

ORIGINAL

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

PETITION OF HEARTLAND GAS PIPELINE, LLC)
FOR ISSUANCE OF A CERTIFICATE OF PUBLIC)
CONVENIENCE AND NECESSITY PURSUANT TO)
IND. CODE § 8-1-2-87.5 AND AN INDETERMINATE)
PERMIT FOR THE CONSTRUCTION AND)
OPERATION OF AN INTRASTATE GAS PIPELINE;)
FOR APPROVAL OF CERTAIN STORAGE AND)
TRANSPORTATION AGREEMENTS, AND RATES)
AND CHARGES APPLICABLE THERETO; FOR)
APPROVAL OF A GAS TARIFF APPLICABLE TO)
SERVICE RENDERED BY PETITIONER; FOR)
APPROVAL OF A SERVICE AGREEMENT FOR)
OPERATION OF THE PIPELINE; AND FOR)
RELATED FINANCING AUTHORITY)

CAUSE NO. 42729

PETITION OF BOARD OF DIRECTORS FOR)
UTILITIES OF THE DEPARTMENT OF PUBLIC)
UTILITIES OF THE CITY OF INDIANAPOLIS, AS)
SUCCESSOR TRUSTEE OF A PUBLIC)
CHARITABLE TRUST, d/b/a CITIZENS GAS &)
COKE UTILITY FOR APPROVAL OF A STORAGE)
SERVICE AGREEMENT AND GENERAL TERMS)
AND CONDITIONS PURSUANT TO WHICH)
CITIZENS GAS & COKE UTILITY WILL PROVIDE)
PRIMARY AND SECONDARY STORAGE SERVICE)
TO HEARTLAND GAS PIPELINE, LLC)

CAUSE NO. 42730

APPROVED: OCT 05 2005

BY THE COMMISSION:
David E. Ziegner, Commissioner
Abby R. Gray, Administrative Law Judge

On September 30, 2004, Heartland Gas Pipeline, LLC ("Heartland") filed its Petition in Cause No. 42729 for a certificate of public convenience and necessity and indeterminate permit for the construction and operation of a proposed natural gas pipeline, approval of certain transportation and storage agreements, approval of a Gas Tariff to be applicable to Heartland's transportation and storage services and authority to finance construction of the pipeline. On the same date, the Board of Directors for Utilities of the Department of Public Utilities of the City of Indianapolis, as successor trustee of a public chartable trust, d/b/a Citizens Gas & Coke Utility ("Citizens") filed its Petition in Cause No. 42730 for approval of an agreement and terms and conditions pursuant to which it would provide certain storage services to Heartland.

Pursuant to 170 IAC 1-1.1-12 and 19, Heartland filed on October 8, 2004, a motion to consolidate Cause Nos. 42729 and 42730, on the grounds that they involve common issues of fact and law and are sufficiently interrelated as to warrant consolidation. The motion was granted

by the Presiding Officers on the record at the Prehearing Conference held on November 3, 2004, as confirmed by the Prehearing Conference Order in this Cause.

On December 29, 2004, Heartland filed pursuant to 170 IAC 1-1.1-4 and Ind. Code § 5-14-3-4, a motion for a protective order finding that a detailed route map (Petitioner's Exhibit MWH-4), constitutes confidential, proprietary, competitively-sensitive trade secret information and an infrastructure record, the disclosure of which would have a reasonable likelihood of threatening public safety. On January 4, 2005, the Presiding Officers issued a docket entry finding that Exhibit MWH-4 should be held as confidential on a preliminary basis.

A petition to intervene in the consolidated causes was filed by an ad hoc group of industrial customers known as the Citizens Industrial Group ("CIG"). The petition to intervene was granted by docket entry on March 17, 2005.

Pursuant to the Prehearing Conference on November 3, 2004, the Prehearing Conference Order dated November 11, 2004, and notice of hearing given as provided by law, proof of which was incorporated into the record by reference and placed in the official files of the Commission, a public hearing was held in this Cause on April 21-22, 2005, in Room Conf. Center #32, Indiana Government Center South, Indianapolis, Indiana. At the hearing, evidence offered by Heartland, Citizens, the Office of Utility Consumer Counselor ("OUCC"), and CIG was admitted into the record.

1. **Notice and Jurisdiction.** Due legal and timely notices of the Prehearing Conference and the evidentiary hearing in this Cause were given and published as required by law. Heartland seeks authorizations necessary for it to operate as a "public utility" within the meaning of Ind. Code § 8-1-2-1(a). Citizens is a "municipally owned utility" within the meaning of Ind. Code § 8-1-2-1(h). The Commission has jurisdiction over each Petitioner and the subject matter of this consolidated proceeding.

2. **Petitioners' Characteristics.** Heartland is a limited liability company organized and existing under the laws of the State of Indiana. The membership interests in Heartland are owned equally by (a) Citizens By-Products Coal Company ("By-Products"), a wholly-owned subsidiary of Citizens and (b) ProLiance Transportation & Storage-Heartland, LLC, which is a wholly-owned subsidiary of ProLiance Transportation & Storage, LLC, which in turn is a wholly-owned subsidiary of ProLiance Energy, LLC ("ProLiance").

Citizens owns, manages, and controls plant, property, equipment, and facilities used and useful for the production, storage, transmission, distribution and furnishing of gas service to approximately 265,620 residential, commercial and industrial customers in and around Marion County, Indiana.

3. **Relief Requested.** Heartland requests a certificate of public convenience and necessity pursuant to Ind. Code § 8-1-2-87.5 and an indeterminate permit pursuant to Ind. Code § 8-1-2-1(i) allowing it to construct and operate a natural gas transmission pipeline extending from an interconnection with the interstate pipeline of Midwestern Gas Transmission Company ("MGT") in Sullivan County to Citizens' underground gas storage field near Johnstown, Indiana in Greene County ("UGS"). Heartland also requests Commission approval of the agreements and

Gas Tariff pursuant to which it will provide gas transportation and storage service, including the rates and charges and General Terms and Conditions relating thereto. Heartland seeks approval, to the extent necessary, of the Service Agreement pursuant to which Citizens will supervise the day-to-day operation of the pipeline. Finally, Heartland requests authorization to finance the pipeline, including by the issuance of bonds, notes and evidences of indebtedness payable at a period of more than twelve months.

Citizens requests Commission approval of a Storage Service Agreement and related General Terms and Conditions pursuant to which it will provide primary and secondary storage services to Heartland from UGS. Citizens also seeks authorization, to the extent necessary, to enter into and implement the terms of new and amended Appendices to the Gas Sales and Portfolio Administration Agreement between Citizens and ProLiance to reflect changes resulting from the Heartland project.

4. Petitioners' Cases-In-Chief.

(a) **Heartland's Evidence.** Petitioner's witness Mark W. Head, ProLiance's Director of Pipes and Storage, described Heartland's proposed project. He said the new pipeline will provide Heartland's customers with improved direct access to a gas supply hub near Chicago which has increased in significance in recent years due to the construction of new pipeline capacity connecting the Chicago Market Hub not only to traditional gas supply basins such as the Gulf Coast and the Mid-Continent areas, but also to Canada and increasingly the Intermountain West basin. Mr. Head explained the Heartland project was developed as a way for the Indianapolis area to derive greater benefit from this new resource at a reasonable cost. The project only requires the construction of approximately 25 miles of new pipeline by taking advantage of the fact that Citizens already owns a pipeline extending from UGS to the Indianapolis area. Also, connecting the Heartland pipeline to UGS allows Citizens to optimize the use of UGS.

Mr. Head stated that Heartland will provide firm and interruptible transportation and storage services. Heartland's initial pipeline capacity will be partially subscribed on a firm basis by ProLiance primarily for a delivered sales service on behalf of Citizens and, secondarily, to meet the requirements of ProLiance's other customers. Additional firm transportation capacity will be available for other customers. Heartland's storage capacity, obtained pursuant to its Storage Service Agreement with Citizens, will be subscribed by ProLiance, primarily for a firm delivered sales service on behalf of Citizens and, secondarily, on an interruptible and secondary basis for ProLiance's other customers.

Mr. Head said the new pipeline will allow Heartland's customers to diversify their gas supply and gas transportation options. In addition, the project will increase competition between supply basins and pipeline companies, and, therefore, will provide competitive pressure on the delivered gas prices from both the traditional Gulf Coast supply basin and the Chicago Market Hub. Finally, the project will allow the customers of Heartland to avail themselves of new storage opportunities and allow Citizens to improve the utilization of its existing UGS infrastructure.

According to Mr. Head, the capital cost of the pipeline is currently projected to be \$17.22 million. This projection was developed with the assistance of Mustang Engineering of Houston, Texas, which is providing engineering services for the proposed project. Mustang used industry-wide standard pipeline and construction practices to prepare the cost estimate.

Mr. Head testified that ProLiance will be responsible for managing the business affairs of Heartland pursuant to an Operating Agreement of the member companies (Petitioner's Exhibit MWH-7). ProLiance will be paid a fixed monthly fee to cover administrative and general overhead. ProLiance's fee is based on a cost estimate reflecting ProLiance's experience in providing similar services to the Ohio Valley Hub, LLC ("OVH"). Under the Operating Agreement, ProLiance will be reimbursed for reasonable and proper costs, expenses and expenditures paid or incurred for the services being provided.

Mr. Head identified the Service Agreement between Heartland and Citizens (Petitioner's Exhibit MWH-8) pursuant to which Citizens will supervise, direct and control the day-to-day operations of Heartland's facilities; operate, maintain and repair the facilities in compliance with applicable laws (including pipeline safety regulations); manage the rights-of-way and easements; provide the gas control function; and provide other services. As compensation, Citizens will receive a fixed monthly fee to cover administrative and general expense overheads and will be reimbursed for reasonable and proper costs, expenses and expenditures. Citizens' fee is based on Citizens' experience with operating UGS and similar pipeline facilities.

Mr. Head will be the ProLiance representative responsible for overall management of the Heartland project. He described his extensive experience in operating and managing gas transmission and distribution systems and underground storage fields, including OVH and the White River Storage Field, and while previously employed by Southern Indiana Gas and Electric Company ("SIGECO"). OVH is a ProLiance-managed, 9.2 mile long, 16-inch gas intrastate pipeline that connects a storage field of SIGECO to interstate gas pipelines owned by Texas Gas Transmission Corporation ("Texas Gas") and MGT.

Mr. Head explained that Heartland will be a so-called "Hinshaw" pipeline and, pursuant to Section 1(c) of the Natural Gas Act, will be exempt from most Federal Energy Regulatory Commission ("FERC") regulation. The Hinshaw exemption applies to pipeline companies that receive and deliver gas in the same state where the gas is consumed and are subject to regulation by a state commission. FERC's rules allow Hinshaw pipelines to obtain blanket certificates to engage in certain limited FERC jurisdictional activities that otherwise would be considered interstate transportation. Heartland intends to apply to FERC for such a blanket certificate.

Mr. Head testified that the design capacity of Heartland's pipeline will be 80,000 Dth per day on a firm basis and up to 10,000 Dth per day on an interruptible basis. Heartland and ProLiance will have two firm transportation agreements. The first agreement (Petitioner's Exhibit MWH-9) will provide firm transportation of up to 45,000 Dth per day and will be used by ProLiance to deliver gas to Citizens for Citizens' system supply. The second agreement (Petitioner's Exhibit MWH-10) will provide firm transportation of up to 25,000 Dth per day, which will be available for use by ProLiance to market gas to other customers. The remaining 10,000 Dth per day will be available to other parties wishing to transport on Heartland.

The proposed transportation rates are contained in Heartland's proposed Gas Tariff (Petitioner's Exhibit MWH-11). The maximum firm transportation reservation rate was developed from the cost of service study prepared by Heartland witness Dwight Work. The minimum transportation rate is a nominal value which will allow Heartland the flexibility, if market conditions so dictate, to provide transportation services at a discount to the maximum rate. However, a discounted rate is not available under Heartland's agreements with ProLiance. In addition, the Tariff provides for interruptible transportation services. Heartland expects that initially all of its transportation services will be pursuant to the two ProLiance contracts mentioned earlier.

Mr. Head discussed the Storage Service Agreement between Heartland and Citizens (Petitioner's Exhibit LCL-2) that will provide Heartland with primary storage service and secondary storage service. The primary storage service is a firm service with a specified Maximum Inventory Quantity, Maximum Daily Injection Quantity, and Maximum Daily Withdrawal Quantity. The obligations of Heartland under the Secondary Storage Service are "secondary" to its obligations under the primary storage service. That is, on any given day, Heartland will first meet the needs of its customer holding primary storage service before it meets the needs of customers holding secondary storage service. Similar to the primary storage service, the secondary storage service has a specified Maximum Inventory Quantity, Maximum Daily Injection Quantity, and Maximum Daily Withdrawal Quantity.

As explained by Mr. Head, Heartland will provide corresponding primary storage service to ProLiance (Petitioner's Exhibit MWH-12) with a Maximum Inventory Quantity of 4,860,000 Dth. ProLiance will use this service, in conjunction with its 45,000 Dth per day firm transportation service on Heartland, to meet its obligations to Citizens for a firm delivered service. Heartland will provide a secondary storage service to ProLiance (Petitioner's Exhibit MWH-13) with a Maximum Inventory Quantity of 2,000,000 Dth, which ProLiance can use, in conjunction with its 25,000 Dth per day firm transportation service on Heartland, to serve other customers.

As provided in Heartland's Gas Tariff, variable costs for both the primary and secondary storage service will be recovered through a commodity charge and a fuel retention factor that match those in Citizens' Storage Service Agreement with Heartland. Additionally, the secondary storage service will have a reservation rate of 15¢ per Dth per year (1.25¢ per Dth per month) that will be assessed per unit of Maximum Inventory Quantity. Because Citizens is both the ultimate recipient of the primary storage service capacity and the ultimate source of such capacity to Heartland, no separate reservation rate will be assessed for primary storage service.

The Gas Tariff (Petitioner's Exhibit MWH-11) includes the applicable rates, service request form, and transportation and storage service agreement forms. The Tariff also includes the general terms and conditions that will apply to Heartland's services.

Daniel Short, ProLiance's Vice President of Finance, testified regarding the financing of the project and the resulting capital structure and cost of capital. He said Heartland will use a combination of equity and debt capital to finance the project. Equity capital will be funded by Heartland's two owners in amounts directly proportional to their respective ownership interests, *i.e.*, 50% by ProLiance Transportation & Storage-Heartland, LLC and 50% by By-Products.

Heartland anticipates using conventional debt from a commercial bank as its source of debt capital.

Mr. Short testified that for Heartland to obtain term debt, the lender will require that a majority of the available transportation capacity be subscribed under long-term contracts providing a stable revenue stream from year to year. The lender will take into consideration other factors as well, including debt service coverage ratios. Mr. Short testified that capitalization ratios of 50% equity and 50% debt will satisfy lender expectations and produce debt service coverage ratios the lender will find reasonable. The debt also will be secured by a lien on Heartland's assets.

Mr. Short said Heartland's debt will be amortized over 15 years, a period matching the term of the supporting agreements. Debt principal payments will be made in fixed quarterly installments. The debt will mature in seven years at which time a balloon payment will be made in the remaining principal amount. During construction, the interest rate will be the London Interbank Offered Rate, plus a lender margin. Mr. Short noted that Heartland plans to fix the interest rate once capital spending is complete at the end of the construction period. He stated the applicable interest rate will depend upon market conditions, but currently the interest rate is estimated to be 4.63% during construction and 6.18% thereafter. Amortizing the underwriting fee and issuance expenses over the term of the loan results in an effective interest rate of 6.33%.

Mr. Short opined that Heartland's cost of capital, will be approximately 9.67%, as determined by Mr. Work in his cost of service study and using a cost of common equity of 13%, as recommended by Heartland witness Andrew E. Goebel, and a debt cost rate of 6.33%.

Mr. Goebel testified regarding Heartland's cost of common equity. Mr. Goebel, an independent consultant, was formerly President and Chief Operating Officer ("COO") of Vectren Corporation and its regulated subsidiaries including SIGECO. Prior to the merger that formed Vectren, he held a number of positions at SIGECO, including Controller, Treasurer, Senior Vice President, Chief Financial Officer and Chief Executive Officer. He was also the President and COO of SIGCORP, Inc., the parent company of SIGECO. Mr. Goebel has extensive experience with respect to the financial management of regulated utilities and the non-utility segments of SIGECO's and SIGCORP's businesses. He also serves on the Board of Directors of the largest bank holding company headquartered in Indiana. Mr. Goebel has been involved in the financing and refinancing of hundreds of millions of dollars of debt and equity security issuances.

In Mr. Goebel's opinion, Heartland's cost of common equity is at least 13%. He believes 13% is an appropriate rate of return on equity to use for ratemaking purposes, giving consideration to (a) the business risks associated with the project; (b) Heartland's small size; (c) the need to provide returns that encourage the building of new pipelines in Indiana; (d) the need to provide returns that encourage the development, expansion and efficient operation of Indiana-based underground gas storage; (e) the proposed capitalization of Heartland, which includes significant use of low-cost debt capital; (f) the organization of Heartland as a flow-through entity for tax purposes; and (g) the returns provided other pipeline projects by FERC.

As a start-up company in an ever changing, uncertain natural gas industry with a very significant up-front capital expenditure required to execute its business plan, Mr. Goebel's

assessment is that Heartland has significant risks that need to be recognized in the authorized rate of return. Heartland is a new entrant in the pipeline business, and initially will need to invest about \$17 million to construct the new pipeline before it will have any revenue. Heartland will not have an exclusive service area and will be subject to competition from much bigger interstate pipelines with much greater resources. Although Heartland's risk is mitigated to a certain extent by its 15-year contracts with ProLiance, a much longer life span will be necessary for Heartland to recover its investment. Mr. Goebel noted that the depreciation rates that Heartland proposes to use assume at least a 40-year life span for the project. However, there is no impediment to a large competitor deciding to construct a pipeline over the next 15 years which would challenge Heartland's business case. Additional capital investments will need to be made from time to time by Heartland for replacements and improvements, each of which will extend the time necessary for Heartland to fully recover its investment. In Mr. Goebel's opinion, Heartland, as a small entity in an industry made up of very large competitors, will need to provide exemplary service at a low cost in order to succeed. An additional and very significant risk is that there is no assurance that the natural gas supply situation in the United States will be such that the pipeline even will be useful for the very long 40-year period of its depreciable life.

Mr. Goebel pointed out that, even for companies the size of SIGECO, the Commission has recognized the disadvantage that small size creates in accessing capital markets. He stated in the case of Heartland, which is less than 2% the size of SIGECO in terms of capitalization, there is a risk premium warranted for size. Mr. Goebel stated that Heartland's business will lack geographic diversification, a factor that increases risk and hence Heartland's cost of common equity.

Mr. Goebel testified that due to its small size, Heartland is not able to obtain "project financing" matching the very long-term nature of the project. In other words, the Heartland project is using lower cost intermediate-term debt to fund a long-term asset. According to Mr. Goebel, that is very good for customers because it minimizes the cost of capital to be reflected in rates, but it also exacerbates the risk to the equity owners because the intermediate term debt must be refunded only seven years down the road. No one knows what the level of interest rates, or even the availability of debt will be for projects of this type at that time. Mr. Goebel thought that these risks should be recognized in establishing the overall return for the company.

Mr. Goebel mentioned the significant benefits to the State of Indiana from the Heartland project, which include providing central Indiana with low cost access to the Chicago Market Hub, increased competition among supply basins and interstate pipeline companies for business in Indiana and optimization of the use of UGS. He considered it significant that the pipeline will be built and operated by an Indiana-based company subject to the jurisdiction of this Commission, rather than an interstate pipeline not having an Indiana focus regulated by FERC in Washington D.C. In Mr. Goebel's opinion, the Commission should authorize a rate of return that will encourage Indiana-based projects like Heartland's and which will allow Heartland to attract the capital necessary to achieve the benefits for Indiana consumers and the Indiana economy that will result from the project.

Mr. Goebel stated that the capital structure of smaller gas distribution companies operating in Indiana and subject to the Commission's jurisdiction generally have elected to operate with equity components of capitalization above 75%. By utilizing a more leveraged

financing approach, Heartland will lower the cost to its customers because the capital structure will reflect a substantial amount of low cost debt. But the increased financial risk from the additional leverage should increase the cost of equity.

Mr. Goebel also explained that Heartland's cost of capital results in a much smaller revenue requirement because Heartland is a limited liability company not subject to income taxes. In Heartland's case, the actual return, on a pre-tax equivalent basis, is much below that provided to other regulated companies under the Commission's jurisdiction which recover their cost of capital including related income taxes. On a tax-equivalent basis, the 9.67% pre-tax cost of capital for Heartland would, for a tax-paying entity, be approximately 15%. Mr. Goebel emphasized that, even though Heartland's requested cost of equity is greater than the allowed after-tax cost of equity of the small Indiana gas utilities, on a comparable pre-tax return basis (which is the amount actually included in customer rates), the return on equity capital and the overall cost of capital in recent small gas distribution company rate cases are much higher than that being sought by Heartland. Mr. Goebel further noted that in three recent small gas distribution company rate cases, the utilities had significantly less debt in their capital structures than Heartland proposes to have. Mr. Goebel calculated that the overall pre-tax cost of capital authorized in each of these cases was in excess of 14.35%, much larger than Heartland's requested pretax cost of capital of only 9.67%.

Mr. Goebel also considered it important to recognize that although Heartland itself does not incur an income tax liability because it is organized as a limited liability company, its income does not completely escape income taxation. Approximately 30% of Heartland's income will flow through to Vectren Corporation where it will be subject to federal and state income taxes at a combined rate of 40.525%. This tax liability is a cost to Vectren Corporation that must be paid from its share of Heartland's earnings. This means that one of Heartland's investors will not earn the return authorized by the Commission on an after-tax-basis. Mr. Goebel thought the Commission should recognize this fact in evaluating Heartland's proposed rate of return.

Mr. Goebel also reviewed the cost of capital determinations in FERC orders involving new pipelines. He stated these new pipeline companies are generally many times the size of Heartland, and their equity owners are often very large corporate entities with vast pipeline and other infrastructure holdings, characteristics that allow a more leveraged financing approach. Mr. Goebel believed comparing Heartland's request to the pre-tax rate of return that FERC is approving for new pipelines is especially pertinent because, if Heartland does not undertake the project, and if it were undertaken at all, it most likely would be constructed by a FERC-regulated interstate pipeline. In that case, FERC's view of the appropriate cost of capital would be manifested in the prices ultimately paid by Indiana end-users.

Mr. Goebel's analysis indicated that, despite the greater amount of debt financing that the larger entities can often attract, the after-tax costs of capital are higher in three recent FERC-regulated projects than Heartland's requested cost of capital. Mr. Goebel noted that although two of these pipelines are limited liability companies, FERC's policy is to include income taxes computed using the statutory corporate income tax rate in the pipeline's revenue requirement when the LLC members are tax-paying corporations.

Mr. Goebel also pointed out that in 2004, FERC authorized one new pipeline company a return of 14.75% on equity on a capital structure that was slightly less leveraged than Heartland. *Trailblazer Pipeline Co.*, 106 FERC ¶ 63,005 (2004). That rate of return ultimately was revised, pursuant to a settlement, but even the settlement resulted in an equity return estimated to be about 14% in a capital structure similar to Heartland's. *Trailblazer Pipeline Co.*, 107 FERC ¶ 61,008 (2004). Mr. Goebel also focused on another FERC-authorized project that was similar to Heartland in that the Petitioner sought to make an investment of about \$13 million to purchase, upgrade and extend an old oil pipeline of about six miles in distance in order to offer new sources of gas supply and transportation to east central Missouri. *Missouri Interstate Gas, LLC*, 100 FERC ¶ 61,312 (2002). In that case, FERC authorized a 14% rate of return on the 44.71% of its capitalization comprised of common equity and a 7.33% return on the debt component for an overall rate of return of 10.31% plus the recovery of income taxes at the combined federal and state statutory rates. Mr. Goebel stated this results in a pre-tax cost of capital of over 15% (compared to Heartland's requested 9.67%). Mr. Goebel stated that he found compelling the fact that the requested pre-tax return for Heartland is as much as one-third less than for the comparable FERC cases.

Mr. Goebel concluded that Heartland's proposed cost of capital of 9.67% and its proposed cost of common equity of 13.0% are reasonable and should be accepted by the Commission in this proceeding.

Dwight S. Work, a certified public accountant and utility consultant with Work & Greer, PC, sponsored a report on Heartland's projected cost of service and proposed maximum rates for transportation service. Mr. Work developed the transportation rates based on projected construction costs and operating expenses because Heartland does not have any historical cost experience. Mr. Work used a forward-looking test year of the twelve months ending October 31, 2006, which will be the first twelve months of Heartland's operations if the time schedule discussed in Mr. Head's testimony is met.

Mr. Work utilized Heartland's projected average rate base for the test year. Based on the testimony of Mr. Short and Mr. Goebel, Mr. Work's report reflects a rate of return on Heartland's rate base of 9.67%, with a capital structure of 50% debt at a cost rate of 6.33% and 50% equity at a cost rate of 13%.

For comparison purposes, Mr. Work also developed a projected cost of service for each of the four twelve month periods following the test year. Mr. Work used operation and maintenance expenses of \$363,726 for the first year, and escalated that level at 3% per year for years 2007 through 2010. Mr. Work said Heartland anticipates that it will incur additional maintenance costs every five years for smart pigs and inspections.¹ The estimated cost of this additional maintenance is \$260,000 and was included as an expense in 2010, the last year of the projection period. The cost of service for each year also includes projections for depreciation expense, property taxes and the IURC fee. No state or federal income taxes were included in the cost of service because Heartland is a limited liability company, which is a flow-through entity for income tax purposes.

¹ A smart pig is a device for inspecting pipelines for corrosion. Such inspections are required by the United States Department of Transportation. (Tr. B-5.)

The projected common equity return component was derived by multiplying each year's average rate base by the weighted cost of equity. The projected interest expense component was derived by multiplying each year's average rate base by the weighted cost of debt.

Mr. Work used depreciation rates that are the same as those used by OVH. Mr. Work believes OVH is a good proxy to use for establishing depreciation rates for Heartland because OVH's plant is very similar to Heartland's project.

Mr. Work also calculated the allowance for funds used during construction that would be accrued while the pipeline is under construction. Mr. Work included in the projected rate base cash working capital computed by dividing the operations and maintenance expense for each year by eight. He noted that the one-eighth or "45-day" formula is a well-accepted method of estimating cash working capital, particularly for small utilities like Heartland. (Tr. B-6.)

Mr. Work calculated the maximum firm transportation rate using the straight fixed variable rate design methodology. Because Heartland classifies all of its cost of service as fixed costs, the total cost of service for the year ending October 31, 2006 was divided by the firm daily commitment of 70,000 Dth and that result was then divided by 365 days to obtain the maximum daily reservation charge of 9.68¢ per Dth.

Mr. Work proposed a maximum interruptible commodity charge of 9.68¢ per Dth.

(b) **Citizens' Evidence.** In its case-in-chief, Petitioner Citizens offered the testimony and exhibits of its witnesses, Lindsay C. Lindgren and LaTona S. Prentice. Mr. Lindgren is the Vice President of Gas Operations for Citizens. Mr. Lindgren indicated that Citizens currently receives gas from Panhandle Eastern Pipeline Company ("Panhandle") and Texas Gas. Any gas Citizens receives, which is not distributed to customers as flowing supply, is available for injection into the UGS facility, off-system storage facilities, and Citizens' liquefied natural gas storage facilities located in Marion County, Indiana. Typically, Citizens injects gas into storage during the spring, summer and fall months in order to have that gas available for withdrawal to serve its customers' needs during peak demand periods in the winter. Mr. Lindgren described the UGS facility in Greene County, Indiana as comprised of six underground aquifer storage reservoirs located in porous limestone rock formations, which are interconnected to compression, purification and measurement systems. According to Mr. Lindgren's testimony, the total storage capacity of the UGS facility is approximately 7 BCF of working gas surrounded by 25 BCF of cushion gas, native rock, and water. The UGS facility in turn is connected to the Citizens distribution system in Indianapolis by a 20-inch, 49-mile pipeline.

Mr. Lindgren generally described the gas supply planning process for Citizens, which incorporates daily, monthly and long-term supply planning to meet the needs of its customers. The implementation of the Citizens Energy Select rate unbundling program, which began in June 2003, did not significantly change the monthly, daily and long-term supply planning processes at Citizens. However, Mr. Lindgren testified that, as more transportation-eligible customers select gas suppliers other than Citizens in Phase II of the unbundling program which commenced January 1, 2005, he anticipated additional customers transporting their own gas could cause changes in its gas supply planning. He further testified that additional demand destruction due to conservation and general economic conditions would result in the sub-optimization of UGS

during certain periods. This expectation caused Citizens to explore ways to optimize use of the UGS facility in a manner that would benefit Citizens' customers.

In pursuing the Heartland project, Mr. Lindgren testified Citizens objectives were to: (i) reduce the delivered gas cost to the system supply customers of Citizens, (ii) diversify the gas supply options and interstate gas supply serving Citizens, (iii) improve and optimize the utilization of the UGS facility, and (iv) maintain control or the utilization of the UGS facility in order to continue to provide safe, dependable gas service to its customers. Mr. Lindgren testified the Heartland pipeline would permit Citizens to access additional sources of gas supply at the Chicago Market Hub, which would result in a decrease in pipeline demand costs and pipeline variable costs. When netted with commodity costs, the savings to Citizens would be approximately \$1 million per year. Those estimated annual gas cost savings would be passed along to Citizens' customers through the GCA mechanism.

Mr. Lindgren further testified Citizens' customers also will benefit from a portion of the income received from By-Products' 50% ownership in Heartland and By-Products' 39% ownership in ProLiance being eligible for inclusion in the Customer Benefit Distribution Tracker, which Citizens uses to provide benefits to customers from the activities of its unregulated subsidiaries.

Citizens currently uses approximately 70% of the storage capacity of the UGS facility based on Citizens' gas supply needs for a severe season. The remaining 30% of UGS storage capacity is used to support the hydraulics of the storage fields. Based upon the implementation of the Heartland pipeline project and the storage service that Citizens will provide Heartland under the proposed Storage Service Agreement, Mr. Lindgren indicated he expects the utilization rate of the UGS facility to reach 100% through cycling capacity that cannot be optimally utilized by Citizens in providing services to its system supply customers. He further testified that the existing load factor of 10%-12% for the pipeline connecting the UGS facility with the Indianapolis distribution system would be improved, by allowing Citizens to take additional base load gas volumes from the new Heartland lateral pipeline to its city gate, thereby displacing a portion of the current deliveries on Texas Gas. Mr. Lindgren stated Citizens, with Commission approval of the Heartland project, would be able to achieve significant cost savings by permanently displacing capacity on the Texas Gas pipeline through restructuring certain appendices to the Gas Sales and Portfolio Administration Agreement with ProLiance to eliminate that displaced Texas Gas capacity.

Mr. Lindgren's testimony provided an overview of the Storage Service Agreement and its Exhibit A, the General Terms and Conditions of Service, which Citizens seeks approval of in this proceeding. Under that Agreement, Citizens would provide a primary storage service of up to 4.86 BCF Maximum Inventory Quantity ("MIQ") and a secondary storage service of up to 2.0 BCF MIQ. Under Article 2 of the Storage Service Agreement, Heartland agrees to deliver gas to Citizens at the point of receipt up to the 4.86 BCF MIQ for injection into storage and Citizens agrees to re-deliver gas to Heartland from storage at the point of delivery up to the Maximum Daily Withdrawal Quantity ("MDWQ").

Mr. Lindgren testified that under the proposed Storage Service Agreement, Citizens, in its sole discretion, can restrict injections into storage by Heartland based upon the current storage

inventory and operating parameters of the UGS facility. Heartland also acknowledges in the Storage Service Agreement that its daily injections into and withdrawals from the UGS facility for secondary storage service are secondary to any primary storage service rights set forth in Article 2 of the Agreement. Citizens analyzed its severe weather system requirements based on a severe season using 6,311 degree days which it actually experienced in the 1976-77 heating season. That modeling resulted in a forecasted need for Citizens to have access to a primary storage service of 4.86 BCF. The remaining 2 BCF volume serves to assist Citizens in maintaining the proper hydraulic profile of UGS and is important in terms of ensuring appropriate deliverability and serviceability of UGS throughout the injection and withdrawal seasons. According to Mr. Lindgren, even though the 2 BCF is required to maintain overall primary storage deliverability from a physical standpoint, it is available for Citizens to provide as a secondary storage service to Heartland, as long as deliverability of the 4.86 BCF primary volume is maintained.

Continuing with his description of the proposed Storage Service Agreement, Mr. Lindgren indicated that the parties selected a 15-year term to ensure that the Heartland project could be financed. The 15-year term also allows for more business certainty than would a shorter term and adds to the ability to enter into supporting agreements necessary to balance the rewards and risks associated with building a new intrastate gas pipeline.

In Mr. Lindgren's opinion, the proposed Heartland project would not have any adverse impact on the Global RFP process that was included in the Settlement Agreement approved in Cause No. 37399-GCA50(S1). Mr. Lindgren stated that in the event Citizens and Vectren elect to conduct the Global RFP and then select a winning bidder to provide both utilities with gas supply and portfolio administration services under new gas supply agreements, the Storage Service Agreement with Heartland will not be affected. Mr. Lindgren indicated the primary storage service agreement between Heartland and ProLiance and the corresponding firm transportation agreement between those parties would be assigned to the new gas supplier, along with the other pipeline contracts that support the Gas Sales and Portfolio Administration Agreement between ProLiance and the Utilities.

Mr. Lindgren also provided support for the 2.7% fuel retention factor for injection and withdrawal from the UGS facility, but deferred to Citizens' witness LaTona Prentice for purposes of describing the derivation of the rates and other rate-related provisions of the Storage Service Agreement. However, Mr. Lindgren testified that the reservation rate of 15¢ per Dth for secondary storage service was appropriate in his opinion. He testified that the cost for the UGS storage facility volume rights on a secondary firm basis was determined to fall between 13¢ and 28¢ per Dth. The foregoing range was based on a third-party review of similar type demand charges associated with subordinated rights conducted by Stone & Webster. According to Mr. Lindgren's testimony, the value of 15¢ per Dth was selected based on the uncertainty of having secondary storage available on a daily basis and the fact that Citizens' primary storage requirements always will be met before any secondary storage service from UGS would be made available to Heartland.

In addition to Heartland's witness Mark Head, Mr. Lindgren also provided an overview of the nature of the duties and responsibilities Citizens would perform under the Service Agreement. He described the qualifications and experience of the Citizens employees that would

be performing the services described in the Service Agreement. Citizens will manage, operate and maintain the Heartland pipeline in accordance with established regulations and sound gas industry practices and that Citizens' specific duties would include supervision and control of facility operations, maintenance and repair activity, gas control responsibility and operational reporting. Mr. Lindgren testified Citizens has successfully owned and operated the UGS facility and related systems since 1961. Citizens has a staff of employees located on site in Greene County that are able to provide 24-hour coverage and support for associated gathering, compression, purification and instrumentation systems associated with the proposed pipeline. Citizens' management and operating teams in Greene County include qualified and experienced engineers, geologists, pipeline technicians, welders and gas control specialists. The cost estimates for each service Citizens will provide to Heartland under the Service Agreement were based on Citizens' actual experience and were adjusted, as appropriate, for each individual service activity.

In conclusion, Mr. Lindgren testified Commission approval of the relief requested in its Petition and the Heartland Petition will benefit Citizens' customers in the following ways:

1. The new Heartland intrastate pipeline will allow gas purchases from the Chicago Market Hub and transportation of that gas on MGT and the Heartland pipeline to Citizens' system at a lower total delivered cost.
2. The Heartland pipeline will enable Citizens to diversify its gas supply portfolio and obtain gas supply from the Inter-Mountain West and Canada.
3. The Heartland pipeline will enhance utilization of both the UGS facility and the 20-inch pipeline to Citizens' distribution center in Indianapolis.
4. With an additional pipeline connection, Citizens will have a reduced risk of physical delivery interruptions.
5. Direct ownership by Citizens' subsidiary, By-Products, of 50% of Heartland, will minimize delivery risks and provide Citizens with a substantial measure of control over Heartland operations.
6. The incremental volumes on the new Heartland pipeline will provide Citizens with an opportunity to recognize the full value of the UGS facility.
7. A third pipeline gas resource to the Citizens' system increases options for third-party suppliers and their customers.

Citizens also offered as part of its case-in-chief the Direct Testimony and Exhibits of LaTona S. Prentice, Director of Regulatory Affairs. Ms. Prentice described the basis for the rates for secondary storage service set forth in the Storage Service Agreement and the proposed changes and additions to various Appendices to the Gas Sales and Portfolio Administration Agreement between Citizens and ProLiance that are directly related to the Heartland project. Ms. Prentice indicated the proposed reservation rate of 15¢ per Dth for secondary storage service was negotiated between Citizens and Heartland. The agreed upon 15¢ per Dth rate was divided by 12 months to produce a resulting reservation rate of 1.25¢/Dth of secondary MIQ that is

reflected in the Storage Service Agreement. The commodity rate in the Storage Service Agreement applies to both primary and secondary services. It was determined by reducing the 3-year average variable cost of operating the UGS facility by the 3-year average total fuel cost to establish net variable cost. The net UGS facility variable cost then was divided by the 3-year average injections and withdrawals from UGS, resulting in an approximate 2.65¢/Dth net variable cost or commodity rate applicable to all injections and withdrawals.

As a result of the proposed Heartland project, Citizens and ProLiance agreed to certain amendments to the Appendices to the Gas Sales and Portfolio Administration Agreement. In addition, certain new appendices, Appendix J.6 and Appendix J.7, were added to reflect new services ProLiance will be providing to Citizens resulting from implementation of the Heartland project.

Ms. Prentice described the proposed amendments to Appendix A, Appendix B, Appendix C, Appendix E, Appendix J.1 and the proposed new Appendices, J.6 and J.7. Appendix J.6 is a new Annual Delivery Service ("ADS") fashioned after existing ADS Appendices to provide for the transportation of supplies on MGT and the Heartland pipeline. Appendix J.7 is a new ADS service fashioned after the storage components of Appendices J.1, J.2 and J.3 to provide for the delivery from and to the UGS facility consistent with the primary storage service agreements between Citizens Gas, Heartland and ProLiance. Ms. Prentice described why the storage refill quantities in Appendices J.1 through J.3 are priced based upon 1/7th of the total summer purchase quantity times the applicable monthly index price and the storage refill quantity in Appendix J.7 was priced at 1/14th of the total summer purchase quantity times two separate monthly index prices. She indicated that unlike the storage service contained in Appendix J.1 that is sourced through a single pipeline, Texas Gas, and the storage services contained in Appendices J.2 and J.3 that are sourced off of one pipeline, Panhandle, the storage service in Appendix J.7 is capable of being sourced from two pipelines, Texas Gas and MGT.

5. OUCG's Case-In-Chief. The OUCG presented the testimony of Richard A. Galligan and Jerome D. Mierzwa. Mr. Galligan is a Principal with Exeter Associates, Inc. (Exeter), located in Columbia, Maryland. Mr. Mierzwa also is a Principal and Vice President of Exeter. Exeter specializes in providing public utility-related consulting services.

Mr. Galligan stated that the \$1 million in anticipated savings to Citizens per year is a net cost advantage of commodity, demand, and variable cost differences with and without the Heartland pipeline. In his view, the resource costs of building and operating the 25-mile proposed pipeline are not a function of the number of owners of the pipeline. Mr. Galligan concluded the Heartland pipeline project is economic and consistent with least-cost gas acquisition principles, when owned entirely by Citizens. Relying upon Mr. Mierzwa's Testimony and Exhibits, Mr. Galligan testified that if Citizens were to finance and own the entire Heartland pipeline, not only would it enjoy the anticipated \$1 million annual gas procurement savings related to its acquisition of gas for its retail sales customers, but Citizens also would benefit by the revenues generated from use of the Heartland pipeline to meet other loads in the Indianapolis area. Mr. Galligan stated that additional revenues related to and generated by third-party transporters using the Heartland pipeline would reduce the unit cost of service for gas flowing through the Heartland pipeline, which would further increase the cost savings related to Citizens' use of the pipeline. Mr. Galligan testified that consistent with least-cost acquisition principles,

the Commission should order Citizens to proceed with the pipeline project as sole owner. Mr. Galligan further noted that the option of having Citizens build the pipeline has the distinct advantage of permitting lower cost, tax-exempt financing of the pipeline project.

In commenting upon the proposed Storage Service Agreement, Mr. Galligan stated that through a non-competitive, non-arms-length negotiation, Citizens and its subsidiary arrived at an agreement for secondary storage service, which includes, among other things, a 15-year service term and a 15¢ per Dth charge applicable to 2 BCF of annual storage capacity. Mr. Galligan testified ProLiance would be able to use Citizens' UGS facility to provide storage service to its customers which procure their gas supplies in the competitive marketplace. He also indicated that preventing other suppliers from having an opportunity to acquire the secondary storage service unfairly advantages ProLiance and, to the extent the agreed-upon \$300,000 annual payment is inadequate, unfairly disadvantages Citizens' retail gas sales customers. Again, relying upon Mr. Mierzwa, Mr. Galligan stated Citizens' retention and use of the 2 BCF of secondary storage capacity would benefit its retail customers far more than the \$300,000 annual payment Citizens would receive under the Storage Service Agreement.

Mr. Galligan also raised a concern with respect to the 15-year term for the Storage Service Agreement. He stated there would be no assignment of the 2 BCF of secondary storage service provided by Citizens to Heartland as part of the Global RFP process after the expiration of the current term of the Gas Sales and Portfolio Administration Agreement on March 31, 2007. Mr. Galligan testified that market area storage, a valuable Citizens' asset, should not be disposed of by Citizens and taken off the market for a 15-year period just prior to the conduct of a Global gas acquisition and delivery solicitation. According to Mr. Galligan, Citizens' resulting post-March 2007 gas costs could be expected to be higher than they otherwise would be if potential suppliers had access to the 2 BCF of secondary storage service. Based on the foregoing, Mr. Galligan stated the Storage Service Agreement should be disapproved by the Commission.

Mr. Galligan testified he does not know what the market value of the 2 BCF secondary storage service is because Citizens failed to make this service available through a competitive release. In his opinion, the market price for this storage service can be determined only by utilizing the marketplace. A non-arms-length "negotiation" between two affiliated parties cannot be expected to yield the market price. In conclusion, Mr. Galligan recommended that Citizens should retain the 2 BCF of alleged surplus annual storage capacity, unless it can demonstrate that such retention is at odds with least-cost gas acquisition principles. He further stated that the Commission should reject Citizens' sale of secondary storage service to Heartland at the negotiated terms and conditions included in the Storage Service Agreement. Mr. Galligan said that, if Citizens can demonstrate it has unused storage capacity that is not better retained for use by its retail sales customers, it should release that capacity through a non-discriminatory, competitive release process.

The OUCC's witness Mierzwa had concerns that as a result of the primary storage service arrangement set forth in the proposed Storage Service Agreement, Citizens may be entitled to no more than 80,000 Dth per day from its UGS facility. He indicated that on a number of occasions in the past, Citizens has withdrawn more than 80,000 Dth per day from the UGS facility. In the event that Citizens were limited to 80,000 Dth per day, Mr. Mierzwa stated it may be necessary for Citizens to purchase high cost spot market gas supplies to meet its customers'

requirements. He also observed that any limitation of 80,000 Dth per day suggested to him that Citizens no longer maintains complete unilateral control of its storage facilities. He stated that failure of Citizens to control its storage would be a violation of Section 4 of the Gas Sales and Portfolio Administration Agreement between Citizens and ProLiance.

Mr. Mierzwa had other concerns with respect to the storage service ProLiance will provide Citizens. Under the proposed amended Appendices to the Gas Sales and Portfolio Administration Agreement, Mr. Mierzwa indicated Citizens must nominate its desired daily storage deliveries 24 hours in advance and currently there is no such requirement. He stated that under this proposed arrangement, Citizens' UGS flexibility will be reduced, as well as its control over storage operations. He said this could possibly lead to higher gas costs for Citizens' customers.

With respect to the 2 BCF of secondary storage service provided in the Storage Service Agreement, Mr. Mierzwa testified Citizens could realize a profit from the summer/winter price differential and used an example of 85¢ per dekatherm x 2 BCF, producing a profit in the neighborhood of \$1.7 million. Mr. Mierzwa testified that Citizens made no demonstration that the 2 BCF for secondary storage service could not be retained by Citizens and utilized to capture the summer/winter price differential savings for its ratepayers.

Mr. Mierzwa also disputed Citizens' claim that the 15¢ per Dth charge for secondary storage service is comparable to the charges assessed by other pipelines for similar services. He stated that the proposed 15¢ per Dth charge is significantly below what Texas Gas and Panhandle charge.

Mr. Mierzwa disagreed with Mr. Lindgren's testimony that the Storage Service Agreement would not have any impact on the Global RFP process. Mr. Mierzwa testified one of the most valued assets Citizens has to offer a potential gas supplier is storage. He asserted that if the Storage Service Agreement is approved by the Commission, Citizens still would be required to provide secondary storage service to ProLiance beyond the March 31, 2007 date, reducing the amount of storage service available to any new gas supplier, and the attractiveness of being Citizens' new gas supplier.

The next subject Mr. Mierzwa addressed was the recommended use of tax-exempt bonds by Citizens to finance the Heartland pipeline. Mr. Mierzwa prepared Schedule DJM-2 to show that if tax-exempt bonds were utilized by Citizens to finance construction of the Heartland pipeline, the annual Heartland project cost of service would be reduced by approximately \$865,000 to \$1.6 million. Mr. Mierzwa also raised concerns regarding the nearly \$2 million in contingencies included in the \$17.2 million estimated cost for the Heartland pipeline. Mr. Mierzwa indicated these contingent costs may or may not be incurred if Heartland is built, as proposed, since the total \$17.2 million cost is just an estimate. He indicated actual costs of the pipeline will not be known until after rates have been established.

Mr. Mierzwa's recommendation to address this particular concern was that if the Commission approves the Heartland project under the proposed ownership arrangement, Heartland should be required to file with the Commission within three years after the in-service

date to justify its existing rates. As precedent for this particular recommendation, Mr. Mierzwa pointed to certain FERC cases.

Mr. Mierzwa raised a concern with respect to the fact that Heartland had designed its proposed rates for service on 70,000 Dth per day. Mr. Mierzwa noted the firm design capacity of the Heartland pipeline is 80,000 Dth per day. According to Mr. Mierzwa, if Heartland is able to sell any of the currently unsubscribed firm capacity, it would over-recover its cost of service. Mr. Mierzwa recommended that if the Commission authorizes the Heartland pipeline to be constructed under the proposed ownership arrangement, 90% of the revenues realized by Heartland from the sale of the currently unsubscribed firm capacity and from the provision of interruptible service should be credited back to Citizens and ProLiance in proportion to their firm capacity entitlements. In that event, Citizens' share of the credits would flow through to GCA customers. Mr. Mierzwa indicated the crediting of revenues from services for which no applicable history exists is also consistent with FERC policy. Using this recommended approach, Mr. Mierzwa testified an incentive exists for Heartland to sell the unsubscribed capacity and to provide interruptible service, while ensuring that Heartland does not significantly over-recover its cost of service.

6. Citizens Industrial Group's Case-In-Chief. At the request of the Industrial Group, the Commission took administrative notice of, and made part of the evidentiary record of the April 21, 2005 hearing, the GCA50 Settlement Agreement in Consolidated Cause Nos. 37394GC50S1, 37399GC50S1 and 42233 dated June 4, 2002, with attached Exhibits A and G; the Commission Order approving the GCA50 Settlement in Consolidated Cause Nos. 37394GC50S1, 37399GC50S1 and 42233 dated July 24, 2002; and the Commission Order in Cause No. 40437 dated September 12, 1997. These documents were admitted into the record as Intervenors Exhibit 1.

Mr. Nicholas Phillips, Jr. testified on behalf of the Citizens Industrial Group. He also recommended that the Commission reject the proposed ownership structure.

At the outset Mr. Phillips observed that Citizens Gas has two other pending proceedings in which Citizens Gas has proposed to transfer revenues to unregulated affiliates: Cause Nos. 37399-GCA84S1² and 42726. Mr. Phillips testified in both these other proceedings violation of the affiliate guidelines included in the GCA50 Settlement.

Mr. Phillips testified that the Petitioners' proposed cost of service does not utilize the entire capacity of the line. Any sales in addition to the two proposed ProLiance contracts would result in Heartland overearning. In addition, Mr. Phillips observed that since ProLiance is in charge of management of the pipeline, it is unclear whether ProLiance wishes to allow any other entities to buy capacity on the pipeline. Mr. Phillips called Heartland a shell corporation and noted it would not have any employees.

² The Order in Cause No. 37399-GCA84S1 was approved by the Commission on September 22, 2005.

Mr. Phillips also testified that if Citizens Gas owned the proposed pipeline, the resulting capital cost would be considerably lower. Exhibit NP-1 demonstrated Mr. Phillips' analysis and showed the total revenue requirement would be reduced by approximately 32% if Citizens Gas owned the project and had a 5% cost of capital. Mr. Phillips' 5% estimate was based on a variety of factors and represented the upper-end of the high quality tax-free debt interest cost. Notably, the last debt issuance report by Citizens Gas had a fixed interest cost of 4.59%.

Mr. Phillips testified that it was appropriate for the Heartland project to be constructed as a 100% Citizens Gas owned project. Citizens Gas' infrastructure is integral to the project. The existing 49-mile pipeline from UGS to Citizens Gas delivery system as well as the UGS itself are the ingredients that make the project work. Under a 100% Citizens Gas owned structure, Citizens Gas would still operate and maintain the project as proposed by Heartland. Mr. Phillips also testified that the majority of the gas that will flow on the pipeline will be recovered from GCA customers. Therefore, the higher cost associated with providing a 13% return on equity, as proposed by the Petitioners, will flow through to the regulated customers as a GCA charge, but the revenues earned by the pipeline will be transferred to the unregulated affiliates of Citizens Gas and ProLiance. Mr. Phillips concluded that the proposed structure was hardly in ratepayers' best interests.

Mr. Phillips was also concerned about turning over rights and control to the UGS to ProLiance. He testified that Citizens Gas' ratepayers have paid and continue to pay for the UGS facility through rates, but under the proposed structure, ProLiance would use the facilities to obtain profits. Mr. Phillips cited the Commission's September 12, 1997 Order in Cause No. 40437 which showed the establishment of ProLiance as an unregulated affiliate was based on Citizens Gas retaining complete unilateral control of all physical plant required for gas delivery, including transportation and storage facilities. The language and commitment by Citizens Gas to "retain complete unilateral control of its physical gas delivery, distribution, storage and transportation facilities," was repeated in the GCA50 Settlement.

Mr. Phillips testified that Citizens Gas has other on-system gas storage -- two LNG facilities. If Citizens Gas has excess storage facilities, Citizens Gas should demonstrate why ratepayers should continue to pay for the LNG facilities, which are more expensive to operate. Mr. Phillips testified that the Commission should not allow Citizens Gas to contractually transfer the rights to lower cost UGS without a complete study of the impact of all of Citizens Gas' storage facilities. In addition, Mr. Phillips testified if Citizens Gas has excess storage facilities, those facilities should be offered to all interested parties, not just ProLiance.

Mr. Phillips testified that the utilities' proposal violates General Guidelines A, C and D, and Specific Guideline 3 of the affiliate guidelines. Mr. Phillips testified that General Guidelines C and D addressing discrimination and comparability of service and Specific Guideline 3, addressing storage particularly, appear to be completely ignored by Citizens Gas and ProLiance under the proposed structure. ProLiance alone receives 25,000 dth/day of firm capacity and the secondary storage service. Furthermore, if any other marketers wish to buy pipeline capacity, arrange transportation or negotiate rates on Heartland, they would have to negotiate with ProLiance, as Manager of Heartland.

Mr. Phillips was particularly concerned that Citizens Gas would extend its current 50/50 rule and require a certain amount of transportation gas be delivered through Heartland. If Citizens Gas extended that rule to Heartland, transportation customers and other marketers will be forced to buy transportation service from ProLiance, a competitor in the gas marketplace. This proposed structure, including ProLiance as an owner and manager of the pipeline, is a potentially anti-competitive situation.

Mr. Phillips recommended that if the pipeline is approved that it be owned and operated by the regulated operations of Citizens Gas. If Citizens Gas has excess pipeline, distribution or storage capacity, that capacity should be offered by contract to all interested third parties on an equal opportunity basis, not just to ProLiance. Earnings from these facilities would be used to offset the revenue requirements of Citizens Gas' regulated gas operations resulting in lower rates to customers.

If the Commission approves the project with its proposed ownership structure, Mr. Phillips recommended that the Commission institute safeguards to hold regulated ratepayers harmless from the structure involving unregulated affiliates. Rates, including all terms and conditions for Citizens Gas' regulated customers should be no higher and no more onerous than if Citizens Gas owned and operated the new pipeline.

7. Petitioners' Rebuttal.

(a) **Heartland's Rebuttal.** In rebuttal, Mr. Head first pointed out that CIG witness Phillips and OUCC witness Galligan recognized that the project had merit, was reasonable and was in the public interest.

Referencing Mr. Mierzwa's testimony about Citizens shedding firm transportation capacity on Texas Gas, Mr. Head pointed out that the 45,000 Dth per day Texas Gas firm transportation contract is dedicated to Citizens and does not terminate until October 31, 2008. He said an essential component of the project is that ProLiance has agreed to absorb the costs related to this stranded capacity which will save Citizens' customers \$4.4 million per year and more than \$13 million in total.

Mr. Head disagreed with Mr. Mierzwa's testimony that the NYMEX summer/winter price differential is approximately 85¢ per Dth and that the profit which potentially could be realized from the purchase of secondary storage service at this differential is approximately \$1.7 million. Mr. Head first pointed out it is difficult to make the above calculation due to the non-firm nature of the injection and withdrawal rights of the secondary storage service. On any day that Citizens is injecting gas into or withdrawing gas from its UGS facility and utilizing the maximum capacity of the storage fields, there will be no capacity available for secondary storage service. The capacity available for secondary storage will be known only on a day-to-day basis. Accordingly, the user of the secondary storage service cannot have an exact plan of daily activity in order to capture the winter/summer price spreads.

Second, Mr. Head asserted that as with any commodity market, the value of the summer/winter spread of natural gas on the NYMEX changes from and day-to-day and even moment-to-moment based on a multitude of factors, including supply and demand. Weather is a

particularly significant factor. For example, if a winter season is colder than normal, storage service customers are likely to withdraw more gas than normal in order to meet the demand. This would create a larger "hole" for the next summer injection season. Market forces will adjust the NYMEX prices accordingly. Mr. Head explained that the holder of the secondary storage rights would be subject to the risk that the summer/winter price spread and the timing of injections and withdrawals will not create enough revenue to cover the cost of the storage service. Mr. Head characterized Mr. Mierzwa's estimate of potential profits as very speculative, given the nature of the secondary storage service and the variability of the factors that affect the market prices.

Mr. Head also disagreed with Mierzwa's testimony that the proposed primary storage service arrangement could prevent Citizens from increasing UGS withdrawals to meet higher requirements of its customers, potentially forcing it to purchase high cost spot market gas supplies. He explained that the Heartland Gas Tariff adopts the nomination procedures of the North America Energy Standards Board which provide four opportunities on a daily basis to adjust nominations. Mr. Head asserted these procedures will provide ample means for Citizens to adjust UGS withdrawals to meet the changing needs of its customers.

Mr. Head also defended the reasonableness of the \$2 million contingency factor included in the estimated \$17.22 million pipeline construction costs. He said the cost estimate was prepared by Mustang, a well respected engineering firm, utilizing generally accepted industry standards. Mr. Head testified that it is typical in the industry to include a contingency calculation in estimated pipeline construction costs to cover unknown items that may cause additional costs during project implementation. For this particular pipeline cost estimate, Mustang utilized a 10% rate on material and a 15% rate on installation and all other items, a standard practice in the pipeline and engineering industry. To provide examples of the need for the contingency, Mr. Head showed that the length of the pipeline has increased from 25.2 miles to 25.6 miles as a result of discussions with landowners about easement rights, new survey information and discussions with the required environmental and permitting agencies. This change alone will result in an increase in pipeline construction costs because more steel pipe will need to be purchased, more right-of-way will need to be acquired and additional installation costs will need to be incurred. Additionally, the price of steel and specifically steel pipe has seen a dramatic increase in pricing over the last year due to the world-wide increase in demand for steel. In fact, the price of steel pipe increased 15% to 45% during the last six months of 2004. The outlook is for an additional increase of 5% to 12% during the first six months of 2005. Citing these examples, Mr. Head said he continued to believe that the \$17.22 million cost estimate for this project is reasonable, although there is still a risk that the actual cost will be higher.

With respect to OUCC witness Mierzwa's recommendation that Heartland should be required to file with the Commission within three years after the in-service date to justify its existing rates, Mr. Head said he did not object to a true-up of the actual capital costs and the actual volume transported through Heartland at the completion of the third calendar year following the pipeline's in-service date, provided an adjustment will be made regardless of whether the actual costs are greater or lesser than the estimated cost.

With respect to the possibility that Heartland will be able to sell additional capacity above the 70,000 Dth per day provided for in the ProLiance contracts, Mr. Head said Heartland will be

offering services on an open-access, non-discriminatory basis. The owners of Heartland are motivated to sell the remaining 10,000 Dth per day of firm transportation capacity at the maximum rates under a multi-year term contract. However, he asserted, at this point in time, the possibility of selling more than 70,000 Dth per day is not fixed, known and measurable. Over six months after the Commission filing, no other entities have approached Heartland to discuss the terms and conditions of a possible firm transportation agreement. Similarly, Heartland hopes to be able to sell incremental interruptible transportation capacity, but at the present time it is impossible to quantify when or if any interruptible transportation service will be sold. Mr. Head contended that imputing an arbitrary volume for transportation rate design purposes would most likely put Heartland at a serious risk for under-collecting its cost of service.

In rebuttal to Mr. Phillips contention that it is not clear whether Heartland capacity would be made available to entities other than ProLiance, Mr. Head testified Heartland will operate on an open-access, non-discriminatory basis, and it is in the best interest of the owners of Heartland to sell additional firm or interruptible transportation capacity. He also pointed out the administration of the Manager's duties will be handled mostly in the Evansville office, away from the trading and operations group of ProLiance located in the Indianapolis office.

(b) Citizens' Rebuttal. Citizens' witnesses Lindgren and Prentice also testified on rebuttal. Mr. Lindgren indicated his agreement with OUCC witness Galligan that the proposed Heartland project is reasonable and in the public interest, but disagreed with Mr. Galligan's recommendation that the Commission should order Citizens to finance and own 100% of the proposed pipeline. Mr. Lindgren noted that the proposed Heartland structure involved ProLiance indirectly as a partner, which allows for the projected gas cost savings to be realized because ProLiance has agreed to absorb the stranded Texas Gas capacity cost in the amount of \$4.4 million per year. That cost otherwise would continue to be incurred by Citizens until October 31, 2008, when the Texas Gas contract expires. In addition, Mr. Lindgren noted that under the proposed structure, which involves Heartland operating as a separate Indiana public utility, ProLiance would contract for transportation capacity on the Heartland Pipeline for a 15-year period, which guarantees higher utilization of the pipeline, allowing the Heartland tariff to be more cost-effective for customers. According to Mr. Lindgren, if Citizens were financing the pipeline on its own, there would be less capacity subscribed and, therefore, a higher unit delivery service cost for customers.

Mr. Lindgren also disagreed with the contention of CIG witness Phillips that the Heartland project is more expensive since Citizens' customers would pay for added expenses through higher gas costs in the GCA. To the contrary, Mr. Lindgren testified the Heartland project is more economical for the customers of Citizens under the proposed project structure because Heartland shares the costs and helps increase benefits for customers. Mr. Lindgren also noted that with Heartland being an Indiana intrastate pipeline, the revenues for use of the pipeline would not go to an out-of-state interstate pipeline company, which should provide economic benefits to Indiana that otherwise would not exist. Mr. Lindgren reiterated that the purpose of the Heartland pipeline project is to maximize the advantages to customers of Citizens. The project will provide direct and indirect benefits to Indiana, to Citizens' customers, including lower delivered gas costs, access to more pipeline supply options, higher utilization of Citizens' gas supply facilities, increased reliability of supply, continued control of UGS facilities, better-

managed gas supply costs from demand reductions and increased transport options for third party suppliers.

Mr. Lindgren also responded to Mr. Phillips claim that the proposed Heartland structure allowed Citizens to relinquish control over the UGS facility to Heartland. Mr. Lindgren reiterated that one of the original objectives of the Heartland project was to ensure that Citizens would continue to maintain control over the utilization and operation of the UGS facility in order for it to continue to provide safe, dependable gas service to customers. Citizens accomplished the goal of continued control over the UGS facility through the terms of the Storage Service Agreement, with continued ownership of the UGS facility by Citizens, through a Service Agreement for Citizens to operate the new pipeline and related gas control activities on behalf of Heartland, and through By-Products having 50% ownership in Heartland. In summary, Mr. Lindgren testified Citizens will continue to own and control 100% of the UGS facility, while deriving approximately 70% of the economic value of the Heartland pipeline project and 100% of the gas costs benefits. Mr. Lindgren also rebutted concerns raised by OUCC witness Mierzwa that Citizens would lose flexibility in the operation of the UGS facility under the proposed Storage Service Agreement. Mr. Lindgren noted that current supply planning procedures for Citizens require all supply resources to be managed and planned each gas day, which allows for intraday changes to storage resources, both on and off system. This supply planning flexibility will continue into the future, notwithstanding the proposed Storage Service Agreement.

In rebuttal to the OUCC's witnesses contention that Citizens should retain the 2 BCF of secondary storage capacity in order to "capture" for its customers the benefits of the summer-winter differential, Mr. Lindgren responded by stressing that adding 2 BCF to Citizens' supply plan involves more than just withdrawing another 2 BCF from storage. He noted each supply option available to Citizens must support the entire supply process and cannot be utilized in a manner that will sub-optimize the overall supply process. Citizens' gas supply planning and procurement process involves forecasting customer demand and subsequently designing and operating with an optimum portfolio mix of delivery and storage services to meet the requirements of its customers at the lowest cost reasonably possible. The supply plan model Citizens uses devises an optimum mix of delivery services, using pipeline supply, pipeline storage and Citizens' storage to meet its customers' energy needs.

Mr. Lindgren testified Citizens must balance transportation services from Texas Gas and Panhandle on a daily, monthly and annual basis, along with on-system storage assets of UGS and LNG, while accommodating customer gas demand. Mr. Lindgren reiterated that the proposed 2 BCF of secondary storage is used by Citizens for hydraulic purposes to support the 4.86 BCF primary storage deliverability needs. In Mr. Lindgren's opinion, the 2 BCF is necessary to serve Citizens' needs because without that 2 BCF of secondary storage capacity, Citizens would be unable to withdraw the 4.86 BCF necessary to meet its system supply needs. The Heartland proposal allows Citizens to maintain ultimate control over the 2 BCF, while optimizing the value of the 2 BCF to provide savings to Citizens' customers through the GCA and the Customer Benefit Distribution tracker.

In response to OUCC witness Mierzwa's claim that the Storage Service Agreement may limit Citizens to no more than 80,000 Dth per day from the UGS facility, Mr. Lindgren responded that the current supply plan maximum withdrawal quantity is set at 80,000 Dth per

day, which continues after Heartland goes on-line. However, based on operating conditions, inventory levels, pressure profiles and other considerations, Citizens still will have the right to withdraw more than 80,000 Dth per day to meet supply needs, as provided in Paragraph 2.3 of the Storage Service Agreement.

Mr. Lindgren also responded to OUCC witness Galligan's contention that any unused storage capacity Citizens might have should be bid on an annual basis, noting that Citizens must maintain control over when and how much of the secondary storage capacity is withdrawn. Based on the need for Citizens to plan for severe season send-out and maintain the hydraulics of the field, Mr. Lindgren testified Citizens has no "excess volume" of UGS to bid on an annual basis. The secondary storage service in the Storage Service Agreement is designed to optimize storage that currently is used and useful for system supply needs.

Mr. Lindgren also addressed the concerns raised by the OUCC and CIG that in the event Citizens and Vectren elect to conduct a Global RFP and select a winning bidder to provide them with gas supply and portfolio administration services, primary storage service covering the 4.86 BCF of storage service and the corresponding firm transportation agreement with Heartland would be assigned to the new gas supplier. Mr. Lindgren indicated that the 4.86 BCF of primary storage service otherwise would not have been part of the Global RFP, but for the Heartland proposal.

In Mr. Lindgren's opinion, the Heartland project will make being Citizens' portfolio administrator even more attractive than it otherwise would have been. In response to CIG witness Phillips' statement that Citizens should offer all interested parties LNG and UGS storage, Mr. Lindgren disagreed and testified Citizens gas supply plan and storage portfolio are designed to be balanced, safe, dependable, cost-effective and to meet customers' demand for gas during a severe season. The Heartland project optimizes utilization of storage facilities and provides benefits to all system supply and third party transport customers through lower gas costs and increased supply diversity.

Finally, Mr. Lindgren addressed the issue raised by CIG concerning the so-called "50/50" rule, which was agreed to as part of the settlement in Cause No. 41605. Mr. Lindgren disagreed with Mr. Phillips' claims that the "50/50" rule would be applied to the Heartland pipeline project and indicated that if the Commission approves the Heartland project as proposed, Citizens will agree to revise the "50/50" rule to provide for something other than equal delivery on the three pipelines. He indicated a reasonable approach would involve having a maximum percentage limit on each pipeline, with the ability for Citizens to waive the maximum percentage delivery provision at its sole discretion, which would allow for sound gas supply planning for system supply and the customers of third party suppliers.

Citizens' witness Ms. Prentice indicated she also agreed with OUCC witness Galligan that the factual record in this case supports the conclusion that the pipeline project described in the Heartland Petition would be reasonable and in the public interest. However, she disagreed with Mr. Galligan with respect to his claim that 100% ownership of the proposed pipeline by Citizens, instead of by Heartland, would be more advantageous. Instead, she testified that 100% ownership of the proposed pipeline by Citizens would increase the cost of providing service to

Citizens' customers and not be as advantageous as the structure proposed in the Heartland/Citizens case-in-chief.

Ms. Prentice had four primary reasons for her disagreement with Mr. Phillips and the OUCC's witnesses regarding their position that Citizens should build the pipeline and use tax-exempt financing to cover the entire cost of 16-inch pipeline facility. First, simply constructing a new pipeline connecting Citizens' system to MGT would not meet Citizens' original objectives. Nor would it result in many of the same direct and indirect benefits for its customers. Second, both Mr. Phillips' and Mr. Mierzwa's revenue requirements calculations for the hypothetical Citizens pipeline failed to recognize that Ind. Code § 8-1.5-3-8 prescribes a cash revenue requirements ratemaking methodology, meaning that the principal and interest payments on the debt and incremental working capital from the pipeline project would be recoverable from customers in its rates for transportation service. Third, Ms. Prentice noted both Mr. Phillips and the OUCC's witnesses presumed Citizens would construct a 16-inch pipeline to serve its system supply needs and provide additional capacity to third parties which might be interested in transporting on the pipeline. In her view, however, Citizens could not justify constructing a pipeline larger than was needed to meet its system supply needs. Finally, Mr. Phillips and the OUCC's witnesses incorrectly presumed Citizens would continue to experience the same gas cost savings from 100% ownership interest of the pipeline, which she disputed.

Ms. Prentice explained the hypothetical revenue requirement for a 16-inch pipeline, if that pipeline were to be owned and financed 100% by Citizens, on her Exhibit LSP-2R. Following the municipal utility ratemaking guidelines in Ind. Code § 8-1.5-3-8, Citizens' construction and ownership of the new 16-inch pipeline connected to MGT would cause an increase to its non-gas revenue requirement of \$2,144,042, which would be the responsibility of Citizens' system supply and transportation customers alone, rather than being spread among Citizens' on-system customers, off-system customers and other transporters on the proposed Heartland pipeline connection. Assuming a 20-year payment schedule for the repayment of the debt associated with financing the pipeline, the annual debt service principal payments would be approximately \$955,000. According to Ms. Prentice, when that revenue requirement is added to the increased working capital revenue requirement, the total revenue requirement, assuming construction and 100% financing by Citizens with tax-exempt bonds, would be greater than the revenue requirement of the project proposed by Citizens and Heartland. Page 2 of Exhibit LSP-2R showed a comparison of Petitioner's case-in-chief revenue requirements to the three revenue requirement scenarios, assuming 100% ownership by Citizens of the new 16-inch pipeline connection. That Exhibit shows that both Mr. Phillips and Mr. Mierzwa failed to include the principal payment on the debt, which would be a revenue requirement for a municipally owned utility.

Ms. Prentice also described why, as a regulated local distribution company, Citizens would be required to make investments and improvements to its system in a prudent manner. She indicated that if Citizens were to construct facilities that exceeded what its customers reasonably required in order to receive adequate and reliable service, it would run the risk the OUCC or an intervenor would take the position that some portion of the investment in such facilities was imprudent and not used and useful to provide service. She also noted Citizens is not in the unregulated gas marketer business and doubted Citizens would construct a pipeline larger than its system supply needs in order to sell natural gas off-system in a risky, competitive gas market.

Citizens has no shareholders to absorb any losses from a competitive business endeavor and selling natural gas off-system as a gas marketer in a competitive market at non-tariffed rates could jeopardize the tax-exempt status of Citizens' financing for the project, if the sale of some portion of the pipeline capacity were considered a "private use." Ms. Prentice testified that if the "private use" test is violated, then the bonds would become taxable retroactively and any apparent savings between taxable and tax-exempt debt would be gone. Ms. Prentice testified Citizens was not willing to take on these risks as a regulated utility.

On the issue of Citizens and its customers experiencing the same gas costs savings as contended by the OUCC and CIG, if Citizens directly constructed and owned the new pipeline, Ms. Prentice countered that a significant component of the Heartland project is ProLiance's absorption of stranded Texas Gas capacity costs. Citizens has included revised and new appendices to the Gas Sales and Portfolio Administration Agreement between Citizens and ProLiance, with modifications to reduce the maximum daily quantity, maximum seasonal quantity and monthly demand cost to reflect the 45,000 Dth per day of Texas Gas capacity that ProLiance would absorb. Ms. Prentice testified this reduction amounts to \$4.4 million in demand cost savings per year to Citizens and its customers. This demand cost savings would not be realized if the pipeline project were to be constructed and owned by Citizens alone. According to Ms. Prentice, the ultimate result of Citizens' sole ownership of a new pipeline connection to MGT would be an increase of \$2.7 million to Citizens' current pipeline demand and variable charges by the pipeline demand charges paid to MGT for the additional pipeline capacity of 45,000 dekatherms per day. Citizens would have to continue to carry the demand charges on both pipelines until the Texas Gas contract expires on October 31, 2008.

As a result of the foregoing, Ms. Prentice concluded that when \$2.1 million in incremental non-gas cost revenue requirements are added to incremental gas cost of \$2.7 million and charged to Citizens' system supply and transportation customers, Citizens' customers would not realize any savings at all from the hypothetical ownership of a 16-inch pipeline and instead would be paying rates higher than current rates. Therefore, in Ms. Prentice's opinion, the Heartland pipeline project as proposed by Citizens and Heartland, is a more prudent and beneficial investment for customers than 100% ownership of the pipeline connection by Citizens.

Ms. Prentice rebutted Mr. Phillips' testimony regarding his concern that regulated revenue would be used to pay for unregulated service provided by affiliates. She noted that Citizens' system supply customers would pay for capacity on Heartland, but that Heartland would be an Indiana public utility regulated by the Commission. Therefore, the GCA charge would include the transportation cost of another regulated entity the same as all other pipeline charges paid by GCA customers. Ms. Prentice also rebutted Mr. Phillips' testimony that Citizens would be transferring control over UGS to ProLiance under the proposed Storage Service Agreement between Citizens because Citizens will continue to maintain complete operation, management and control over the UGS facility.

In response to Mr. Galligan's claim that the market value of Citizens' 2 BCF of secondary storage service can be determined only through competitive bidding, Ms. Prentice indicated Citizens retained Stone & Webster to perform a market valuation study to determine the market value for secondary storage services similar to the secondary storage service provided to Heartland. In Ms. Prentice's opinion, it is not necessary to bid out a service in order to

