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ILLINOIS COMMERCE COMMISSION

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NICOR GAS COMPANY	:	
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Rebuttal Testimony of
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1 **Q. Are you the same Jeff D. Makholm, Ph.D, who presented direct testimony in this**
2 **proceeding?**

3 A. Yes.

4 **Q. What is the purpose of your rebuttal testimony?**

5 A. The purpose of this testimony on behalf of Nicor Gas Company (“Nicor Gas” or the
6 “Company”) is to respond to the direct testimony and exhibits of Illinois Commerce
7 Commission Staff (“Staff”) witness Mr. Michael McNally (ICC Staff Exhibit 5.0)¹
8 and the direct testimony of Citizens Utility Board/Cook County State’s Attorney’s
9 Office (“CUB/CCSAO”) witness Mr. Christopher C. Thomas² on the fair rate of
10 return on common equity for Nicor Gas’s utility operations. In addition, I update the
11 cost of equity evidence provided in my direct testimony and exhibits.

12 **Q. What conclusions do you draw?**

13 A. I conclude the following:

- 14 1. My updated cost of common equity estimate is **10.68 percent**, based on my
15 discounted cash flow (“DCF”) analysis of six comparable gas local distribution
16 companies. My updated capital asset pricing model (“CAPM”) estimate is **10.95**
17 **percent**. Nicor Gas has filed its reply case to request **10.82 percent**, which is
18 midway between my updated DCF and CAPM estimates. Nicor Gas Exhibit 21.1
19 presents the overall cost of capital results.
- 20 2. With reasonable and justified amendments that I recommend for Mr. McNally’s
21 and Mr. Thomas’s analyses, their cost of equity estimates move up to **10.68**
22 percent and **10.36** percent, respectively.
- 23 3. Mr. McNally’s proxy group is a problem. Not only did it begin as less reflective
24 of Nicor Gas’ regulated utility operations than the proxy groups employed by Mr.
25 Thomas and myself, but half the companies contained in it are rapidly
26 diversifying into non-utility businesses. Indeed, four out of the eight companies
27 Mr. McNally employed in his group no longer meet his own criterion for
28 inclusion (*i.e.*, 70 percent of revenues from distribution utility operations).
29 Because of his proxy group’s lack of comparability to Nicor Gas, his 23 basis
30 point final downward adjustment for Nicor Gas is unjustified and unsound.

¹ Direct Testimony of Michael McNally, Docket No. 04-0779, ICC Staff Exhibit 5.0.

² Direct Testimony of Christopher C. Thomas, Docket No. 04-0779, CUB-CCSAO Exhibit 1.0.

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- 31 4. Short-term debt is not a source of permanent capital and should not be included in
32 Nicor Gas's capital structure.
- 33 5. Mr. McNally's cost of equity and overall cost of capital recommendations are
34 markedly lower than any return on common equity that has been allowed by other
35 state regulatory commissions for the past two years and should cause the
36 Commission to be dubious about the overall reasonableness of his results.
- 37 6. The key requirement for the success of the regulation of any investor-owned
38 utility is to assure that the company in question maintains its financial integrity so
39 that the utility is able to continue to fund its operations and serve the public. I
40 conclude that the overall return recommended by Mr. McNally, both because of
41 his recommendations on equity costs and short term debt, would weaken Nicor
42 Gas' currently favorable position in the market for capital.
- 43 7. Economic regulation is not a zero-sum game. Both ratepayers and investors
44 benefit from fair regulation. Material change in the regulatory compact could
45 adversely affect utility customers in Illinois. The public would not be well
46 served—either in the quality of services they receive or in the prices for those
47 services—without consistency and predictability in regulation. Such consistency
48 is not apparent in Mr. McNally's recommendation.

49 **Q. How do you organize your rebuttal testimony?**

50 A. In **Section I**, I update my discounted cash flow (DCF) cost of equity evidence as well
51 as the Capital Asset Pricing Model (CAPM) analysis that I use as a check on my DCF
52 results. I perform my update using stock prices dated February 7, 2005, which is the
53 same stock price date used by Staff witness Mr. McNally.

54 In **Section II**, I examine the testimony of Staff witness Mr. McNally and
55 CUB/CCSAO witness Mr. Thomas. **Section II** has five parts:

- 56 • First, I critique Mr. McNally's proxy group selection as well as his *ad hoc* 23
57 basis point adjustment to his proxy group results.
- 58 • Second, I critique Mr. McNally's and Mr. Thomas's cost of equity calculations,
59 and I respond to their criticisms of my own. I provide tables showing the sources
60 of the differences between Mr. McNally's and Mr. Thomas's recommendations
61 and my own cost of equity analysis.
- 62 • Third, I address the exclusion of selling and issuance costs by both Mr. McNally
63 and Mr. Thomas.

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64 • Fourth, I comment on Mr. McNally’s “regression beta” calculation in his CAPM
65 analysis.

66 • Fifth, I show that Mr. McNally’s and Mr. Thomas’s cost of equity
67 recommendations are low relative to the allowed returns granted by regulators in
68 other jurisdictions, and markedly so in Mr. McNally’s case.

69 In **Section III**, I examine the short-term debt recommendation of Mr. McNally and
70 the hypothetical capital structure recommendation of Mr. Thomas. I explain that Mr.
71 McNally’s short-term debt recommendation is unreasonable because it fails to
72 recognize that short-term debt is not a source of permanent capital and would punish
73 Nicor Gas for its beneficial ability to store gas during the summer for use during the
74 winter. I show as fleetingly rare the instances where short-term debt is included in
75 local distribution gas companies’ capital structures in the US. Mr. McNally’s
76 proposal is not well grounded in financial theory and is inconsistent with past
77 Commission decisions for gas distributors in Illinois. I recommend that it not be
78 adopted.

79 I recommend, as well, that Mr. Thomas’s proposed hypothetical capital structure for
80 Nicor Gas not be adopted. Nicor Gas’ equity ratio is within a reasonable range of
81 *S&P*’s benchmarks. There is no good conceptual or practical reason to discard *S&P*’s
82 reasonable range of capital structures and adopt a point estimate that *S&P* itself does
83 not use. Using hypothetical capital structure ratios is an extreme measure to second-
84 guess management decisions on how best to finance its operations to keep costs and
85 rates down. Particularly in light of the success that Nicor Gas has had in keeping its
86 prices the State’s lowest among major gas distributors, such an extreme measure is
87 not warranted here.

88 In **Section IV**, I explain the implications of the Staff’s proposed cost of capital on the
89 Company’s ability to maintain its current level of financial integrity, and the benefits
90 that Nicor Gas’ financial integrity has provided to customers. I explain the financial
91 integrity implications of Mr. McNally’s short-term debt, capital structure, and cost of

92 equity recommendations and Mr. Thomas's hypothetical capital structure and cost of
93 equity recommendations.

94 **I. UPDATED COST OF EQUITY ANALYSIS**

95 **Q. What is the purpose of this section of your testimony?**

96 A. I update my cost of equity calculations. The purpose of this update is two-fold. First,
97 it demonstrates the need to be sensitive to changing equity market conditions—which
98 is particularly important given the length of these rate case proceedings. Second, it
99 underscores what I conclude is the unreasonableness of Mr. McNally's recommended
100 cost of common equity for Nicor Gas' gas distribution operations of 9.54 percent and
101 Mr. Thomas's recommendation of 9.94 percent.

102 **Q. Did you update your comparable group of gas distribution companies?**

103 A. Yes. As shown on Nicor Gas Exhibits 21.1 through 21.11, I updated my proxy group
104 to reflect information that has become available since filing my direct testimony. I
105 use a proxy group of six companies that are comparable in risk to Nicor Gas's
106 regulated distribution operations.

107 In my update, I use the same comparable group criteria as in my direct testimony.
108 Beginning with the companies included in *Value Line's* natural gas distribution
109 industry, my screening criteria are: (1) operating revenues from regulated utility
110 operations of at least 80 percent of total operating revenues; (2) at least eight quarters
111 of stable or increasing dividends; and (3) no current involvement in mergers or
112 acquisitions.

113 This methodology allows me to screen the universe of market-traded gas distribution
114 utilities and eliminate companies with a large percentage of revenues from non-utility
115 operations (*e.g.*, Laclede Group, People's Energy, or South Jersey Industries),
116 company's that have cut or eliminated their dividend (*e.g.*, SEMCO Energy and
117 Southern Union), or are currently involved in merger activity. In this way, I screen
118 out companies whose equity securities are not representative of those of a gas

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119 distribution utility like Nicor Gas. Mr. McNally, on the other hand, has included
120 companies that have greater proportions of non-utility activities, making his proxy
121 group less reflective of Nicor Gas' regulated gas operations in Illinois, and has
122 compounded the problem by then penalizing Nicor Gas by 23 basis points because it
123 is less risky than that group.

124 **Q. Please describe the results of your updated calculations.**

125 A. I updated my data using the same stock price date, February 7, 2005, as Mr. McNally
126 to ensure that my other calculations are strictly comparable to his. I determined a
127 DCF cost of equity for the comparable group of 10.68 percent, as shown in Nicor Gas
128 Exhibit 21.9, which contrasts to the 9.14 percent calculated by Mr. McNally. My
129 updated proxy group includes the six companies identified in Nicor Gas Exhibit 21.2.
130 Nicor Gas Exhibits 21.3 through 21.9 provide the details of my DCF analysis using
131 my comparable group.

132 Nicor Gas Exhibits 21.10 and 21.11 provide the details of my updated CAPM
133 analysis. Using a forward-looking return for the market, similar to the approach used
134 by Mr. McNally, produces a CAPM cost of equity result of **10.95 percent**.

135 **II. REBUTTAL TO MICHAEL MCNALLY AND CHRISTOPHER C.**
136 **THOMAS**

137
138 **Q. How do you structure this portion of your testimony?**

139 A. My testimony in this section is divided into four parts.

140 1. I deal with two basic problems that have to do with the comparable group used by
141 Mr. McNally to calculate his cost of equity estimate and then subsequently adjust
142 it downward subjectively by 23 basis points.

143 2. I discuss specific issues related to Mr. McNally's and Mr. Thomas's cost of
144 equity calculations. As part of this discussion, I explain that Mr. McNally and/or
145 Mr. Thomas mistakenly critiqued my DCF methodology, including criticisms of
146 my use of *Value Line* data. I quantify what Mr. McNally's and Mr. Thomas's
147 DCF cost of equity estimates would have been if they had avoided these problems
148 with their DCF analyses.

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149 3. I discuss Mr. McNally's CAPM analysis. I generally accept his methodology and
150 explain what the result would be if I were to modify his "regression beta"
151 analysis.

152 4. Third, I discuss Mr. McNally's and Mr. Thomas's objections to adjustments for
153 issuance costs.

154 I finish the section by comparing these witnesses' recommendations to those costs of
155 equity awarded by other regulators. One has merely to examine the actual equity
156 costs awarded by regulatory commissions to other gas utilities around the country to
157 support the reasonableness of Nicor Gas' requested return on common equity. While
158 my return on common equity recommendation is squarely within the range of allowed
159 returns, Mr. McNally's recommendation is well outside that range.

160 **A. Comparable Group Issues**

161 **Q. How does Mr. McNally's group differ from your comparable group?**

162 A. Mr. McNally and I agree that Cascade Natural Gas, Nicor Inc., Northwest Natural
163 Gas, and Piedmont Natural Gas, should be included in the comparable group used to
164 set Nicor Gas's cost of equity. We disagree with respect to the use of AGL
165 Resources, KeySpan, Laclede Group, Peoples Energy, South Jersey Industries, and
166 Southwest Gas.

167 **Q. Why did you exclude AGL Resources, Laclede Group, Peoples Energy, and**
168 **South Jersey Industries from your comparable group?**

169 A. Each of these companies receives a large proportion of their revenues from non-utility
170 sources, which makes their comparability to a natural gas distributor like Nicor Gas
171 reasonably suspect. While these company's had gas utility revenues that were more
172 than 70 percent of total revenues in 2003, an examination of these companies' 10-K's
173 for 2004 shows that each of these companies now fail to meet Mr. McNally's 70
174 percent criteria.

- 175 • AGL Resources had 95 percent of revenues from utility sources in 2003, which
176 fell to 61 percent in 2004.

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- 177 • Laclede Group had 74 percent of revenues from utility sources in 2003, but this
178 proportion fell to 69 percent in 2004.
- 179 • Peoples Energy had 71 percent of revenues from utility sources in 2003, which
180 fell to 66 percent in 2004.
- 181 • South Jersey Industries had 74 percent of revenues from gas utility operations in
182 2003, but that fell to 61 percent in 2004.

183 Thus, when Mr. McNally's own criteria are updated to reflect 2004 financial results,
184 these companies would drop from his proxy group. These are relatively highly
185 diversified firms, with business risks that are likely different from those faced by a
186 regulated natural gas distributors.

187 **Q. Why did you include KeySpan Corp. and Southwest Gas in your comparable**
188 **group?**

189 A. Each of these firms meets my first comparable group criteria, which requires that
190 each company have revenues from utility operations that is greater than 80 percent of
191 the firm's total revenues. Nor should these companies be excluded based on my other
192 comparable group selection criteria.

193 KeySpan, a natural gas distributor, followed by *Value Line* in its Natural Gas
194 (Distrib.) industry group, is the largest gas distributor in the Northeast, serving most
195 of New York City and Long Island as well as Boston, Massachusetts and parts of
196 New Hampshire. While KeySpan also has electric services operations in New York,
197 about 66 percent of its total revenues are from its natural gas distribution operations,
198 while about 26 percent comes from electric services. About 92 percent of its total
199 revenues come from regulated sources. KeySpan is thus comparable to Nicor Gas
200 and should be included in the comparable group used to calculate Nicor Gas's cost of
201 equity capital.

202 Southwest Gas is a natural gas distributor also, followed by *Value Line* in its Natural
203 Gas (Distrib.) industry, and derives 85 percent of revenues from utility sources.
204 Further, Southwest Gas is labeled by *S&P* with an SIC code 4924 and thus should

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205 meet the criteria for inclusion in *S&P Utility Compustat*. While Southwest Gas was
206 (apparently) not included in *S&P Utility Compustat*, it should qualify for inclusion in
207 Mr. McNally's comparable group for the reasons stated above.

208 **Q. What do you conclude regarding Mr. McNally's proxy group?**

209 A. Mr. McNally's proxy group is not representative of the risk of Nicor Gas' gas utility
210 operations, as half of the companies in his group—four of eight—have too great a
211 share of non-utility operations, particularly for the latest information available. That
212 is, from 2003 to 2004, the average percent of regulated revenue for those four moved
213 from 78.5 percent down to 64.3 percent.

214 Compared to a proxy group comprising gas utilities that remain highly focused on
215 regulated activities (such as the groups used by Mr. Thomas and myself), I cannot
216 conclude that Mr. McNally's proxy group is sound.

217 **Q. If Mr. McNally and you had used the same peer group, what would his DCF cost
218 of equity estimate have been?**

219 A. He would have produced a DCF cost of equity estimate of 9.23 percent and his
220 overall cost of equity recommendation would be 9.54 percent. When I add back the
221 23 basis point comparable group penalty, the overall cost of equity recommendation
222 is 9.81 percent. This would be the case if all of his other data sources and
223 assumptions remained the same but for his proxy group.

224 **Q. Did Mr. McNally adjust his recommendation for Nicor Gas on the basis of his
225 proxy group—the one you say is unrepresentative of Nicor Gas?**

226 A. Yes. Mr. McNally made a 23 basis point downward adjustment to his recommended
227 cost of equity for Nicor Gas on the basis of his premise that Nicor Gas' equity is less
228 risky than that of his proxy group as signaled by two things: (1) *S&P* bond rating
229 differences; and (2) *S&P* "business profile" scores for Nicor Gas versus his proxy
230 group.

231 **Q. Is that a problem?**

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232 A. Yes, it is a problem. From the perspective of trying to gauge investors' opinions on
233 the cost of equity for gas utilities objectively, Mr. McNally pulled his adjustment out
234 of the air—a characterization that I do not think is unfair. I say this for the following
235 reasons:

- 236 • *S&P* credit ratings do not pertain to equity risks or equity costs.
- 237 • The differences between Nicor Gas' and his proxy group's *S&P* "business
238 profile" score rests solely on the high scores that *S&P* ascribes to the diversified
239 companies—companies that have no business forming part of a gas distribution
240 proxy group. *Without these diversified companies, the S&P median score for his*
241 *group is identical to Nicor Gas—that is, 2.0.* Thus, if Mr. McNally drops the
242 Companies that no longer meet his own criterion (*i.e.*, 70 percent of revenues
243 from gas utility operations), he loses one leg upon which his 23 basis point
244 adjustment stands.
- 245 • Regarding the remaining leg for that adjustment, Mr. McNally uses average credit
246 rating differences—which have no conceptual read-across to any possible equity
247 risk difference.
- 248 • Ultimately, Mr. McNally makes no allowance for reasonable ranges when
249 assessing risk, as *S&P* always does. That is, *S&P* concedes, but Mr. McNally
250 does not, that a diversity of financial ratios can be consistent with similar risk
251 profiles and credit ratings.

252 Contrary to the care that is generally taken with the theory and application of DCF
253 and CAPM analyses in rate cases, Mr. McNally has taken no care with his 23 basis
254 point adjustment. He simply found a convenient adjustment without any conceptual
255 foundation. Indeed, his premise regarding "business profile" differences is shaky in
256 the extreme—resting on a proxy group that no longer satisfies his stated criteria. As
257 such, his adjustment goes beyond subjectivity to unsupported speculation. He simply
258 has shown nothing to demonstrate that equity markets agree with him regarding the
259 relative risk of Nicor Gas.

260 **Q. Please explain, from a conceptual standpoint, the problems with an adjustment**
261 **based on the difference between the average interest rates of AA rated and an A**
262 **rated utility bond, as Mr. McNally has done.**

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263 A. The basic problem is that equity risk and debt risk—and the costs investors require to
264 bear those risks—are different things. The problem is not that it is an “apples-to-
265 oranges” comparison. It is more like a “fruits-to-vegetables” comparison. Equity and
266 debt are very different financial securities—the difference between the bond yield of
267 AA and A rated bonds has nothing to do with differences in equity risk of comparing
268 a proxy group to a single firm.

269 In particular, common equity investors are entitled to the residual value of the firm
270 after owners of senior securities and other creditors and lenders have been paid.
271 Bond holders, in contrast, have a written contract that provides for a fixed schedule of
272 principal and interest payments (as well as particular procedures to take over a
273 company if those payments are not forthcoming). Debt holders—whether they own
274 AA rated bonds or A rated bonds—have a high degree of certainty that they will be
275 repaid in a timely manner. The differential between bond yields of AA and A rated
276 utility bonds cannot provide a credible indication of the difference between the cost
277 of equity of Nicor Gas and the proxy group. Mr. McNally’s *ad hoc* adjustment of 23
278 basis points is simply his unsupported, speculative adjustment with no credible basis
279 from the standpoint of financial theory or practice.

280 **B. Specific Issues on Cost of Equity Calculations**

281 **Q. What issues will you address here?**

282 A. I will deal with the following issues in Mr. McNally’s analysis of the cost of equity
283 capital:

- 284 1. Mr. McNally tied himself to a single growth rate source, avoiding perhaps the
285 most popular and credible source of all—*The Value Line Investment Survey*.
- 286 2. Mr. McNally’s criticism of my sustainable growth rate reflects: (a) his
287 misunderstanding of the nature of my calculations; and (b) his unsupported notion
288 about how companies sell new stock.
- 289 3. Mr. McNally introduces a second, subjective, growth rate into his DCF analysis
290 by selecting, by hand, the “next” dividend payment for his proxy group
291 companies before allowing his other growth rate to take over.

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292 4. Mr. McNally fails to account for issuance costs. Based on his own criteria, the
293 Company has shown that it has never received cost recovery of its prudently-
294 incurred selling and issuance costs, and therefore issuance costs should be
295 recovered as part of the cost of equity capital.

296 5. He has not calculated his regression CAPM beta according to his description.

297 I comment on the following shortcomings in Mr. Thomas's analysis of the cost of
298 equity capital:

299 1. He uses out-of-date stock prices in his DCF analysis.

300 2. He declines to use a quarterly DCF model, even though it has been a well-known
301 and expected feature of Illinois utility regulation for more than 20 years.

302 3. He fails to account for issuance costs.

303 I deal with Mr. McNally's and Mr. Thomas's serially, beginning with DCF dividend
304 yield and growth rate issues, then CAPM issues, and, finally, selling and issuance
305 cost issues.

306 I summarize at the end of this sub-section the effect of these specific issues on Mr.
307 McNally's and Mr. Thomas's calculations.

308 **1. Mr. McNally Ties Himself to Only a Single Source for Growth Rates**

309 **Q. Mr. McNally uses only Zacks and fails to use *Value Line* as a source of growth
310 rate data. Is this appropriate?**

311 A. No. He uses only a single source for his growth rate, rather than a diversity of
312 credible sources and credible approaches. In particular, he omits the use of what is
313 probably the most widely used and highly regarded source of the financial data that is
314 used in utility rate cases—*The Value Line Investment Survey*. *Value Line* data are
315 unique in that *Value Line* is not affiliated with any bank, broker, or insurance
316 company.”³ In light of the widespread use of *Value Line* among investors and its

³ Jennifer Francis, Qui Chen, Donna R. Philbrick, and Richard H. Willis, *Security Analyst Independence* (Charlottesville, VA: Research Foundation of CFA Institute, 2004), p. 22.

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317 subscription-driven independence, it should be included along with other sources to
318 reflect what investors think

319 If Mr. McNally had properly relied upon disinterested financial analysis produced by
320 *Value Line* when developing his growth rates, Mr. McNally's cost of equity
321 recommendation for the gas group would have been 54 basis points higher.

322 **Q. Please elaborate on the usefulness of *Value Line* in cost of capital cases.**

323 A. *Value Line* is a highly useful provider of financial information. First, *Value Line* is
324 the mostly widely subscribed service of its type. Second, *Value Line* sells not stock
325 but analysis of stocks. It is an independent, well-regarded and much-used resource,
326 gauging by its wide circulation.⁴ The Research Foundation of CFA Institute explains
327 that:

328 The corporations whose stocks are covered compensate neither Value Line
329 nor the individual analysts following the company. All Value Line
330 revenues come from fees collected from subscribers. As a result of this
331 independence, any bias in Value Line analyst forecasts cannot be
332 attributed to analyst desires to attract revenue-generating business in the
333 form of investment banking fees or brokerage commissions.⁵

334 *Value Line's* estimates of growth area good gauge of investor's expectations. A study
335 by Brown and Rozeff shows that *Value Line* analysts make better forecasts than could
336 be obtained by employing historical data only.⁶ *Value Line* may indeed help to shape
337 investor expectations.

338 In addition, the Research Foundation of CFA Institute explains (p. 23) that "[a]nother
339 unique and desirable feature of *Value Line* data is the breadth of forecasts reported.

⁴ *Value Line* points out, in a letter to potential subscribers, that "Value line is not in the retail brokerage business. *Value Line* does not accept advertising. Value Line does not receive any financial compensation when you make an investment. Which is why we can guarantee the analysis you're reading is free of bias—and completely independent of the companies we're writing about." *Value Line Investment Survey*, undated letter, p. 1.

⁵ Francis, et al., *supra* note 3, p. 22.

⁶ L.D. Brown and M.S. Rozeff, "The Superiority of Analyst Forecasts As Measures of Expectations: Evidence From Earnings," *Journal of Finance*, 33, 1 (March 1978), 1-16.

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340 When a *Value Line* analyst updates coverage of a given stock, the analyst provides
341 annual estimates of many different measures, including sales, operating margins, net
342 profit margin, tax rates, cash flows, capital investments, earnings, and dividends.”⁷
343 This breadth of forecasts allows independent experts to use *Value Line* data in a
344 number of theoretically sound ways.

345 While I agree that Zacks is a reputable firm that collects the growth rate estimates of
346 financial estimates and publishes consensus growth rate information, I disagree with
347 Mr. McNally’s reliance on only one source of growth rate data. Widely distributed
348 forecasts—such as Zacks’ consensus five-year growth rate estimates—influence both
349 the current stock price and DCF cost of equity. But other equally valid measures of
350 growth rates exist, such as those that can be constructed using *Value Line* data.

351 **Q. Is Mr. McNally’s reliance on a single growth rate a weakness in his analysis?**

352 A. Yes, it is a weakness. Failing to use another widely-reputed source like *Value Line*
353 prevents Mr. McNally from checking and tempering the results of his single growth
354 rate source. There are not many sources of the critical growth rate forecasts—a
355 credible analysis should use all the credible sources available.

356 **2. Sustainable Growth Rate Issues**

357 **Q. Mr. McNally discusses your sustainable growth rate on pages 33 to 35 of his**
358 **testimony, claiming that you mismatched data from different time periods and**
359 **created a meaningless entanglement in your result. Is that correct?**

360 A. No. Reading those pages, I think that Mr. McNally mis-read my calculations and my
361 exhibit, for I did not mismatch data as he contends. Let me explain.

362 The sustainable growth rate (*i.e.*, the BR + SV growth rate) should be implemented
363 with financial ratios expected to prevail in the future, as is well known and widely

⁷ Francis, et al., *supra* note 3, p. 23.

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364 agreed.⁸ My sustainable growth rate is indeed based solely on *Value Line* projected
365 data (for 2007-2009) for the return on common equity, estimated dividend per share
366 and estimated book value per share, as shown on Nicor Gas Exhibits 4.10 and 21.5. I
367 used no current data for those basic inputs.

368 I do, however, use a *factor* to transform the end-of-year 2007-2009 projected book
369 values from *Value Line* to an average mid-year book value, which I label as R_{av} . I
370 create that factor—which was 1.0189, or 1.89 percent, for the group average in my
371 direct testimony—by reference to the rate of growth of the latest two observed end-
372 of-year book values for the proxy group companies. My purpose in Exhibit 4.10 is to
373 express the projected return on a mid-year book value—to be slightly higher (by an
374 average factor of 1.89 percent for this proxy group) than the value stated on year-end
375 book values in *Value Line*. Standard financial analysis practice directs the use an
376 average measure of common equity. Thus, Davidson *et. al* explain that “[b]ecause
377 the earnings rate *during the year* is being computed, the measure of investment
378 should reflect the average amount of assets [or equity capital] in use during the
379 year.”⁹

380 **Q. So you’re saying that Mr. McNally’s criticism of your mixing of current and**
381 **projected data in your sustainable growth rate is a misunderstanding only?**

382 A. Yes. While I have expressed my methodology in the exhibits accompanying my
383 sustainable growth rate calculations in the same way for over a decade, and in many
384 different rate cases, I do want to be clear. I think in the future I’ll add a few words of
385 explanation in the footnotes on my future “Exhibit 4.10s” to avoid such a
386 misunderstanding.

387 **Q. Mr. McNally also says that another part of your sustainable growth rate is**
388 **“likely overstated.” Is that correct?**

⁸ For example, see Morin, R. A., *Utilities’ Cost of Capital*, Public Utilities Reports, Inc., Arlington, VA (1984), page 136.

⁹ See: S. Davidson, C.P. Stickney, and Roman Weil, *Financial Accounting*, 4th (Chicago: Dryden Press, 1985), pp. 238-239.

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389 A. It is not. The issue revolves around whether the component of the growth rates of the
390 proxy group companies might be lower if future shares are issued at less than the
391 market price (bringing in less money to fuel future growth). Mr. McNally offers no
392 evidence that those companies would issue future shares for less, and I know of none.
393 I think it is eminently reasonable to assume that those companies will issue new
394 equity securities for prices prevailing in the market. The assumption is neither
395 “questionable” nor “upwardly-biased” as he claims on page 36 of his testimony.

396 **3. Mr. McNally Erroneously Criticizes my *Value Line* EPS Growth Rate**
397 **Analysis**

398 **Q. Please respond to Mr. McNally’s comments on your *Value Line* EPS growth rate**
399 **methodology.**

400 A. Mr. McNally claims (p. 36) that my five-year *Value Line* EPS growth rate is “flawed.”
401 But, five-year growth rate forecasts are the industry norm and I make my calculation
402 with data that is ideally suited for that purpose. Further, my approach is preferable to
403 the published *Value Line* five-year EPS growth rate, which uses a three year average
404 as the base period that introduces out-of-date data into the calculation.

405 Mr. McNally uses five year growth rate data from Zacks but seems surprised to
406 discover that a five year *Value Line* EPS growth rate is used—but five years is the
407 industry norm that *Value Line* builds its projections from. Mr. McNally’s discussion
408 merely confuses the issues.

409 **4. Mr. McNally’s Introduction of a Second, Subjective Growth Rate and**
410 **Problems With Mr. Thomas’s Dividend Yield Calculation**

411 **Q. Do you have concerns about Mr. McNally’s dividend yield calculation in his**
412 **DCF analysis?**

413 A. Yes. Mr. McNally does not consistently use his single Zacks growth rate estimate
414 when he adjusts the current dividend to reflect expected dividend growth. That is to

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415 say, the equation he lists on line 319 of his testimony has a single growth rate, g , but
416 the way that Mr. McNally has performed his analysis introduces a second.

417 **Q. Please explain.**

418 A. The correct way to calculate the expected dividend payment (D_1) when the quarterly
419 DCF model he shows is to observe the previous four quarterly dividend payments and
420 multiply those figures by 1 plus the growth rate (*i.e.*, $D_1 = D_0(1+g)$) for each of the
421 four quarters.

422 **Q. How does Mr. McNally calculate the expected dividend (D_1) for his dividend
423 yield calculation?**

424 A. He observes (see McNally Dir., Staff Ex. 5.0, page 18) that utilities generally increase
425 their dividend once a year, if at all. He assumes that the utility will follow that same
426 pattern, if it changed its dividend during the previous year. If not, he assumes that the
427 dividend would change in the next quarter. He says that the average expected growth
428 rate was applied to the current dividend rate to estimate the expected dividend rate,
429 except, if the next dividend had already been declared, the declared dividend value is
430 entered. His approach produces a downward bias to the current dividend yield and
431 the DCF calculation—not a large bias, but a bias nonetheless.

432 **Q. Please explain the bias.**

433 A. The downward bias follows from not increasing the current quarterly dividend of all
434 of the companies by $(1 + g)$, with g being his single Zacks growth rate. Mr. McNally
435 uses a subjective “pick-and-choose” approach that responds to short-term phenomena,
436 without acknowledging that his method builds this subjectivity into an infinite-
437 horizon DCF model. He uses a growth rate in his dividend yield calculation that is
438 different from his Zacks growth rate, even though he professes (page 16) to be using a
439 “constant-growth DCF model.” If Mr. McNally had used the standard DCF
440 methodology, his DCF cost of equity recommendation would be three basis points
441 higher.

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442 **Q. Does Mr. McNally acknowledge this downward bias?**

443 A. No. The regulatory process can be made less contentious if there is agreement on the
444 proper basic DCF model. Getting the smaller details right when implementing the
445 DCF model will make the regulator's cost of capital determination more credible.

446 **Q. Do you have concerns about Mr. Thomas's dividend yield calculation in his DCF**
447 **analysis?**

448 A. Yes. First, while the actual effect of Mr. Thomas's use of out-of-date stock prices is
449 minor in this particular instance, I am very concerned about applying the cost of
450 capital estimation methods that I use in a consistent manner. Mr. Thomas uses out-
451 of-date stock prices that do not match his growth rates. Using stock prices for the
452 period November 1, 2004 to January 31, 2005 is not consistent with the basic tenets
453 of the efficient market hypothesis. Yesterday's prices are useless as a gauge to
454 investors' current expectations. With regard to investor expectations, the informative
455 value of yesterday's stock prices will be completely superseded by today's stock
456 prices. There is no reason to average in older data. Moreover, with regard to the
457 stock price, for example, analysts could use selective stock price averaging to
458 surreptitiously raise or lower a calculated result.

459 Second, Mr. Thomas does not use a quarterly DCF model even though the use of a
460 quarterly DCF model has been a consistent feature of Illinois regulation for more than
461 20 years.

462 **Q. What is the effect of not using the quarterly DCF model?**

463 A. Failure to use a quarterly DCF model lowers his recommendation by proper measure
464 of the expected dividend lowers Mr. Thomas's recommendation by 15 basis points.

465 **C. Inconsistencies in Calculating CAPM**

466 **Q. Do you disagree with any aspects of Mr. McNally's CAPM analysis?**

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467 A. My primary area of disagreement is with the calculation of Mr. McNally's regression
468 beta. Nicor Gas Exhibits 21.10 and 21.11 provide the details of my updated CAPM
469 analysis. Using a forward-looking return for the market, similar to the approach used
470 by Mr. McNally, produces a CAPM cost of equity result of 10.95 percent.

471 **Q. Please explain your concerns about Mr. McNally's regression beta analysis.**

472 A. I have two concerns. First, Mr. McNally's "regression beta" results are not readily
473 *visible* to the market so, unlike *Value Line's* published beta, they are unlikely to be
474 factored into investor expectations.

475 Second, Mr. McNally's discussion (p. 27) of his regression beta methodology does
476 not explain his use and quantification of Treasury Bill returns (which he apparently
477 calculates as absolute values). Using Mr. McNally's stock returns and his market
478 returns in a standard regression analysis, without the Treasury Bill returns, produces
479 an adjusted regression beta of 0.69, which would increase his overall CAPM
480 recommendation of 10.39 percent to 10.66 percent.

481 Third, using weekly returns rather than monthly returns in his regression beta would
482 further increase his recommended CAPM result.

483 **Q. Please explain why weekly returns might be preferable to monthly returns in a**
484 **CAPM analysis.**

485 A. While *Value Line* uses 259 weeks of weekly stock market returns, Mr. McNally uses
486 60 monthly observations of stock market returns. The use of monthly stock prices to
487 calculate returns may capture less of the correlation between the gas utility share
488 price movement and the market.

489 **Q. Please provide your overall evaluation of the CAPM.**

490 A. Mr. McNally criticizes (pp. 41-42) me incorrectly for arguing that CAPM provides no
491 measure of central tendency.¹⁰ Aside from that, Mr. McNally's use of his regression

¹⁰ I limited my comments on measures of central tendency to those elements common to all CAPM calculations for any company—the risk free rate. See line 720 of my direct testimony.

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492 beta in his CAPM analysis demonstrates what mischief may—intentionally or
493 unintentionally—pervade CAPM analyses in utility rate cases. There remain
494 questions regarding the CAPM that nobody has answered well in over 20 years of its
495 attempted application in utility rate cases; these questions heavily influence the
496 result.¹¹ Diana Harrington discusses the problems associated with changing some of
497 the parameters used in calculating betas using historical data.¹² Leaving witnesses
498 wide latitude to provide inputs into CAPM analyses merely invites an irresolvable
499 dispute over arcane data sources and methods of data manipulation.

500 **Q. Should the Commission rely on Mr. McNally’s regression beta results?**

501 A. No. The Commission should rely on the *Value Line* betas—those seen by thousands
502 of subscribing investors—and discard the Mr. McNally’s own, non-standard
503 regression beta calculations.

504 **D. Issuance Costs**

505 **Q. Does Mr. McNally’s make an adjustment to his DCF results to deal with**
506 **issuance costs?**

507 A. No. He ignores issuance costs, referring to a “policy” of the Commission that has not
508 compensated for such costs. He explains (p. 40) that selling and issuance costs are to
509 be allowed only if the utility can verify both that it has incurred the specific amount
510 of flotation costs for which it seeks compensation and that those costs have not been
511 previously recovered through rates.

¹¹ For a survey of the theoretical and practical problems associated with the CAPM, see John Y. Campbell, “Asset Pricing at the Millennium,” *The Journal of Finance*, Vol. LV, No. 4, August 2000, pp. 1515-1567.

¹² Harrington notes that “[t]he choice of each input [used to calculate beta] changes the output, and the size of the difference is enough to cause concern. How should betas be measured, using history? The disconcerting answer is that we do not know.” Diana R. Harrington, *Modern Portfolio Theory, The Capital Asset Pricing Model And Arbitrage Pricing Theory: A User’s Guide*, 2nd ed. (Englewood Cliffs, NJ: Prentice-Hall, 1987, p. 118.

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512 The Company has not recovered the selling and issuance costs associated with its
513 common equity issuances.¹³

514 **Q. Are Mr. McNally's reasons for avoiding the adjustment in this case valid?**

515 A. They are not. He gives five reasons, which I repeat below:

516 1. "the Company has failed to demonstrate that the proceeds raised through the
517 Nicor, Inc. common stock issuances were used for the benefit of Nicor Gas'
518 utility operations." (page 40, lines 805-808).

519 2. "Nicor Gas has provided no documentation that verifies the "Estimated
520 Company's Expenses" shown on Exhibit 4.13 for which it seeks compensation."
521 (page 406, lines 808-810)

522 3. The Commission has repeatedly rejected the use of generalized flotation cost
523 adjustments in previous cases as an inappropriate basis for raising utility rates.
524 (pages 40-41, lines 810-812)

525 4. The Company has provided no documentation to support its claim that it has not
526 previously recovered its flotation costs through rates. (page 41, lines 815-819)

527 5. The Company has provided no documentation that it has issued any new equity
528 since the last rate case, for which new issuance costs would have been incurred.

529 **Q. Are these valid reasons to avoid providing for the selling and issuance expense?**

530 A. No, they are not. Common stock selling and issuance expenses are the equity analog
531 to the same expenses that are uncontroversial elements of rate cases in the case of
532 bonds. When viewed with that analog in mind, Mr. McNally's objections to the use
533 of a selling and issuance expense adjustment in this case are illogical.

534 Mr. McNally's concerns about Nicor Gas's documentation with respect to its selling
535 and issuance costs are addressed in Nicor Gas Company Exhibit 20.0, which is the
536 panel testimony of Nicor Gas witnesses Mr. Richard L. Hawley and Mr. Robert R.
537 Mudra. This panel testimony establishes that there is sufficient record evidence for
538 the Commission to allow an adjustment for selling and issuance costs.

¹³ See NICOR Gas Witness R. Hawley/R. Mudra, Exhibit 20.0.

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539 Because of issuance costs, the net proceeds of common equity issuance will always
540 be less than the total purchase price of the securities issued. Unless an adjustment is
541 made to reflect this phenomenon in the fair rate of return—an adjustment consistent
542 with the issuance cost adjustment already made for debt and preferred stock—the
543 resulting fair rate of return calculations will be too low.

544 **Q. Please explain how Mr. McNally ignores issuance expenses that have never been**
545 **expensed or collected in rates.**

546 A. Traditional practice in many states is to include a return element for selling and
547 issuance expenses, just like a return component is included for such expenses with
548 debt. The only difference between the traditional treatment for debt and equity is that
549 the debt selling and issuance expense *principal* would be amortized to be collected
550 over the term of the debt issue. Since equity has no “term,” as such, there was no
551 amortization of the principal—only an equity rate of return component to reflect a
552 holding charge.

553 Mr. McNally points to a Commission Order from Commonwealth Edison Company
554 (Docket No. 94-0065) that states “The Commission has traditionally approved
555 [flotation cost] adjustments only when the utility anticipates it will issue stock in the
556 test year or when it has been demonstrated that costs incurred prior to the test year
557 have not been recovered previously through rates.”¹⁴ Mr. McNally ignores the fact
558 that Nicor Gas’s selling and issuance costs have not been recovered through rates.

559 **Q. Did you change the methodology that you used to calculate the appropriate**
560 **increment for issuance costs?**

561 A. Yes. In my updated testimony, I now rely solely on Company-specific data, which
562 moots Mr. McNally’s concern about the use of a “generalized” adjustment for selling
563 and issuance costs. This is shown in Nicor Gas Exhibit 21.8.

¹⁴ Order, Docket No. 94-0065, pp. 93-94 as quoted in Direct Testimony of Mr. Michael McNally, Docket No. 04-0779, p. 40.

564 **Q. What does Mr. Thomas say regarding using a selling and issuance cost**
 565 **adjustment in this case?**

566 A. Mr. Thomas opposes (page 16) recovery of selling and issuance on the grounds that
 567 Nicor Gas has no plans to issue additional common equity during the period that the
 568 rates will be in effect. This argument is simply not relevant. Just as in the normal
 569 issuance expense adjustments for debt, the expense pertains to the capital already
 570 raised—not capital that is yet to be issued.

571 **E. Reasonable and Justifiable Amendments to Mr. McNally’s and Mr.**
 572 **Thomas’s DCF Calculations**

573 **1. When Mr. McNally’s DCF Errors Are Corrected, The Result Is An 10.68**
 574 **Percent Cost Of Common Equity Estimate**

575 **Q. Have you quantified the effect of these various problems with Mr. McNally’s**
 576 **estimate of Nicor Gas’s cost of common equity?**

577 A. Yes, I have. **Table 1** shows that correcting these various problems Mr. McNally’s
 578 changes his cost of equity estimate to 10.68 percent rather than the 9.14 percent DCF
 579 cost of common equity that he supports.

580 **Table 1: Corrections to Mr. McNally’s DCF Model**

	Comparable Group ROE		
	McNally's Original Sample	Take Out: AGL Resources, Laclede, South Jersey, Peoples Gas	Add Back: KeySpan and Southwest Gas
	(percent)	(percent)	(percent)
Original	9.14	9.40	9.23
D ₀ to D ₁	9.17	9.40	9.23
Include All Three Growth Rates	9.70	10.47	10.56
Both D ₀ to D ₁ and All Three Growth	9.71	10.47	10.56
With S&I Adjustment	9.83	10.59	10.68

581

582 **2. When Mr. Thomas's DCF Errors Are Corrected, The Result Is An 10.36**
583 **Percent Cost Of Common Equity Estimate**

584 **Q. Have you quantified the effect of these various problems with Mr. Thomas's**
585 **estimate of Nicor Gas's cost of common equity?**

586 A. Yes, I have. **Table 2** shows that correcting these various problems Mr. Thomas's
587 changes his cost of equity estimate to **10.36** percent rather than the 9.14 percent DCF
588 cost of common equity that he supports.

589 **Table 2: Corrections to Mr. Thomas's DCF Model**

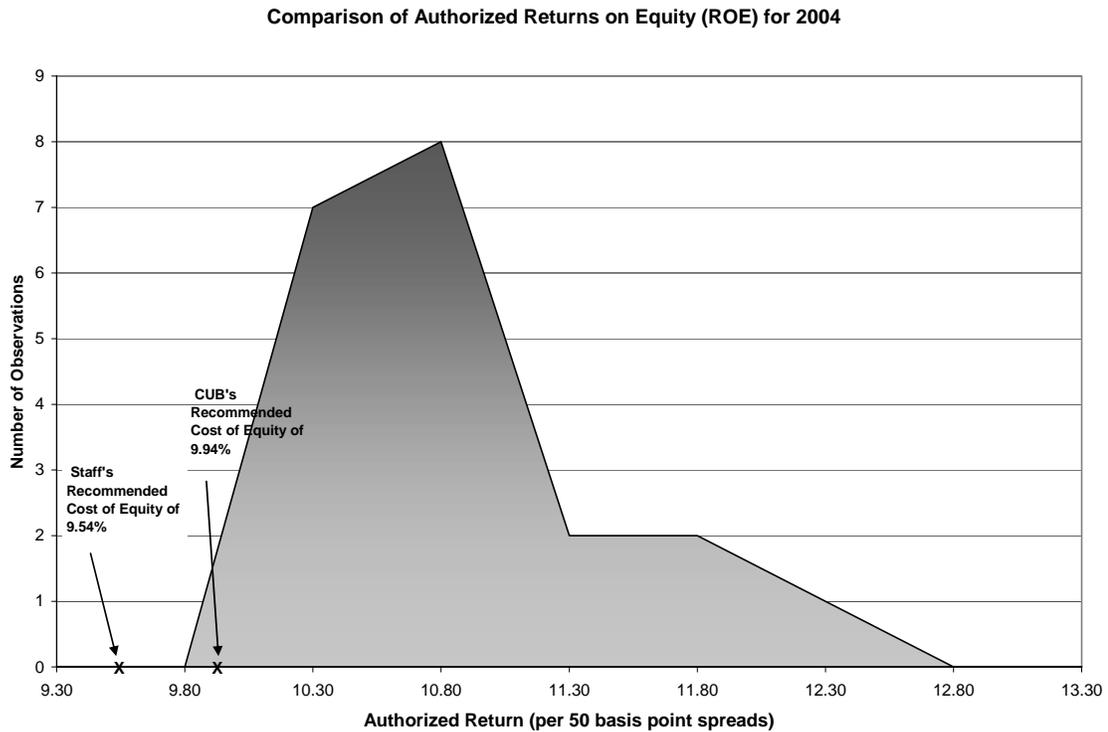
	ROE
Original	9.94%
Failure to Use Quarterly Model	10.09%
5-Year Value Line Growth rate	10.09%
Actual Stock Price Close Instead of 3-month Average	9.92%
BR+SV (Makhholm)	9.99%
Combined Changes	10.24%
+ Including Selling & Issuance Costs	10.36%
CUB's ROE with all Recommended Changes	10.36%

591 **F. Allowed Returns for Other Gas Distributors**

592 **Q. Do you have any data on the allowed ROE granted by other commissions for**
593 **2004?**

594 A. Yes. Consider the following illustration of awarded returns for 2004:

Figure 1. Commission Awarded Rates of Return on Equity for Gas Utilities in 2004



595 There are 20 decisions for gas distribution utilities listed by Regulatory Research
596 Associates for 2004, with a return on equity ranging from approximately 9.90 percent
597 to about 12.00 percent. My previous recommended return was **11.22 percent** and
598 Nicor Gas is now requesting an allowed ROE of **10.82 percent**. The average allowed
599 by other regulatory commissions in the U.S. for 2004 was 10.59 percent. Not a single
600 award was as low as the 9.54 percent return on equity recommendation offered by
601 Mr. McNally.

602 Given this evidence from around the country, I find the term “over-estimate” an
603 inappropriate characterization of my recommendation, as on all 20 occasions during
604 2004, commissions have awarded gas companies more than I recommended in my
605 original testimony for Nicor Gas and my updated recommendation remains within the
606 range of returns granted by other commissions in 2004.

607 **Q. Are you suggesting that the Commission in Illinois use other commissions’**
608 **awarded returns as an input into its own deliberations for Nicor Gas?**

609 A. No. I include this chart not to provide direct support for my own evidence, but rather
610 to show that Mr. McNally’s general opinion about the size of my recommendation is
611 groundless. Mr. McNally may think that my recommendation is grossly inflated
612 compared with *his own recommendation*, but the institutions that ultimately judge the
613 reasonableness of commission awarded returns—the capital markets—would make
614 no such conclusion when my recommendation (as opposed to Mr. McNally’s) falls
615 within the range of allowed returns that they have seen emanating from other
616 jurisdictions.

617 **III. SHORT-TERM DEBT, CAPITAL STRUCTURE, CAPITAL**
618 **ATTRACTION, AND FINANCIAL INTEGRITY**

619 **A. Inclusion of Short Term Debt is the exception, not the rule**

620 **Q. Is short-term debt normally included in a utility’s capital structure for**
621 **ratemaking purposes?**

622 A. No. For example, *The Process of Ratemaking* by Leonard Saul Goodman states that
623 “[i]nclusion of short-term debt in the capital structure is the exception, rather than the
624 rule.” [footnotes omitted]¹⁵ Goodman goes on to explain that the Connecticut
625 Commission applied the rule “that a tenet of sound financial management generally
626 prefers that long-term assets be matched to long-term liabilities.”¹⁶ The general rule
627 is to include only permanent sources of capital in the capital structure.

628 **B. Standard Ratemaking Practice is to Use the Company’s Actual Capital**
629 **Structure**

630 **Q. Do you agree with Mr. Thomas’s proposed capital structure for the Company?**

¹⁵ Leonard Saul Goodman, *The Process of Ratemaking, Volume I* (Vienna, VA: PUR, 1998), p. 603.

¹⁶ *Id.* See also: Re Southern New England Tel. Co., 124 PUR4th 304, 355-56 (Conn. DPUC, 1991).

631 A. No, I do not. Mr. Thomas's capital structure proposals suffer from three serious
632 defects. First, Mr. Thomas fails to recognize that Nicor Gas has reasonably managed
633 its capital structure and the projected actual capital structure should be used for
634 ratemaking purposes. Bonbright notes that "the use of a hypothetical or 'typical'
635 capitalization substitutes an estimate of what the capital cost would be under
636 nonexisting conditions for what it actually is or will soon be under prevailing
637 conditions."¹⁷ Absent a finding of imprudence in its financial management, the
638 Company's projected actual capital structure should be used.

639 Second, Mr. Thomas goes to the middle of the *S&P* range, when the high end of that
640 range is within the zone of reasonableness, even under his method, and therefore
641 should be used. The equity ratio for Nicor Gas' regulated gas utility operations is
642 within a reasonable range of comparable gas distribution equity ratios and *S&P*'s
643 benchmarks. There is no good conceptual or practical reason to discard *S&P*'s
644 reasonable range of capital structures for that ratio and adopt a point estimate, that
645 *S&P*'s itself does not use. Using hypothetical capital structure ratios is an extreme
646 measure to second-guess management decisions on how best to finance its operations
647 to keep costs and rates down. Within a relatively wide zone of reasonableness,
648 differences in capital structures are more than reasonable.

649 Third, Mr. Thomas fails to recognize that if a lower equity ratio is used, the cost of
650 debt and cost of equity would be expected to increase slightly, which would offset
651 some or all of the lower overall cost of capital, from using a more leveraged capital
652 structure. The effect could be more pronounced if Nicor Gas were to lose its AA
653 bond rating subsequent to a Commission decision in this rate case.

654 **C. The "Capital Attraction" Function of Regulated Prices**

655 **Q. What are the key requirement(s) for the success of regulation of investor-owned**
656 **utilities?**

¹⁷ Bonbright, J.C., *Principles of Public Utility Rates*, Columbia University Press, New York (1961), pp. 243-244.

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657 A. The key requirement for the success of the regulation of any investor-owned utility is
658 to assure that the company in question maintains its financial integrity so as to be able
659 to continue to fund its operations and serve the public.

660 **1. Attracting Capital in the Market**

661 **Q. What role does attracting capital play for investor owned utilities?**

662 A. Capital attraction determines the basic constraint that investor ownership places on the
663 level of regulated charges. Professor James C. Bonbright, a widely referenced expert
664 on the principles of public utility prices, describes what he called the “capital
665 attraction function” for investor-owned public utilities as follows:

666 [Capital attraction] is one of the most prominent and most widely
667 recognized functions of public utility rates. Public utility companies are
668 permitted to impose charges for their services largely in order to induce
669 and enable them to supply these services and to make provision for their
670 continuation and for their required expansion. If denied the opportunity to
671 levy compensatory charges, they could not long continue operation in the
672 absence of tax-financed subsidies.

673 ...Rates below this level are deemed deficient because, at least in the long
674 run, they will not enable the company to live up to its obligations to serve
675 the community.¹⁸

676 Professor Roger Morin echoes the importance of capital attraction more recently:

677 It must be understood that both capital attraction and financial integrity
678 standards must be fulfilled in determining a fair rate of return. Despite a
679 deterioration in credit standing, a utility may be able to attract capital
680 temporarily, but at prohibitive costs and under unfavorable terms.
681 Eventually, the utility will face hard funds rationing and/or the costs of
682 financing will become prohibitive, and the utility can not longer attract
683 capital at a reasonable price.¹⁹

¹⁸ *Id.*, pp. 49-50.

¹⁹ Morin, R.A., *Regulatory Finance: Utilities' Cost of Capital*, Public Utilities Reports, Inc., Arlington, Virginia (1994), page 12.

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684 Further, Professor Bonbright states that the capital attraction function for utility
685 ratemaking has always been a key concern for regulators as well as regulated
686 companies.

687 ... In public utility cases in which the general *level* of rates (as distinct
688 from the rate *structure*) is at issue, the capital-attraction standards of
689 reasonable rates tends to be accepted by [regulatory] commissions as the
690 primary basis for their decisions. Even the representatives of the public
691 utility companies will usually base their requests for a rate increase or
692 their opposition to a rate decrease on the ground of a need for credit-
693 sustaining revenue.

694 **2. Capital Attraction Is Not an “Academic” Exercise**

695 **Q. Would violating the *regulatory compact* by adopting extreme ratemaking**
696 **adjustments harm ratepayers?**

697 A. Yes. The *regulatory compact* exists to allow economical capital raising by utilities by
698 giving investors the assurance that as long as the utility acts prudently and serves the
699 public well, their investments will be repaid. As such, a violation of the *regulatory*
700 *compact* would harm customers either by driving up the utility’s costs of securing
701 investment funds or, ultimately, in driving away investors and preventing utilities
702 from having the ability to render uninterrupted service.

703 **Q. Is this a relevant question for Nicor Gas?**

704 A. Yes. Nicor Gas requires investment funds to pay for capital expenditures in utility
705 plant. These capital expenditures are needed for Nicor Gas to continue to provide
706 safe, adequate and reliable service for its customers.

707 **Q. What capital did Nicor Gas raise in recent years?**

708 A. Nicor Gas has raised new capital and/or refinanced in recent years. Without viable
709 and sustained access to the capital markets, Nicor Gas’s customer’s ability to invest in
710 utility plant might have been compromised. At the very least, the capital costs for
711 obtaining those funds for its public service investments would have been considerably
712 greater.

713 **IV. FINANCIAL INTEGRITY IMPLICATIONS OF Mr. McNally's**
714 **RECOMMENDATIONS**

715 **Q. Would Mr. McNally's recommendation, if adopted by the Commission, result in**
716 **a weakened financial picture for Nicor Gas and a possible downgrading of the**
717 **company's debt securities?**

718 A. Yes, it may. As reflected in the rebuttal panel testimony of Mr. Hawley and Mr.
719 Mudra (Nicor Gas Company Exhibit 20.0, pp. 9-10), adopting Mr. McNally's short-
720 term debt recommendation and/or Mr. Thomas hypothetical capital structure
721 recommendation would "place further downward pressure on Nicor Gas' ability to
722 maintain its AA rating and in fact could jeopardize the rating." It does not appear that
723 Mr. McNally and Mr. Thomas have considered the consequences of their
724 recommendations on Nicor Gas's ability to raise debt capital at as low a cost as
725 possible.

726 **Q. Would a downgrading of Nicor Gas's debt raise the company's cost of capital**
727 **generally?**

728 A. Yes. Total risk for a company, which drives its cost of capital, is the sum of business
729 risk and financial risk. It is important to heed the warning signals that suggest that
730 particular ratemaking recommendations could be insufficient to allow Nicor Gas to
731 maintain its current credit ratings.

732 Among other things, utilities that have had their credit ratings lowered have lost the
733 ability to issue commercial paper and/or to draw on bank lines. If this occurred,
734 Nicor Gas's could lose access to a low cost source of debt.

735 **Q. Does this conclude your rebuttal testimony?**

736 A. Yes.