# REBUTTAL TESTIMONY

of

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Finance Department
Financial Analysis Division
Illinois Commerce Commission

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

Proposed general increase in rates for gas service

Docket Nos. 07-0241 and 07-0242
(Consolidated)

August 21, 2007

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## Witness Identification

**Q. Please state your name and business address.**

A. My name is Janis Freetly. My business address is 527 East Capitol Avenue, Springfield, Illinois 62701.

**Q. Are you the same Janis Freetly who previously testified in this proceeding?**

A. Yes, I am.

**Q. What is the purpose of your rebuttal testimony in this proceeding?**

A. The purpose of my rebuttal testimony is to respond to the Rebuttal testimony of Bradley A. Johnson. (North Shore/Peoples Gas Ex. BAJ-2.0) I will also present Staff's revised overall cost of capital and recommend a fair rate of return on rate base for North Shore Gas Company ("North Shore") and The Peoples Gas Light and Coke Company ("Peoples Gas") (individually, the "Company" and collectively, the "Companies"). The overall cost of capital that I recommend for each Company incorporates the rate of return on common equity recommended in the direct testimony of Staff witness Sheena Kight-Garlisch (ICC Staff Exhibit 6.0).

**Q. Please explain the N and P suffixes that appear in your schedule numbers.**

A. Schedules with the suffix "N" relate to North Shore and schedules with the suffix "P" relate to Peoples Gas.

## Cost of Long-term Debt

**Q. Do North Shore and Peoples Gas agree that the cost of long-term debt needs to be adjusted to reflect the stand-alone financial strength of the utility Companies?**

A. Yes, the Companies agree that it is reasonable to adjust the cost of long-term debt to reflect their stand alone financial strength to the extent that it differs from the financial strength of Integrys Energy Group, Inc. North Shore and Peoples Gas further agree that although the adjustments are small in this case, it is important to reflect the Companies' stand alone financial strength in their rates. However, the Companies believe that Staff's adjustments to the costs of long-term debt are excessive, and propose taking only half of the adjustment that I proposed in my direct testimony.[1]

**Q. Why does the cost of capital need to reflect the stand-alone financial strength of the utility Companies?**

A. Section 9-230 of the Public Utilities Act ("Act") indicates that the Commission shall not reflect in a utility's cost of capital any increased risk associated with its affiliation with unregulated or non-utility companies. Since the credit ratings of the Companies were downgraded as a result of their affiliation with unregulated

[1] Rebuttal Testimony of Bradley A. Johnson, North Shore/Peoples Gas Ex. BAJ-2.0.

companies, the costs associated with those lower credit ratings cannot be reflected in the Companies' rates.[2]

Standard & Poor's ("S&P") downgraded the Companies' credit ratings three ratings notches, from AA- to A-, in September 2002. In my direct testimony, I reduced the cost of long term debt for North Shore and Peoples Gas for the bond series that were issued after that downgrade. I based that adjustment on the spread between long-term utility bonds rated Aa and those rated A. Moody's Investors Service ("Moody's") downgraded North Shore and Peoples Gas in September 2002 one ratings notch from Aa2 to Aa3.[3] Hence, at the time the long-term debt was issued by the Companies, the Companies were rated A- from S&P and Aa3 by Moody's.

**Q. Do you agree with the Companies argument that the split ratings should be taken into account when adjusting the cost of long-term debt to reflect the stand alone financial strength of the North Shore and Peoples Gas?**

A. Yes, I agree that the split rating should be reflected in the adjustment to the cost of long-term debt to reflect the stand alone financial strength of the Companies. However, the approach taken by the Companies assumes that no downgrade from Moody's occurred and therefore does not technically comport with the requirements of Section 9-230 of the Act. Although the Companies remained in the Aa range following the downgrade by Moody's, even the effect on the cost of

[2] Standard & Poor's Ratings Direct – Research, North Shore Gas' Ratings Lowered; Outlook Stable, September 26, 2002; Peoples Gas Light & Coke's Ratings Cut; Outlook Stable, September 26, 2002.

[3] Moody's Investors Service, Rating Action: Peoples Energy Corporation, September 23, 2002.

debt of a one notch credit rating downgrade needs to be examined to ensure that not one iota of incremental risk is included in the cost of capital for setting rates in this proceeding.

**Q. Did you determine the effect of the Moody's downgrade on the Companies' cost of debt?**

A. Yes. The utility bond yield spreads that I calculated to estimate the effect of the credit ratings downgrade equal the difference between the average yield on bonds in the Moody's Aa range, which comprises Moody's Aa1, Aa2 and Aa3 ratings and the average yield on bonds in the Moody's A range, which comprises Moody's A1, A2 and A3 ratings. Moody's Aa range is equivalent to S&P's AA range, which comprises S&P's AA+, AA and AA- credit ratings, while Moody's A range is equivalent to S&P's A range, which comprises S&P's A+, A and A- credit ratings. Table 1 shows the Moody's credit ratings and the S&P equivalents.

**Table 1**

| S&P/Moody's | Credit Ratings | |
|---|---|---|
| Range | S&P | Moody's |
| AA/Aa | AA+ | Aa1 |
| | AA | Aa2 |
| | AA- | Aa3 |
| A/A | A+ | A1 |
| | A | A2 |
| | A- | A3 |

As can be seen in Table 1, the downgrade by S&P in September 2002 was three notches, from AA- to A-, while the downgrade from Moody's was one notch, from

Aa2 to Aa3. Hence, on average, the credit rating was downgraded two notches. The spread between yields on bonds in the Aa and A ranges is equivalent to a three notch difference since it most closely reflects the midpoint of the ranges, or the spread between Aa2 and A2. Therefore, I took two-thirds of my original adjustment to reflect the average downgrade of two notches. Specifically, I reduced my original adjustment of the interest rates on the Series N-2 for North Shore and the Series MM-2 and NN-2 for Peoples Gas, as well as the adjustment to the insurance premiums on the tax exempt bond series of Peoples Gas (Series KK, LL, OO, PP, QQ and RR), to reflect only two-thirds of the spread between utility bonds rated Aa and A that I used in my direct testimony.

**Q. How does your proposal to reflect two-thirds of your original adjustment compare to the Companies' proposal to reflect one-half of your original adjustment based on the spread between utility bonds rated Aa and A?**

A. My approach using two-thirds of the Aa-A debt yield spread resulted in an embedded cost of debt of 5.38% for North Shore and 4.66% for Peoples. In comparison, using one-half of the Aa-A debt yield spread, the Company estimated the embedded cost of debt equals 5.39% for North Shore and 4.67% for Peoples. I believe that my approach better comports to the requirements of Section 9-230 of the Act since both of the downgrades are factored in. However, since the Companies' approach to use one-half of the original adjustment results in the same <u>weighted</u> costs of debt of 2.37% for North Shore and 2.05% for Peoples Gas, the adjustments proposed by the Companies are sufficient to remove the incremental cost of capital associated with the credit ratings downgrade due to the Companies' affiliation with nonregulated companies. Although I do not agree with the Companies' approach, I will not contest the Companies' proposed adjustments in this proceeding since they result in the same weighted costs of debt as my adjustments.[4]

**Q. What is North Shore's embedded cost of long-term debt?**

A. Since there was no difference in the weighted cost of debt, I will accept the Company's adjustment, which results in an interest rate of 4.58% for North Shore's Series N-2 bonds, as shown on Schedule 17.2N. The resulting embedded cost of long-term debt for September 30, 2006 equals 5.39% for North Shore, as shown on Schedule 17.1.

**Q. What is Peoples Gas' embedded cost of long-term debt?**

A. Since there was no difference in the weighted cost of debt when taking two-thirds or one-half of my original adjustments to the Series NN-2 and MM-2 bonds and the insurance premiums paid on the tax exempt bonds, I will accept the Company's adjustment, which results in an interest rate of 3.93% for the Series MM-2 bonds and 4.58% for the Series NN-2 bonds, as shown on Schedule 17.2N. These interest rate adjustments, along with the adjustments to the insurance premiums on the tax exempt bonds, result in an embedded cost of

[4] It is my understanding that the Companies' proposed adjustment, which effectively ignored Moody's September 2002 credit rating downgrade, would not comport with Section 9-230 of the Act if it had produced a weighted cost of debt that was as little as one basis point higher than an adjustment that incorporated the Moody's September 2002 credit rating downgrade,

long-term debt for September 30, 2006 equal to 4.67% for Peoples Gas, as shown on Schedule 17.1.

## Rate of Return on Rate Base

**Q. What is your recommended rate of return on rate base for North Shore?**

A. I recommend a 7.69% rate of return on North Shore's rate base. This rate of return incorporates the 9.50% rate of return Staff witness Sheena Kight-Garlisch recommends for North Shore's common equity. The rate of return I recommend on North Shore's rate base is shown on Schedule 17.1.

**Q. What is your recommended rate of return on rate base for Peoples Gas?**

A. I recommend a 7.48% rate of return on Peoples Gas' rate base. This rate of return incorporates the 9.70% rate of return Staff witness Sheena Kight-Garlisch recommends for Peoples Gas' common equity. The rate of return I recommend on Peoples Gas' rate base is shown on Schedule 17.1.

**Q. Does this conclude your direct testimony?**

A. Yes, it does.

# Weighted Average Cost of Capital

## North Shore Gas Company

| | Percent of Total Capital | Cost | Weighted Cost |
|---|---|---|---|
| Long-term Debt | 44.00% | 5.39% | 2.37% |
| Common Equity | 56.00% | 9.50% | 5.32% |
| Total Capital | 100.00% | | |
| **Weighted Average Cost of Capital** | | | **7.69%** |

## The Peoples Gas Light and Coke Company

| | Percent of Total Capital | Cost | Weighted Cost |
|---|---|---|---|
| Long-term Debt | 44.00% | 4.67% | 2.05% |
| Common Equity | 56.00% | 9.70% | 5.43% |
| Total Capital | 100.00% | | |
| **Weighted Average Cost of Capital** | | | **7.48%** |

**North Shore Gas Company**

Embedded Cost of Long-Term Debt
September 30, 2006

| Line No. | Debt Issue Type, Coupon Rate | | | Date Issued | Maturity Date | Date Reacquired | Principal Amount | Face Amount Outstanding | Unamortized Discount or (Premium) | Unamortized Debt Expense (Gain) | Carrying Value | Annual Coupon Interest | Annualized Amort. of Discount or (Premium) | Annualized Amort. of Debt Expense | Annualized Interest Expense |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | [A] | | | [B] | [C] | [D] | [E] | [F] | [G] | [H] | [I]=[F-G-H] | [J]=[A*F] | [K] | [L] | [M]=[J+K+L] |
| 1 | First Mortgage Bonds: | | | | | | | | | | | | | | |
| 2 | Series M | 5.00% | (1) | 12/18/98 | 12/01/28 | | $ 30,035,000 | $ 29,250,000 | $ - | $ 1,046,000 | $ 28,204,000 | $ 1,463,000 | $ - | $ 47,000 | $ 1,510,000 |
| 3 | Series N-2 | 4.58% | | 04/29/03 | 05/01/13 | | 40,000,000 | 40,000,000 | 21,000 | 528,000 | 39,451,000 | $ 1,833,000 | 3,000 | $ 80,000 | 1,916,000 |
| 4 | Sub-Total | | | | | | 70,035,000 | 69,250,000 | 21,000 | 1,574,000 | 67,655,000 | 3,296,000 | 3,000 | 127,000 | 3,426,000 |
| 5 | Loss on Reacquired Debt | | | | | | | | | | | | | | |
| 6 | Series J | 8% | | 11/01/90 | 11/01/20 | 12/05/02 | - | - | - | 760,000 | (760,000) | - | - | 54,000 | 54,000 |
| 7 | Series K | 6-3/8 | (1) | 10/01/92 | 12/01/28 | 01/19/99 | - | - | - | 1,265,000 | (1,265,000) | - | - | 57,000 | 57,000 |
| 8 | Series M | 5.00 | (1) | 12/18/98 | 12/01/28 | Various | - | - | - | 14,000 | (14,000) | - | - | 1,000 | 1,000 |
| 9 | Sub-Total | | | | | | - | - | - | 2,039,000 | (2,039,000) | - | - | 112,000 | 112,000 |
| 10 | Total | | | | | | $ 70,035,000 | $ 69,250,000 | $ 21,000 | $ 3,613,000 | $ 65,616,000 | $ 3,296,000 | $ 3,000 | $ 239,000 | $ 3,538,000 |
| 11 | Embedded Cost of Long-Term Debt (M / I) | | | | | | | | | | | | | | 5.39% |

Note: (1) Tax-exempt bonds.

The Peoples Gas Light and Coke Company

Embedded Cost of Long-Term Debt
September 30, 2006

| Line No. | Debt Issue Type, Coupon Rate | | | | Date Issued | Maturity Date | Date Reacquired | Principal Amount | Face Amount Outstanding | Unamortized Discount or (Premium) | Unamortized Debt Expense (Gain) | Carrying Value | Annual Coupon Interest | Annualized Amort. Of Discount or (Premium) | Annualized Amort. Of Debt Expense | Annualized Interest Expense |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | [A] | | | | [B] | [C] | [D] | [E] | [F] | [G] | [H] | [I]=[F-G-H] | [J]=[A*F] | [K] | [L] | [M]=[J+K+L] |
| 1 | First and Refunding Mortgage Bonds: | | | | | | | | | | | | | | | |
| 2 | Series HH | 4.75% | (1) | | 03/01/00 | 03/01/30 | - | $ 50,000,000 | $ 50,000,000 | $ - | $ 1,676,000 | $ 48,324,000 | $ 2,375,000 | $ - | $ 72,000 | $ 2,447,000 |
| 3 | Series KK | 5.00% | (1) | | 02/06/03 | 02/01/33 | - | 50,000,000 | 50,000,000 | 605,000 | 1,443,000 | 47,952,000 | 2,500,000 | 23,000 | $ 55,000 | 2,578,000 |
| 4 | Series LL | 3.05% | (1) | | 02/20/03 | 02/01/33 | - | 50,000,000 | 50,000,000 | - | 731,000 | 49,269,000 | 1,525,000 | - | $ 28,000 | 1,553,000 |
| 5 | Series MM-2 | 3.93% | | | 02/27/03 | 03/01/10 | - | 50,000,000 | 50,000,000 | 167,000 | 291,000 | 49,542,000 | 1,966,250 | 49,000 | $ 85,000 | 2,100,250 |
| 6 | Series NN-2 | 4.58% | | | 04/29/03 | 05/01/13 | - | 75,000,000 | 75,000,000 | 40,000 | 997,000 | 73,963,000 | 3,437,000 | 6,000 | $ 151,000 | 3,594,000 |
| 7 | Series OO | 3.70% | (1) | (2) | 10/09/03 | 10/01/37 | - | 51,000,000 | 51,000,000 | - | 882,000 | 50,118,000 | 1,887,000 | - | $ 28,000 | 1,915,000 |
| 8 | Series PP | 3.66% | (1) | (2) | 10/09/03 | 10/01/37 | - | 51,000,000 | 51,000,000 | - | 867,000 | 50,133,000 | 1,867,000 | - | $ 28,000 | 1,895,000 |
| 9 | Series QQ | 4.88% | (1) | | 11/25/03 | 11/01/38 | - | 75,000,000 | 75,000,000 | - | 1,551,000 | 73,449,000 | 3,656,000 | - | $ 48,000 | 3,704,000 |
| 10 | Series RR | 4.30% | (1) | | 06/01/05 | 06/01/35 | - | 50,000,000 | 50,000,000 | - | 906,000 | 49,094,000 | 2,150,000 | - | $ 32,000 | 2,182,000 |
| 11 | Sub-Total | | | | | | | $ 502,000,000 | $ 502,000,000 | $ 812,000 | $ 9,344,000 | $ 491,844,000 | $ 21,363,250 | $ 78,000 | $ 527,000 | $ 21,968,250 |
| 12 | Loss on Reacquired Debt | | | | | | | | | | | | | | | |
| 13 | Series X | 6.88% | (1) | | 03/01/85 | 02/01/33 | 03/14/03 | - | - | - | 1,527,000 | (1,527,000) | - | - | 58,000 | 58,000 |
| 14 | Series Y | 7.50% | (1) | | 03/01/85 | 02/01/33 | 04/03/00 | - | - | - | 692,000 | (692,000) | - | - | 26,000 | 26,000 |
| 15 | Series Z | 7.50% | (1) | | 03/01/85 | 03/01/15 | 04/03/00 | - | - | - | 554,000 | (554,000) | - | - | 66,000 | 66,000 |
| 16 | Series AA | 10.25% | (1) | | 03/01/85 | 06/01/35 | 08/01/95 | - | - | - | 1,481,000 | (1,481,000) | - | - | 52,000 | 52,000 |
| 17 | Series BB | 8.10% | (1) | | 05/01/90 | 10/01/37 | 05/01/00 | - | - | - | 706,000 | (706,000) | - | - | 23,000 | 23,000 |
| 18 | Series DD | 5.75% | (1) | | 12/01/93 | 11/01/38 | 12/01/03 | - | - | - | 2,239,000 | (2,239,000) | - | - | 70,000 | 70,000 |
| 19 | Series EE | Variable Rate | (1) | | 12/01/93 | 10/01/37 | 10/14/03 | - | - | - | 232,000 | (232,000) | - | - | 7,000 | 7,000 |
| 20 | Series FF | 6.10% | (1) | | 06/01/95 | 06/01/35 | 06/02/05 | - | - | - | 1,426,000 | (1,426,000) | - | - | 50,000 | 50,000 |
| 21 | Series GG | Variable Rate | (1) | | 03/01/00 | 02/01/33 | 03/27/03 | - | - | - | 1,305,000 | (1,305,000) | - | - | 50,000 | 50,000 |
| 22 | Series II | Variable Rate | (1) | | 03/01/00 | 10/01/37 | 11/12/03 | - | - | - | 797,000 | (797,000) | - | - | 26,000 | 26,000 |
| 23 | Series JJ | Variable Rate | (1) | | 03/01/00 | 10/01/37 | 10/14/03 | - | - | - | 797,000 | (797,000) | - | - | 26,000 | 26,000 |
| 24 | Sub-Total | | | | | | | $ - | $ - | $ - | $ 11,756,000 | $ (11,756,000) | $ - | $ - | $ 454,000 | $ 454,000 |
| 25 | Total | | | | | | | $ 502,000,000 | $ 502,000,000 | $ 812,000 | $ 21,100,000 | $ 480,088,000 | $ 21,363,250 | $ 78,000 | $ 981,000 | $ 22,422,250 |
| 26 | Embedded Cost of Long-Term Debt (M / I) | | | | | | | | | | | | | | | 4.67% |

Notes: (1) Tax-exempt bonds.
(2) Based on auction rate in effect at April 25, 2007.