STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

NORTH SHORE GAS COMPANY	:	
	:	No. 14-0224
Proposed General Increase In Rates For Gas Service.	:	and
	:	No. 14-0225
THE PEOPLES GAS LIGHT AND COKE COMPANY	:	Cons.
	:	
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BRIEF ON EXCEPTIONS OF NORTH SHORE GAS COMPANY
AND THE PEOPLES GAS LIGHT AND COKE COMPANY

December 16, 2014

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BRIEF ON EXCEPTIONS OF NORTH SHORE GAS COMPANY
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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 December 5, 2014, 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

The Proposed Order, on a majority of subjects, makes findings and recommendations that are consistent with the evidence and applicable law. The Proposed Order also correctly rejects attempts by some intervenors to inject into these Dockets subjects that properly belong (if anywhere) in the pending Docket regarding Wisconsin Energy Corporation's proposed acquisition of Integrys Energy Group, Inc., the ultimate parent company of the Utilities.

These Dockets are 2015 "future test year" gas distribution rate cases. The Utilities' proposed base rate "revenue requirements" (costs of serving customers) are based on (1) their forecasted capital project and operating costs for 2015, subject to appropriate adjustments; and (2) their real costs of capital. The 2015 forecasts were prepared using well-established processes that conform with Generally Accepted Accounting Principles; the forecasts are supported by extensive, detailed testimony and exhibits, including evidence that supports the costs as such as well as evidence regarding the drivers of changes in costs since the Utilities' existing rates were established in their 2012 rate cases[1]; and the forecasted financial statements were duly examined by an independent Certified Public Accountant, Deloitte and Touche LLP, that confirmed that the statements conform with the applicable accounting standards for prospective financial statements as required by the Commission's rules.[2] The Utilities' real costs of capital, both costs of equity and costs of debt, also have been shown by careful analyses.[3] The Utilities' proposed rate designs are based on extensive cost of service studies (there are no opposing cost of service studies), and thus they reflect cost causation, but they also apply considerations of gradualism.[4]

The Utilities' Exceptions are focused primarily on: (1) their real costs of capital; (2) recovery of certain amounts invested to benefit customers, especially the 2014 costs of Peoples Gas' Accelerated Main Replacement Program ("AMRP") and the associated costs of removal; and (3) rate designs that properly reflect both cost causation and gradualism.

<u>The Utilities' real costs of accessing the capital that they use in serving customers</u>. The Proposed Order recommends Staff's proposed 9.05% cost of common equity ("ROE"), compared with the 10.25% proposed by the Utilities and the 9.28% approved by the Commission in *Peoples Gas 2012*. The evidence shows that all of the major factors that influence the market cost of common equity have changed in ways that **increase** that cost since *Peoples Gas 2012*.

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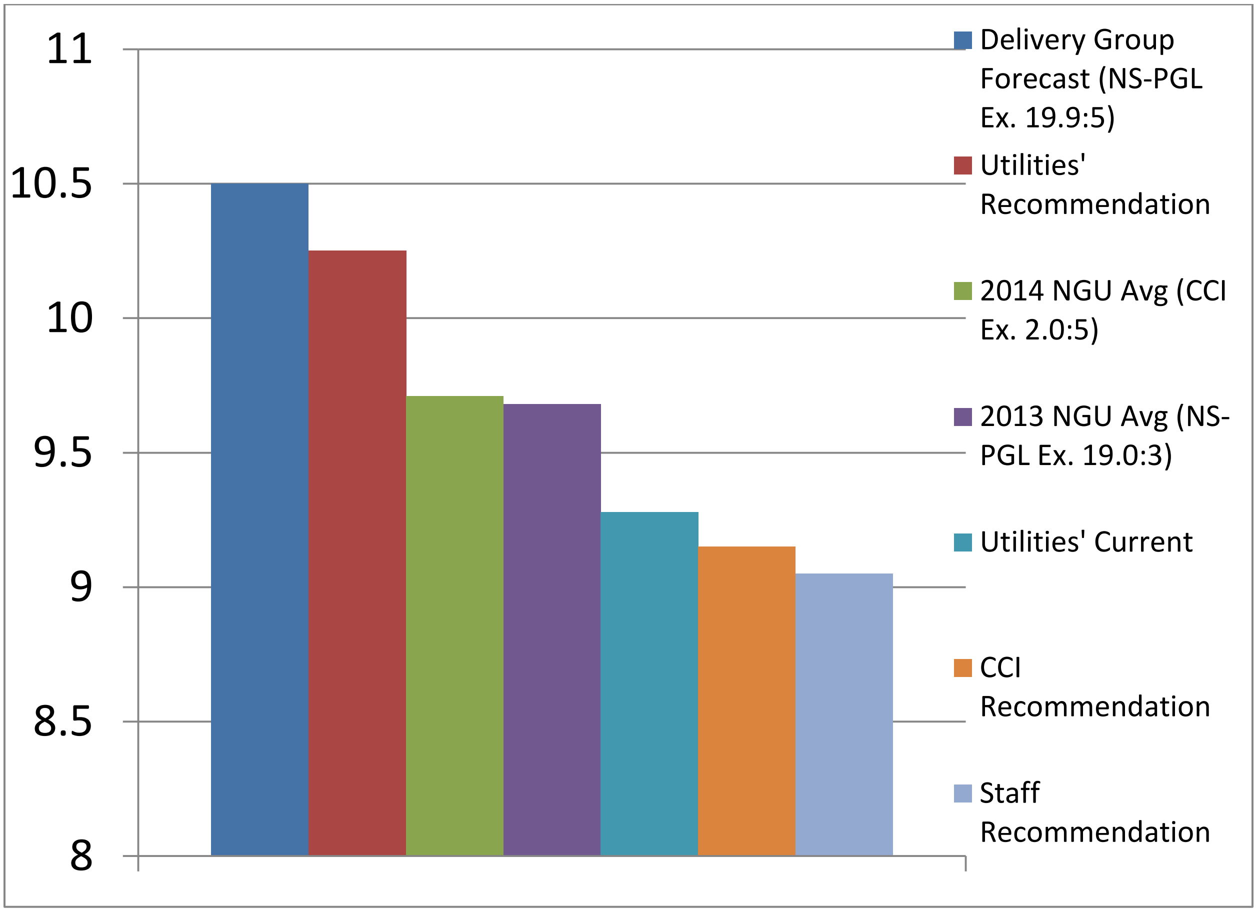
1 *North Shore Gas Co., et al.*, ICC Docket Nos. 12-0511/12-0512 Cons. (Order June 18, 2013; Order on Rehearing Dec. 18, 2013) ("*Peoples Gas 2012*").
2 *E.g.*, NS-PGL Initial Brief ("IB") at 1-3, 9-12, 17-18, 44-45; NS-PGL Reply Brief ("RB") at 10-11; 83 Ill. Adm. Code § 285.7010.
3 *E.g.*, NS-PGL IB at 94-114; NS-PGL RB at 79-89.
4 *E.g.*, NS-PGL IB at 117-139; NS-PGL RB at 92-117.

The current cost of equity also is reflected in the recent decisions of public utility commissions in other states. The following chart illustrates that the Staff ROE recommendation is not reasonable.

ROE COMPARISON



The Proposed Order's recommending an ROE lower than that approved in *Peoples Gas 2012*, rather than increased, is not consistent with the economic facts. *See* Section VI of this Brief on Exceptions.

<u>Peoples Gas' 2014 costs of its Accelerated Main Replacement Program and the associated costs of removal</u>. The Proposed Order recommends the AG's proposed reductions to recovery of Peoples Gas' 2014 AMRP costs and the associated costs of removal, subject to Staff's corrections of the AG's calculations. The AG's proposal is extrapolated from capital

expenditure figures as of July 2014 that fail to take into account or disregard: (1) the annual construction cycle; (2) the construction delays that occurred at the beginning of 2014 due to unusually cold weather; (3) the AMRP contractors' plans to offset some, but not all, of those delays; (4) the post-July AMRP capital expenditures data and capital additions data that are in the record; and (5) the Utilities' estimated level of spending for the remainder of 2014. As of the evidentiary hearing, the most reliable figures for these 2014 costs were the figures found in Peoples Gas' rebuttal, which did take into account all of the above factors. The Utilities, in this Brief on Exceptions, however, also are submitting proposed updates based on data that has been added to the record pursuant to a Staff motion granted by the Administrative Law Judges. The proposed updates yield adjustments that are in between the AG proposal's figures and Peoples Gas' rebuttal figures. *See* Section IV.C.1.a of this Brief on Exceptions.

Rate designs that properly reflect both cost causation and gradualism. The Proposed Order recommends adoption of Staff's proposed rate designs, which are based on limiting fixed cost recovery in fixed charges. That would result in rates that purportedly promote conservation but do so by sending the false price signal that lower customer usage causes the Utilities to incur lower fixed costs. The Utilities do not advocate placing all fixed cost recovery in fixed charges in this case, even though it would best represent cost causation. Instead, their proposals gradually move towards such a rate design in a way that is consistent with past Commission policy for gas utilities, including North Shore and Peoples Gas. *See* Section IX of this Brief on Exceptions.

The Commission should approve the Proposed Order with the corrections and updates proposed by the Utilities. Such a final Order would be supported by the evidence and lawful, and it would yield rates that are just and reasonable.[5]

III. REVENUE REQUIREMENT

A. North Shore

EXCEPTION NOS. 1 AND 2

Exception Nos. 1 and 2 both relate to Section III.A of the Proposed Order. Exception No. 1 is a proposal to add language regarding the "Companies Position", in light of the material included in the Proposed Order regarding the AG's position. Exception No. 2 is a proposal to change the revenue requirement figure in the "Commission Analysis and Conclusion" section.

Discussion of Exception No. 1. The Utilities, in their post-trial briefs and their November 7, 2014, Proposed Language for Draft Order, discussed the substantive legal standards that govern these cases, the allocation of the burden of proof and the burden of going forward with the evidence, the Commission's duty to decide these cases based on the evidence and the law, and the unlawfulness of the Commission basing a decision on speculation.[6] A large portion of the legal discussion set forth verbatim a quotation from the *Peoples Gas 2012* Order, which in turn quoted the Order in the Utilities' 2011 rate cases.[7] The Utilities also responded to a number of assertions made by the AG about the law and the Utilities' costs and services.[8]

In brief, with respect to the legal points, the Utilities showed that:

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[5] As to the legal standards that govern these cases, please see Section III.A of this Brief on Exceptions.
[6] *E.g.*, NS-PGL IB at 7-8, 42, 100-102; NS-PGL RB at 4, 7-8, 8-10, 17-18; 11/7/14 Proposed Language for Draft Order at 7-8.
[7] *North Shore Gas Co., et al.*, ICC Docket Nos. 11-0280/11-0281 Cons. (Order Jan. 10, 2012) ("*Peoples Gas 2011*").
[8] *E.g.*, NS-PGL RB at 5-8, 9, 11, 96-98, 101-105, 108-110; 11/7/14 Proposed Language for Draft Order at 8.

- The Commission is legally required to establish rates that are just and reasonable to the utility and its stockholders as well as customers.
- Under long-established federal and Illinois constitutional and 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 cost of capital.
- A utility bears the burden of proof that its proposed rates are just and reasonable, but once it presents a *prima facie* case,[9] the burden of going forward with the evidence shifts to the other parties that challenge its costs to show unreasonableness due to inefficiency or bad faith. The utility does not bear the burden of proof on all issues that conceivably are relevant to the reasonableness of its rates, nor is it required in its direct case to anticipate and disprove the objections opposing parties might make.
- The Commission must decide contested cases based on the evidence in the record and the applicable law. Speculation is not a lawful basis for a Commission decision.

The citations for these points are found on the pages referenced in footnotes 6 and 8 of this Brief on Exceptions.

The Utilities also noted that the AG's Corrected Initial Brief (at 6-7) discussed certain case law, but that the AG cited the same cases and made the same points in its briefs in *Peoples*

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[9] The Utilities, in their direct case, presented far more than a *prima facie* case. *E.g.*, NS-PGL RB at 10-11; *see also, e.g.*, NS-PGL IB at 17-18 and NS-PGL RB at 11 (voluminous citations of evidence supporting rate base); NS-PGL IB at 44-45 (voluminous citations of evidence supporting operating expenses); NS-PGL IB at 94-114 (discussion of extensive evidence supporting cost of capital). No party has contended (much less shown) that the Utilities failed to present a *prima facie* case.

Gas 2012. The Utilities stated that they do not understand the AG (or any other party) to argue that any case law or other authority allows the Commission to set rates that do not allow a utility the opportunity to recover fully its cost of service (revenue requirement). The cases, including the first and most recent case cited by the AG, do not support such a result. NS-PGL RB at 9.

The Utilities also made the point that, as the Commission found in both the *Peoples Gas 2011* Order (at 5, 137) and the *Peoples Gas 2012* Order (at 11), and as shown again by the evidence here, allowing a utility the opportunity to recover fully its costs of service, including its costs of capital, is in the long-term interests of customers, because this is necessary in order for the utility to be able to provide adequate, safe, and reliable service over time at the least long-term cost. *E.g.*, NS-PGL IB at 3, 7-8; Derricks Direct ("Dir."), PGL Ex. 1.0, 4:65 – 5:88.

As indicated above, the Utilities also responded to a large number of legal and factual assertions made in the AG's Initial Brief.

Section III.A of the Proposed Order, in discussing the Companies Position, does not set forth the Utilities' legal points nor reference their responses to the AG's assertions. *See* Proposed Order at 6. However, Section III.A of the Proposed Order, in discussing the AG's Position, sets forth the AG's assertions in detail. *See* Proposed Order at 6-10.

Accordingly, Exception No. 1 proposes language to be added to the discussion of the Companies' Position section. Such language needs to be added in order to fairly and accurately present the issues and, more specifically, the opposing positions in light of the Proposed Order's detailed discussion of the AG's Position. Exception No. 1 should be adopted.

<u>Discussion of Exception No. 2</u>. The Proposed Order (at 10), in the Commission Analysis and Conclusion section, finds a figure of $85,358,000, which does not include the uncontested figure of $1,597,000 for Other Revenues (but which does appear elsewhere in the Proposed

Order), for North Shore's approved revenue requirement.[10] The Utilities have contended that the correct figure given the evidence in the record is $89,778,000, consisting of $88,181,000 in base rates plus the $1,597,000 of Other Revenues). *E.g.*, NS-PGL IB at 9; NS-PGL RB at 11.

The Utilities are preserving that position through this Brief on Exceptions, except the Utilities are willing, in the interest of narrowing the issues, to accept certain adjustments for purposes of the instant cases, as discussed in Sections V.C.3.a.iv, V.C.3.d (in part), and V.C.3.e of this Brief on Exceptions.

Exception No. 2 would change the $85,358,000 figure to $89,778,000, noting that this includes $1,597,000 of Other Revenues, provided that the $89,778,000 figure is subject to adjustment for the above-referenced items proposed to be accepted. The Findings and Ordering Paragraphs and Appendix A to the Proposed Order would need to be conformed as well. Exception No. 2 should be adopted.

B. <u>Peoples Gas</u>

EXCEPTION NO. 3

The Proposed Order (at 11), in the Commission Analysis and Conclusion section, finds a figure of $667,340,000, which is the sum of the base rates figure of $650,734,000 and the uncontested Other Revenues figure of $16,606,000, for Peoples Gas' approved revenue requirement. The Utilities have contended that the correct figure given the evidence in the record is $697,407,000, consisting of $680,801,000 for base rates plus the $16,606,000 for Other Revenues. *E.g.*, NS-PGL IB at 11; NS-PGL RB at 12.

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[10] The Proposed Order presentation here is inconsistent with the remainder of the Proposed Order. The North Shore revenue requirement figure on page 10 excludes Other Revenues, but the Peoples Gas revenue requirement figure on page 11 includes Other Revenues. Findings 18 and 19 on pages 225-226 of the Proposed Order have both figures for both Utilities, as do Appendices A and B of the Proposed Order.

The Utilities are preserving that position through this Brief on Exceptions, except: (1) the Utilities are willing, in the interest of narrowing the issues, to accept certain adjustments for purposes of the instant cases, as discussed in Sections V.C.3.a.iv, V.C.3.d (in part), and V.C.3.e of this Brief on Exceptions; and (2) Peoples Gas is presenting updates regarding 2014 AMRP costs and associated costs of removal (and for the Calumet system upgrade project), as discussed in Section IV.C.1.a of this Brief on Exceptions.

Exception No. 3 would change the $667,340,000 figure to $697,407,000, noting that this includes $16,606,000 of Other Revenues, provided that the $667,340,000 figure is subject to adjustment for the above-referenced items proposed to be accepted and the AMRP-related updates. The Findings and Ordering Paragraphs and Appendix B to the Proposed Order would need to be conformed as well. Exception No. 3 should be adopted.

The Utilities also note that the Proposed Order's $667,340,000 and $650,734,000 figures have slight miscalculations, because of errors reflected in operating income,[11] *i.e.*, as a result of certain errors these two figures are a net $12,000 too high assuming the recommendations of the Proposed Order. Exception No. 3, in the alternative, includes corrected figures of $667,328,000 and $650,722,000. Those figures and the underlying corrections also are discussed further as to Exception No. 24 in Section X of this Brief on Exceptions.

[11] Proposed Order, Appendix B, p. 1, column (b), lines 13 and 14 incorrectly shows amounts of $112,762,000 and $25,694,000, instead of $112,771,000 and $25,686,000. Appendix B, p. 3, column (k), lines 17-19 incorrectly reflect income taxes of: state income tax $135,000, federal income tax $564,000, and deferred income taxes and ITCs Net $0, instead of state income tax $389,000, federal income tax $1,535,000, and deferred income taxes and ITCs Net ($1,215,000), as shown in NS-PGL Ex. 37.5P.

C. Proposed Reorganization

EXCEPTION NO. 4

The Proposed Order (at 22) reaches the right outcome, given the evidence and the law, regarding attempts to bring into this case issues that belong, if anywhere, in ICC Docket No. 14-0496 regarding the proposed Wisconsin Energy Corporation ("WEC") – Integrys Energy Group, Inc. ("Integrys"), transaction. The Utilities believe, however, that the Commission Analysis and Conclusion section also should include additional language that the CCI[12] proposals on this subject were untimely, were not supported or addressed by any witness nor otherwise based on the evidence, and cannot properly or fairly be considered in these Dockets. Exception No. 4 would add such language and should be adopted.

IV. RATE BASE

C. Potentially Contested Issues (All subjects relate to NS and PGL unless otherwise noted)

1. Plant

a. 2014 AMRP Additions and Associated Costs of Removal (Including derivative impacts on Accumulated Depreciation and Accumulated Deferred Income Taxes) (PGL)

EXCEPTION NOS. 5 AND 6

The Proposed Order (at 37): (1) recommends approval of the AG's proposed adjustments to Peoples Gas' 2014 AMRP additions and to the associated costs of removal, subject to Staff's corrections of the AG's figures; and (2) finds that Peoples Gas ultimately will recover its actual 2014 prudent costs of AMRP additions and the associated costs of removal through Rider QIP – Qualifying Infrastructure Plant ("Rider QIP"). The Proposed Order's adjustment is incorrect.

[12] CCI = City of Chicago, Citizens Utility Board, and Illinois Industrial Energy Consumers (also "City-CUB-IIEC").

The AG's position is based on a simplistic extrapolation from data on capital expenditures from January through July 2014. The AG's position fails to take into account (1) the effects of the unusually cold winter weather on the pace of construction at the beginning of 2014, (2) the contractors' plans to remediate (in part) those delays, and (3) the annual construction cycle, including the timing of the peak construction season, as well as disregarding (4) data on post-July 2014 expenditures and capital additions and (5) the estimated amounts for the remaining months of 2014. Lazzaro Rebuttal ("Reb."), NS-PGL Ex. 23.0 2nd Rev., 3:60 – 6:117; Lazzaro Surrebuttal ("Sur."), NS-PGL Ex. 38.0, 2:39-41, 3:57 - 5:94; NS-PGL Ex. 38.1; Lazzaro Tr. at 129:10-21, 131:19 – 132:12. The Proposed Order (at 37), however, correctly adopts Staff's revisions to the AG's calculations, assuming that the AG's position were to be adopted.

The Proposed Order's recommendation is not consistent with the evidence, as discussed below, but the Utilities, in the interests of narrowing the issues, are proposing updates that yield middle ground figures, as explained later in this subsection of this Brief on Exceptions. Exception No. 5 relates to the Companies Position section. Exception No. 6 relates to the Commission Analysis and Conclusions section.

<u>Background</u>. In its direct case, Peoples Gas explained the historical need and main system upgrade goals for AMRP, including: (1) the retirement of 1,870 miles of cast iron/ductile iron gas distribution mains, (2) the upgrade of approximately 300,000 service pipes, (3) the relocation of gas meters from inside of customer facilities to outside, and (4) the upgrade of the gas distribution system from a low pressure to a medium pressure system. Lazzaro Dir., PGL Ex. 8.0 2nd Rev., 11:220-223; NS-PGL IB at 30-32. Further, both the Commission and the General Assembly have recognized the need for and benefits of accelerated main replacement. NS-PGL RB at 25-26.

Why the Proposed Order's Recommendation Is Not Consistent With the Evidence. Despite the demonstrated need for improvements and the Utilities' evidence regarding their costs, the Proposed Order adopts the AG's position, as corrected by Staff, which would reduce recovery of Peoples Gas' 2014 AMRP additions by a gross $65,877,000 and would reduce recovery of the associated costs of removal by $17,231,000.

As of the evidentiary hearing, the only reasonable set of figures for the 2014 AMRP additions and the associated costs of removal were those presented by Peoples Gas in rebuttal, which reflected updated reduced costs of the 2014 AMRP additions and associated costs of removal, and reflected the factors that were disregarded by the AG. Lazzaro Reb., NS-PGL Ex. 23.0 2nd Rev., 3:60 – 6:117; NS-PGL IB at 30-35; NS-PGL RB at 25-32. Those Peoples Gas rebuttal figures were adopted by CCI in briefing. CCI IB at 8.

In adopting the AG's adjustments, the Proposed Order disregards actual data for August 2014, which demonstrated that the August 2014 AMRP capital expenditures were $38,465,000, which is $6,349,000 above the budgeted figure for that month, $32,116,000, and the Utilities' evidence that then-estimated expenditures for the four remaining months of the year were $25 million to $30 million per month. Lazzaro Sur., NS-PGL Ex. 38.0, 4:78 – 5:85; NS-PGL Ex. 38.1; Lazzaro Tr. at 129:10-21; *see also* Lazzaro Tr. at 131:19 – 132:12 (explaining that Peoples Gas has taken advantage of new opportunities for construction that developed since the revised budget was prepared). Further, Staff's own cross-examination exhibit shows that August 2014 AMRP capital additions were $27,364,786. Staff Group Cross Ex. 1 at Peoples Gas' response to Staff data request DLH 34.04. That evidence is more supportive of the Utilities' rebuttal figures than of the AG's proposal.

Although the AG's post-hearing Initial Brief, in defending its extrapolation from AMRP capital expenditures data for January through July 2014, focused on a comparison of the actual AMRP capital expenditures for January through August 2014 to Peoples Gas' budget (as revised earlier in 2014), as broken down for those eight months, that comparison does not support the AG's proposal. *See* AG IB Corr. at 16-17. First, Peoples Gas' rebuttal figures, unlike the AG's rebuttal proposal, took into account the delays due to weather, the contractor plans to reduce some of those delays, and the construction cycle, as well as the then estimate for the rest of the year. Second, the AG proposal is based on capital expenditures only through July 2014, even though even the AG's own Initial Brief shows that in August 2014, actual AMRP capital expenditures were $38,465,000, which is $6,349,000 above the budget for that month, as noted above. *See* AG IB Corr. at 17

Despite the above data, the AG made no modification to reduce its proposed adjustments, not even to reflect the August 2014 capital expenditures. NS-PGL RB at 29. The data presented for August 2014 is more consistent with Peoples Gas' figures as presented in rebuttal testimony than with the AG's proposal. *Id*. In fact, the AG's Reply Brief's assertion that "we should not expect that actual spending in the final four months of 2014 will equal budgeted capital expenditure" again ignores the August 2014 data, and provides no valid basis for rejecting Peoples Gas' September estimate of spending in the remainder of 2014. *Id*. Further, the AG's adjustment is based on a selective reliance on the budget, as it places no weight on the total budget figures, but only focuses on the variances in the first seven months of the year. *Id.* That is inappropriate, especially in light of the fact that Peoples Gas has demonstrated that it has taken advantage of new opportunities for construction that developed since the revised budget was prepared – opportunities that will arise in the closing months of 2014. Lazzaro Tr. at 131:19 - 132:12.

The AG's adjustment is based, in part, on the assertion that expected AMRP capital expenditures for the last four months of the year, of $25 million to $30 million per month, is contrary to the revised budget's figures for those months. AG IB Corr. at 18-19. However, that again ignores: (1) the fact that August 2014 expenditures were more than $6 million over the revised budget, (2) the contractors' plans to make up in part for the delays earlier in the year, and (3) Mr. Lazzaro's testimony regarding opportunities that developed after the revised budget was prepared. NS-PGL RB at 29-30. Notably, although the AG complains that when Mr. Lazzaro testified about those opportunities he did not explain them in more depth, this topic was raised during cross-examination, but the AG did not ask Mr. Lazzaro to provide such an explanation. Rather, the AG stopped its cross-examination of Mr. Lazzaro at that exact point. *See* Lazzaro Tr. at 131:19 – 132:12.

The Proposed Order's adoption of the AG's adjustment to the costs of removal associated with AMRP based on January through July 2014 actual costs also disregards actual expenditures in August 2014 as well as the available information as of September regarding the remainder of the year. Moreover, the Proposed Order also disregards that the AG's adjustment is inconsistent, and that the AG argues that the August removal costs being almost $1 million under the budget supports its proposal while the AG argues that August AMRP costs being over $6 million over the budget is irrelevant and does not undercut its proposal. NS-PGL RB at 30.

Although Staff supported the AG's adjustments (as corrected by Staff), Staff provided no testimony actually addressing the merits of any version of the AG proposal, apart from Staff's speculation that Peoples Gas' rebuttal's reduced figures did not appear attainable. *See* Hathhorn

Reb., Staff Ex. 6.0, 17:346 – 18:366. In addition, Staff's support of the AG's adjustments is based primarily on figures for QIP additions (including both AMRP additions and the uncontested revised costs of the Calumet project), less retirements. *See* Staff IB at 14-15. However, the AG proposal recommended by the Proposed Order is based on an analysis of capital expenditures (not capital additions), and does not factor in retirements. Thus, Staff's focus on capital additions and not expenditures failed to take into account the large amount of 2014 expenditures that have already been incurred but have not yet been recorded as additions. NS-PGL RB at 31. Thus, based on the record as of the evidentiary hearing, Peoples Gas' rebuttal figures for AMRP costs and the associated costs of removal are the only figures that should be approved.

<u>The Utilities' Proposed Updates</u>. The Utilities note, however, that, pursuant to a Staff motion granted by the Administrative Law Judges, the evidentiary record also contains, from the Utilities' Rider QIP filings, actual AMRP capital additions data (and data for the associated costs of removal), as well as actual data for the other QIP project, the Calumet system upgrade project,[13] for September and October 2014, and that Peoples Gas is filing such data for November 2014 today, December 16, 2014.

That data still indicates that the AG position results in excessive adjustments, but the Utilities, in order to narrow the issues, now propose to update -- i.e., reduce -- the 2014 AMRP costs and associated costs of removal (and the Calumet project costs) based on (1) data in and derived from the post-hearing data through November 2014 plus (2) the Utilities' December 2014 costs as previously estimated as of rebuttal. These proposed updates result in middle

[13] *See, e.g.*, Section IV.B.1.c.ii of the Proposed Order (at 24) regarding the Calumet project.

ground figures. More specifically, these proposed updates reduce net plant in rate base by $46,181,000. The proposed updates are shown in more detail -- including showing the full derivative impacts on rate base and operating expenses -- in Attachment 1 hereto, which is similar to NS-PGL Ex. 37.5P, which is relied upon in part by the Proposed Order (in its Appendix B, p.3, column (k), and p. 5, column (d)). In addition, contemporaneous herewith, the Utilities are serving an even more detailed supporting working Excel spreadsheet to Staff and intervenors, which spreadsheet is similar to the work paper the Utilities produced for NS-PGL Ex. 37.5P.

Please note that, if the proposed updates are approved by the Commission, then, because of the Calumet project update, the following phrase should be added to the last sentence of each of Sections IV.B.1.b and IV.B.1.d.ii of the Proposed Order: ", subject to the updates discussed in Section V.C.1.a of this Order".

<u>Rider QIP</u>. The Proposed Order (at 38) states that the revenue cap restriction on Rider QIP will not prohibit Peoples Gas from filing for rate recovery through a traditional rate case should the cap restriction begin to influence Peoples Gas' AMRP progress. That finding is problematic. If the Commission reduces the 2014 AMRP costs and related removal costs as urged by the AG (and Staff), and it turns out that 2014 costs are higher than the AG speculated they will be, as the data indicates they will be, then the amount of QIP investment that Peoples Gas can make and recover under Rider QIP while staying with the annual average revenue cap in 2015 (and in all subsequent years until new base rates are set and in effect) will be reduced. Egelhoff Sur., NS-PGL Ex. 43.0 Rev., 15:316 – 16:343. That could potentially adversely impact future QIP projects, mainly the AMRP, unless Peoples Gas was to file another rate case. *Id*. at 16:340-343; *see also* Egelhoff Reb., NS-PGL Ex. 29.0 Rev., 26:566-572.

The Proposed Order is inconsistent, moreover, because elsewhere it extends the rate case expense amortization period on the assumption that in the WEC-Integrys reorganization approval Docket, the Commission will approve the reorganization and a proposed commitment not to file for rates that would be effective before two years from the closure of the transaction. *See* Proposed Order at 105-106 and Section V.C.4 of this Brief on Exceptions.

Although Staff has claimed that the Utilities are using their concern about the cap in Rider QIP as a reason to include an excessive amount of 2014 AMRP and associated removal costs in rate base (Staff IB at 25-26), the opposite is true. The AG and Staff are using Rider QIP as a failsafe to argue that the Commission should not worry about excessive rate base reductions here because the rider will fix them. The Utilities are not arguing that anything about the rider means that the Commission should approve any rate base figure that the evidence shows to be too high. NS-PGL RB at 32. The Utilities are arguing that the facts in evidence show that, as of the evidentiary hearing, their rebuttal figures were the only reliable figures, but they are willing to update the figures, resulting in middle ground numbers, as discussed above. The Proposed Order's adoption of the AG's adjustments should be rejected and the updates should be adopted.

The Proposed Order should be amended consistent with the language in Exception Nos. 5 and 6. Exception No. 5 adds a paragraph to the Companies Position section (to note the proposed updates). Exception No. 6 addresses the Commission Analysis and Conclusions section (and also has conforming language for Sections IV.B.1.b and IV.B.1.c.ii of the Proposed Order).

2. Cash Working Capital

a. OPEB Lead

EXCEPTION NO. 7

The Proposed Order (at 42) adopts Staff's and CCI's recommendation to reflect an other post-employment benefits ("OPEB") positive expense lead of 170.00 days in the cash working capital ("CWC") calculation for North Shore and a positive lead of 169.91 days in the CWC calculation for Peoples Gas.

In brief, cash working capital is the amount of funds required to finance the day-to-day operations of a utility. *E.g.*, Hengtgen Dir., PGL Ex. 7.0, 18:391-393. CWC usually is calculated using a "lead/lag study", which is a study of the applicable cash flows, and that is how it has been calculated in the instant cases. *E.g.*, *id.* at 1:13-14.

The OPEB leads proposed by the Utilities are based upon an analysis of the actual payments to the trust for OPEB in 2012, the most recent calendar year data that was available at the time the studies were conducted. Hengtgen Sur., NS-PGL Ex. 37.0, 3:59-61. In accordance with customary practice, the Utilities considered the timing of all of the payments made during the year and dollar weighted them, resulting in proposed negative lead values of 66.64 for North Shore and 99.09 for Peoples Gas. *Id.* at 3:63 – 4:66.

The Proposed Order incorrectly bases its adoption of Staff's adjustments on "the historical OPEB payment activity and the lack of a required payment date," and incorrectly finds that "it is not reasonable to base the 2015 future test year on the early payment date that occurred in 2012." *See* Proposed Order at 42.

The Proposed Order's adoption of Staff's lead values for OPEB expenses should be rejected for several reasons. Staff's rejection of the actual cash flow data from 2012 relating to the OPEB leads, and substitution of hypothetical later payments, is flawed, inconsistent with the position taken by Staff and adopted by the Commission in prior rate cases of the Utilities, is selective, is a double-count, and is one-sided. *E.g.*, NS-PGL IB at 37. The Proposed Order's recommendation also is inconsistent with the cash working capital calculations recently approved in *Commonwealth Edison Co*., ICC Docket No. 14-0312 (Order Dec. 10, 2014).

Staff wrongly argues that the Utilities' cash payments for OPEB during calendar year 2012 were not made in accordance with "normal practice," and that a payment date of December 18, 2012, is more reasonable than the Utilities' January 9, 2012, payment date. Hathhorn Dir., Staff Ex. 1.0, 9:193 – 10:201. However, the OPEB trust payments do not have a specific due date, a fact which Staff admits. NS-PGL IB at 37; Hathhorn Dir., Staff Ex. 1.0, 9:195-196. Staff's adjustment is based upon a limited historical view of the Utilities' OPEB payments, focusing solely on payments made in 2013 and pending payments in 2014. Hathhorn Dir., Staff Ex. 1.0, 9:195-196. Despite Staff's assertion, the timing of the OPEB trust payments are consistent with the Utilities' historical practice, as in two out of the last three full calendar years, the Utilities made OPEB payments very early in the year. Hengtgen Reb., NS-PGL Ex. 22.0 REV, 8:165-169. Historical OPEB activity demonstrates that the timing of OPEB trust payments were appropriately timed and reasonable.

Further, the Proposed Order's adoption of Staff's proposal disregards the fact that Staff's position is inconsistent with its position taken in *Peoples Gas 2012*, wherein Staff argued that the OPEB lead should be set at the intercompany billing lead. In contrast, in the instant proceeding, Staff bases its adjustment to the OPEB expense lead on the cash flows provided by the Utilities during calendar year 2012 as adjusted by Staff witness Ms. Hathhorn. This unjustified inconsistency results in lead changes from negative to positive, resulting in a decreased CWC. Hengtgen Reb., NS-PGL Ex. 22.0 REV., 6:115 – 8:160. Similarly, Staff's adjustment relies upon an inapposite and irrelevant Commission Order in an unrelated docket, wherein the payment of pass-through taxes were made in contravention of statutory due dates or due dates prescribed by municipal ordinances. NS-PGL IB at 38-39. This argument is unsupported and unrelated to the issue of OPEB trust payments made in the absence of *any* specific due dates; in fact, the OPEB trust payments at issue in the instant proceeding have no required due date, either through statute, municipal ordinance, or prior Commission decision. NS-PGL IB at 39.

In order to determine the OPEB lead days, the Utilities conducted lead-lag studies that were based on data consisting of hundreds of thousands of cash transactions. Staff failed to provide any sound reason to modify only the OPEB lead payment dates, particularly when this adjustment results in significantly reducing the CWC available to meet day-to-day operational needs. Hengtgen Sur., NS-PGL Ex. 37.0, 4:73-81.

Further, the Proposed Order ignores the fact that Staff's adjustment is incorrect because the OPEB liability already is a rate base deduction, meaning the lead should be at most zero days, and making Staff's proposal a double-counted reduction to rate base. *See* Hengtgen Reb., NS-PGL Ex. 22.0 REV., 6:129-131, 10:211-219. The Commission recently agreed with these same facts in Commonwealth Edison's annual formula rate update proceeding, *Commonwealth Edison Co.*, ICC Docket No. 14-0312 (Order Dec. 10, 2014). The Commission Analysis and Conclusion section of the applicable portion of that Order concludes that because the OPEB expense and liability reduces rate base the "amounts are therefore already accounted for in ComEd's formula rate and revenue requirements, the Commission concludes that applying Staff's proposed payment leads of 203.24 days for pension and OPEB expense would improperly result in a double count reduction to ComEd's rate base". *See* that Order at 13-14. The Utilities' position is that the OPEB expense lead should be at most zero, for the reasons identified above.

The dispute in this case exists because both the Utilities and Staff have computed an OPEB lead based on cash flows. The Utilities used the actual cash flows from calendar year 2012, which was the basis of lead lag study supporting the cash working capital amounts in this case. Staff's opinion was that the actual February payment date is "early", therefore Staff modified the OPEB lead calculations to reflect a payment date in December, which is very late in the year. If the Utilities' position is rejected, using a zero lead value, which the Commission found to be correct in the ComEd case, would in effect be a proposed alternative and compromise between the Utilities' position of an "early" payment and Staff's position of a late payment and effectively represents a payment made in the middle of the year.

Moreover, the Proposed Order's adjustment improperly results in a one-sided advantage to customers, who will have the benefit of the actual payment date in the form of reduced OPEB expenses that resulted from the actual payment date (the "early" payment according to Staff) being included in the calculation of operating expenses in the Utilities' revenue requirements. OPEB expenses, all else being equal, are reduced by contributions to the OPEB trust and the earnings on the assets resulting from those contributions. Hans Dir., PGL Ex. 12.0, 11:234 - 13:276. The adjustments recommended by the Proposed Order would deny the Utilities the time value of the actual payment date, while giving customers the benefit of the actual payment date, which is inconsistent, unfair and unreasonable.

The timing of the Utilities' payments to the OPEB trust were made in accordance with historical practice, and were not required to be made at any specific time of the year. Further, Staff's adjustment to the OPEB lead is based solely upon its subjective opinion as to the appropriateness of the timing of the payments; Staff has provided no evidence supporting its claim that these payments are more appropriately made at the end of the calendar year. As such, the Proposed Order's adjustment to the OPEB lead days based upon the timing of such payments is erroneous and should be rejected. The Proposed Order should be revised consistent with the language in Exception No. 7.

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

EXCEPTION NO. 8

The Proposed Order (at 51) recommends exclusion of Peoples Gas' pension asset of $17,350,000 and North Shore's pension liability of $(8,000) from rate base, while also reducing rate base by the Utilities OPEB liabilities. As grounds for these findings, the Proposed Order relies on the findings of past Commission Orders. *Id.*

The Utilities recognize that (1) the Commission, in the Utilities' 2007, 2009, 2011, and 2012 rate cases, found that the Peoples Gas pension asset (and the then North Shore pension liability or asset, as applicable) should not be included in the calculation of rate base; and (2) there also found that the Utilities' OPEB liabilities nonetheless should be included in the calculation; and, furthermore, (3) that the *Peoples Gas 2009* Order was affirmed on appeal on this subject.[14]

While the Utilities agree with the Commission's past findings that, if a pension asset is excluded, then a pension liability also should be excluded, the Utilities respectfully request that

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14 ICC Docket Nos. 07-0241, 07-0242 (Order Feb. 5, 2008) ("*Peoples Gas 2007*") at 32-36; *Peoples Gas 2009* Order at 35-37, *aff'd in relevant part, 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 33; *Peoples Gas* 2012 Order at 80-90. The Appellate Court also has upheld the Commission's decision to allow Commonwealth Edison Company 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 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.

the Commission reconsider whether to include Peoples Gas' pension asset in the instant proceeding. As discussed in Section III.A 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).

The Commission's past decisions to exclude the Peoples Gas pension asset (and, when applicable, North Shore's) from rate base were based on findings 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 at 36. Staff advanced that same position in the instant case, while the AG simply proposed to apply the prior Commission decisions. *E.g.,* Hathhorn Dir., Staff Ex. 1.0, 14:285-286; Hathhorn Reb., Staff Ex. 6.0, 10:200-205; Effron Dir., AG Ex. 1.0, 12:249 - 13:267.

The Commission should reconsider approving inclusion of the pension asset(s) in rate base because:

(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. Hans Dir., NS Ex. 12.0, 14:307-310; Hans Dir., PGL Ex. 12.0, 14:312-315.

(3) The rates on which customers' bills are based reflect the accrual of pension expense. Hans Dir., NS Ex. 12.0, 14:310 – 15:323; Hans Dir., PGL Ex. 12.0, 14:315 – 15:328.

(4) 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 end 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. Hans Dir., NS Ex. 12.0, 15:323-328; Hans Dir., PGL Ex. 12.0, 15:328-335; Hans Reb., NS-PGL Ex. 26.0, 9:174-183.

(5) Cumulative pension contributions, that is, direct contributions into the trust, have exceeded cumulative recognized Generally Accepted Accounting Principles ("GAAP") pension expense. Hans Dir., NS Ex. 12.0, 15:331-334; NS Ex. 12.3; Hans Dir., PGL Ex. 12.0, 15:338 – 16:342; PGL Ex. 12.3.

The Proposed Order disregards the Companies' third point, that customers, by paying their bills, do not pay for the pension asset, because the bills customers pay are based on the accrual of pension expense (*i.e.*, they do not include future pension obligations that have not yet been recognized). NS-PGL IB at 41. Staff claims that customers paid for the pension asset (Staff IB at 20-21, 26-27) (and the AG does so implicitly by citing past Orders to that effect), but does not explain how customers supposedly pay for the pension asset, as discussed further below, and, specifically, does not refute the fact that the bills customers pay are based on the accrual of pension expense. A pension asset exists when cumulative funding <u>exceeds</u> the cumulative amount of recognized pension expense. Hans Dir., NS Ex. 12.0, 15:317-321; Hans Dir., PGL Ex. 12.0, 15:322-326. That is why the term "prepaid pension" (or prepaid pension expense) sometimes is used to refer to a pension asset. *E.g.*, Hans Dir., NS. Ex. 12.0, 15:321-322; Hans Dir., PGL Ex. 12.0, 15:326-327. Customers did not pay for the excess by which cumulative pension funding exceeds cumulative recognized pension expense. That means they did not pay for the pension asset. In reliance upon prior Commission orders, Staff simply argues that pension assets are created with funds supplied by ratepayers and that the Utilities have not provided evidence to distinguish this case from prior Commission rulings. Staff IB at 20-21. Staff advances its long-standing position and fails to provide any new evidence to support its claims. In contrast, the Utilities have noted in testimony and in briefing that the rates upon which customers' bills are based reflect the accrual of pension expense. Thus, customers do not pay for the pension asset itself. *See* NS-PGL IB at 41; Hans Dir., NS Ex. 12.0, 14:310 - 15:323; Hans Dir., PGL Ex. 12.0, 14:315 - 15:328

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 in *Peoples Gas 2012*. In the instant proceeding, Staff offers a limited response in rebuttal testimony, asserting that the facts between the instant proceeding and the prior Commission Orders are unchanged and that the Utilities' arguments are based solely on theoretical contributions. Hathhorn Reb., Staff Ex. 6.0, 12:241-247. However, Staff continues to fail to provide a sound reason the above points are incorrect or do not support the inclusion of the pension assets in rate base. Staff's sole response to this point in its Initial Brief admits that the pension asset is funded by normal operating revenues. Staff IB at 20. In fact, this appears to be the underlying basis of Staff and the AG's claim that customers pay for the pension asset, other than the additional incorrect Staff theory discussed above. However, as the evidence makes clear, funds from normal operations include repayment of the utility's cost of capital, so the utility's use of that repayment for pension funding does not mean that the funding is not capital of the utility. Hans Dir., NS Ex. 12.0, 15:323-328; Hans Dir., PGL Ex. 12.0, 15:328-333; Hans Reb., NS-PGL Ex. 26.0, 9:174-190. In addition, Staff's reasoning is inconsistent. When the subject at hand is whether incentive compensation costs should be recovered, and the metric is net income, Staff contends, and the Commission has agreed, that the metric is "shareholder-oriented". *See, e.g.*, Kahle Dir. Staff Ex. 2.0, 23:476-497, quoting *Peoples Gas 2011* Order at 54. Yet, here, where it has been shown that the prepayment of pension expense is a reduction to net income and retained earnings, Staff contends that the funds in question are customer-supplied. Further, the Commission Analysis and Conclusion in *Peoples Gas 2011* Order (at 33) did not expressly address this argument, nor did the *2012 Rate Cases* Order. Nor does the Proposed Order do so here.

The data provided to support point 5, above, has only been presented in the *2012 Rate Cases* and here, although somewhat similar points sometimes were made in the previous rate cases. Staff does not address or dispute this point. Thus, the Commission has sufficient grounds for reconsidering this issue and, of course, the decision must be based on the evidence in the record of the instant Dockets. 220 ILCS 5/10-103; 220 ILCS 5/10-201(e)(iv)(A).

Further, the AG did not respond to or dispute any of the Utilities' points in detail; instead, the AG asserted that the adjustments made by its witness were in accordance with the Commission's previous findings in the past relevant dockets. *See* AG IB Corr. at 22-23. In addition, although CCI did not address this issue in testimony, CCI argues that the Commission should adopt the proposal to properly account for pension assets, which are ratepayer funded. In support of this position, CCI simply refers to the past Commission decisions on this topic, and adopts the propositions of Staff and the AG.

Accordingly, the Commission should approve the inclusion of Peoples Gas' pension asset and North Shore's pension liability in rate base. In the alternative, if the Peoples Gas pension asset is not included in rate base, consistent with the Proposed Order, then the Commission should remove the OPEB liabilities from rate base. The Proposed Order should be amended consistent with the language in Exception No. 8.

V. OPERATING EXPENSES

C. Potentially Contested Issues (All subjects relate to NS and PGL unless otherwise noted)

3. Other Administrative & General

a. Integrys Business Support Costs

iv. Legal (NS)

The Proposed Order at (80) recommends the AG's adjustment to North Shore's legal expenses, which is supported by Staff. While the Utilities believe the adjustment is unwarranted, they are willing, in the interests of narrowing the issues, to accept this adjustment for purposes of the instant cases.

d. Charitable Contributions

EXCEPTION NO. 9

The Proposed Order at (101) recommends Staff's adjustments to charitable contributions, which exclude (1) all donations made in Illinois but outside of the applicable utility's service territory and (2) all donations made outside of Illinois.

The Utilities believe that both sets of adjustments are unwarranted and unlawful. NS-PGL IB at 88-91; NS-PGL RB at 70-72.

However, in the interests of narrowing the issues, the Utilities are willing to accept for purposes of the instant cases the second category of adjustments, *i.e.*, the non-Illinois donations adjustments.

With respect to the donations in Illinois but outside of the applicable utility's service territory, the Utilities disagree with the Commission's ruling in *Peoples Gas 2012*.

Section 9-227 of the Act, 220 ILCS 5/9-227, does not include such a restriction and forbids disallowances based on a rule. Furthermore, the evidence shows that these donations are reasonable in amount, and consist largely of the Utilities matching individually small charitable contributions by the Utilities' employees that are in communities where the employees live, and that strengthening the overall network of charitable institutions in northern Illinois and surrounding areas is beneficial to the Utilities' service territory in general. NS-PGL IB at 89-90; NS-PGL RB at 70-72.

The statutory requirement for recoverability of utility charitable expenditures is indicated in Section 9-227 is:

> …whether a rate or other charge or classification is sufficient, donations made by a public utility for the public welfare or for charitable scientific, religious or educational purposes, provided that such donations are reasonable in amount.

220 ILCS 5/9-227. Section 9-227 expressly allows recovery of donations made by a public utility for "…the public welfare or for charitable scientific, religious, or education purposes…" as the amounts are reasonable (the reasonableness of the amounts is uncontested here). Further, 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 recommended outcome on donations within Illinois is unlawful, bad policy, and contrary to the interests of customers.

In addition, the Proposed Order language should be modified to reflect that the exclusion of out of State contributions is based on a number of recent cases. There are many more, older cases in which no such exclusion was made. Exception No. 9 should be adopted.

c. Social and Service Club Membership Dues

The Proposed Order (at 104) recommends Staff's adjustments to social and service club dues. While the Utilities believe the adjustments are unwarranted, they are willing, in the interests of narrowing the issues, to accept these adjustments for purposes of the instant cases.

2. Amortization Period for Rate Cases Expense

EXCEPTION NO. 10

The Proposed Order (at 105-106) adopts Staff's proposal to change the rate case expense amortization period from two years as proposed by the Utilities to two and one-half years as proposed by Staff. The Proposed Order does so on the assumptions that the WEC-Integrys reorganization will be approved and that the proposal of the Joint Applicants in the reorganization docket (in brief, to not propose new rates that would become effective earlier than two years from closure of the transaction).

The Utilities' proposal to amortize rate case expenses is based on what the Utilities have experienced in their most recent rate cases. *E.g.,* Moy Dir., PGL Ex. 6.0, 13:281-286; Moy Dir., NS Ex. 6.0, 13:282-287. The two-year period also is the same period approved in the Utilities' 2012 rate cases. *Peoples Gas 2012* Order at 170, 175.

The Utilities believe that Staff's proposal is too speculative to adopt at this time, because it assumes approval in that Docket, which means approval not only by the Commission but also by the applicable out of state regulatory authorities, and Commission approval that specific proposed condition. *See* Moy Sur., NS-PGL Ex. 36.0, 9:189 – 10:202. Moreover, Staff's proposal does not take into account the possibility, raised by both Staff and CCI, of ratemaking proceedings that could occur earlier than that proposed condition would provide for, in the event of changed circumstances, although the Utilities do not believe that such changed circumstances will occur. Exception No. 10 changes the amortization period to two years and should be adopted.

VI. RATE OF RETURN

EXCEPTION NOS. 11-14

The leading economic indicators are improving. Interest rates are increasing, as are distribution utility ROEs. These developments point to higher costs of capital for the Utilities in 2015 than those costs were in mid-2013 when the Utilities' rates were last set. Accordingly, the Utilities seek modest increases in their costs of short-term and long-term debt and their cost of equity. Contrary to the current market conditions and trends, however, the Proposed Order adopts the Staff position on all contested cost of capital issues and recommends across-the-board decreases in the Utilities' capital costs. The Commission should correct this illogical, unreasonable and unjust result by granting Exception Nos. 11-14 and approving the Utilities' requested costs of capital.

A. Overview

The Commission has reduced the Utilities' returns by about 100 basis points since 2010. Peoples Gas' authorized overall return on rate base has fallen from 8.05% to 6.67%, and its authorized rate of return on equity ("ROE") from 10.33% to 9.28%. *Peoples Gas 2009* Order at 130; *Peoples Gas 2012* Order at 209. North Shore's authorized overall return has fallen from 8.19% to 6.72%, its ROE from 10.23% to 9.28%. *Peoples Gas 2009* Order at 130; *Peoples Gas 2012* Order at 208. These reductions were undoubtedly related to the prolonged recession and the federal government's intervention keeping interest rates at historical lows. Moul Dir., PGL Ex. 3.0, 31:654 – 32:664.

The U.S. economy is now on the rebound and capital costs are rising. Leading economic indicators including stock prices are improving. Moul Dir., PGL Ex. 3.0, 20:422 - 21:430. Interest rates are rising. Moul Dir., PGL Ex. 3.0, p. 28 table, 32:672 – 676; PGL Ex. 3.12; Moul Reb., NS-PGL Ex. 19.0, p. 12 table. Earnings growth and authorized ROEs for distribution utilities are increasing. Moul Reb., NS-PGL Ex. 19.0, 2:41 – 46, p. 5 table & 10:183-184; Gorman Reb., CCI Ex. 2.0, p. 5 table. This evidence can lead to only one conclusion: that the Utilities' costs of capital will be higher in 2015 than it was in June 2013 when the Utilities' rates were last set.

Consistent with the expectation of rising capital costs, the Utilities seek modest increases in their returns. Peoples Gas seeks an increase from 6.67% to 7.21%, North Shore from 6.72% to 6.89%. Gast Sur., NS-PGL Ex. 34.0, 4:85. Each of these returns is based on a 10.25% rate of return on common equity. Moul Dir., PGL Ex. 3.0, 38:798-807.

The Proposed Order adopted Staff's recommendation to further <u>reduce</u> the Utilities' returns. Contrary to the clear and convincing evidence of higher capital costs in 2015, the Proposed Order adopts Staff's proposal to reduce the Utilities' overall rates of return for 2015: from 6.67% to 6.56% for Peoples Gas and from 6.72% to 6.26% for North Shore, each based on a reduction in ROE from 9.28% to 9.05%. Staff RB at 34. Staff insists that the Utilities' ROE be established exclusively on the basis of the mathematical models without regard to economic trends and financial market conditions. Staff's is an ivory tower approach that exalts form over substance, theory over reality.

The record as a whole supports the Utilities' request for modestly increased returns. The Commission should reject the Proposed Order's recommended returns because they rely solely on Staff's advocacy and ignore the full record of what the Utilities' costs of capital will be in 2015. Establishing a utility's costs of capital for a future test year is not an academic exercise that can be reduced to broad assumptions (like Staff's position that it is impossible to forecast interest rates accurately) and a few formulas that ignore financial market conditions and trends (like Staff's mathematical models, which produced results lower than even CCI's). As it has in the Utilities' recent rate cases, the Commission should also consider the available evidence of financial market conditions and trends, including ROEs recently authorized for other natural gas utilities, to judge the reasonableness of the various parties' advocacy positions. If it does so, the Commission will find that the returns advocated by Staff and CCI grossly inadequate and the returns advocated by the Utilities well within the range of reasonableness. Even if it does not accept the Utilities' requests, the Commission should at least recognize the likelihood of increased capital costs in the test year by increasing the Utilities' authorized ROEs and overall returns over their current levels.

C. Cost of Short-Term Debt

EXCEPTION NO. 11

The Proposed Order (at 116) accepts Staff's short-term debt interest rate "predictions" even though they are not predictions at all, but rather historical spot day interest rates. The Proposed Order adopts Staff's position that interest rates cannot be forecast and there is no alternative to relying on "current" rates in a future test year rate case. The Staff position is utterly without foundation and the Commission should take this opportunity to reject it unequivocally.

The Utilities base their 2015 short-term borrowing costs on forecasts published by *Moody's*. The Utilities estimate these costs to be 1.06% for North Shore and 1.19% for Peoples Gas. Gast Reb., NS-PGL Ex. 18.0, p. 4 table; NS-PGL Exs. 18.2N & 18.2P. The credit rating agency's interest rate forecasts are without question verifiable and unbiased. These types of forecasts are "used by investors to formulate their expectations for the future." Moul Sur., NS-PGL Ex. 35.0, 2:43-44. Such forecasts are an eminently reasonable basis to predict the Utilities' costs in the future.

By contrast, Staff proposes lower short-term debt costs – 0.74% for North Shore and 0.91% for Peoples Gas – based on the actual yields of commercial paper on June 12, 2014. Freetly Reb., Staff Ex. 8.0, 2:34 – 3:47. Staff's reliance on historical "spot day" interest rates to forecast capital costs in a future test year is arbitrary and unreliable and should be rejected. As Staff itself recognizes, relying on historical data "will necessarily be arbitrary" because the analyst must choose the historical timeframe for the data. Freetly Dir., Staff Ex. 3.0, 28:508-510. Basing a forecast on historical data will produce the "correct" result only by chance. *Id*. at 28:510-511, 518-519. Recognizing that spot data "is exposed to inefficiencies from a number of sources" on any given day, the Commission has asked to be informed of "the conditions or financial climate of the spot day and whether any of these might cause material market inefficiencies." *Peoples Gas 2009* Order at 125-126. Staff did not attempt to make this showing with respect to its spot day interest rates in this case.

Instead, Staff argues that "current" interest rates are better predictors of future interest rates than published forecasts like *Moody's*. Freetly Dir., Staff Ex. 3.0, 4:78-79. Staff claims that it is impossible to forecast interest rates because such forecasts are too often "inaccurate." Freetly Reb., Staff Ex. 8.0, 4:63-69. It is undeniably true that few if any forecasts will be exactly correct in hindsight. Pointing to a few selected instances where interest rate forecasts "overstated" the actual yields that occurred,[15] Staff posits the truism that "no one can predict with certainty when interest rates will begin to rise, the rate which they will rise, how long they will rise before falling again, the rate at which they will fall, or even whether they will rise before they fall further." Freetly Reb., Staff Ex. 8.0, 4:70 – 5:77 & 6:91-94. This is a truism because nothing that depends on future events can be forecasted "with certainty" because no one can know "with certainty" what future conditions will be. Moul Sur., NS-PGL Ex. 35.0, 2:42-43. This doesn't mean, however, that forecasts are not accurate based on the information available when they are made.

Even the cited source of Staff's "random walk" theory does not support Staff's contention that "the current return [is] the best estimate going forward." *See* Freetly Reb., Staff Ex. 8.0, 4:69-70. The cited portion of Dr. Malkiel's work presents his thesis that "[t]he past history of stock prices cannot be used to predict the future in any meaningful way." Burton G. Malkiel, *A Random Walk Down Wall Street* at 146 (4th Ed. 1985) (emphasis added). This says nothing about the utility of analyst forecasts of stock prices (or interest rates).

All that Staff's "random walk" theory proves is that on any given day, it is impossible to know whether intervening events will cause a forecast to be wrong on the high side or the low side or by how much. If a forecast's performance in hindsight is truly random, as Staff claims, then there is no reason to believe that today's forecasts are either too low or too high. What is important is that the forecast is objective and credible. Staff did not challenge the credibility or

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15 Staff's selection of forecasts was arbitrary and Staff failed to inquire as to the reasonableness of any of them. NS-PGL IB at 98.

objectivity of the *Moody's* short-term debt forecasts on which the Utilities relied. Gast Dir., PGL Ex. 20, 9:166-177.

Finally, Staff's objection to the use of interest rate forecasts for debt costs in a future test year is inconsistent with Staff's own reliance on forecasts in its cost of equity analyses, including (1) analysts' growth forecasts (Freetly Dir., Staff Ex. 3.0, 9:173-179) used in its DCF model; (2) "expected" quarterly dividends used in its DCF model (*id*. at 10:200 – 11:210); and (3) gross domestic product inflation and growth forecasts from the Energy Information Administration ("EIA"), *Global Insight* and the *Survey* (*id*. at 16:301-313) used in its Capital Asset Pricing Model ("CAPM"). Staff's reliance on such forecasts must mean that Staff agrees that forecasts from credible and objective sources are reliable for the purpose of establishing a utility's cost of capital in a future test year.

For these reasons, the record strongly supports basing the Utilities' short-term debt costs on *Moody's* forecasts instead of a short-term debt rate selected by Staff on a single date several months ago. The Commission should put to rest Staff's unsupported and misguided position that "current" interest rates are to be preferred over verifiable and unbiased interest rate forecasts to forecast a utility's debt cost in a future test year.

D. Cost of Long-Term Debt

EXCEPTION NO. 12

North Shore's cost of long-term debt is uncontested. Proposed Order at 118. The Proposed Order (at 118) adopts Staff's proposed long-term debt costs for Peoples Gas, which include costs for future issuances based on historical spot day rates. For the same reasons as the Utilities object to the historically-based short term-debt rates, discussed above, they urge the

Commission to establish Peoples Gas' long-term debt cost based on credible and objective forecasts where applicable.

E. <u>Return on Equity</u>

EXCEPTION NO. 13

1. <u>The Context</u>

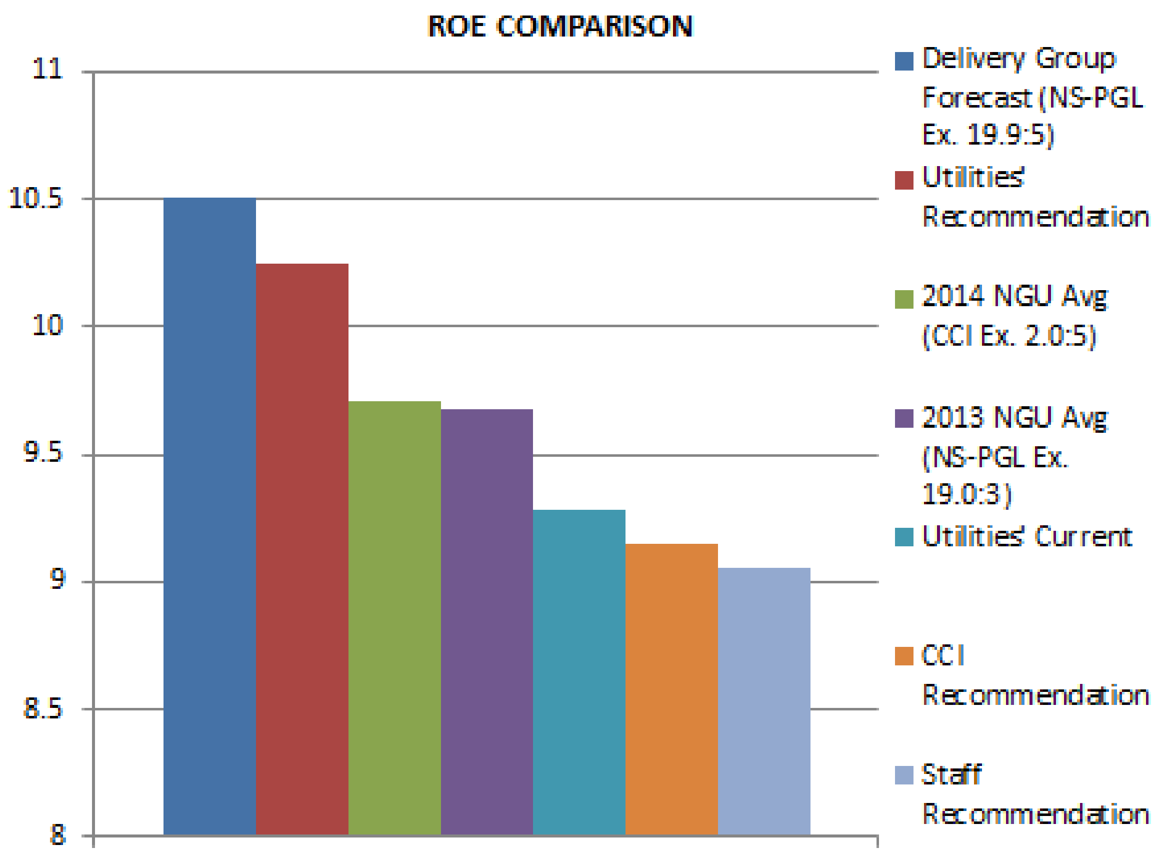
Historically, when setting a public utility's authorized ROE, the Commission relied exclusively on certain mathematical models designed to estimate a firm's market cost of equity. In recent cases, however, the Commission has recognized that "each of the financial models is theoretical and has its own limitations." *Peoples Gas 2009* Order at 123. The Commission has also recognized that the models are "highly dependent on analyst judgment as to the inputs, and therefore are susceptible to manipulation. Although these models provide the best information of what we need for the purposes at hand, their limitations require that we also consult general financial market information to ensure that the model results presented us are reasonable rates of return on equity based on the models that we deem appropriate for our consideration." *Id*.

More recently the Commission reiterated that it will consider current market conditions and trends, including the returns recently authorized for other utilities "provided the data are verifiable and unbiased." *Peoples Gas 2012* at 205. Such general market data "provide relevant comparative information" for the Commission's assessment of the parties' cost of equity evidence. *Id*. Such information included the then-current "<u>average of recent ROEs authorized for natural gas utilities</u>" and noted that "A-rated utility equity risk premiums have recently increased significantly as interest rates remain at historic lows." *Id*. (emphasis added).

Earlier this year, the Federal Energy Regulatory Commission ("FERC") reached similar conclusions, rejecting the "mechanical application" of the Discounted Cash Flow ("DCF") model and expanding its "zone of reasonableness" inquiry to include results from the Risk Premium, Capital Asset Pricing Model ("CAPM") and Expected Earnings approaches as well as "record evidence of state commission-approved ROEs." *Martha Coakley, Mass. Attorney Gen.*, Docket No. EL11-66-001, 147 FERC ¶ 61,234 (2014), at PP 142-148 (emphasis added). FERC, like this Commission, "has repeatedly held that it does not establish utilities' ROE based on state commission ROEs ... because those ROEs 'are established at different times in different jurisdictions which use different policies, standards, and methodologies in setting rates.'" *Id*. at P 148. FERC confirmed this position, but considered other authorized returns as "an indicator" that an upward adjustment of the ROE was required in the case before it. *Id*. Consideration of other returns is necessary to ensure that investments in the utilities under review were not put at a competitive disadvantage in the capital market. *Id*. at P 150.

Consistent with these recent pronouncements, the Utilities' cost of equity witness supplemented his mathematical models with a wide variety of information concerning current and future market conditions, which is the same kind of information routinely relied upon by banks and investors. The evidence uniformly leads to the conclusion that the Utilities' cost of equity will be higher in 2015 than it was in 2013 when the Commission last set the Utilities' rates. "Stellar" stock market performance and increasing strength in the leading economic indicators point to an improving economy. Moul Dir., PGL Ex. 3.0, 20:422 – 21:430. Interest rates are projected to continue to rise due to the Federal Reserve's tapering of its quantitative easing program to support the economy in response to the 2008 financial crisis. *Id*. at 28:586-597, 31:654 – 32:678; Moul Reb., NS-PGL Ex. 19.0, 11:202 – 12:209.

Consistent with these leading economic indicators, forecasted returns for the group of publicly-traded electric and natural gas distribution utilities used to estimate the Utilities' cost of equity (the "Delivery Group")[16] are projected to average 10.50%, which is significantly higher than the Utilities' current authorized return of 9.28%. Moul Reb., NS-PGL Ex. 19.0, 4:74 - 5:78. This forecasted growth in returns is consistent with the increase in the average authorized returns for natural gas utilities nationally from 9.68% in 2013 to 9.71% in the first half of 2014. *Id*. at 3:45-46. Indeed, the average return in the second quarter of 2014 was 9.84%. Gorman Reb., CCI Ex. 2.0, p. 5 table. The following table compares the parties' ROE proposals to these data, and shows the Staff and CCI proposals to be outliers:



[16] *See* Moul Dir., PGL Ex. 3.0, 4:59 – 5:82.

Staff urges the Commission to ignore ROEs of other utilities, arguing that unless all of the "crucial factors that influenced the allowed returns" are known, "any evaluation of the return recommendations in this proceeding via comparison to the returns authorized for other natural gas utilities is useless because there is no basis on which to assess comparability." Freetly Reb., Staff Ex. 8.0, 8:131-144 (emphases added). Staff protest is overwrought given this Commission's (and FERC's) recognition that other utility ROEs should be considered as "indicators" to ensure that the return set in an individual case meets constitutional standards. The Commission has thus rejected Staff's view that other ROEs "should only be used as indicators when all of the facts of the rate proceedings in which the return was set are comparable." Staff RB at 28.

Moreover, the Utilities have accounted for Staff's "crucial factors," which Staff identified as relative risk, flotation cost adjustment and market environment. Freetly Reb., Staff Ex. 8.0, 8:134-140.[17] The Utilities' sample of such returns is restricted to 2013 and 2014 and therefore captured "market fundamentals that are closely aligned with the present." Moul Sur., NS-PGL Ex. 35.0, 4:77-79. The evidence is based on a large sample, which encompasses the diversity of risk characteristics and minimizes the effect of any given factor. *Id*. at 4:79-85. Credit ratings among utilities are "tightly clustered" and do not represent a likely source of variation in authorized returns. The same is true for flotation costs, as few commissions adjust for them. *Id*. at 4:89 – 5:103. Thus, Staff's assertion that "there is no basis on which to assess comparability"

[17] Staff's reply brief (at 28-29) added another of these "factors," the state regulatory structure. But Staff cited no evidence to support its speculation that any of the other ROEs cited by the Utilities or CCI were based on a historical test year.

of actual recent ROEs to those that the Commission should authorize for the Utilities (Staff RB at 29) is simply untrue.

Finally, Staff contradicts itself by offering its own comparative ROE evidence, namely various calculations of the cost of equity for the U.S. market "as a whole." Staff IB at 57. Staff asserts that a 9.0% ROE for the Utilities is "representative of the return investors can earn on other investments of comparable risk." *Id*. at 57. According to Staff, the overall U.S. market cost of equity is anywhere from 8.80% to 9.52%. *Id*. at 57-58. But Staff does not explain why these published measurements of the "overall market" cost of equity deviated so dramatically from Staff's own calculation of the "expected rate of return on the market" for purposes of its CAPM model. Based on a DCF analysis on the firms in the S&P 500 Index, Staff calculates that cost to be <u>12.43%</u>, which is 291 to 363 basis points higher than Staff's other calculation. Freetly Dir., Staff Ex. 3.0, 17:320-333. By comparison, Mr. Moul calculated the total return on the market of U.S. equities to be <u>10.90%</u>. Moul Dir., PGL Ex. 3.0, 33:681-700.

The most direct calculation of investments of risk comparable to the Utilities is Mr. Moul's Comparable Earnings model, which estimates "the returns realized by non-regulated firms with comparable risks to a public utility." Moul Dir., PGL Ex. 3.0, 35:726-727. Using six categories of comparability of risk to the Delivery Group and reviewing both historical and forecasted returns for non-utility companies, Mr. Moul calculated a <u>10.30%</u> ROE for investments of comparable risk to the Utilities, which is very close to his recommendation of a <u>10.25%</u> ROE for the Utilities based on his other models. *Id*. at 37:795.

For all of these reasons, the Commission should reject the constrained view of the evidence reflected in the Proposed Order and continue to consider general market conditions and trends, including recent ROEs for other utilities, in its assessment of the parties' cost of equity positions. Doing so does not mean, as Staff and CCI contend, that the Commission would be basing its ROE decisions on such data. But it does demonstrate that Staff's and CCI's proposed ROEs are grossly inadequate. The Commission's adoption of the Proposed Order's ROE of 9.05% "would provide a signal to the investment community of unsupportive regulation of the Utilities." Moul Reb., NS-PGL Ex. 19.0, 4:70-71.

2. The Proposed Order's One-Sided Approach Is Inconsistent With The Commission's Balancing Approach

The Proposed Order (at 141) adopts Staff's position on all contested cost of capital issues. In basing the Utilities' ROE on Staff's advocacy alone, the Proposed Order is inconsistent with the balancing approach this Commission has taken in each of the Utilities' four rate cases since 2007. The Commission's approach rejects Staff's position, adopted in the Proposed Order, that the Staff mathematical models should be treated as infallible devices capable of generating a single correct answer. Instead, recognizing the models' limitations and their malleability by the analysts who employ them, the Commission has considered a combination of the models presented by the Utilities, Staff, and, to a lesser extent, other parties, in setting the Utilities' ROEs.

In the Utilities' 2007 rate cases, the Commission averaged the Utilities' DCF model (unadjusted for leverage), the Utilities' CAPM model (adjusted for leverage) and Staff's CAPM model to arrive at a 10.38% market required ROE before adjustments. The Commission rejected Staff's DCF result of 8.23% as "anomalous." *Peoples Gas 2007* Order at 92.

In the Utilities' 2009 rate cases, the Commission again rejected Staff's DCF result of 10.23%, this time because Staff changed its methodology – from a "constant growth" model to a "multi-stage" model – without "a sufficient explanation of what circumstances in the current case would warrant such a preference." *Peoples Gas 2009* Order at 125. The Commission rejected Staff's position "that the non-constant growth form of the model must be used any time it can be claimed that analyst growth rates are not sustainable." *Id*. The Commission averaged the Utilities' 10.67% DCF result (unadjusted for leverage) with Staff's constant growth DCF result of 11.76% (as calculated by the Utilities). Finding Staff's use of historical spot data unreliable, the Commission also averaged Staff's CAPM result of 9.95% with the result of 10.52% from Staff's CAPM using forecasted interest rates. Averaging the DCF average with the CAPM average, the Commission found the Utilities' cost of equity to be 10.73% before adjustments for riders. *Id*. at 129-130.

In the Utilities' 2011 rate cases, the Commission averaged the overall ROE recommendations of the Utilities (10.85%) and Staff (8.85%) with Governmental and Consumer Intervenors' DCF result (8.94%) to arrive at a base ROE of 9.55% before a rider adjustment. *Peoples Gas 2011* Order at 140. The Commission explained as follows:

> The Commission notes that no party's position is held without flaw as indicated by the parties' respective testimony in this proceeding. Each party has advocated a cost of equity that other parties believe reflect incorrect calculations through subjective, biased inputs. However, the Commission does not believe the imperfections in the models presented in this case are so flawed as to warrant an outright dismissal of the model for purposes of determining a reasonable rate of return…. The Commission, based upon the evidence presented, does not believe that any party's position stands out as being sufficiently superior to any other position, such that a single party's estimation technique should prevail…. The Commission believes, based on the record before it, that blending the parties' proposals in this manner results in an average return that significantly diminishes any perceived upward or downward bias as set forth in the different positions of the parties.

Id. at 139-140.

Finally, in the Utilities' 2012 rate cases, the Commission determined the Utilities' market required ROE to be 9.33% before a rider adjustment by averaging the Utilities' and Staff's DCF and CAPM results. *Peoples Gas 2012* Order at 207. In averaging the two DCF results, the Commission explained that it "does not endorse every input to or every aspect of the DCF analyses performed by the Utilities or by Staff. Nevertheless, for purposes of this proceeding, the Commission finds <u>that each provides useful input in estimating the market required return on common equity</u>." *Id*. at 206 (emphasis added). The Commission made a similar finding as to the Utilities' and Staff's CAPM results. *Id*. at 207.

The Commission's balancing approach is in keeping with its observations about the limitations and malleability of the mathematical models and the need to consider conditions and trends in the financial markets as "indicators" of the reasonableness of the advocacy positions presented it. If the Commission was inclined to follow the balancing approach it used in the Utilities' two most recent rate cases, and averaged the parties' ROE positions, the result would be <u>9.48%</u> (10.25% + 9.05% + 9.15% / 3). This result would still lag significantly behind the most recent average natural gas utility authorized ROE of 9.84% and the projected average natural gas utility ROE of 10.50% (NS-PGL IB at 103), but it would be at least directionally consistent with the uncontested evidence of an improving economy and increasing capital costs in the market.

3. <u>The Commission Should Reject Staff's DCF Result</u>

As discussed above, the Commission has considered at least one form of the Utilities' DCF model in each of their last four rates cases and their CAPM model in three of them. Similar treatment is justified in these cases because the Utilities have presented the same methodologies performed by the same witness that they presented in each of their last four rate cases. NS-PGL IB at 105-106. By contrast, the Commission has rejected Staff's DCF model twice, once because it produced "anomalous" results and once because Staff changed its methodology without an adequate explanation. In these cases, Staff's DCF again produced an anomalous result, in part as a result of an unsupported change in methodology. The Proposed Order (at 144) adopts Staff's DCF result without any consideration of these failings.

Staff's DCF result of 8.82% is anomalous. This result is not even in the ballpark of natural gas ROEs authorized to date in 2014, which have ranged from 9.18% to 10.40%. Gorman Reb., CCI Ex. 2.0, at p. 5 table.[18] Moreover, Staff's outlier DCF result is significantly lower – by 50 basis points – than Staff's DCF result in the Utilities' 2012 rate cases. *Peoples Gas 2012* Order at 206. Directionally, Staff's current DCF result flies in the face of the trend toward higher capital costs in 2015. The Commission should reject Staff's DCF result on this basis alone.

Staff got such an anomalously low result in part by changing its approach to estimating the growth component of the DCF model. Staff's longstanding approach, consistent with that of the Utilities', is to base the DCF growth component on analyst forecasts of earnings per share ("EPS") growth.[19] Moul Sur., NS-PGL Ex. 35.0, 5:108-113. This approach is appropriate. EPS growth is "the DCF model's primary focus because under the constant price-earnings multiple assumption of the model, the price per share of stock will grow at the same rate as earnings per share." Moul Dir., PGL Ex. 3.0, 16:325-328.

But in the instant cases, Staff averaged *Value Line* EPS forecasts with *Value Line* forecasts of dividends per share ("DPS"), book value per share, cash flow per share, and percent

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[18] Staff's original DCF result was 8.84%. Freetly Dir., Staff Ex. 3.0, 11:213. In response to Mr. Moul's criticism of its reliance on historical spot stock prices, Staff reduced its DCF result to 8.71% by purporting to adopt Mr. Moul's dividend yield "in order to reduce issues in this proceeding." Freetly Reb., Staff Ex. 8.0, 11:194-197. After the Utilities pointed out that Staff had not, in fact, conceded to Mr. Moul's position, Staff agreed to include Mr. Moul's dividend yield, which increased Staff's DCF result to 8.82%, just 2 basis points different than Staff's original DCF result.

[19] Staff could identify only one instance over 20 years ago in which it included forecasted DPS growth in the DCF model. *See* Staff IB at 51.

retained to common equity. Then, Staff averaged this average "*Value Line*" forecast with EPS growth forecasts from four other published sources. Moul Reb., NS-PGL Ex. 19.0, 8:133-137. This blending of growth forecasts resulted in a Staff DCF growth rate of 4.77%. Freetly Dir., Staff Ex. 3.0, 9:166. Had Staff limited itself to analyst forecasts of EPS growth consistent with its longstanding practice, the Staff DCF growth rate would have been 5.11%. Moul Reb., NS-PGL Ex. 19.0, 8:142.

By contrast, Mr. Moul considered both historical and forecasted growth data and did not simply average selected values. Because "[e]arnings per share growth is the primary determinant of investors' expectations regarding their total returns in the stock market," Mr. Moul focused on EPS growth forecasts. With these forecasts ranging from 4.70% to 5.58%, Mr. Moul selected a DCF growth component of 5.25% to reflect improving business conditions. Moul Dir., PGL Ex. 3.0, 19:394 – 21:430.

On rebuttal, Staff agreed to narrow the *Value Line* forecasts it averaged for the DCF growth component. However, Staff retained the *Value Line* DPS forecast so as not to ignore "the slowing in growth of dividends that is necessary to achieve an increase in the earnings retention rate." Freetly Reb., Staff Ex. 8.0, 12:228 – 13:231. This increased Staff's DCF growth rate by only 5 basis points, to 4.82%. *Id.*, 13:237.

Despite its modification, Staff's approach in these cases remains inconsistent with Staff's past reliance on EPS forecasts alone. Staff presented an argument that DPS growth "should not be ignored," but failed to explain why Staff "ignored" DPS growth in every rate case but one in the last 20-plus years. *Id.*, 12:212. In reality, the only purpose served by Staff including DPS growth was to lower the growth component of its DCF model.

In addition, Staff's inclusion of DPS growth in conjunction with EPS growth results in a double counting of declining dividend payout ratios among natural gas utilities. Moul Reb., NS-PGL Ex. 19.0, p. 10 table. The forecasted dividend yield for the Delivery Group is already included in the DCF model and by definition this forecast reflects the declining dividend payout ratios. Moul Dir., PGL Ex. 3.0, 15:302-322, 19:385-388 (Lower DPS growth than EPS growth "translates into a declining dividend payout ratio in the future.").[20] Thus, Staff's DCF model counts the declining dividend payout ratios among natural gas utilities twice, once in the forecasted dividend yield and once again in DPS growth rates included in the growth component. By the same token, the Companies' model does not "ignore" DPS growth, as Staff claims (Staff RB at 30), because it is reflected in the forecasted dividend yield.

For these reasons, the Commission should reject Staff's DCF model in these cases. Alternatively, if it considers Staff's DCF model, the Commission should adjust it to reflect the average EPS growth for the Delivery Group of 5.11%. Combined with the agreed dividend yield of 4.00% (Staff RB at 29-30), Staff's corrected DCF result would be 9.11% instead of 8.82%.

4. **Staff's CAPM Model Is Fundamentally Flawed**

The Proposed Order (at 143) accepts Staff's CAPM result of 9.27% without any consideration of its inherent flaws. The Commission should reject Staff's CAPM result for two reasons. First, it is based on historical spot day interest rates from over a year ago, which have no relation whatsoever to what interest rates will be in 2015. Second, Staff's unique "beta"

[20] Staff asserted that this point was not supported by the evidence because Mr. Moul did not make it in his testimony. Staff RB at 30. That is neither here nor there, as the Utilities point is based on the record evidence. Staff also quoted the Utilities as claiming that "there is no 'forecasted reduction in dividends.'" *Id*. The Utilities made no such claim.

measurement of systematic risk is biased because it is always lower than the published, verifiable and unbiased betas for the Utilities.

a. Staff's use of historical spot day interest rates <u>to predict a future cost of equity is arbitrary</u>

Both the Utilities and CCI rely on *Blue Chip* <u>forecasts</u> of Treasury yields for the risk-free rates in their CAPM estimates of the Utilities cost of equity in the <u>2015</u> test year. Moul Dir., PGL Ex. 3.0, 32:672; Gorman Dir., CCI Ex. 1.0, 29:639-643. By contrast, Staff uses the <u>actual</u> interest rates on Treasury securities on <u>October 31, 2013</u>. Freetly Dir., Staff Ex. 3.0, 15:297.

According to Staff, the "latest available" interest rate, stock price or other datum on a single day is a better predictor of what that datum will be in the future than the forecasts made by governmental and commercial analysts on which investors and analysts routinely rely. Staff RB at 27. Staff's position is fatally flawed because it relies on hindsight. Moul Sur., NS-PGL Ex. 35.0, 2:42-43. All that a given day's interest rate indicates is the cost of a certain type of debt capital on that day. It says <u>nothing</u> about what that that cost of capital will be in the future.

A credible forecast represents the best estimate by an unbiased forecaster with the information then available. The fact that intervening events may cause future rates to differ from a forecast does not render the forecast inaccurate <u>when it was made</u>. Staff provided no evidence that the *Blue Chip* forecasts were inaccurate or otherwise faulty <u>at the time they were made</u>. To the contrary, the manner in which the forecasts are compiled render them very credible indeed.

Again, under the Commission's prior decisions the question is whether the data in question are "verifiable and unbiased." *Peoples Gas 2012* Order at 205. The credibility and objectiveness of the *Blue Chip* forecasts is undisputable:

> Blue Chip does not actually make forecasts of interest rates itself. Rather, Blue Chip conducts a monthly survey of noted economists from academic institutions, banking, brokerage, business consulting, financial institutions,

> investment advisory firms, and rating agencies. Presently, there are forty-eight (48) contributors to the Blue Chip survey. Blue Chip takes the results of its monthly surveys and publishes the consensus of these individual forecasts. The major attributes of Blue Chip are its independence, the influence it has on investors' expectations of future interest rates, and the objectivity of the survey that encompasses the wide range of viewpoints obtained from a broad sample of renowned economists.

Moul Sur., NS-PGL Ex. 35.0, 3:48-56. The use of such "verifiable and unbiased" data in determining the Utilities' cost of equity is entirely appropriate and far superior to relying solely on historical spot day data to establish that cost in a future test year.[21] Staff's claims that the Utilities "did not show that the forecasts they relied on were reasonable" and "offer no alternative test of credibility" are demonstrably false. *See* Staff RB at 27.

Even if Staff's theory was valid, and "current" interest rates are better forecasts of future interest rates (*id*.), interest rates from <u>October 31, 2013</u> can in no way be considered "current" for the purpose of setting the Utilities' rates for 2015. *See* Freetly Dir., Staff Ex. 3.0, 15:297. Even if such rates accurately reflected investor expectations over a year ago (Staff RB at 32), those expectations have nothing to do with what investors expect interest rates to be in 2015.

The Proposed Order (at 142) accuses the Utilities of "cherry picking" interest rates and ignoring "the significance of [the] last several years of substantially lower interest rates that continue to be in effect at this time." The Proposed Order misconstrues the Utilities' CAPM inputs. Mr. Moul recognized, and the Proposed Order ignores, the uncontested proof that interest

[21] Staff asserts that the Utilities do not know what the word "biased" means. Staff RB at 31. The Utilities understand the Commission to have used the term not in its statistical sense but in its more common meaning of "a particular tendency, trend, inclination, feeling or opinion, especially one that is preconceived or unreasoned." http://dictionary.reference.com/browse/bias In this sense, the *Blue Chip* forecasts are indisputably unbiased.

rates are already rising and are expected to be even higher in 2015 than they were in the "last several years." Moul Dir., PGL Ex. 3.0, 31:648 – 33:680.

The Commission should reject Staff's CAPM model because it based on outdated historical interest rates. Alternatively, the model should be adjusted to incorporate either Mr. Moul's *Blue Chip*-based risk-free rate of 4.25% or Mr. Gorman's *Blue Chip*-based risk-free rate of 4.30%. Moul Dir., PGL Ex. 3.0, 32:672 – 33:680; Gorman Dir., CCI Ex. 1.0, 29:643.

b. Staff's betas are biased downward

Staff is not content to rely on the "betas" – the theoretical measurement of the systematic risk of the Delivery Group – published by well-recognized sources like *Value Line*. In addition to two published betas, Staff also averaged in a "regression beta" of its own creation. *Id*. There is no need for this additional beta measurement and it is not a data point on which any investor could possibly rely. Moul Reb., NS-PGL Ex. 19.0, 13:222-226. By contrast, *Value Line* betas are routinely relied on by investors and thus are used in the actual pricing of stocks by the market. *Id*. at 13:227-231. Accordingly, both the Utilities and CCI relied on *Value Line* betas alone. Moul Dir., PGL Ex. 3.0, 30:628; Gorman Dir., CCI Ex. 1.12.

Of more concern is the fact that the Staff betas for the Utilities are always lower than the published betas. Moul Sur., NS-PGL Ex. 35.0, p. 7 table. The published betas are indisputably "verifiable and unbiased" in the sense that they are published for the purpose of informing investors and not developed exclusively to persuade a fact finder. The only purpose served by Staff's lower beta is to reduce its CAPM results presented in the Utilities' rate cases. For that reason alone, the Commission should reject Staff's beta.

In this case, if only the published betas are considered, Staff's CAPM result is 9.71% instead of 9.27%. Moul Reb., NS-PGL Ex. 19.0, 13:234-235. If the Staff CAPM analysis relies only on the *Value Line* betas as the Utilities' and CCI's did, the result is 9.82%. *Id*. at 13:242.

c. **If the Commission considers Staff's CAPM result, it should be corrected for the appropriate risk free rate and beta**

Staff's CAPM result of 9.27% is the product of its biased dividend yield and growth rate. If the Utilities' parameters are used, Staff's CAPM result is 9.89% (((12.43% - 4.25%) x .69) + 4.25%). If CCI's parameters are used, the Staff CAPM result is 10.40% (((12.43% - 4.30%) x .75) + 4.30%).

5. **CCI's ROE Analysis Is Based On An Improper Proxy Group**

Staff accepted the Utilities' Delivery Group for the purpose of running its cost of equity models. Freetly Dir., Staff Ex. 3.0, 9:165 & 18:337. On that score, at least, the Utilities' and Staff's model results can be compared on an "apples to apples basis." CCI, however, used a different proxy group comprised of a group that excluded two of the Delivery Group companies. One company was properly excluded because it became an acquisition target in the time between the Utilities' and CCI's analyses. CCI also excluded Laclede Group because it is pursuing an acquisition of another company. CCI did not justify this exclusion, pointing only to the fact that a credit rating agency had placed the company on watch for potential downgrade. Gorman Reb., CCI Ex. 2.0, 9:168 – 10:187. Mr. Gorman did not provide any evidence that Laclede Group's proposed acquisition impacted the company's fundamentals. Moul Reb., NS-PGL Ex. 19.0, 18:338-343.

The weight of the evidence favors the use of the Delivery Group to estimate the Utilities' cost of equity. CCI's reliance on a different proxy group was not justified and therefore its analyses are not comparable to those of the Utilities or Staff. Accordingly, consistent with the Proposed Order, the Commission should disregard CCI's analyses.

a. CCI's DCF result of 9.00% is based on <u>inappropriate methodology and inputs</u>

i. CCI did not support its use of a non-<u>constant form of the DCF model</u>

In addition to two versions of the constant growth form of the DCF model, CCI presented a non-constant growth version. In the Utilities' 2010 test year rate cases, the Commission rejected Staff's reliance on a non-constant growth form of the DCF model, noting that the constant growth model "has been favored by the Commission for years." *Peoples Gas 2009* Order at 124. The Commission found that Staff had not justified its departure from prior practice:

> In contrast to the constant growth version of the DCF model, which assumes one, steady rate of future dividend growth, Staff's non-constant growth model assumes multiple stages of growth on the theory that, given the large difference between the near-term growth rates for the Gas Group and the expected long-term growth of the overall economy, the continuous sustainability of the near-term growth rates for the Gas Group is unlikely. Staff, however was unable to demonstrate the unsustainability of the analyst growth rates it relied on which we must assume took into account indicators of below average growth associated with the Gas Group, including earnings retention rates and risk/return.

Id. In addition, the Commission rejected "Staff's position that the non-constant growth form of the model must be used any time it can be claimed that analyst growth rates are not sustainable. Rather we will require a more robust showing that application of the constant model is appropriate." *Id*. at 125.

CCI does not attempt to make this "more robust showing" for its non-constant growth model. To the contrary, Mr. Gorman testified that his <u>constant</u> growth model "is a reasonable reflection of rational investment expectations over the next three to five years." Gorman Dir., CCI Ex. 1.0, 21:487-488. He included a non-constant form of the model simply to reflect an "outlook of changing growth expectations." *Id*. at 21:492.

For this reason alone, the Commission should disregard CCI's non-constant growth DCF model. If another reason was needed, the result of this model – 8.65% -- is far too low to be credible, even by CCI's own evidence of 2014 year-to-date gas utility ROEs, which <u>average</u> over 100 basis points higher. Gorman Reb., CCI Ex. 2.0, p. 5 table. If CCI's non-constant growth DCF result is excluded, CCI's constant growth DCF result is <u>9.50%</u>. Gorman Dir., CCI Ex. 1.0, p. 27, table.

ii. Many of CCI's DCF results are <u>far too low to be credible</u>

The Commission has in the past rejected DCF results that are "anomalous." *Peoples Gas 2007* Order at 92. Many of Mr. Gorman's constant growth DCF rates for Delivery Group companies are so anomalous that they undercut the credibility of his DCF results:

Company		DCF
AGL Resources		6.59%
Consolidated Edison		7.86%
New Jersey Resources		7.26%
Northwest Natural Gas		7.96%
Piedmont Natural Gas		7.60%
Southwest Gas		5.76%

Moul Reb., NS-PGL Ex. 19.0, 18 table.

"It is a fundamental tenet of finance that the cost of equity must be higher than the cost of debt by a meaningful margin to compensate for the higher risk associated with common equity investment." Moul Reb., NS-PGL Ex. 19.0, 18:351 – 19:353. The six-month average yield on Baa-rated public utility bonds is 4.98%. *Id*. at 19:354-355. Even under Mr. Gorman's 30-year historical average equity risk premium of 3.80% (which is much lower than the more recent premiums in excess of 5.00%), his DCF results for 6 of the Delivery Group companies are far below the minimum expected cost of equity of 8.78%, much less the average 2014 authorized gas utility ROE of 9.71%. CCI Ex. 2.3.

F. Weighted Average Cost of Capital

EXCEPTION NO. 14

The following proposed changes to the rate of return summary figures follow from Exception Nos. 11-13.

1. Peoples Gas

The Commission should include in Peoples Gas' 2015 rates an overall ROR of 7.21% comprised of a capital structure of 50.33% equity, 46.51% long-term debt and 3.16% short-term debt, a cost of long-term debt of 4.32%, a cost of short-term debt of 1.19% and a cost of equity of 10.25%. NS-PGL Ex. 34.1P.

2. North Shore

The Commission should include in North Shore's 2015 rates an overall ROR of 6.89% comprised of a capital structure of 50.48% equity, 38.94% long-term debt and 10.58% short-term debt, a cost of long-term debt of 4.13%, a cost of short-term debt of 1.06% and a cost of equity of 10.25%. NS-PGL Ex. 18.1N.

IX. RATE DESIGN

B. General Rate Design

1. Allocation of Rate Increase

EXCEPTION NOS. 15 AND 16

Regarding Companies' Position Section. The Proposed Order rejected IIEC's proposed across-the-board method of allocating the rate increase in this proceeding. Proposed Order at

169-170. The Utilities agree with that result. However, the description of the Utilities' position is predominantly derived from their arguments responding to IIEC's proposed allocator for demand-classified transmission and distribution ("T&D") costs. *See* Proposed Order at 166-167. The Utilities' evidence provided several reasons IIEC's across-the-board proposal was flawed, including the fact that it ignores the Embedded Cost of Service Studies ("ECOS studies"), produces inter-class subsidies, and rests on a flawed analogy to an Ameren rate case. NS-PGL IB at 121-122; NS-PGL RB at 98-101.

The Commission should include a more complete description of the Utilities' arguments against IIEC's allocation method and delete from this section arguments concerning the T&D allocator. The Commission should adopt Exception No. 15.

<u>Regarding Commission Analysis and Conclusion Section</u>. As stated, the Proposed Order rejected IIEC's proposed across-the-board method of allocating the rate increase. Proposed Order at 169-170. However, the Commission Analysis and Conclusion begins with a discussion of the T&D allocator. The Utilities recommend that the section remove the allocator language to avoid confusion and replace it with a statement of the Commission's conclusion on the rate allocation method. Aside from the policy reasons the proposal is flawed, the fact that the Commission elsewhere rejected IIEC's proposed changes to the ECOS studies (*see* Proposed Order Sections VIII.B.1 and VIII.B.2 at 150-163) makes IIEC's rate allocation proposal moot, as IIEC's rationale for the across-the-board proposal was predicated on its ECOS study changes (Collins Dir., IIEC Ex. 1.0, 24:532 - 25:538). The Commission should adopt Exception No. 16.

2. Fixed Cost Recovery

EXCEPTION NO. 17

Regarding the Commission Analysis and Conclusion Section. The Proposed Order adopts Staff and intervenor positions that movement away from greater fixed cost recovery in fixed charges is appropriate. Proposed Order at 187-190. The conclusions in this section are flawed for several reasons and adversely affect all the contested service classification rate design decisions.

First, the Proposed Order adopts the misleading characterization of the Utilities' rate design proposals as "SFV based." Proposed Order at 188. The term "SFV" is the abbreviation for "straight fixed variable." A straight fixed variable rate design is one in which 100% of fixed costs are recovered in fixed charges. Egelhoff Dir., NS Ex. 15.0, 15:301-306; PGL Ex. 15.0 REV., 14:300 - 15:305. The Utilities do not have SFV rate design for any service classification. The Utilities are not proposing SFV rate design for any service classification. Egelhoff Reb., NS-PGL Ex. 29.0 REV., 4:74-85. It is the Utilities' position that, absent decoupling, SFV rate design is the correct cost causal rate design, but they have not proposed an SFV rate design in this case. Egelhoff Dir., NS Ex. 15.0, 15:309-318; PGL Ex. 15.0 REV., 15:308-317. The misuse of this term, by Staff, intervenors, and the Proposed Order, is troubling because it misrepresents the Utilities' proposals and makes it easier to dismiss them as out-of-step with Commission policy. In fact, Commission policy for gas utilities is gradual movement towards fixed cost recovery in fixed charges. NS-PGL IB at 125-126. The Commission, consistently with several prior orders, reaffirmed this policy for North Shore and Peoples Gas in their most recent rate cases (*Peoples Gas 2012* Order at 237-238), issued in June 2013, in which the Commission reiterated its "policy of increasing fixed cost recovery through fixed charges on a gradual basis." *Also see* Egelhoff Dir., NS Ex. 15.0, 13:275-14:293; PGL Ex. 15.0 REV., 13:275-14:292.

Second, the Proposed Order contends that "SFV rate designs are inconsistent with energy conservation." Proposed Order at 189. The flaw with this reasoning is that it sends an inaccurate price signal under the guise of promoting energy conservation. As the Commission recognized in a Nicor Gas case, "[t]he portion of fixed costs that are currently recovered through a volumetric charge are in fact fixed costs, and thus cannot be conserved. Moving a greater percentage of fixed cost recovery to fixed charges rather than volumetric charges provides a more stable revenue stream and sends a better price signal to the consumer." *In re Northern Illinois Gas Company d/b/a Nicor Gas Company*, ICC Docket No. 08-0363 (Order Mar. 25, 2009) at 91.

If a gas main costs $1,000, it will cost $1,000 whether 0 therms of gas flow through the main or one million therms of gas flow through that same main. Energy conservation does not reduce the cost of the main. A rate design that places fixed costs in variable charges is premised on the fallacy that a customer using less gas causes lower amounts of fixed costs. The problem is that the $1,000 of main costs in base rates is unaffected by usage. The cost does not become $500 if a customer reduces its usage by half. Egelhoff Reb., NS-PGL Ex. 29.0 REV., 7:140 - 8:164. The way Illinois gas utilities support Illinois' energy efficiency policies is through the Commission-approved programs they offer under Section 8-104 of the Act.

Third, the Proposed Order appears to understate or ignore the amount of a customer's gas bill that a customer may affect through conservation. Proposed Order at 189. Even under an SFV rate design, a large part of the typical customer bill is variable because it includes commodity costs, taxes, and several other variable charges. Under the Utilities' proposals, which continue to include significant amounts of fixed costs in variable charges, 70% of a North Shore Service Classification ("S.C.") No. 1 heating customer's bill is volumetric and the amount for Peoples Gas is 60%. Egelhoff Reb., NS-PGL Ex. 29.0 REV., 9:193-195. While the Utilities disagree with the premise of creating inaccurate price signals to promote conservation, the fact is that the Utilities' rate designs include a substantial volumetric component that results in lower bills for lower usage.

Finally, rate design policy for electric utilities (*see* Proposed Order at 189) does not and ought not to apply to gas utilities, at least as long as electric utilities operate with formula rates[22] and gas utilities do not. Formula rates are quite different than what apply to gas utilities like North Shore and Peoples Gas. Formula rates provide for a comprehensive reconciliation against all actual non-fuel costs and, thus, with some limits, the process takes into account higher or lower costs. Egelhoff Reb. NS-PGL Ex. 29.0 REV., 6:112-124. In contrast, for the Utilities, the Commission determines costs in the rate case and establishes an approved revenue requirement. The Utilities' decoupling mechanisms reconcile to this approved revenue requirement and not to actual costs. Movement away from fixed cost recovery in fixed charges has much less of an effect on an electric utility's ability, under EIMA, to recover its revenue requirement. NS-PGL IB at 126-127; NS-PGL RB at 108.

The Commission should affirm its long-standing rate design policy for gas utilities of encouraging gradual movement towards fixed cost recovery in fixed charges. The Commission should adopt Exception No. 17.

[22] "Formula rates" refers to rates set under the Energy Infrastructure Modernization Act ("EIMA").

C. Service Classification Rate Design

2. Contested Issues - North Shore and Peoples Gas

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

EXCEPTION NO. 18

Regarding Commission Analysis and Conclusion Section. The Proposed Order adopted Staff's rate design for S.C. No. 1, Non-Heating. Proposed Order at 195-196. For the reasons stated in Section IX.D.2, Fixed Cost Recovery, of this Brief on Exceptions the Staff proposal is flawed because it is inconsistent with cost-based rate design. Without repeating the points addressed in excepting to Section IX.D.2, the Utilities summarize their arguments on the Proposed Order's reliance on moving away from "SFV based rates" and on what fixed costs should be recovered in fixed charges.

First, references to "SFV based rate design" and "SFV based rates" (Proposed Order at 188, 189) confuse the question before the Commission. The Utilities do not have and are not proposing an SFV rate design. Egelhoff Reb., NS-PGL Ex. 29.0 REV., 4:74-85. The term "SFV based" has no objective meaning as it is being used. At what percentage of fixed cost recovery in fixed charges does a rate design represent an "SFV based" rate design? That question has no answer because the rate design concept of straight fixed variable rates is the simple proposition that all fixed costs are recovered in fixed charges. Egelhoff Dir., NS Ex. 15.0, 15:301-306; PGL Ex. 15.0 REV., 14:300 - 15:305. The term "SFV based" seems to presume gradations of SFV rate design, but neither the Proposed Order nor the evidence in this case defines such gradations.

Second, customer classified and demand classified costs are fixed costs. Egelhoff Reb., NS-PGL Ex. 29.0 REV., 7:148 - 9:189. Drawing a line at including only customer classified costs in fixed charges (for this service classification, the customer charge) is inconsistent with that fact. Demand costs include items like storage, land, structures and improvements, mains, compressor station equipment and measuring and regulating equipment. The costs of investment in these items do not vary with customer usage or even if the customer's design day requirements change. Egelhoff Sur., NS-PGL Ex. 43.0 REV., 4:73-76. Placing recovery of non-storage demand classified distribution costs in a volumetric charge (Proposed Order at 190) incorrectly presumes that customer usage affects these costs. It does not. The costs of the storage or land in the base rates that the Commission approves in this proceeding will not change because a customer uses more or less gas on the peak day or any other day, and the recovery of these costs in a volumetric charge is, therefore, flawed. Egelhoff Sur., NS-PGL Ex. 43.0 REV., 4:84 - 6:112.

The Commission should affirm its long-standing rate design policy for gas utilities of encouraging gradual movement towards fixed cost recovery in fixed charges. The Commission should adopt Exception No. 18.

b. Service Classification No. 1, Small Residential Service, Heating

EXCEPTION NO. 19

Regarding Commission Analysis and Conclusion Section. The Proposed Order adopted Staff's rate design for S.C. No. 1, Heating. Proposed Order at 195-196. For the reasons stated in Section IX.D.2, Fixed Cost Recovery, of this Brief on Exceptions, the Staff proposal is flawed because it is inconsistent with cost-based rate design. The reasons stated in Section IX.E.2.a of this Brief on Exceptions for the S.C. No. 1 Non-Heating rate design also apply to the S.C. No. 1 Heating rate design.

The Commission should affirm its long-standing rate design policy for gas utilities of encouraging gradual movement towards fixed cost recovery in fixed charges. The Commission should adopt Exception No. 19.

c. <u>Service Classification No. 2, General Service</u>

EXCEPTION NOS. 20 - 22

<u>Regarding Companies' Position Section</u>. The Proposed Order, instead of describing the Utilities' S.C. No. 2 rate design, describes the Utilities' proposed rate design for S.C. No. 1, Heating. Proposed Order at 209-210. This Exception correctly describes the Utilities' S.C. No. 2 proposals, including how the Utilities addressed the Commission's directive to examine the number of blocks in their distribution charge. As with S.C. No. 1, the Utilities' S.C. No. 2 proposals are predicated on setting this service class at cost and gradually increasing fixed cost recovery in fixed charges. They also responded to the Commission's directive to review their three-block distribution charge by proposing consolidating the first two blocks. The Commission should adopt Exception No. 20.

<u>Regarding Staff's Position Section</u>. The Proposed Order, instead of describing Staff's S.C. No. 2 rate design proposals, describes the Staff's proposed rate design for S.C. No. 1, Heating. Proposed Order at 210-211. It also includes the intervenors' S.C. No. 1 proposals. The intervenors did not address S.C. No. 2 rate design. Although the Utilities expect that Staff will address this omission in its Exceptions, the Utilities' Exception, taken generally from Staff's Initial Brief (Staff IB at 98-104) describes the Staff's proposals in the event Staff does not do so. The Commission should adopt Exception No. 21 or Staff's own description of its proposal.

<u>Regarding Commission Analysis and Conclusions Section</u>. The Proposed Order does not appear to address S.C. No. 2. *See* Proposed Order at 211-212. For example, it refers to

intervenor proposals, and no intervenor proposed an S.C. No. 2 rate design. Moreover, Staff's proposal included three scenarios (Johnson Dir., Staff Ex. 4.0, 40:920 - 42:941, 59:1306 - 60:1326) and the Proposed Order does not address them. Finally, it does not address the uncontested proposal that responds to the Commission's directive that the Utilities address the number of blocks in their distribution charges. *Id*. at 34:793 - 35:802, 53:1183-1192.

If, as it appears, the Proposed Order intended to adopt the Staff proposal, for the reasons stated in Section IX.D.2, Fixed Cost Recovery, of this Brief on Exceptions that proposal is flawed, because it is inconsistent with cost-based rate design.

The Commission should affirm its long-standing rate design policy for gas utilities of encouraging gradual movement towards fixed cost recovery in fixed charges. The Commission should adopt Exception No. 22. (If the Commission adopts Staff's proposal, it is imperative that it accurately describe the proposal and the preferred option from Staff's alternatives to give the Utilities adequate direction for their compliance filings.)

3. Classification of SC No. 1 Residential Heating and Non-Heating Customers

EXCEPTION NO. 23

Regarding Commission Analysis and Conclusions Section. The Proposed Order rejects proposals that the Utilities conduct an in-depth study or review of customer classifications as "heating" or "non-heating" under S.C. No. 1 and, instead, adopted the Utilities' suggestion that they include in their customer communications about the rate case information emphasizing to S.C. No. 1 customers the significance of the "heating" and "non-heating" designations and encourage customers to call with questions or concerns or to request an inspection. Proposed Order at 216. However, the Proposed Order also added requirements that the Utilities prepare to be able to report to Staff the number of inquiries generated by the communication and the number of resulting inspections and reclassifications. *Id*.

The Utilities agree with the rejection of the study and review proposals. However, the proposal that they be prepared to report inquiries and actions attributable to the proposed customer communications will likely be difficult to implement fully and accurately. The Utilities anticipate that it will be generally feasible to note in their customer records when a customer inquires about his or her S.C. No. 1 classification, but they are doubtful that they can easily track if the inquiry resulted from the communication about this rate case. Likewise, the Utilities anticipate that they can track service orders associated with a heating/non-heating verification and reclassifications. Again, however, they are doubtful that they will be able to link those activities to the proposed communication.

The Commission should modify the Proposed Order to require only that the Utilities be prepared to report on inquiries and related actions associated with the S.C. No. 1 heating and non-heating classifications without trying to link those inquires and actions to the required customer communication. The Commission should adopt Exception No. 23.

X. FINDINGS AND ORDERING PARAGRAPHS AND APPENDICES

EXCEPTION NO. 24

The Proposed Order's Findings and Ordering Paragraphs, and the Appendices to the Proposed Order, should be revised to reflect the Utilities' figures relating to their revenue requirements and the components thereof, consistent with the Utilities' applicable above Exceptions. There also is a typographical error that should be corrected.

The Utilities also note, as an alternative and technical Exception, that the Proposed Order reflects, and its Appendix B contains, very slight calculation errors that result, if the recommendations of the Proposed Order were to be taken as given, in the approved Peoples Gas revenue requirement being $12,000 too high, as discussed above in relation to Exception No. 3 and as shown also and in more detail in Attachment 2 hereto.

XI. CONCLUSION

Therefore, North Shore Gas Company and The Peoples Gas Light and Coke Company, for all reasons set forth in this Brief on Exceptions and in the separate Exceptions language document, and in their prior Initial Brief, Reply Brief, and their November 7, 2014, Proposed Language for Draft Order, respectfully request that the Commission 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: December 16, 2014

Respectfully submitted,

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