STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

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

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

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

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

I. INTRODUCTION

The Utilities open their BOE with summary arguments that incorporate a concept of "full cost recovery" that does not appear in the PUA. *See, e.g.,* PGL/NS BOE at 11. The Utilities suggest (without asserting) that the Proposed Order's established positions may provide less than

the law requires. *Id.* That phrase is a transparent rhetorical device,[1] as the Utilities themselves admit the applicability of the PUA's statutory limitations. *See* PGL/NS BOE at 4, 12 ("full recovery of its prudent and reasonable costs of service"). A utility's recoverable costs must be proved (by credible, competent evidence of record) to be prudently incurred and reasonable, and they must be recovered through rates that are just and reasonable. 220 ILCS 5/9-101, 5/9-201(c); PGL/NS BOE at 4, 8, 12. The Commission's traditional practices and past determinations provide "full recovery" of the costs utilities are legally entitled to receive. Rates that collect any more are not just and reasonable, and therefore unlawful.

Many of the Utilities' BOE arguments share characteristics that diminish their credibility and value to the Commission. First, though the Utilities understandably repeat arguments from prior briefs, they frequently do not acknowledge or respond to the opposing intervenor evidence and arguments supporting Proposed Order conclusions. Unfortunately, such rote repetition impels replays of responsive arguments that the Utilities do not engage substantively. This pointless loop does not advance informed debate, and it denies the Commission the benefit of narrowed issues and refined positions that should emerge from successive rounds of testimony and briefs.

CUB-City also note their concurrence with Staff's observation about the Proposed Order's undue reliance on language from the Utilities' Draft Proposed Order. "[M]uch of the language in the ALJ's PO reflects the Utilities' biases." Staff BOE at 32. Staff's observation provides a plausible explanation for some of the gratuitous *dicta* found in the Proposed Order. *See, e.g.,* PO at 205 (considering other commissions' ROEs (figures the Commission has

[1] Similarly, the Utilities claims of "recovery shortfalls" and denials of cost recovery also are comparisons to their proposals, not revenue requirements or costs determined in accordance with the PUA. PGL/NS BOE at 12, 7.

repeated found irrelevant and unreliable) and inviting speculative "context" and expectations commentary re cost of equity); *also* CUB-City BOE at 37-39; CUB-City Init. Br. at 56-57 (and cases cited).

VI. Rate Base

C. Contested Issues

1. Year End Rate Base or Average Rate Base

The Utilities claim that the Proposed Order's approval of an average rate base has the effect of "reducing Peoples Gas' rate base . . . and its annual revenues . . . ." PGL/NS BOE at 10. First, the *Commission* -- not a utility proposing a rate base -- determines the amount of prudently incurred investment being used to provide utility service, *i.e.*, the rate base. 220 ILCS 5/9-201, 5/9-211; *see* CUB-City BOE at 5-8; CUB-City Init. Br. at 11-18, CUB-City Reply Br. at 12-14. The Proposed Order properly removed imprudent, unlawful or unproven amounts from the Utilities' proposal, as one step in its determination of the rate base and revenues to be used in setting rates in this case. There has been no reduction to the Utilities' lawful revenue requirement.

The Utilities also claim that the "Proposed Order errs, in that on the facts of this case, the 'year-end' method should be used" and assert that refusing to do so denies them an opportunity for "full cost recovery." PGL/NS BOE at 10-11. Governing law precludes a Commission determination of the cost of service to be recovered in rates (revenue requirement) in the manner the Utilities request, that is, using rate base costs that exceed test year amounts.

The Utilities' arguments fail to acknowledge or even address the applicable legal requirements that constrain lawful outcomes on this record. The Commission is required to determine revenue requirements using the test year process defined in its test year rules. 83 Ill.

Adm. Code Parts 285, 286, 287; *Business & Professional People in the Public Interest v. Illinois Commerce Comm.*, 136 Ill. 2d 192, 226 (1989). In addition, the PUA expressly requires that Commission determinations be based exclusively on record evidence. 220 ILCS 5/10-103. Here, the record does not contain the post-test year costs the Utilities propose to recover in rates, because the Utilities did not quantify or present those costs. Instead, the Utilities offer the test year-end rate base as a substitute for one piece of the required record evidence. Moreover, the rate base represents only one element of the unquantified revenue requirement for the post-test year (rates effective) period their proposal targets. Although the Utilities rejected the rates effective period as their test year, they base their claims of "shortfalls" and denials of recovery on the unsupported, qualitative supposition that their post-test year rate base -- and revenue requirement -- will be larger than test year amounts.

The Proposed Order finds -- as the Utilities admit -- that the average rate base method best calculates their investment costs for the 2013 test year selected under the Commission's test year rules. PO at 38; CUB-City Init. Br. at 12-13. Rather than addressing the reality that an average test year best measures rate base costs for the chosen test year, the Utilities complain that they may not achieve the "full cost recovery" they measure using non-test year costs. PGL/NS BOE at 13. The comparison charts of cost and recovery in the Utilities' BOE are presented to support their assertions of under-recovery. In fact, they are a meaningless exercise in disingenuous arithmetic calculations. PGL/NS BOE at 14-15.

The Utilities' charts assume an investment pattern for which there is no record evidence, and they use time periods inconsistent with test year concepts and the Commission's rules. The Commission's test year rules explicitly prescribe costs determined over a full 12-month period -- not a self-serving six month period that skews results. 83 Ill. Adm. Code 287.20. "To determine

accurately a utility's revenue requirement, 'a utility must present its rate data in accordance with a proposed one-year test year.'" 2012 IL App (4th) 100962, ¶ 12, *citing Business and Prof'l People for the Pub. Interest v. Illinois Commerce Comm'n* ("*BPI II*"), 146 Ill. 2d 175, 237-38 (1991). As a matter of mathematics, many different investment patterns can produce an annual average level of investment equal to the average of the test year's beginning and ending rate base balances.

Setting aside the numerous test year rule violations on which the comparisons rest, any serious "under-recovery" claim must consider all (potentially offsetting) costs and revenues -- not just the Gross Plant figures shown in the Utilities' charts.[2] The patterns and comparisons the Utilities show on their charts were selected for favorable results and visual effect, not accuracy. In any case, the other variables in the Utilities' chart are hypothetical amounts based on arbitrary assumptions and have no demonstrated relevance to the Commission's task in this case. PGL/NS BOE at 14, 15.

Finally (as to the charts), the Utilities assert that their compromise proposal results in rates that best match costs in their arbitrary six-month period. PGL/NS BOE at 11; PGL/NS Exc. at 38. Here, the Utilities persist in using their own distorted definition of the matching principle incorporated in the Commission's test year rules. *See* CUB-City Init. Br at 13-15; PGL/NS Exc. at 38, 39. As the Illinois Supreme Court held in reviewing other rates set for post-test year periods, the Commission is required to follow its own test year rules; it cannot rely on

[2] Gross Plant is offset by numerous variables in the calculation of rate base. *See* PO App. B, p 5 of 18. The Utilities assert -- without explanation (in their brief or cited record testimony) -- that "the same relationships would result" provided unnamed adjustments are "corrected for." PGL/NS BOE at 14, n. 20.

the Utilities' hash of self-serving, *ad hoc* calculations. *Business and Prof'l People for the Pub. Interest v. Illinois Commerce Comm'n* ("*BPI I*"), 136 Ill. 2d 192, 219 (1989).

Next, the Utilities seek justification for their year-end rate base proposal in an assertion that their post-test year investments will be above the test year average. PGL/NS Exc. at 39. Even if that assertion were supported in this record (and it is not), a mismatch of post-test year revenue requirement elements, like the Utilities' use of post-test year rate base costs with test year 2013 revenues, was held to be unlawful by the Illinois appellate court.[3] "The use of a test year prevents a utility from overstating its revenue requirement by using low revenue data from one year and high expense data from another." 2012 IL App (4th) 100962, *citing Business & Professional People in the Public Interest v. Illinois Commerce Comm.*, 146 Ill. 2d at 38 (1991). The specific facts of this case cannot displace controlling law. *Compare* PGL/NS Exc. at 38.

The Utilities frame the Commission's determination as deciding which of three approaches it describes (year-end, average, or part-year average) best meets legal requirements for just and reasonable rates and recovery of reasonable and prudent costs of service. PGL/NS BOE at 12. The Utilities do not engage the substance of intervenors' arguments showing that the governing statutory and decisional law precludes Commission adoption of the two utility proposals.

Several additional arguments augment the Utilities' kitchen sink collection. The Utilities argue "[t]here is nothing wrong, of course, with new rates going into effect that include some

[3] The Utilities point to a different Proposed Order recommendation characterized as "based on the theory that rates should be set in a manner that reflects costs during the period the rates will be in effect," as support for a rate base based (without cost evidence) on a post-test period. NS-PGL BOE at 16. To the extent the Commission deems the recommendations irreconcilable, the governing case law must prevail, and neither decision can rely on post-test year costs or revenues. CUB-City also note that if the Utilities had simply used the test year rules to align their test year with the rates effective period, reconciliation would be achieved.

plant investment costs that have not yet been incurred, for that is inherent in future test year ratemaking." PGL/NS BOE at 16. But "test year ratemaking" is defined by the Commission's rules, which the Utilities' proposal disregards. The Utilities also argue for the validity of their proposal with the observation that their rate base calculations "use only test year data." PGL/NS BOE at 18. The Commission should ignore this disingenuous word play. Using test year data to calculate hypothetical costs is not the same as basing rates on test year costs. This argument has no discernible limits, and (if accepted) it would require the Commission to approve any calculation of a hypothetical revenue requirement component, as long as the calculation used only test year data. The claim that such calculations rest partly on the logic of CUB-City arguments is baseless. PGL/NS BOE at 18. There is no logic in the Utilities' proposal other than the mathematical certainty that it will inflate their rate base.

CUB-City addressed the Utilities' false claim that the Commission's filing rules authorize a year-end rate base in their Reply Brief (at 10-12). The 13-months of investment data required by the rules could (mathematically) support an average year rate base calculation (for example, near-constant investment from offsetting increases and decreases during the test year).

The Utilities then cite circumstances that are different from their last rate case as justification for the year-end rate base approach. However, the record shows that the Utilities were aware of each of the circumstances they point to as justification when the new rate tariffs were filed. *See* CUB-City Init. Br. at 16-18. Despite that awareness, they did nothing to adapt their test year proposal to those circumstances. Instead, they ask that the Commission adopt a novel rate base calculation to compensate for their decision not to expend the effort required to use advantageous options the test year rules provide. A pertinent (if not major) consideration in that regard should be the undisputed evidence that the Utilities could have avoided the very test

year rules constraints they view as problematic. In any case, as the Proposed Order found (at 86), the facts of this case do not warrant diverging from the Commission's consistent use of an average rate base with future test years.

2. Plant

b. Accelerated Main Replacement Program Projects (PGL)

The Utilities previously suggested that AMRP could not proceed if their rate increase request were modified as CUB-City and other intervenors showed to be appropriate. *See* CUB-City Init. Br. at 20-21; CUB-City Reply Br. at 17. Now, the Utilities admit that the proposed disallowances would not require cessation of the AMRP. "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." PGL/NS BOE at 9. Though the Utilities restate the non-specific earnings pre-condition to their commitment to complete AMRP, no party argues that the Utilities should not recover their lawful costs. Therefore, long term sustainability of the AMRP should not be a problem under an adjusted revenue requirement request or under the oversight arrangement Staff has proposed and CUB-City support.

The Utilities' BOE also attributes unwarranted significance to circumstances that have no evidentiary importance. "Even the AG and intervenors the Citizens Utility Board . . . and the City of Chicago . . . did not submit any evidence recommending denial of any 2012 AMRP costs." CUB-City have limited resources, and, of necessity, they focus their rate case participation in selected areas. Moreover, intervening parties have no legal obligation to present evidence on every issue in utility rate cases; utilities bear the burden of proof. 220 ILCS 5/9-201(c). Thus, a decision not to litigate a particular issue does not connote either agreement with the Utilities' position or a lack of interest. Unlike Illinois utilities, intervenors lack access to

ratepayer funding of their litigation expenses. The Utilities infer too much from the simple realities of litigation before the Commission.

4. Retirement Benefits, Net

Consistent with the decisions in NS-PGL's last three rate cases, the Proposed Order correctly removes the Utilities' pension assets from rate base. The Utilities argue that the Commission should reverse three rate cases worth of precedent by allowing their pension assets here, identifying five grounds for reconsideration. NS-PGL BOE at 25-27. These are, verbatim, the same five points the Utilities raised in their Initial Brief at 53-54, which were rightfully rejected by the Proposed Order. As CUB pointed out in its Reply Brief at 18-19, the Utilities admit that four of those five points have been raised and considered by the Commission in previous cases where the pension asset was disallowed. NS-PGL Init. Br. at 54. They claim to have presented new data (in surrebuttal) to support one single fact (that cumulative pension contributions have exceeded Generally Accepted Accounting Principles pension expense)—"although somewhat similar points sometimes were made" in prior cases. *See id*. at 53-54, NS-PGL BOE at 28-29. In reality, no new facts were presented that justify a decision to deviate from the Commission's regular practice of disallowing a pension asset. The Commission's previous, well-reasoned decisions should again provide guidance here, and the pension asset should be removed from rate base. Shareholders should not earn a return on these ratepayer-supplied funds. CUB-City, Staff and AG have all made similar recommendations that no pension asset be included in rate base.

As the Utilities have admitted, all of the facts and arguments presented in this case were presented to and considered by the Commission in past cases. *See* NS-PGL Init. Br. at 54. To deviate from the Commission decisions in those cases would be a drastic departure from past

Commission practice. Commission decisions are afforded less deference and require greater justification on appeal where they drastically depart from past practice. *BPI I*, 136 Ill. 2d at 228. This record lacks the new factual and policy bases for change required to justify departure from previous decisions. The Utilities' exceptions to the treatment of retirement benefits should therefore be rejected.

6. Accumulated Deferred Income Taxes

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

The Proposed Order's analysis of this issue correctly notes that, because the Illinois state corporate income tax rates will decline in 2015 and again in 2025, a weighted average state income tax rate should be used to compute Deferred State Income Tax Expense. PO at 112. This is also known as normalization. The Utilities argue that there is not cause to "deviate" from the Commission's Order in Docket No. 83-0309 ("83-0309 Order"), which allegedly supports their flawed approach reflecting known changes to the state income tax rate. NS-PGL BOE at 32-38. The Utilities' argument assumes the validity of their own biased mis-interpretation of the 83-0309 Order, which addressed the need for consistent tax normalization accounting by Illinois utilities. As shown below, the Proposed Order's adoption of the CUB-City and AG normalization approach is in keeping with the 83-0309 Order, as well as with the Utilities' own concerns about consistency.

In the 83-0309 Order, one of the Commission's objectives was to treat income taxes consistently among Illinois utilities. Feb 8 tr. 717:8-12. That Order stated: "such uniform treatment for ratemaking purposes of such deferred tax accounts for Illinois utilities which utilize deferred tax accounting should be adopted in each utility's next rate filing..." CUB-City Ex. 2.0, 42-43:932-36. ComEd and Ameren apply normalization accounting for the Illinois SIT rates

specified in the state tax law following recent formula rate case decisions. If NS and PGL do not use the same accounting method as two of Illinois' largest public utilities, uniform treatment would not be achieved across Illinois utilities on a matter that does not hinge on facts specific to the utility.

The Utilities themselves have shown great concern for consistency in the accounting method used by Illinois public utilities. NS-PGL BOE at 37-38. They argue that the average rate assumption method ("ARAM"), their preferred methodology, "ensures consistency across Illinois utilities." *Id*. at 37. They acknowledge, however, that the recent ComEd and Ameren formula rate cases adopted the methodology supported by CUB-City. *Id*. The Utilities argue that "[i]f 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..." and go on to argue that it cannot be applied to Northern Illinois Gas Company ("Nicor") because Nicor has agreed not to file a rate case until next year.[4] Although two of Illinois' largest public utilities are using the CUB-City methodology, NS-PGL contends that a deviation from that methodology encourages consistency because one utility cannot immediately adopt that method. The Commission should disregard that illogical, circular argument.

The CUB-City and AG approach of normalization accounting acknowledges that Illinois' state corporate income tax rate is only temporary. The tax rate increased from 7.3% to 9.5%,

[4] Though the Utilities state that Nicor, as a result of its merger, "agreed not to file a rate case for three years," (PGL/NS BOE at 38), the agreement was actually that Nicor may file a general rate case at a time that would allow new rates to go into effect three years following the date its merger closed. ICC Docket 11-0046, Final order of December 7, 2011 at 32. In practicality, therefore, Nicor may file a rate case in eight months, in January of 2014. That rate case may use a 2015 future test year, as the Utilities argue, but may also use any historical test year of Nicor's choosing.

effective January 1, 2011 through 2014. CUB-City Ex. 1.0, 55:1522-24, *id*. at 57:1583-85. In the years 2015-2024, the Illinois corporate income tax rate will be 7.75%, and beyond 2025 the rate will return to 7.3%. CUB-City Ex. 1.0, 57:1584-1585. Because the Illinois state corporate income tax rates specified in the statute decline in 2015 and 2025, a weighted average state income tax rate must be used to compute Deferred State Income Tax Expense, so that the lower tax rates used to determine deferred expense in later years are properly recognized in calculating the deferred liability used in this case.

The Utilities argue that a normalization accounting methodology distorts costs of service, providing a benefit to current customers through the sacrifice of future customers. NS-PGL BOE at 34. However, the Utilities' static 9.5% state income tax rate ignores the fact that, in less than two years, the Illinois corporate income tax rate will be 7.75%, and beyond 2025 the rate will be 7.3%. CUB-City Ex. 1.0, 57:1584-1585. The Proposed Order correctly notes that under the Utilities' preferred ARAM method ratepayers would be forced to pay excessive deferred income tax expenses today. PO at 112.

The Commission should reject the Utilities' alternate proposed language, which requests that the Commission make a statement applicable to all Illinois utilities (that the 83-0309 Order and, specifically, ARAM is still controlling) though the record has demonstrated that normalization accounting is appropriate here. NS-PGL BOE at 38. The Commission need not issue such a broad statement in this Order, particularly in light of the fact that ComEd and Ameren already use normalization accounting. The Commission should continue to consider each case on its merits, and does not need to include such dictum in this rate case Order.

V. Operating Expenses

C. Contested Issues

2. Non-union Base Wages

The Proposed Order correctly adopts Staff's adjustment to reduce the increase for non-union wages to a more reasonable level. The Utilities' proposed methodology is the same as the methodology they proposed in their last rate case, which was rightly rejected by the Commission at that time. While the inflation rate is forecasted to be only 2.28%, the Utilities request an increase of 3.45%. Staff Ex. 13.0, 9:160-70. The Bureau of Labor Statistics Cost Index shows that during the 12 months ending September 2012, wages and salaries increased only 2.3%. The evidence in the record demonstrates that the Utilities' projected wage and salary escalation is not reasonable given the current market. Thus, the Utilities' exceptions to the Proposed Order's correct conclusion should be rejected.

4. Distribution O&M

a. Plastic Pipefitting Remediation Project

The Proposed Order properly disallows costs of the Plastic Pipefitting Remediation Project ("PPRP"). In their BOE, Peoples relies on its assertion that it is reasonable to replace the fittings at this time. The dispute here is not whether or when the corrections should be made, but whether they are the result of PGL imprudence in the original work. Staff demonstrated that if PGL had initially complied with the Commission's Rules regarding the fittings, they would not have incurred these costs. Staff Ex. 16.0, 7:135-41. Whether it is reasonable to replace them now (because PGL can coordinate doing so with other scheduled work) is irrelevant. The previous fittings did not comply with industry standards (Staff Ex. 6.0, 6:150-54), and the Commission should not allow PGL to recover (and earn a return on) costs to remediate their

previous non-compliance. To do so would not encourage future compliance. The Utilities' BOE provides no justifiable reason to deviate from the Proposed Order's conclusion on this matter.

6. Administrative and General

a. Adjustments to Integrys Business Support Costs

The Proposed Order correctly found that "the AG's proposed adjustments are supported by the evidence, reasonable, and should be adopted." PO at 160. The AG's adjustment, as revised in Mr. Brosch's rebuttal testimony, proposes to disallow $2,727,000 from the Utilities' operating expenses for Integrys Business Support costs allocated to the Utilities for two home centers and for depreciation costs. *See* AG Reply Br. At 46-47. The Proposed Order correctly concluded that the Utilities "have failed to meet their burden of explaining and justifying the basis for" these costs. PO at 160. The Commission should adopt the Proposed Order's conclusion in full.

All parties agree that the under the PUA, which the Proposed Order correctly applies, it is the Utilities' burden to show that these costs are prudent and reasonable. The Utilities claim that the costs attributable to the increased services are based on forecasts by subject matter experts and are, therefore, reasonable. The Utilities claim that the AG's proposed adjustment to the two home centers, for TEG Corporate Controller expenses and IBS Legal-Centrally Budgeted expenses, ignores the Utilities' support for those amounts. For the expenses attributable to the TEG Corporate Controller home center, the Utilities claim that the variance in these costs from historical amounts is "mainly due to increased outside services related to convergence standards and International Financial Reporting Standards." Utilities' BOE at 52. However, the Utilities fail to rebut Mr. Brosch's testimony that these increased forecasts were speculative, partially attributable to merger-related services, and should not be charged to the regulated Utilities in

Illinois even if actually incurred in the test-year. AG Ex. 4.0 at 53; AG Ex. 4.7. Even if the Commission finds that the Utilities presented a *prima facie* case with respect to these expenses, which they did not, Mr. Brosch's testimony specifically addressing these increases is unrebutted in the record. Therefore, the Utilities have failed to carry their burden to support the reasonableness and prudence of the TEG Corporate Controller home center costs allocated to the Utilities and the Commission should adopt the Proposed Order's conclusion on this matter in full.

For the expenses attributable to the IBS Legal-Centrally Budgeted home center, the Utilities claim that the application of a 2.2% inflation rate to the 2010-2012 average leads to an amount less than what is projected for recovery in the 2013 test-year, and therefore, their projection is reasonable. Utilities' BOE at 52. The Utilities' claim fails to address the testimony in the record establishing that the fees in total continue to be overstated in the 2013 forecast, even after the Utilities' witness Ms. Gregor's testimony was taken into account. AG Ex. 4.0 at 54-55. The Utilities had an opportunity to supplement the evidence on this matter if they had reasponded to the AG's request for more detailed information of recorded historical legal fees to better assess the reasonableness of the Utilities' projection. The Utilities objected to that request and therefore left the evidentiary record without support for their increased projection. AG Ex. 4.8. Therefore, the Utilities have failed to carry their burden to support the IBS Legal-Centrally Budgeted home center costs allocated to the Utilities. The Commission should adopt the Proposed Order's conclusion on this matter in full.

For depreciation costs, the Utilities claim that their proposed operating expense amount accounts for depreciation and that, therefore, the AG's proposed adjustment is redundant. Utilities' BOE at 52-53. However, the AG's proposed adjustment does specifically address the

updated in-service date for the Utilities' Work Asset Management ("WAM") system to replace a full year's worth of depreciation with a more appropriate amount. AG Ex. 4.0 at 55-56. Therefore, the AG's proposed adjustment is not redundant to the Utilities' requested operating expense amount, and the Commission should adopt the Proposed Order's conclusion on this matter in full.

Staff argues for their more comprehensive adjustment to reduce intercompany charges, but their adjustment does not appear to take into account the costs for which the Utilities did, in fact, carry their burden to show were just and reasonable. *See* Staff BOE at 24-25. However, Mr. Brosch's adjustment, as modified in his rebuttal testimony, accounts for those costs and is therefore the most reasonable adjustment in the record supported by the evidence. The AG's proposed adjustment to reduce the Utilities' operating expenses by $2,727,000 was found reasonable and supported by the evidence by the Proposed Order, and should also be adopted by the Commission.

c. Charitable Contributions

Even though the Proposed Order does not adopt Staff's proposed adjustment in full, CUB-City finds that the Proposed Order's conclusion is reasonable. PO at 166-167. Although the Commission would be supported by the record evidence in adopting Staff's proposed adjustment in full, the Proposed Order was correct to find that the Utilities have not "shown that the charitable contributions to universities outside of Illinois will benefit customers in the Utilities' service territory." *Id*. at 167. The Proposed Order also correctly applied the law, stating that to recover an expense for charitable contributions from ratepayers, a "utility must show that the donation will provide a benefit to customer in its service territory." *Id*. at 166.

The Utilities claim that Section 9-227 of the PUA "expressly allows recovery of donations made for 'educational purposes' as long as the amounts are reasonable." PGL/NS BOE at 53. The Utilities are correct that no party contests the reasonableness of the amounts of the contributions. However, this characterization of the law fails to address the ratepayer-benefit test, which requires that the utility seeking to recover a charitable contribution demonstrate that the contribution will provide a benefit to customers in that utility's service territory.. Nevertheless, the Utilities claim that the contributions at issue do benefit their ratepayers with the plain statement that "the Utilities showed customer benefits of donations to educational institutions outside of their service territories." PGL/NS Reply Br. at 113. This conclusory statement fails to cite any evidence in the record, because there is no such evidence. At best, the Utilities' testimony established that "Illinois universities have in the past and currently provide educated utility workers to serve customers and an educated citizenry within the service territory." NS-PGL Ex. 26.0 at 9. This testimony, if considered credible evidence without any sort of quantitative documentation showing how many of the Utilities' workers were in fact educated by those universities, supports the factual distinction drawn by the Proposed Order in disallowing recovery of contributions made to out-of-state universities. There is no evidence in the record, even of the non-quantified type provided for Illinois universities, establishing that contributions to out-of-state universities benefit the Utilities' ratepayers. The Utilities have thus failed to carry their burden to demonstrate that these contributions benefit their ratepayers and the Commission should adopt the Proposed Order's conclusion.

VI. RATE OF RETURN

E. Cost of Equity

1. The Context

The Utilities open their argument for a higher equity return with an observation that affirms (rather than challenges) the adequacy, or possible excess, of their past returns and the Commission's cost of equity determinations. "This financial strength [from past determinations] has given the Utilities the ability to obtain capital at reasonable cost <u>even in the wake of the 2008 financial crisis and the ensuing "Great Recession</u>." PGL/NS BOE at 56 (emphasis added). Notwithstanding that starting point, the Utilities continue to press for an increase in the return on the investment used to provide utility service. *Id.* at 10.

The Utilities offer several arguments to support that request. Each is flawed, and none justify the requested increase. The principal bases of their disagreements with the Proposed Order are matters the Commission has previously held to be insufficient for the remedy they seek. Predictably, they rely heavily on the language of the Proposed Order inviting reliance on matters such as (a) comparisons to other commission return awards and (b) subjective opinions on what investors expect, based on guesses about what pieces of data influence investment, and on how markets will react, instead of actual observed market data.

The Utilities also unsurprisingly applaud the Proposed Order's reversal of the Commission's regular practice of rejecting adjustments to the results of empirical models, where the adjustments are based on unverifiable, subjective predictions of market reactions, investor perceptions and expectations, or how investors make their decisions. Neither the Commission nor the Utilities can say with non-speculative assurance what investors take into account when they buy and sell equity securities, setting a risk-based cost of equity. That speculative exercise – whether performed by the Commission or by hired experts (whose perspectives and subjective

opinions are likely to favor their employers) –bears only a tenuous relationship to competent evidence of record.

As the Commission has concluded in prior cases, the Commission is better served by observing the empirical results of those impenetrable investor deliberations and reactions, instead of trying to guess their course and outcome. If the factors the Utilities allege are critical actually are important, those factors -- along with other factors unknown or undervalued by speculations about their effect -- will be reflected in the empirical market results the Commission currently relies on through its consistent adoption of DCF and CAPM analyses. The Commission has affirmed the superiority of such empirical analyses in numerous prior cases.

Other than unfortunate *dicta* in the PO, the Utilities identify no new factors that warrant the Proposed Order's casual jettisoning of the consistent, fundamental approach of the Commission's prior cost of equity determinations. The Commission should reject the Proposed Order's step backward toward reliance on unverifiable, subjective opinion.

The Utilities' BOE is just a small example of what the Commission can expect if this door is opened. Proposals to adjust empirical model results based on subjective factors like the "quality and direction of regulation" (PGL/NS BOE at 58), "average of recent ROEs authorized for natural gas utilities" (*id.* at 59), and "negative signal[s] to the financial markets" (*id.* at 59) will flood Commission proceedings. As in this case, observations the Commission has previously expressly held to be irrelevant and unreliable – like the average of return awards by other commissions for other utilities with unknown risk factors – will be offered to challenge unfavorable empirical model results.

For instance, the Utilities argue that "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." PGL/NS BOE at 9. Similarly, they argue 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." *Id.* at 58. The fatal deficiencies of relying on other commission decisions have been repeatedly explained by the Commission. *See, e.g.*, North Shore Gas, et al., Docket Nos. 07-0241/07-0242, Order, Feb 5, 2008 at 90 ("by determining the Utilities' ROEs via comparison to existing ROEs, the Commission would be disregarding its duty to impose only cost-based and reasonable rates on the Utilities' customers").

Additional concerns that arise from an undue emphasis on subjective interpretations of selected (possibly qualitative) industry data are illustrated by Staff's exposure of an apparently disingenuous presentation of such information by the Utilities. *See* Staff BOE at 48. The Proposed Order invites more of such information, though its connection to Illinois utilities is tenuous, even when accurate. A review of Staff's demonstration should persuade the Commission that its policy emphasizing utility-specific empirical analyses is correct. Illustrating the same need for extreme caution, the Utilities' BOE offers another set of chart presentations purporting to show a need for moderation of intervenor positions. *See* PGL/NS BOE at 60-62. However, the Utilities omit important relevant data from their charts – *viz.*, their own recommendations. The inclusion of the Utilities' recommendations would reveal a greater need for moderation of the utility positions.

The Utilities offer the comment, as part of their cost of equity arguments, that "[t]he Commission's support is even more important now as Peoples Gas implements its accelerated cast iron main replacement program." PGL/NS BOE at 56. However, the Utilities have not proven that there is any incremental risk associated with pipe maintenance, a task PGL should be

performing regularly and continuously. This basic utility function does not require the support of a higher return or any modification of the Commission's traditional analyses.

3. DCF
4. CAPM

Staff's BOE highlights a serious fault in the Proposed Order's analysis – the absence of any express treatment of the proposed leverage adjustment in the Utilities' DCF and CAPM analyses.

> The ALJs' PO fails to address the Utilities' leverage adjustment. As the PO itself notes in its summary of the Utilities' positions, the results of the Utilities' DCF and CAPM analyses reflect the application of a leverage adjustment. . . . Utilities' draft PO does not address this issue in its conclusions. Likewise, as a direct result of it reliance on the Utilities' draft PO, the ALJs' PO also identifies the leverage adjustment as a primary dispute, but neglects to address this critical issue.

Staff BOE at 32-33. Staff notes an apparent reliance on the Utilities' Draft Proposed Order and a similar absence of any analysis of this issue in that utility document. *Id*. at 33.

From the articulated reasoning of the Proposed Order, it is not entirely clear whether the Utilities' leverage adjustment has been accepted or rejected. The Proposed Order qualifies its cost of equity determination, but does not make this matter any clearer.

> The Commission does not endorse every input to or every aspect of the CAPM analyses performed by the Utilities or by Staff. Nevertheless, for purposes of this proceeding, the Commission finds that each provides useful input in estimating the market required return on common equity.

PO at 207. Staff highlights the danger that an issue ostensibly resolved in one way is not reflected in the same way in revenue requirement calculations. Obviously, if there is an inconsistency, it should be corrected – a step that is impossible if there is no clear decision in the Commission's order. Even if there is not a clear inconsistency, mere ambiguity from the absence

of an express ruling or from imprecision in subsequent calculations can lead to confusion or possible misinterpretation of a Commission decision. Staff's BOE illustratively recounts the Utilities' use of just such an occurrence to argue that the Commission's consistent opinions on this issue do not establish a clear policy. Staff BOE at 34-35.

In absence of any express treatment of this issue in the Proposed Order, CUB-City inferred that the Proposed Order had followed the Commission's consistent policy of rejecting leverage adjustments. That inference -- though perhaps reasonable based only on the absence of any stated justification for a reversal of Commission policy -- may be characterized as inaccurate, if the order is not modified. As Staff advises, the Commission must correct the Proposed Order. Staff BOE at 32-38.

6. Effect of Riders UEA and VBA

In their BOE, CUB-City noted the flawed logic and lack of record data supporting the Proposed Order's conclusion that an adjustment for Rider UEA was not needed, because "trackers such as Rider UEA have become quite common." CUB-City BOE at 41. Staff's BOE shows that even in today's environment such facile inferences from broad, unspecific industry data are misguided. Here, "approximately 40% of the Delivery Group companies have no bad debt trackers at all" (Staff BOE at 39); in those circumstances, industry-wide data are not reliable indicators. Even if the Commission does not correct the Proposed Order's undue reliance on "context" information that the Commission has found irrelevant in prior cases, the facts proved in <u>this</u> case do not support the Utilities' request for an increased cost of common equity.

Like CUB-City, Staff finds the Proposed Order's language inviting more emphasis on such data problematic. Staff also proposes modifications to similar effect as CUB-City's proposed modifications.

IX. RATE DESIGN

C. Service Classification Rate Design

2. Contested Issues – North Shore and Peoples Gas

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

In presenting their argument in favor of greater "fixed cost" recovery, the Utilities ignore the fact that the Proposed Order upholds their rate decoupling rider, Rider VBA, the intent and function of which is the very same as the Utilities' rate design proposal: to provide greater guarantee of revenue recovery. PGL/NS BOE at 70. Providing the Utilities both Rider VBA and a greater cost recovery through fixed charges would essentially provide double revenue assurance, when the evidence does not support the need for either. See CUB-City Init. Br. at 64-78. Furthermore, the Utilities disregard the fact that other utilities in Illinois do not have a rider mechanism like Rider VBA in place. For this reason alone, the Utilities' exception to the Proposed Order's conclusion on residential heating class rate design should be rejected.

The Utilities additionally cite to the fact that their proposal "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." PGL/NS BOE at 71. This argument completely ignores the long-standing, prevailing law requiring rates to be set based on costs. Class cost of service is the prime criterion the Commission looks at in determining the proper allocation among customer classes**.** *City of Chicago v. People of Cook County*, 133 Ill.App.3d 435, 444 (1st Dist. 1985)("*City of Chicago*"). It is not the only criterion the Commission may consider, however. *Id*. Considerations of rate continuity or the desirability of making changes gradually can properly limit changes in rate design. *Id*. (citing *International Minerals & Chemicals Corp. v. Mayo*, 336 So.2d 548, 552. (Fla.1976)). The Illinois Appellate Court has also upheld a

Commission determination that only in the face of significant public policy considerations should deviation from cost-based rate design be allowed. *Commonwealth Edison Co. v. Illinois Commerce Comm'n*, 398 Ill.App.3d 510, 526. With regard to the Commission's decision to move gradually toward a more cost-based rate design, the Illinois Appellate Court ruled that, "[t]he fact that the Commission has not moved as rapidly as U.S. Steel would like is not grounds for reversal." *City of Chicago,* 133 Ill.App.3d at 444.

In this proceeding, the evidence demonstrates that PGL and NS's residential class is currently paying more than the costs to serve it. AG Ex. 3.0R, 23:507-512, citing AG Ex. 3.10, lines 9-13; AG Ex. 3.0R, 19:421-428, citing AG Ex. 3.08, lines 9-13. While the bifurcation of the residential class into heating and non-heating classes partially addresses this problem, the Utilities' preferred move to 80% cost recovery in fixed charges (*i.e*. the customer charge) is not based on an examination of the actual costs to serve the residential heating class, but rather an arbitrary cost recovery threshold allegedly representing the "Commission's long-standing policy in favor of increased fixed cost recovery through fixed charges." PGL/NS BOE at 70. Based on this record, however, 80% cost recovery in fixed charges is not supported by the evidence of the actual costs to serve residential heating customers. The move from what is now 54% cost recovery in fixed charges to 80% also constitutes a more dramatic shift in fixed cost recovery than can reasonably be described as "gradual." The 80% cost recovery in fixed charges approved for other utilities is not justified in this proceeding because there is no demonstration that it relates to NS and PGL's actual costs to serve residential heating customers, and the jump in fixed charges could reasonably be expected to produce rate shock.

In contrast, AG Witness Rubin's proposed residential rate design carefully analyzed the Utilities' Cost of Service Study ("COSS") to develop a proposed rate design that properly

recognizes the impact of demand costs on the cost of service. The Utilities' rate design proposal for residential heating customers neither recognizes nor appropriately recovers the substantial demand-related costs that the Utilities incur to serve heating customers. AG Ex. 3.0R, 22:485-490. For example, NS's demand-related cost is approximately 35% higher than its proposed rate per therm. AG Ex. 3.0R, 23:507-512, citing AG Ex. 3.10, lines 9-13. PGL's demand-related cost is approximately 29% higher than its proposed rate per therm. AG Ex. 3.0R, 19:421-428, citing AG Ex. 3.08, lines 9-13.

The end results of a rate design that mis-allocates demand-related costs to the fixed monthly customer charge are (1) that low-use customers pay more than the cost to serve them and (2) that high-use customers pay less than the cost to serve them. This failure to recognize the demand cost disparity shown by the ECOSS perpetuates cross-subsidization within the heating class. This is the same flaw that led to NS's existing rates greatly over-recovering costs from non-heating customers. AG Ex. 3.0R, 22:485-490. The residential rate structure proposed by Mr. Rubin appropriately recognizes the difference between customer costs and demand related costs and allocates costs appropriately, implementing the important policy concerns, as noted by the Proposed Order, that rates be set with consideration of the "principles of gradualism, rate continuity, and rate understandability." PO at 237. Thus, CUB-City respectfully request that the Commission reject the Utilities' exception and instead adopt CUB-City Exception No. 13 on pages 47-48 of their BOE.

XI. CONCLUSION

WHEREFORE, CUB and the City respectfully request that the Commission adopt the Proposed Order's conclusions on the issues discussed in this brief.

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Respectfully Submitted,

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