaluating at least seven alternative treatments in that proceeding (*id*. at *4), the Commission determined that ARAM should be adopted uniformly by all Illinois utilities because:

> (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 …

Id. at *29-30. ARAM allows the return of excess (or deficient) ADIT over the remaining useful life of the assets, which gave rise to the excess (or deficient) deferred taxes. Interestingly, 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.

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%. Stabile Reb., NS-PGL Ex. 30.0 Rev., 12:285-293. 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 second formula rate proceeding, and Docket No. 12-0293, Ameren Illinois' second formula rate proceeding. Stabile Sur., NS-PGL Ex. 46.0, 19:432-435. 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; *Commonwealth Edison Co*., ICC Docket

No. 12-0321 (Order Dec. 19, 2012), pp. 32-33; *Ameren Ill. Co.*, ICC Docket No. 12-0293 (Order Dec. 5, 2012), pp. 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. Stabile Reb., NS-PGL Ex. 30.0 Rev. 13:310-313.

B. The Proposed Order's Recommended Methodology Distorts Costs of Service

In its *83-0309 Order*, the Commission adopted 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, as noted above, 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. The AG and CUB-City proposed partial flow through methodology, which the Proposed Order would adopt, distorts costs of service and does not balance and protect the interests of all stakeholders in favor of a quick payback of benefits. The proposed methodology unfairly sacrifices future customers in order to provide a benefit to current customers. As such, the AG and CUB-City proposal should be rejected.

The Proposed Order (at p. 112) incorrectly concludes that

> The lower deferred tax balances and correspondingly larger future rate base amounts simply and consistently account for the time value of money during those years that the Companies are not receiving the larger tax deferral benefits that would be collected from customers under the ARAM method.

By using ARAM as prescribed by the *83-0309 Order*, the Utilities 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, who benefit from the *asset*, pay a normalized cost of the asset. However, the AG and CUB-City adjustment is based on originating plant-related book to tax differences that are expected to arise in the 2013 test year. The tax positions driving the majority of these originating plant-related book to tax differences are: tax repair deductions taken on

capital expenditures that will be capitalized and depreciated and accelerated tax and bonus depreciation deductions over book depreciation deductions. The effect of the AG and CUB-City proposed methodology for a tax repair 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 Init. Br. at 64-65; Stabile Reb., NS-PGL Ex. 30.0 Rev., 7:154-163. 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. This is improper because future customers who will be paying for the same *asset* through depreciation are denied the benefit. The Commission recognized this in rejecting a quick payback method in the *83-0309 Order* and it should do so here.

As the Commission acknowledged in the *83-0309 Order*, ARAM is fair to all customers as it normalizes the tax benefit or tax deficiency into rates over the assets' in-service life -- matching the depreciation expense which originally caused the book to tax difference. NS-PGL Init. Br. at 65-66; Stabile Reb., NS-PGL Ex. 30.0 Rev., 8:191-193. Interestingly, one of the reasons that the AG and CUB-City argue (*see, e.g.*, AG Init. Br. at 5-18; CUB-City Init, Br. at 11-18) and the Proposed Order relies upon (at p. 38) to reject the Utilities' year-end rate base proposal is the matching principal; a concept which they abandon here. Furthermore, under ARAM, the benefit or deficiency of any rate change is included in rate base only to the extent *realized* and then it is normalized into rates as a component of cost of service as the book to tax difference reverses, such as over the useful life of the assets that originally created the book to tax difference. Stabile Reb., NS-PGL Ex. 30.0 Rev., 9:215-10:219. As acknowledged by the

Proposed Order (at p. 117), the repairs deduction methodology elected by the Utilities is still at risk with gas industry guidance still pending and the interpretation of electric industry guidance that has been issued in question. As such, any calculation of a future tax "benefit" is in question. Stabile Reb., NS-PGL Ex. 30.0 Rev., 8:194-9:203. Because a tax benefit or deficiency is only recorded when realized under ARAM, the tax impact of any future adjustment of a tax estimate related to a temporary book to tax difference, such as depreciation, is minimized and normalized over the remaining life of the underlying asset. *Id.* at 10:219-226. Thus, 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 any one group.

C. The Proposed Order Methodology Is Inconsistent With Existing Regulations Regarding Normalization

The methodology adopted by the Proposed Order to account for deferred taxes is also contrary to existing regulations regarding normalization. In its *83-0309 Order*, the Commission was keenly aware that the uniform method to be used by all Illinois utilities and that would be applied to both federal and state income tax changes be "nonviolative of the IRS's prescription of normalization for utility ratemaking purposes." *83-0309 Order*, 1985 Ill. PUC Lexis 5 at *29-30. Thus, the Commission should reject the use of the partial flow through methodology.

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 Init. Br. at 62-63; Stabile Sur., NS-PGL Ex. 46.0, 9:198-202. Utility normalization is prescribed in two places: the federal income tax rules on normalization and the FERC regulation on normalization. *Id.* at 8:194 – 9:214. The Proposed

Order recommendation would reduce the amount of tax deferred as prescribed for in these regulations. In other words, the Proposed Order methodology no longer reflects the difference between the actual tax liability and the tax liability based upon book expenses. This proposal is no longer "nonviolative of the IRS's prescription of normalization for utility ratemaking purposes."

Finally, the intent of allowing for accelerated tax depreciation is not to reduce utility rates by providing a "quick payback" of excess deferred taxes when federal or state tax rates change. NS-PGL Init. Br. at 63; Stabile Sur., NS-PGL Ex. 46.0, 11:251-260. More importantly, the reason the Proposed Order method is not a direct violation of normalization rules is because at issue is a change in state income tax rate and not the federal tax rate. *Id.* at 11:264-12:270

D. ARAM Ensures Consistency Across Illinois Utilities

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 state tax rate at issue is not different from other temporary changes in state income tax rates that occurred in 1989 and 2003. NS-PGL Rep. Br. at 59-60; Stabile Sur., NS-PGL Ex. 46.0, 18:422-19:426. *See also* Stabile Reb., NS-PGL Ex. 30.0 Rev., 12:283-293. As noted in the Proposed Order (at p. 112), the proposed methodology is similar to that used in the ComEd and Ameren formula rate cases, which are the only known deviations from ARAM that has occurred in over twenty-five years. However, the records in those proceedings are devoid of any discussion of the merits of such a methodology. Stabile Sur., NS-PGL Ex. 46.0, 20:476-21:491. If this methodology is to be used for the state income tax rate change at issue then it should be applied 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. *Id.* at 20:494 – 21:496. 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 receiving any of the "flow-through" benefits of the temporary schedule rates. *Id.* at 21:511 – 22:525. This is just one example. Thus, not only does adopting this methodology treat the Utilities' present and future customers differently, it is treating utility customers in Illinois differently.

E. Conclusion

The record demonstrates good cause has not been demonstrated to deviate from ARAM. Staff agrees. For the foregoing reasons, Exception No. 6, Alternative (1) should be adopted.

(ii) If the Commission Adopts the Proposed Order Proposal, Clarifying Language Is Required

If the Commission determines that the partial flow through method proposed by the AG and CUB-City is appropriate, then the Proposed Order should be amended based on the Utilities' recommend language in Exception No. 6, Alternative (2), to clearly state that (1) ARAM and the *83-0309 Order* still control changes in federal and state income tax rates and (2) good cause has been shown for the income tax rate change at issue in this proceeding to deviate from that Order.

Additionally, the Utilities propose language for the Proposed Order in Exception No. 7, Alternative (2), to allow the Utilities to implement the new methodology correctly and to properly reflect the amount of the adjustment. First, the AG and CUB-City related adjustment that the Proposed Order adopts results in a one-sided income statement adjustment. Stabile Reb., NS-PGL Ex. 30.0 Rev., 16:378-391. Therefore, the Proposed Order should be amended to also include an adjustment to the balance sheet that would decrease deferred taxes by the same amount. *Id.* Additionally, the Proposed Order should reflect that the AG and CUB-City

adjustment is only based upon plant-related book-to-tax differences. *Id.* Finally, the change in the state income tax rate became effective on January 1, 2011. As a result, consistent with the ComEd and Ameren dockets, the Commission should order the Utilities to re-measure deferred taxes for its next rate case consistent with this Order for originating differences from the time the temporary state tax rate became effective. *Id.*

Second, the Proposed Order adopts the AG's computation of the adjustment to reflect the use of the partial flow through method. However, this computation does not reflect the effect of the Proposed Order regarding plant, including for example the rejection of the AG's proposal to impute the repairs deduction on AMRP-related work. Therefore, the Proposed Order should adopt the adjustments in Schedule 7N and 7P of the CUB-City Initial Brief for North Shore and Peoples Gas, respectively. *See also* CUB-City Ex. 2.1, page 22 of 41.

V. OPERATING EXPENSES

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

1. Administrative & General

i. Update to IBS Return on Investment

Technical Exception No. 5

The Proposed Order (at p. 120) reflects that the Utilities and the AG agreed that the Integrys Business Support rates of return reflected in costs charged and allocated to the Utilities should be updated. As the Utilities have reviewed this subject, however, they have identified that there has been some ambiguity in discussion of the subject and that neither party provided specifics of the calculation method they intended, and that this is reflected in the Proposed Order's Appendices.

The Utilities, in rebuttal, updated the IBS returns to reflect the returns approved in *Peoples Gas 2011*. Moy Reb., NS-PGL Ex. 26.0, 5:107.

However, neither the AG in rebuttal, nor the Utilities in surrebuttal, nor either party at the evidentiary hearing, discussed how any further update could or should be made to reflect the rates of return approved in the final Order in these Dockets.

The final Order in this Docket is expected near the end of June 2013. Thus, IBS amounts charged or allocated to the Utilities will not reflect the rates of returns in the final Order until July 2013. One possibility is to use the amounts based on the returns approved in *Peoples Gas 2011*, but if the IBS amounts are to be adjusted to reflect the final approved rates of return in the instant Dockets, as appears to be intended, then the adjustments should only be made at the 50% (six months calculation) level, because IBS costs will not change retroactively. Such a 50% calculation would reduce these costs at North Shore by $20,291, and at Peoples Gas by $13,125. Technical Exception No. 5 should be adopted.

3. Depreciation Expense

i. WAM System

Technical Exception No. 6

The Utilities note that while this subsection concerns depreciation expense related to the Work Asset Management ("WAM") system, the subject involves amounts billed to Peoples Gas by IBS and, therefore, is an Administrative and General Expense item. Accordingly, this subsection technically belongs as Section V.B.1.k rather than as Section V.B.3.i. The Utilities apologize for not earlier identifying this technical point regarding the outline.

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

2. Wage Increase Corrections

Exception No. 7

The adjustment to the Utilities' capitalized construction wages made by this section of the Proposed Order is derivative of the Proposed Order's erroneous recommendations that the Commission adopt an average year rate base methodology, as well as Staff's proposed adjustments to the Utilities' non-union wage bases. Proposed Order, p. 131. For the reasons fully explained in Section IV.C.1, *supra*, and Section V.C.3, *infra*, respectively, of this Brief on Exceptions, the Commission should reject both of those recommendations. If the Commission rejects the average year rate base methodology, then no "correction" to Staff's adjustment of the Utilities' capitalized construction wages is necessary. If the Commission rejects Staff's proposed non-union wage base adjustments, then there will be no such adjustment here to "correct." Consequently, under either scenario, the "correction" recommended in this section of the Proposed Order becomes unnecessary and should not be adopted. Exception No. 7 should be adopted.

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

Exception No. 8

The Proposed Order's recommendation to accept Staff's adjustment to the Utilities' non-union wage base increase for 2013 from 3.45% to 2.28% (Proposed Order, p. 136) suffers from two major flaws. First, and most significant, Staff's calculation of this adjustment adopted by the Proposed Order results in a disallowance that is nearly ten times greater than should be generated by the 1.17% adjustment to Peoples Gas' base wages increase proposed by Staff, and nearly four times greater than should be generated for North Shore. This error is caused by

Staff's failure to account for the fact that a large portion of the increase in the Utilities' non-union base wages for 2013 is attributable to the significant increases in the Utilities' headcounts that have occurred since their last rate cases. Second, the Proposed Order's recommendation to adjust the Utilities non-union base wage increase from 3.45% to 2.28% should be rejected for failing to consider uncontradicted record evidence supporting the Utilities' proposed increases.

a. The Erroneous Calculation of the Non-Union Base Wages Adjustment Must Be Corrected

The Utilities requested that their non-union base wages from 2012 to 2013 be increased from $59,045,000 to $66,665,000 for Peoples Gas and from $10,346,000 to $11,027,000 for North Shore. Part of this increase in the Utilities' non-union base wages was attributable to a planned increases in the amount of wages paid to existing employees which, in total, amount to 3.45% of the Utilities' non-union base wages. Cleary Reb., NS-PGL Ex. 29.0, 13:283 – 18:401. The remaining portion of the increase in the Utilities' base wages was attributable to a significant overall increase in the Utilities' non-union workforces. Hoops Dir., PGL Ex. 8.0, 14:283 - 16:330; Hoops Reb., NS-PGL Ex. 28.0 Rev., 13:263 – 14:292; Hoops Sur., NS-PGL Ex. 44.0, 10:220 - 11:237.

Staff's proposed adjustment that the Proposed Order recommends adopting is to reduce the planned increase in wages paid to employees from 3.45% to 2.28%. This 1.17% adjustment to wage increases requested by the Utilities should result in disallowances of $691,000 for Peoples Gas (.0117 * $59,045,000) and $121,000 for North Shore (.0117 * $10,346,000). Staff's calculation of its adjustment adopted by the Proposed Order, however, grossly miscalculates the amount of this adjustment, resulting in recommended disallowances of $5,637,000 for Peoples Gas and $418,000 for North Shore. *See* Proposed Order, Appendices A and B at p.3, col. (l),

line 18. The reason is that Staff's calculation of this disallowance failed to account for the portion of the overall increase in the Utilities' non-union base wages attributable to their increased headcounts, calculating that non-union base wages should increase between 2012 and 2013 only by a total of 2.28% of the 2012 amount. *See* Ostrander Reb., Staff Ex. 13.0, Staff Schedules 13.02 N and P, p. 2. Adopting this calculation of the proposed 1.17% adjustment would thus erroneously result in actual disallowances equal to 9.5% of Peoples Gas' and 4.0% of North Shore's non-union base wages. Moreover, this calculation implicitly results in a "vacancy" adjustment by disallowing the costs of the Utilities' increased headcounts for 2013, a result that is inconsistent with the Proposed Order's recommendation to reject such an adjustment requested by the AG and CUB-City. *See* Proposed Order, pp. 140-141.

Accordingly, even if the Commission agrees with the Proposed Order's recommendation to adopt Staff's proposal to adjust the Utilities' non-union base wages increase of 3.45% to 2.28%, the Commission needs to correct the calculation of the disallowances to properly reflect an amount equal to only 1.17% of the Utilities' 2012 non-union base wages (*i.e.*, $691,000 for Peoples Gas and $121,000 for North Shore). The Utilities have proposed Exceptions language in Alternative (2) to Exception No. 8 should the Commission wish only to correct the calculation of the disallowance resulting from this adjustment, but adopt the 1.17% adjustment to the Utilities' non-union base wages increase recommended by the Proposed Order.

b. The Record Evidence Does Not Support Staff's Non-Union Base Wages Adjustment

Furthermore, the record evidence does not support adopting Staff's proposed adjustment to the Utilities' non-union base wages increase, even if it is correctly calculated. One of the main errors in the Proposed Order's analysis of Staff's proposal is that it treats the overall 3.45% increase in the Utilities' non-union base wages as a whole, when in fact it is comprised of three

separate components. The undisputed record evidence demonstrates that the Utilities' requested increase in non-union base wages of 3.45% consists of: (i) a general wage increase (2.60%); (ii) a pool of funds to provide for merit-based increases to particular high-performing employees (0.45%); and (iii) a pool of funds to provide for costs attributable to pay increases commensurate with promotions and market adjustments (0.40%). Cleary Reb., NS-PGL Ex. 29.0, 17:360-369, 18:283-401. By adopting Staff's approach of merely comparing a 2012-2016 forecast of consumer inflation (2.28%) to the Utilities' overall non-union base wages increase (3.45%), the Proposed Order's analysis fails to address the record evidence supporting each of the individual components of the Utilities' non-union base wages increase. This divide between the record evidence and the Proposed Order's analysis results in the Proposed Order's conclusion lacking the support of substantial record evidence.

i. The Record Evidence Supports Recovery Of the Component to be Used For Individual Merit-Based Increases

The divergence between the record evidence and the Proposed Order's recommendation is greatest with respect to the component of the Utilities' non-union base wages increase consisting of a pool of funds to be used to provide additional, individual pay increases to particular employees who have demonstrated exemplary performance. Cleary Reb., NS-PGL Ex. 29.0, 18:393-398. In the aggregate, these individual increases total an amount equal to 0.45% of the Utilities' total non-union base wages. *Id*. 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 record 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 witness Mr. Ostrander's opinion as to appropriate wage increases for high-performing employees.

On cross-examination, Staff witness Mr. Ostrander testified 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, and 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. Ostrander Tr. 2/5/13, 250:3-16, 250:20-252:6; *see also* Ostrander Reb., Staff Ex. 13.0, 13:233-235. The record evidence established that the merit-based increases to be funded by this component of the non-union wage base increase would be given only to employees who receive exemplary performance reviews to bring those 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%). Cleary Sur., NS-PGL Ex. 45.0, 14:289-293. Further, the record evidence confirmed that, contrary to Staff's belief, the Utilities have no discretion in whether or not to use the full amount of these funds because it is automatically used to award individual merit-based increases to high performing employees; the Utilities used the full amount of these funds in both 2011 and 2012; and not every non-union employee receives such an increase, but rather, <u>only those who receive exemplary performance reviews</u>. Ostrander Tr. 2/5/13, 252:21-254:1, 254:4-255:19, 257:16 - 259:22; NS-PGL Cross Ex. 3; Cleary Sur., NS-PGL Ex. 45.0, 14:279-287, 14:289-295; NS-PGL Exs. 45.4 and 45.5.

Thus, all of the record evidence compels the conclusion 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 Proposed Order, however, fails to account for this evidence in its analysis and conclusion. Accordingly, the Commission should reject the Proposed Order's recommended elimination of this component of the Utilities' non-union wage base increase.

ii. The Record Evidence Supports Recovery Of the Component to be Used <u>For Individual Promotional Increases</u>

Similarly, the Utilities presented additional evidence in these Dockets to support the recovery of the component of the Utilities' requested non-union base wages increase to be used to provide discrete pay increases to employees who are promoted, which in the aggregate total an amount equal to 0.40% of the Utilities' total non-union base wages. Cleary Reb., NS-PGL Ex. 29.0, 18:387-392. While the use of these funds – unlike the component used to award individual merit-based increases – is discretionary, the record evidence shows that it is a common market practice for employers to budget for promotions in this manner, as well as that the Utilities 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. *Id.*; Cleary Sur., NS-PGL Ex. 45.0, 14:301 - 15:306; NS-PGL Ex. 45.4 Further, the record evidence confirms that contrary to Staff's assumption, these funds also are not awarded to all employees, but rather, only to specific employees who receive promotions where a commensurate increase in pay for the new position is appropriate. Cleary Sur., NS-PGL Ex. 45.0, 15:306-308. As with the merit-based component of the Utilities' non-union base wages increase, the Proposed Order's analysis fails to account for or address this evidence. For these reasons, the Proposed Order's recommended elimination of this component of the Utilities' proposed non-union base wages increase likewise should be rejected. Exception No. 8, Alternative (1A), should be adopted.

As discussed in the Utilities' post-hearing briefs, however, the Utilities recognize the concern expressed by Staff in testimony that because the use of these funds is discretionary, less than the full forecasted amount of such funds has been used in previous years. Consequently, the Utilities propose in the alternative that for this component of its requested non-union wage base

increase, the Commission award an amount of recovery equal to the percentage by which such funds accounted for the Utilities' respective total non-union wages in 2012: 0.154% for Peoples Gas and 0.007% for North Shore. *See* NS-PGL Ex. 45.6. Proposed language for this alternative is shown in Exception No. 8, Alternative (1B).

iii. The Proposed Adjustment to the General Wage Increase Based on a Forecast of CPI Is Not Supported by the Record Evidence

The component of the Utilities' non-union base wages increase to which the Proposed Order'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. Yet, the Proposed Order's reliance on a forecast of the Consumer Price Index ("CPI") for purposes of determining an appropriate level of general wage increase is misplaced and lacks support in the record evidence.

The CPI is a measure designed to reflect consumer spending patterns and not the wage-setting decisions of employers. The Bureau of Labor Statistics calculates CPI for purposes of showing a change over time in the prices paid by consumers for a market basket of goods and services. Cleary Reb., NS-PGL Ex. 29.0, 19:422 - 20:427 and n.4; Cleary Sur., NS-PGL Ex. 45.0, 12:243-251. Also, CPI is overly broad for purposes of determining a reasonable market wage increase for a natural gas utility because it is calculated based upon all urban consumers and is not focused on specific industries, such as energy or utility services. Cleary Reb., NS-PGL Ex. 29.0, 20:427-430.

Further, the Proposed Order's conclusion that the CPI forecast upon which it relies is more appropriate because it covers a five-year period (2012-2016) rather than the single year of 2013, and thus "more accurately" matches the period that the rates set in this case will be in effect (Proposed Order, p. 136), lacks any support in the record evidence. Moreover, this

conclusion contradicts the Proposed Order's reasoning in recommending that an average rate base be used. This reasoning also is incorrect as a matter of law 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 Sections 9-220(h) and 9-220(h-1), 220 ILCS 5/9-220(h) and (h-1).

Additionally, the Proposed Order's analysis of the Utilities' evidence of the Bureau of Labor Statistics' Employment Cost Index fails to grasp its relevance. The Employment Cost Index – unlike the CPI – is specifically designed to measure changes in wages and salaries <u>by industry</u>, and it reveals that wages <u>in the utility industry</u> have been increasing at a faster pace than overall wages generally (2.3% versus 1.5% for the twelve months ended September 2012). Cleary Reb., NS-PGL Ex. 29.0, 20:431-438 and n. 5; Cleary Sur., NS-PGL Ex. 45.0, 12:256 – 13:268 and n. 5. The significance of this evidence is that the forecast for CPI, which is a broad measure <u>not</u> differentiated by industry or service type, likely will <u>under-predict</u> 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. This evidence thus further undermines the Proposed Order's recommendation.

Finally, the Commission should reject the Proposed Order's recommendation because 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. Cleary Reb., NS-PGL Ex. 29.0, 17:372-379; Ostrander Tr. 2/5/13, 251:13-19. 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 for the 2013 test year. 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%. Ostrander Reb., Staff Ex. 13.0, 13:233-235; Cleary Reb., NS-PGL Ex. 29.0, 18:382-386. The Utilities' proposed general wage increase of 2.60% thus is well below the market average that the record evidence shows to be forecasted for wage increases in 2013. The Proposed Order's approach would have the Commission rely upon the less-applicable evidence that is in the record – like urging the installation of a screw with a hammer when there is a screwdriver sitting right at the top of the toolbox – and thus should be rejected,

Accordingly, for the reasons stated above, the Commission should adopt Exception No. 8, Alternative (1).

5. Distribution O&M

a. Plastic Pipefitting Remediation Project

Exception No. 9

The Proposed Order (at p. 143) incorrectly concludes that the O&M expenses related to the Plastic Pipefitting Project should be disallowed. Contrary to the Proposed Order's finding, as Utilities witness Mr. Hoops testified, Peoples Gas "determined that the most reasonable and safest approach was to replace the fittings at this time given its ability to coordinate some of the replacement with other planned construction and maintenance by Peoples Gas and by the City of Chicago." Hoops Reb., NS-PGL Ex. 28.0 Rev., 12:256-259. Thus, at this time, Peoples Gas can optimize work already being performed and not delay such an important project. Peoples Gas continues to maintain that the most reasonable and safest approach is to replace the pipefittings.

These costs are prudent and reasonable and should be approved. Therefore, Exception No. 9 should be adopted.

7. Administrative & General

a. Adjustments to Integrys Business Support Costs

Exception No. 10

The Proposed Order (at p. 160) adopts the AG's proposed adjustments to IBS costs charged and allocated to the Utilities as revised in the AG's rebuttal. While the Utilities agree with the Proposed Order that, in comparison to Staff's analysis, the AG's proposed adjustments are more reasonable, neither set of adjustments should be adopted.[31]

The Utilities' direct testimony presented Peoples Gas' and North Shore's budgeted and forecasted transactions with affiliated interests for 2012 and 2013. Gregor Dir., PGL Ex. 5.0 Rev., 18:396 - 19:405; PGL Ex. 5.1, Sched. C-12, pp. 1-2; Gregor Dir., NS Ex. 5.0 Rev., 15:336 – 16:347; NS Ex. 5.1, Sched. C-12, p. 1. The amounts include amounts billed to the Utilities by IBS, with a simplifying assumption re injuries and damages expenses discussed further below. The amounts billed by IBS to the Utilities are billed pursuant to the Master Regulated Affiliated Interest Agreement ("Regulated AIA") approved by the Commission in *The Peoples Gas Light and Coke Company: Petition for an order approving an agreement for the provision of facilities and services and the transfer of assets between affiliates pursuant to Sections 7-101, 7-102, and 7-204A(b) of the Illinois Public Utilities Act*, ICC Docket No. 07-0361 (Order Dec. 5, 2007). Gregor Dir., PGL Ex. 5.0 Rev., 18:398-400; Gregor Dir., NS Ex. 5.0 Rev., 16:338-340.

[31] The Utilities' positions are shown to be supported by the evidence, and the Staff-proposed adjustments are shown to be without merit, by pages 100-103 of the Utilities' Initial Brief and pages 90-96 of the Utilities' Reply Brief.

The AG's direct testimony proposed adjustments to the costs of each of the eight IBS "home centers" (a "home center is a department or a specific cost or activity (*e.g.*, Gregor Dir. PGL Ex. 5.0 Rev., 5:105-107), and to IBS depreciation costs. The AG revised its proposal in rebuttal, however, to propose adjustments to the costs of two IBS home centers and to IBS depreciation costs. The depreciation costs issue appears to have been resolved. *See* Proposed Order, p. 120.

More specifically, the AG's rebuttal proposes to disallow, as to those two home centers:

(1) as to "TEG Corporate Controller" expenses, $600,000 as to Peoples Gas and $101,000 as to North Shore; and

(2) as to "IBS Legal – Centrally Budgeted" expenses, $591,000 as to Peoples Gas and $61,000 as to North Shore.

AG Ex. 4.1, Sched. C, p. 2, col. (I), and Sched. C-8; AG Ex. 4.2, Sched. C, p. 2, col. (I), and Sched. C-8.

The AG's two IBS home center adjustments are incorrect. As background, it should be noted that the AG's direct testimony proposal was based on the mistaken theory that the eight IBS home centers had unexplained costs. The forecasted costs of each IBS home center were individually determined by subject matter experts through a careful process, and also were reviewed and approved. *E.g.*, Gregor Dir., PGL Ex. 5.0 Rev., 6:115- 7:138. The AG's direct testimony called the variances in the IBS home center costs unexplained, but the AG's witness misread information from the Utilities, which showed that certain variances were "unexplained" by either the general wage increase or inflation, but were explained by other factors. Gregor Reb., NS-PGL Ex. 25.0, 5:91-102. Two minor adjustments to IBS home center costs were warranted, and, accordingly, the Utilities made those two adjustments in their rebuttal. *Id*. at

5:91- 6:112; NS-PGL Exs. 25.4, 25.5; NS-PGL Ex. 29.2N, col. [I] and [J]; NS-PGL Ex. 29.2P, col. [I] and [J]; NS-PGL Ex. 26.1N, col. [D]; NS-PGL Ex. 26.1P, col. [D].

The AG's rebuttal's proposed adjustments to the costs of two IBS home centers are unwarranted and incorrect. First, all of the IBS home center costs have been fully explained and supported by the Utilities as to all of the home centers, and only two minor adjustments identified in the AG's direct testimony were warranted, both of which the Utilities made in rebuttal, as noted above.

Second, the AG's rebuttal's proposed adjustments to the IBS Corporate Controller home center costs are without merit. The variance in these costs on which the AG proposal is based is mainly due to increased outside services related to convergence standards and International Financial Reporting Standards ("IFRS"). Gregor Sur., NS-PGL Ex. 41.0 Rev., 6:111-121; NS-PGL Ex. 41.5. The Proposed Order's Commission Analysis and Conclusion section does not identify any reason for rejecting the Utilities' evidence on this home center.

Finally, the AG's rebuttal's proposed adjustments to the IBS Legal home center costs also are without merit. The AG claims these costs have been overstated, but the 2010-2012 average was $7,421,000, and, with a 2.2% inflation rate (the Moody's inflation factor that was used by the Utilities when no other cost factor was known), that would result in a figure of $7,585,000, which is $48,000 **more** than the 2013 amount used by the Utilities. Gregor Sur., NS-PGL Ex. 41.0 Rev., 6:122-129; NS-PGL Ex. 41.6. The Proposed Order's Commission Analysis and Conclusion section does not identify any reason for rejecting the Utilities' evidence on this home center.

The AG's rebuttal's proposed IBS home center cost adjustments are unwarranted and should be rejected. The AG's rebuttal's proposed IBS depreciation costs adjustments now are

redundant. The Utilities already have made the appropriate adjustments to the IBS home center costs and to the IBS depreciation costs in their rebuttal and surrebuttal, respectively. Exception No. 10 should be adopted.

c. Charitable Contributions

Exception No. 11

The Proposed Order (at pp. 166-167) correctly rejects the proposed adjustments to the Utilities' charitable contributions, except the Proposed Order recommends adoption of Staff's proposed adjustments to remove $7,000 ($6,650 rounded) of contributions by Peoples Gas to out of state universities. Proposed Order, Appendix B, p. 4, col. (s). Staff's adjustment, while very small, is wrong legally and counter-productive, and it should be rejected.

The $6,650 of contributions in question are to universities in Wisconsin ($200), Indiana ($3,000), and other nearby states ($3,300), except for contributions of $50 and $100 to universities in New York and South Carolina, respectively. NS-PGL Rep. Br., p. 112.

Section 9-227 of the Act, 220 ILCS 5/9-227, expressly allows recovery of donations made for "educational purposes" as long as the amounts are reasonable (the reasonableness of the amounts is proven and uncontested here). The Utilities have shown that the charitable contributions in question are in fact charitable contributions, that they are recoverable, therefore, under Section 9-227, and, moreover, that the utility had provided information in its "Part 285" Schedule C-7 in support of the contributions exceeding that required under 83 Ill. Adm. Code § 285.3070 (instructions for Schedule C-7 on charitable contributions). Moy Dir., PGL Ex. 6.0, 14:306 - 15:326; Moy Reb., NS-PGL Ex. 8:160 – 9:180; Moy Sur., NS-PGL Ex. 42.0 Rev., 9:184-201.

Furthermore, Section 9-227 limits the power of the Commission to establish rules disallowing charitable contributions, stating in part: "In determining the reasonableness of such donations, the Commission may not establish, by rule, a presumption that any particular portion of an otherwise reasonable amount may not be considered as an operating expense. The Commission shall be prohibited from disallowing by rule, as an operating expense, any portion of a reasonable donation for public welfare or charitable purposes."

The Staff position sought to establish a principle (in substance, a rule) disallowing charitable contributions outside a utility's service territory. That is contrary to Section 9-227 both in terms of its provisions regarding what is recoverable and in terms of its provisions limiting disallowance by rule. The Proposed Order does not adopt the Staff position in full, but adopts it as to contributions to non-Illinois universities. That still is contrary to Section 9-227.

Staff relied on four Commission decisions from 2011-2012. Staff did not indicate that any decision before 2011 supports its proposal. Thus, while Section 9-227 was added to the Act in 1987, Section 9-227 apparently was not interpreted by the Commission to permit disallowing a utility's charitable contributions outside its service territory until 2011. In *Commonwealth Edison Co*., ICC Docket No. 10-0467 (Order May 24, 2011), at p. 108, the Commission disallowed contributions outside the utility's service territory. However, the Commission relied at least in part on the finding that "there is no evidence that these contributions provide any benefit to ratepayers in ComEd's service territory." Here, however, there is such evidence.

In *Commonwealth Edison Co*., ICC Docket No. 11-0721 (Order May 29, 2012), at p. 98, the Commission interpreted the term "public welfare" in Section 9-227 to mean the rate-paying public in the utility's service territory, and disallowed a contribution to the University of Wisconsin. However, Section 9-227 provides for recovery of contributions "for the public

welfare or for charitable scientific, religious or educational purposes…." (Emphasis added.) Those are four different categories of recoverable contributions, as the Commission later has recognized.[32] Thus, even assuming *arguendo* the correctness of the interpretation there of "public welfare", which is not correct,[33] that term should not apply to charitable contributions for educational purposes, which is what is involved here. Furthermore, the Commission expressly recognized that a contribution out of the service territory could benefit customers in the service territory, and it rejected the contribution to the University of Wisconsin based on its particular facts, *i.e.*, that it supported a nuclear engineering program.

In *Ameren Illinois Co.*, ICC Docket No. 12-0001 (Order Sept. 19, 2012), at p. 79, the Commission disallowed a donation to the City of Springfield because it was outside the utility's service territory and did not aid the "public welfare". The "educational purposes" language of Section 9-227 applies here, not the "public welfare" language.

Finally, in *Commonwealth Edison Co*., ICC Docket No. 12-0321 (Order Dec. 19, 2012), at pp. 45-46, the Commission stated in part that it "routinely disallows contributions to organizations outside a utility's service territory. See Docket 11-0721, Order at 98; Docket 10-0467, Order at 108; and Docket 12-0001, Order at 79." That plainly is an over-simplification, however, as the above discussion shows, and, moreover, it once again does not recognize the differences between the "public welfare" and the other three categories of cost recovery under Section 9-227, although some of the donations at issue there were to educational institutions. Furthermore, once again, the Commission expressly recognized that donations

---

[32] Section 9-227 "recognizes four categories of recoverable contributions." *Ameren Illinois Co.*, ICC Docket No. 12-0001 (Order Sept. 19, 2012), p. 78 (discussed further below).

[33] *See, e.g.*, BLACK'S LAW DICTIONARY at p. 1732 (9th ed. 2009). *See also, e.g., Pliura Intervenors v. Ill. Commerce Comm'n*, 405 Ill. App. 3d 199, 209, 942 N.E.2d 576, 584-85 (4th Dist. 2010), which considered the meaning of "public need" and "public convenience and necessity" in Section 15-401 of the Act, 220 ILCs 5/15-401, and held that those terms should be defined broadly and not limited to Illinois' borders. *Pliura* rejected as unduly narrow the assertion "that the 'Commission must consider the public need of Illinois citizens, not Midwesterners, [United States c]itizens, or citizens of the world'" under Section 15-401. *Id*. (brackets in original).

outside the service territory could be recovered if they benefitted customers in the service territory, which is the case here.

The Staff position, even when limited to contributions to non-Illinois universities, is wrong and counter-productive. Exception No. 11 should be adopted.

VI. RATE OF RETURN

E. Cost of Common Equity

EXCEPTION NO. 12

1. Overview

Due in large part to this Commission's supportive decisions in their recent rate cases, the Utilities remain financially strong and maintain investment grade "single A" credit ratings. Gast Dir., NS Ex. 2.0, 6:125 – 7:127. This financial strength has given the Utilities the ability to obtain capital at reasonable cost even in the wake of the 2008 financial crisis and the ensuing "Great Recession." *Id.* at 7:130-138. The Utilities' financial strength benefits their customers by reducing the capital costs the Utilities incur and recover through rates.

Even under normal circumstances, the Utilities' business is capital intensive. Their obligation to serve requires them to raise capital whenever they (actually, their customers) need it, regardless of the state of the financial markets at the time. *Peoples Gas 2011* Order, pp. 136-137. The Commission's support is even more important now as Peoples Gas implements its accelerated cast iron main replacement program. This program will require Peoples Gas to raise billions of dollars of capital over the next two decades, with over $220 million to be spent in 2013. Hayes Dir., PGL Ex. 14.0, 5:94-95. Peoples Gas must do so without the support of Rider ICR, the Commission's approval of which was overturned by the courts.

There is less contention among the parties on the Utilities' cost of capital than has recently been the case. The Utilities' proposed capital structure with approximately 50% common equity and 50% debt is uncontested, and it will support the Utilities' strong credit ratings and their continued access to capital at reasonable cost. Gast Dir., NS Ex. 2.0, 6:122-125. The Utilities' forecasted cost of short-term debt is also uncontested. The Utilities and Staff agree on the Utilities' costs of long-term debt based on forecasts of those costs on an annual average basis.

Agreement is not universal. The AG argued that if the Utilities' rate base was set on a year-end basis, so should their long-term debt costs. Staff, the AG and CUB-City all advocated for a reduction of the Utilities' authorized return on equity ("ROE") from 9.45% to 9.06% despite evidence that their market cost of equity is higher than their currently authorized ROE of 9.45%. The Utilities propose a modest increase in their ROE to 10.00%. The overall cost of capital thus proposed by the Utilities is as follows:

Utilities' Proposed Cost of Capital
(NS-PGL Ex. 51.0)

Peoples Gas	**% Capital**	**Cost**	**Weighted Cost**
Short-Term Debt	5.96%	1.26%	0.08%
Long-Term Debt	43.61%	4.37%	1.91%
Common Equity	50.43%	10.00%	5.04%
Weighted Average Cost			7.03%

North Shore	**% Capital**	**Cost**	**Weighted Cost**
Short-Term Debt	7.35%	1.80%	0.13%
Long-Term Debt	42.33%	4.53%	1.92%
Common Equity	50.32%	10.00%	5.03%
Weighted Average Cost			7.08%

2. The Proposed Order Largely Supports the Utilities' Cost of Capital Position

With one critical exception, the Proposed Order's recommended overall costs of capital are consistent with the Utilities' positions. The Proposed Order (at p. 185) accepts the uncontested forecasts of the Utilities' short-term debt costs and adopts the Utilities' position that their long-term debt costs should be set on an annual average basis consistent with the calculation of their undisputed capital structures. It also accepts the Utilities' updated costs of long-term debt reflecting issuances that have occurred since the hearing, thus ensuring that the Utilities' rates reflect the most up-to-date information.

Regarding ROE, the Proposed Order (at p. 205) reflects the Utilities' position that ROEs cannot be set based on mathematical models alone, and that the Commission must also take into account "general market conditions and trends because this information influences the decisions that investors make in the market. This information is relevant to our ROE decisions because we estimate 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." In addition, the Proposed Order (at p. 205) agrees that "it is important to be 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."

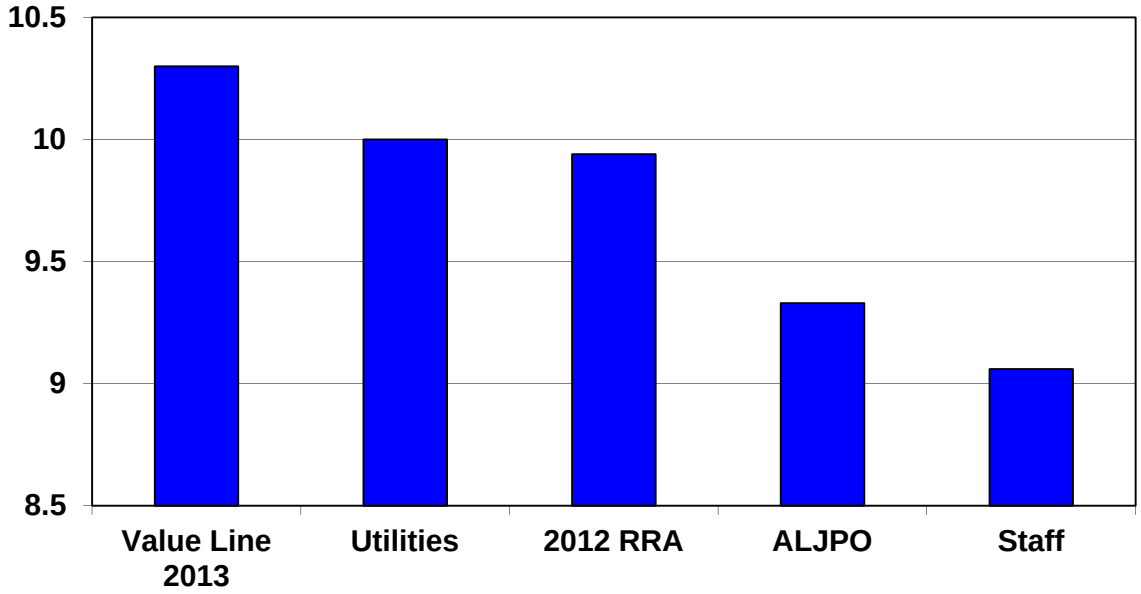
In these observations, the Proposed Order adheres to the Commission's ROE decisions in the Utilities' recent rate cases, including recognition that the Commission's "ratemaking decisions are increasingly important to the Utilities' ability to maintain investment grade credit ratings and reasonable capital 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." *Peoples Gas 2011* Order, p. 137. "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 high credit costs that will make their way to each ratepayer's bill." *Id.*

The Proposed Order (at p. 205) also acknowledges the record evidence that "the average of recent ROEs authorized for natural gas utilities is 9.94%" and that "A-rated utility equity risk premiums have recently increased significantly as interest rates remain at historic lows." Despite these general market conditions (and other evidence in the record) showing that the Utilities' cost of equity is higher than their current ROE of 9.45%, the Proposed Order recommends that the Commission reduce the Utilities' authorized return to 9.33%.

The Proposed Order's conclusion on ROE is inconsistent with the totality of the evidence of the Utilities' cost of equity in the test year, and a reduction of the Utilities' ROE would send a negative signal to the financial markets. *See* Moul Reb., NS-PGL Ex. 24.0 Rev., 3:55 – 4:75. As shown in the following graph, the Staff and Proposed Order ROEs are significantly below the return that the financial markets would expect based on recent authorized returns for natural gas utilities and expected returns in 2013:

Comparison of ROE Positions to Investor Expectations[34]

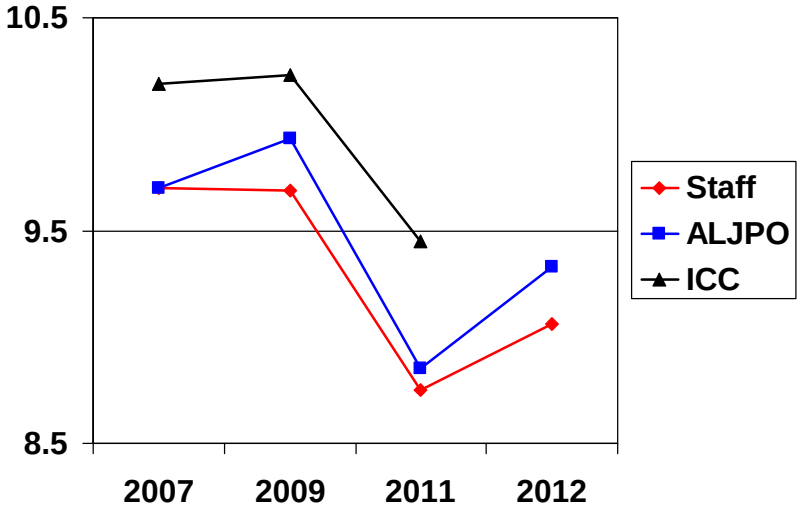


In each of the Utilities' last three rate cases, the Commission has acted to moderate the ROE positions taken by Staff and the Proposed Orders. The following graphs and tables compare the Staff and Proposed Order recommendations to the Commission-authorized ROEs in those cases and the present one.

[34] Value Line's forecasted 2013 ROEs for the Delivery Group used in the Utilities' and Staff's financial models is 10.30%. Moul Reb., NS-PGL Ex. 24.0 Rev., 4:79 – 5:80 (table). The average ROEs for natural gas utilities in 2012 according to Regulatory Research Associates ("RRA") was 9.94%. Staff Cross Ex. 8.

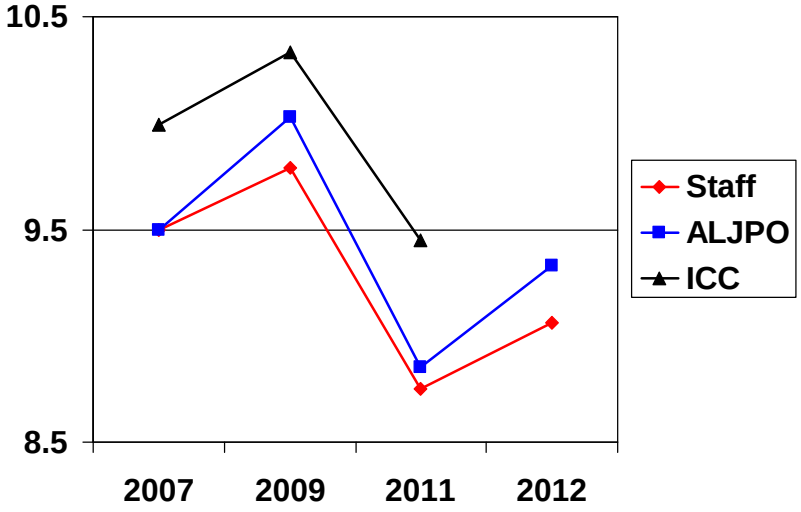
Commission Moderation of Staff and Proposed Order ROEs

Peoples Gas



Rate Case	Staff	Proposed Order	Commission
2007	9.70% (Order at p. 78)	9.70% (PO at p. 95)	10.19% (Order at p. 100)
2009	9.69% (Order at p. 105)	9.93% (PO at p. 130)	10.23% (Order at p. 130)
2011	8.75% (Order at p. 125)	8.85% (PO at p. 137)	9.45% (Order at p. 140)
2012	9.06% (PO at p. 187)	9.33% (PO at p. 207)	

North Shore



Rate Case	Staff	Proposed Order	Commission
2007	9.50% (Order at p. 78)	9.50% (PO at p. 95)	9.99% (Order at p. 100)
2009	9.79% (Order at p. 105)	10.03% (PO at p. 130)	10.33% (Order at p. 130)
2011	8.75% (Order at p. 125)	8.85% (PO at p. 137)	9.45% (Order at p. 140)
2012	9.06% (PO, at p. 187)	9.33% (PO at p. 207)	

For the reasons set forth below, the Commission should likewise moderate the positions taken by Staff and the ALPO in this case. The record evidence supports a modest increase in the Utilities' ROE to **10.00%**.

3. The Utilities' Cost of Equity Is Increasing

a. The Staff's and Utilities' Financial Model Results From 2011-2012 Show an Increased Cost of Equity

The financial models employed by the Utilities' and Staff's cost of equity witnesses varied in result[35] but they were consistent in showing that the Utilities' cost of equity has increased since the Utilities' last rate cases. Staff's model results (unadjusted for riders) increased by 31 basis points, from 8.85% in 2011 to 9.16% in 2012. *Peoples Gas 2011* Order, p. 127; McNally Dir., ICC Staff Ex. 5.0, 30:583. Likewise, the Utilities' model results for increased by 48 basis points, from 10.61% to 11.09%. *Peoples Gas 2011* Order, p. 112 (July 2011 results); Moul Dir., NS Ex. 3.0, 47:1036.[36] If the average of these increases – 40 basis points – was added to the Utilities' current authorized ROE of 9.45%, the result would be **9.85%**.

b. The Regulatory Equity Premium Has Risen Sharply Since 2008

Mr. Moul presented powerful evidence that the "regulatory equity premium" –the degree to which regulators set ROEs above the utility's cost of debt to reflect the higher risk associated with equity –has increased sharply since 2008 as interest rates have fallen to historic lows. Indeed, the regulatory equity premium over the yield on A-rated public utility bonds has risen from 384 basis points in 2008 to "an all-time high" of 581 basis points in 2012. Moul Sur., NS-PGL Ex. 39.0, 4:79-80. If the 2012 equity risk premium was applied to the Utilities' forecasted long-term debt costs in the test year – 4.37% for Peoples Gas and 4.53% for North

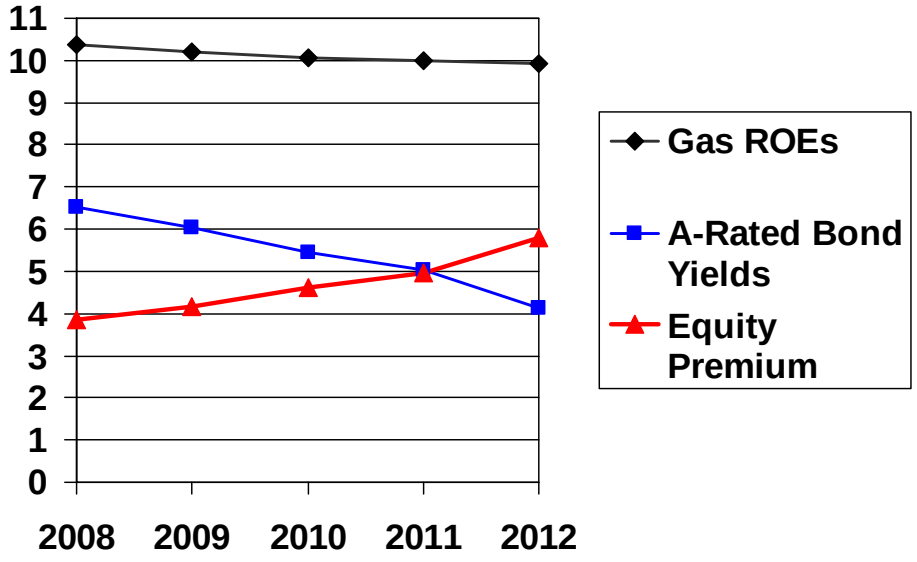
[35] The methodological issues that separate the Utilities and Staff include Staff's reliance on historical spot data, Staff's "beta" measurement for its CAPM, Mr. Moul's leverage adjustment, and Mr. Moul's risk premium model. The Utilities maintain their positions on these and the other ROE methodological issues in this case and incorporate them by reference rather than repeating them here. *See* NS-PGL Initial Br. at 141-145; NS-PGL Reply Br. at 124-130.

[36] Staff in its Reply Brief (at 58-59) makes the wrong comparison in arguing that Mr. Moul's "analysis" showed a decrease in ROE. Staff is comparing Mr. Moul's recommendations in the two cases, which reflect other factors including compromise. Indeed, Mr. Moul's updated recommendation in this case of a 10.00% ROE was expressly stated to be a proposal by the Utilities "to narrow the issues of dispute in this case." Moul Sur., NS-PGL Ex. 39.0, 1:21 – 2:24.

Shore (Proposed Order at 185) – the implied costs of equity would be **10.18%** for Peoples Gas and **10.34%** for North Shore.

Staff in its reply brief (at pp. 61-62) took issue with Mr. Moul's use of the regulatory equity premium, arguing that he presented "a picture that is not only incomplete but false" because "the cost of equity has been falling despite a rise in the equity premium" over the last 20 years. That might be interesting, but Mr. Moul's focus was not the last 20 years. Rather, he pointed to the fact that the premium has increased sharply since 2008. As shown in the following graph, as the premium has increased by over 50% in the last 5 years, the average yield on A-rated utility bonds fell by only 37% (from 6.53% in 2008 to 4.13% in 2012). Over the same period, authorized natural gas utility ROEs fell by only 4% (from 10.37% in 2008 to 9.94% in 2012).

Relationship of ROEs, Bond Yields and Equity Premiums For A-Rated Gas Utilities, 2008-2012



Thus, over the last five years the regulatory equity premium has grown at much greater rate than the rate at which interest rates and ROEs have fallen. The average authorized ROE for A-rated natural gas utilities has flattened out at around 10% despite the continued decline of interest rates, hence the higher regulatory equity premium. This recent development is a stark exception to the "strong, direct correlation" between interest rates and ROEs that Staff asserts has prevailed over the last two decades. If that correlation had held, the regulatory equity premium would have been flat and ROEs would have declined to a greater extent as interest rates continued to fall. Instead, the degree to which the correlation has not held recently is seen in the crossover of the premium and interest rate trend lines in 2011. With further increases in the premium, ROEs would rise even if interest rates continue to fall. Indeed, the average Value Line forecasted 2013 ROEs for the "Delivery Group" used in the financial models is **10.30%**. Moul Reb., NS-PGL Ex. 24.0 Rev., 4:79 – 5:80 (table).

Staff also argued that Mr. Moul "misapplied the Companies' embedded costs of long-term debt to manufacture a contrived ROE estimate of 10.36%." Staff Reply Br. at 62.[37] Staff claimed that the equity premium was overstated because the average A-rated utility bond yield includes yields for utilities rated "A+" and "A" in addition to those rated "A-" like the Utilities. But Staff can point to no evidence to show that excluding "A+" and "A" rated utilities from the calculation of the regulatory equity premium would have made a material difference. Simply asserting that "[s]ubtracting an understated bond yield from the authorized ROE produces an overstated equity risk premium" (*id.* at 62) is not sufficient.

[37] Staff's language may be colorful but ultimately it is disrespectful. And Staff seems to apply a double standard as to what it considers civil discourse. Elsewhere in its reply brief (at 68-69), Staff accused the Utilities of "character assassination" for pointing out that Staff has used a "lower of" approach to the DCF model. The Commission itself took Staff to task for the approach in *Peoples Gas 2009* Order, pp. 124-125.

Staff also complained that the Utilities' embedded cost of long-term debt included historical issuances at costs higher than current yields. Staff Reply Br. at 63. But if the 581-basis-point regulatory equity premium was applied to the Utilities' most current long-term debt cost – 3.96%[38] - the implied ROE would be **9.77%**, which is still significantly higher than Staff's 9.06% or the Proposed Order's 9.33%.

c. Natural Gas Utility ROEs are Significantly Higher Than the Staff and Proposed Order Positions

Another point of reference is the data on recently authorized returns for natural gas utilities throughout the country. Staff relied on such data to argue that there is a "strong, direct correlation" in the movements of interest rates and ROEs over the last 20 years. Staff Reply Br. at 60-61. The sample referenced by Staff, from Regulatory Research Associates ("RRA"), showed that the average ROEs for natural gas utilities were **10.00%** in 2011 and **9.94%** in 2012. Moul Reb., NS-PGL 24.0 Rev., 2:31 – 3:54; Moul Sur., NS-PGL 39.0, 3:61 – 4:85; Staff Cross Ex. 8. The AG's cost of capital witness Mr. Brosch reviewed similar data and found the Utilities' current ROE of 9.45% to be "consistent." Brosch Dir., AG Ex. 1.0, 61:1376-1380 & n. 35. However, the average authorized natural gas utility ROE from that 2012 Public Utilities Fortnightly ("PUF") sample was **9.87%**. Gast Reb., NS-PLG Ex. 23.0, 11:226-228.

In continuing to argue that the Commission should ignore other authorized ROEs for natural gas utilities, Staff repeatedly states the obvious – that the other ROEs were "for other companies, in other jurisdictions, at other times during other market environments" and "were not intended to measure the cost of common equity for the Companies." Staff Reply Br. at 70, 73 (emphases in original). Mr. Moul and the Utilities do not argue otherwise. We merely suggest that other ROEs authorized by other state commissions for natural gas utilities within the

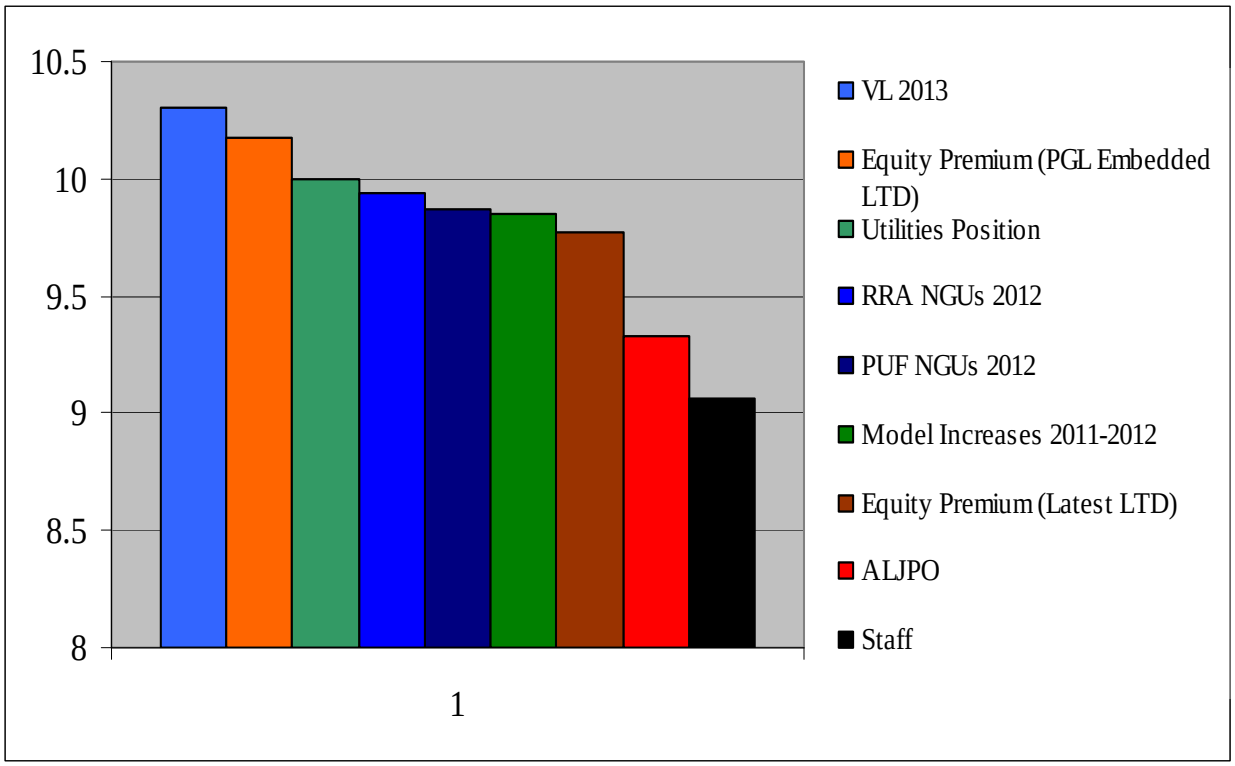
[38] *See* NS-PGL Exs. 51.2N, 51.2P.

last year under very similar market conditions provides an objective and reasonable benchmark for assessing the parties' analyses and positions on the Utilities' ROE. Moul Sur., NS-PGL Ex. 39.0, 2:32 – 3:60.

Staff's abhorrence to the Commission's consideration of other recently-authorized ROEs might make sense if determining a non-publicly traded natural gas utility's cost of equity was a matter of mathematical certainty. As this Commission has recognized, however, the determination is a highly uncertain endeavor and involves no small amount of subjectivity. "[E]ach of the financial models is theoretical and has its own limitations. The models are also highly dependent on analyst judgment as to the inputs, and therefore are susceptible to manipulation." *Peoples Gas 2009* Order, p. 123. These limitations require that the Commission "also consult general financial market information to ensure that the model results presented us are generally consistent with real world conditions, and to guide our determination of reasonable rates of return on equity based on the models that we deem appropriate to our consideration." *Id.*

In other words, there is no single "right" answer when it comes to establishing an authorized ROE. Accordingly, it is not only reasonable but necessary for the Commission to consider evidence beyond the mathematical model results in order to assess their credibility and reasonableness. Based upon all the indicia of current, or at least recent historical, cost of equity for companies in the same business as the Utilities, the Commission should authorize ROEs in the neighborhood of **10.00%**. For these reasons, Exception No. 12 should be adopted.

Indicia of the Utilities' Cost of Equity



F. Weighted Average Cost of Capital

EXCEPTION NO. 13

1. Peoples Gas

The Commission should modify the Proposed Order to include in Peoples Gas' 2013 rates an overall ROR of 7.03% comprised of a capital structure of 50.43% equity, 43.61% long-term debt and 5.96% short-term debt, a cost of long-term debt of 4.37%, a cost of short-term debt of 1.26% and a cost of equity of 10.00%. NS-PGL Exs. 51.0, 51.1, and 51.2P.

2. North Shore

The Commission should modify the Proposed Order to include in North Shore's 2013 rates an overall ROR of 7.08% comprised of a capital structure of 50.32% equity, 42.33%

long-term debt and 7.35% short-term debt, a cost of long-term debt of 4.53%, a cost of short-term debt of 1.80% and a cost of equity of 10.00%. NS-PGL Exs. 51.0, 51.1, and 51.2N.

IX. RATE DESIGN

C. Service Classification Rate Design

2. Contested Issues – North Shore and Peoples Gas

b. Service Classification No. 1, Small Residential Heating Exception No. 14 and Technical Exception No. 7

The Proposed Order adopts Staff's proposed rate design for space heating customers served under Service Classification ("S.C.") No. 1, Small Residential Service. That rate design provides for increasing recovery of non-storage related fixed costs through fixed charges[39] from 67% to 68% for North Shore and from 54% to 61% for Peoples Gas. Proposed Order, p. 237.

The Proposed Order declined to accept the Utilities' proposed 80% recovery of fixed costs through fixed charges on the basis that the Commission should observe the effects of bifurcation before further increasing fixed cost recovery through fixed charges. The Proposed Order characterized this as being in the interest of "the principles of gradualism, rate continuity, and rate understandability." *Id.*

The Proposed Order reaches that conclusion despite the fact that, consistent with several prior Commission Orders cited in the Utilities' Initial Brief (at p. 157), it reiterates the Commission's long-standing support for recovering more fixed costs through fixed charges. Proposed Order, pp. 218, 227, 237. The Proposed Order also concludes that the proposed bifurcation of S.C. No. 1 into heating and non-heating rates "will more accurately reflect customer class homogeneity." *Id.*, p. 216. Implicit in this conclusion, as well as the

[39] The Proposed Order incorrectly describes the proposal as recovering 68% (North Shore) and 61% (Peoples Gas) of fixed costs "through the distribution charges." Proposed Order, p. 237. The quoted percentages apply to recovery through the fixed customer charges and not the distribution charges. Johnson Reb., Staff Ex. 17.0, 2:36-41.

Commission's directive in *Peoples Gas 2011* to address low use and high use S.C. No. 1 customers in the embedded cost of service studies and rate designs, is the determination that increased homogeneity within classes in the rate design is beneficial.

The Proposed Order does not identify what benefits might be realized from the Commission not following its policy of increased fixed cost recovery through fixed charges in this instance or explain why Staff's proposal is consistent with the three principles listed in the Proposed Order. In particular, it is unstated what the Commission or Staff expects to observe about bifurcation's effect on S.C. No. 1 heating customers by limiting the increase in fixed cost recovery through fixed charges or why any observation about bifurcation would affect the fundamental principle that fixed costs should be recovered through fixed charges.[40] Staff stated several times, but without explanation, that the Commission should observe the effects of bifurcation before increasing fixed cost recovery in fixed charges. Johnson Dir., Staff Ex. 8.0, 26:586-589, 29:662-665, 30:684-687, 38:863-866, 41:939-941; Johnson Reb., Staff Ex. 17.0, 7:143-146, 9:184-187.

Likewise, the Proposed Order does not explain how Staff's proposal, more than the Utilities' proposal, advances the three cited rate design principles (gradualism, rate continuity and rate understandability). As stated above, the Proposed Order affirms the Commission's long-standing policy in favor of increased fixed cost recovery through fixed charges, and the Utilities' proposal is consistent with gradual movement towards such greater cost recovery, while Staff's proposal shows little such movement. In terms of rate continuity and understandability, the Utilities showed that the bill impacts of their proposals are as or more

[40] The Commission recognized this principle when it approved Rider VBA, Volume Balancing Adjustment, on a pilot basis and stated "[i]f there is a different mechanism to be employed in this situation, it would be a straight-fixed variable (SFV) rate design which recovers all fixed costs through fixed charges." *Peoples Gas 2007* Order, p. 151.

favorable than the Staff proposal. Grace Reb., NS-PGL Ex. 32.0, 24:541-25:561, 28:628 - 29:647; NS-PGL Exs. 32.9, 32.10. Moreover, the only novel aspect of the Utilities' proposal is splitting S.C. No. 1 into heating and non-heating rates. The basic rate structure, *i.e.*, a customer charge and a distribution charge, is unchanged.[41] It is not apparent how the level of fixed costs in the customer charge affects understandability.

Finally, a notable difference between the Utilities' proposal and Staff's is that the Utilities' proposal recovers a specified percentage of fixed cost recovery through fixed charges. Grace Reb., NS-PGL Ex. 32.0, 23:520 – 25:561, 27:615 – 29:647. By contrast, Staff's proposal recovers only non-storage related customer costs through the customer charge with all remaining non-storage related demand costs being recovered through a flat distribution charge. Johnson Dir., Staff Ex. 8.0, 28:640-645, 40:917-922. Under the proposed revenue requirements that fixed cost recovery would be 61% for Peoples Gas and 68% for North Shore. However, under the final revenue requirements, the percentage may differ if the proportion of fixed customer and demand costs differs. The Utilities' proposal more clearly shows the Commission the amount of fixed cost recovery through fixed charges and offers more certainty for fixed cost recovery as it recovers a specified amount (80%) regardless of any cost shifts that may arise from the final revenue requirements.

The Commission should approve the Utilities' S.C. No. 1 rate design for heating customers. Exception No. 14 should be adopted.

If the Commission does not adopt Exception No. 14, then, on page 237 of the Proposed Order, "fixed costs from 67% to 68% through the distribution charge for North Shore … ."

[41] The Proposed Order and Staff agreed with the Utilities' proposal to move from a two-block distribution charge to a flat distribution charge. Proposed Order, p. 237.

should state "fixed costs from 67% to 68% through the customer charge for North Shore … ." That alternative is Technical Exception No. 7.

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

Exception No. 15

The Proposed Order rejected the Utilities' proposal to include tariff language in S.C. Nos. 1 and 2 to address the rate design that would take effect if a Court or the Commission invalidated Rider VBA, which is the Utilities' full decoupling mechanism. The Proposed Order concluded the proposal was moot, citing a March 29, 2013, Appellate Court decision affirming the Commission's authority to approve Rider VBA, and the Proposed Order's continued approval of Rider VBA on a permanent basis. Proposed Order, p. 248.

The Utilities are encouraged by the Court's well-reasoned opinion and the Proposed Order's continued recognition of decoupling as a sound rate design policy. However, the flaw with the Proposed Order's mootness conclusion is that, on May 3, 2013, the AG filed with the Illinois Supreme Court a motion for an extension of time, until June 7, 2013, to file a petition for leave to appeal the Appellate Court's March 29 decision. Thus, the Utilities' proposal is not moot. The risks to the Utilities of losing Rider VBA and having a rate design that recovers an inadequate amount of fixed costs through fixed charges still exist.[42] For all the reasons stated in the Utilities' Initial Brief (at pages 159-161), the Commission should approve the Utilities' SFV rate design alternative. Exception No. 15 should be adopted.

[42] This is true for S.C Nos. 1 and 2, but particularly for S.C. No. 2, which recovers only 45% and 64% of non-storage related fixed costs through the customer charge for Peoples Gas and North Shore, respectively, under the Utilities' rate design proposals supported by Staff. Grace Dir., PGL Ex. 12.0 Rev., 20:439–443. Grace Dir., NS Ex. 12.0 Rev., 20:434–438. Johnson Dir., Staff Ex. 8.0, 32:747-33:759, 45:1024-1035.

X. TRANSPORTATION ISSUES

B. Contested Issues

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

Exception No. 16

The Proposed Order directed the Utilities to modify their cost recovery method for the CFY program to recover "the costs for running that program" from all eligible customers. Proposed Order, p. 277. The Utilities will not except to this proposal. For clarity, if the Commission adopts this portion of the Proposed Order, the Utilities will eliminate from Rider AGG, Aggregation Service, the Aggregation Charge, which consists of a per Pool and a per customer component. The Utilities' compliance filing will recover the test year costs associated with the Aggregation Charge from all S.C. Nos. 1 and 2 customers and, also for Peoples Gas, from all S.C. No. 8 customers in the customer charge.[43] Exception No. 16, which clarifies the Proposed Order's directive, should be adopted.

XI. FINDINGS AND ORDERING PARAGRAPHS

Exception Nos. 17-25

For the reasons discussed in Section IV of this Brief on Exceptions and in the Utilities' prior briefing, Finding (7) should be modified to reflect Peoples Gas' final revised rate base amount. Exception No. 17 should be adopted.

For the reasons discussed in Section IV of this Brief on Exceptions and in the Utilities' prior briefing, Finding (8) should be modified to reflect North Shore's final revised rate base amount. Exception No. 18 should be adopted.

[43] Aggregation Charge revenues are currently credited back in rate design resulting in a decrease to the customer charge. The credit will be removed, thereby spreading the costs among all customers in each affected service classification.

For the reasons discussed in Section VI of this Brief on Exceptions and in the Utilities' prior briefing, Finding (9) should be modified to reflect Peoples Gas' final proposed cost of capital and the components thereof. Exception No. 19 should be adopted.

For the reasons discussed in Section VI of this Brief on Exceptions and in the Utilities' prior briefing, Finding (10) should be modified to reflect North Shore's final proposed cost of capital and the components thereof. Exception No. 20 should be adopted.

For the reasons discussed in the Introduction and Sections IV, V, and VI of this Brief on Exceptions and in the Utilities' prior briefing, Finding (11) should be modified to reflect Peoples Gas' final proposed base rate net operating income. Exception No. 21 should be adopted.

For the reasons discussed in the Introduction and Sections IV, V, and VI of this Brief on Exceptions and in the Utilities' prior briefing, Finding (12) should be modified to reflect North Shore's final proposed base rate net operating income. Exception No. 22 should be adopted.

For the reasons discussed in the Introduction and Sections IV, V, and VI of this Brief on Exceptions and in the Utilities' prior briefing, Finding (18) should be modified to reflect Peoples Gas' final revised base rate revenue requirement and the resulting rate increase. Exception No. 23 should be adopted.

For the reasons discussed in the Introduction and Sections IV, V, and VI of this Brief on Exceptions and in the Utilities' prior briefing, Finding (19) should be modified to reflect North Shore's final revised base rate revenue requirement and the resulting rate increase. Exception No. 24 should be adopted.

For the reasons discussed in the Introduction and Sections IV, V, and VI of this Brief on Exceptions and in the Utilities' prior briefing, Finding (20) should be modified to reflect North

Shore's final revised base rate revenue requirement and the resulting rate increase. Exception No. 25 should be adopted.

XII. APPENDICES

The Appendices to the Proposed Order should be modified in accordance with the Exceptions discussed in Sections I, IV, V, and VI of this Brief on Exceptions, three of which are technical exceptions to the Appendices (Technical Exception Nos. 2, 3, and 4). The Utilities also present the three following additional Technical Exceptions.

Technical Exception No. 8

Setting aside the Utilities' Exception No. 11, in Proposed Order Appendix A, the amounts on page 4, column (u), lines 14 and 15, should be summed and should appear on line 14 as (642), with – (indicating no amount) in line 15.

Technical Exception No. 9

Setting aside the Utilities' Exception No. 11, in Proposed Order Appendix B, the amounts on page 4, column (t), lines 14 and 15, should be summed and should appear on line 14 as (2,085), with – (indicating no amount) in line 15.

Technical Exception No. 10

Setting aside the Utilities' Exception No. 6, in Proposed Order Appendix B, page 8, line 23, is mislabeled "Plastic Pipefitting Remediation", and should be "State Income Tax Impact".

XIII. CONCLUSION

Therefore, North Shore Gas Company and The Peoples Gas Light and Coke Company, for all reasons set forth above and in their separate simultaneously filed North Shore Gas Company's and The Peoples Gas Light and Coke Company's Exceptions to the Proposed Order,

appearing of record, or reflected in their Initial Brief, their draft proposed Administrative Law Judges' Proposed Order, and their Reply Brief, respectfully request that the Commission adopt the Utilities' Exceptions and enter findings and make conclusions on all uncontested and contested issues consistent with the Utilities' positions taken in testimony and/or stated herein regarding the evidence in the record and the applicable law.

Dated: May 9, 2013

By: John P. Ratnaswamy

Counsel for North Shore Gas Company and The Peoples Gas Light and Coke Company

John P. Ratnaswamy
Carla Scarsella
Rooney Rippie & Ratnaswamy LLP
350 W. Hubbard Street, Suite 600
Chicago, Illinois 60654
(312) 447-2800
john.ratnaswamy@r3law.com
carla.scarsella@r3law.com

Mary Klyasheff
Integrys Energy Group, Inc.
130 E. Randolph Street
Chicago, Illinois 60601
(312) 240-4470
mpklyasheff@integrysgroup.com

Bradley D. Jackson
Foley & Lardner LLP
150 East Gilman Street, Verex Plaza
Madison, Wisconsin 53703
(608) 258-4262
bjackson@foley.com

Theodore T. Eidukas
Foley & Lardner LLP
321 N. Clark Street, Suite 2800
Chicago, Illinois 60654
(312) 832-4913
teidukas@foley.com