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Consulting Economists

Nicor Gas Ex. 10.0

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Northern Illinois Gas Company	)	
d/b/a Nicor Gas Company	)	
	)	No. 08-XXXX
Proposed general increase in rates, and	)	
revisions to other terms and conditions	)	
of service	)	

Testimony of

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Senior Vice President
National Economic Research Associates, Inc.

On behalf of
Nicor Gas Company

April 29, 2008

TABLE OF CONTENTS

Page

I. INTRODUCTION

Q. Please state your name, business address and current position.

A. My name is Jeff D. Makholm. I am a Senior Vice President at National Economic Research Associates, Inc. ("NERA"). NERA is a firm of consulting economists with its principal offices in a number of major U.S. and European cities. My business address is 200 Clarendon Street, Boston, Massachusetts, 02116.

Q. Please describe your academic background.

A. I have M.A. and Ph.D. degrees in economics from the University of Wisconsin, Madison, with a major field of Industrial Organization and a minor field of Econometrics/Public Economics. I also have B.A. and M.A. degrees in economics from the University of Wisconsin, Milwaukee. Prior to my latest full-time consulting activities, I was an Adjunct Professor in the Graduate School of Business at Northeastern University in Boston, Massachusetts, teaching courses in microeconomic theory and managerial economics.

Q. Please describe your work experience.

A. My work centers on economic issues involving pricing, regulation and market issues for the natural gas and electricity industries, among others. My consulting work includes the specific issues of competition, rate design, fair rate of return, regulatory rulemaking, incentive ratemaking, load forecasting, least-cost planning, cost measurement, contract obligations and bankruptcy. I have prepared expert testimony and statements, and I have appeared as an expert witness in many state, federal and United States District Court proceedings, as well as in regulatory and judicial hearings abroad.

I have also directed studies on behalf of utility companies, governments and the World Bank in many countries. In these countries, I have drafted regulations, established tariffs, recommended financing options for major capital projects and advised on industry restructurings. I have also assisted in the privatization of state-owned gas utilities. As part of my international work pertaining to the gas industry, I have conducted formal training sessions for government, industry and regulatory personnel on the subjects of privatization, pricing, finance and regulation of the gas industry.

Regarding rate of return and utility financing questions specifically, I have testified for electric, natural gas, water and telecommunications utility clients before state commissions in Illinois, Pennsylvania, Oregon, Ohio, North Carolina, Kansas, New Jersey, New York, Maryland, California, Virginia, Rhode Island, New Hampshire, Texas, Indiana, Maine, and Connecticut, as well as before the Federal Energy Regulatory Commission. My current curriculum vitae, which more fully details my educational and consulting experience, is provided as **Exhibit 10.1**.

Q. Does your testimony in this proceeding determine the fair rate of return on common equity on behalf of Nicor Gas Company ("Nicor Gas" or the "Company")?

A. Yes. This return on common equity will be used by the Company to calculate its revenue requirement for its state-regulated natural gas delivery system.

II. SUMMARY AND BACKGROUND TO THE DETERMINATION OF A FAIR RATE OF RETURN ON EQUITY

Q. Please summarize your conclusions regarding the fair rate of return on common equity for Nicor Gas' natural gas distribution operations.

A. I recommend a fair rate of return on common equity of **11.05 percent**, as summarized on **Exhibit 10.2**. I base my recommendation on results of DCF and CAPM analyses performed on a proxy group of U.S. gas LDC and combination gas and electric utilities that are comparable to Nicor Gas' regulated utility operations.

A. BACKGROUND TO THE DETERMINATION OF THE FAIR RATE OF RETURN ON COMMON EQUITY

Q. What do you mean by "fair rate of return on common equity?"

A. The essence of traditional public utility ratemaking—the "regulatory compact"—has been that utilities like Nicor Gas have been protected by franchise against certain specific and limited types of competition. In return, the utility has accepted the obligation to provide service on just and reasonable terms. The utility has also accepted the duty to reasonably anticipate the future needs of its customers and to make the investments it judges necessary in order to meet those needs as efficiently as possible. Finally, the utility has accepted that prices would be set so as to recoup operating costs plus a reasonable profit. For a public utility, reasonable profit, under the law and in the financial world, has been defined as a rate of return sufficient to attract capital.

The capital attraction—or "opportunity cost"—standard has been key in determining the fair rate of return for public utilities. When investors make their funds available to a utility, they forego the option to use those funds for another purpose

(either current consumption or another investment). They also put their funds at some risk. In return for foregoing current consumption and incurring risk, utility investors require a return on their funds. This return to investors is a cost to the utility—the "*cost of capital*." In order for the utility to compensate its investors adequately for the current consumption foregone and the risk incurred, the utility must be allowed, as a component of its rates for service, a *fair rate of return* that covers its cost of capital.

Q. Does the way you have just defined the concept of fair rate of return on equity comport with its traditional definition?

A. Yes. The United States Supreme Court established the traditional standard for a fair and reasonable return in its *Hope* decision (*Federal Power Commission et al. v. Hope Natural Gas Co.*, 320 U.S. 591 (1944)):

> …the return to the equity owner should be *commensurate with returns on investments in other enterprises having corresponding risks*. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to *maintain its credit and attract capital.*

(Emphasis added.) This often-quoted passage from the *Hope* decision, besides providing a legal standard for determining the fair rate of return, comports precisely with the opportunity cost standard for determining the fair rate of return that covers the utility's cost of capital.

In an earlier case, *Bluefield Waterworks & Improvement Co. v. Public Service Commission of the State of West Virginia et al.*, 262 U.S. 679, 693 (1923), the Supreme Court defined the proper rate of return as follows:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the

> convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties, but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures.

Furthermore, the Supreme Court stated in *Bluefield* that establishing an insufficient return on invested capital denies shareholders the Constitutional right of due process under the Fourteenth Amendment.

> Rates, which are not sufficient to yield a reasonable return on the value of the property used at the time it is being so used to render the service, are unjust, unreasonable, and confiscatory, and their enforcement deprives the public utility company of its property, in violation of the Fourteenth Amendment.

Q. Has the traditional regulatory compact changed over time?

A. The fact that investors still require a return on their invested capital has not changed. However, in this new era, the extent to which utility operations are regulated at all has changed.

Q. Please explain.

A. Over the past 20 years, deregulation has been implemented in many industries throughout the U.S. and in many other countries. The natural gas industry has not been immune to these changes.

In the U.S., many states have considered how their gas industry can be restructured; a number of states have introduced retail choice. In Illinois, industrial and large commercial customers are able to select a gas supplier, with the local distribution companies ("LDC") providing delivery services under transportation-only rates. For Nicor Gas, customer choice has been permanently available to all customers since July

2002, with the incumbent LDC retaining provider-of-last resort ("POLR") responsibility. Illinois law and regulation continues to be consistent with the traditional regulatory compact insofar as it allows Nicor Gas and other gas utilities the opportunity to recover the opportunity cost of the capital devoted to regulated activities.

Q. Does the traditional concept of fair rate of return apply to all of the capital raised by the utility from investors, or just the common equity component?

A. It applies to all of the capital. This includes a company's common stock equity, preferred stock (if any), and debt included in the capital structure.

Q. Why, then, does your testimony deal primarily with the fair rate of return on common equity?

A. My testimony focuses on the common equity return component because, among all of the aforementioned investor-provided capital, for Nicor Gas or any other utility, the cost of common equity capital is the element that is not observed directly.

In the abstract, three elements and three returns comprise the overall cost of capital. Each of these six components is needed to develop the overall fair rate of return for a utility. They are: the proportions of debt, preferred stock, and common equity in the capital structure and the individual fair returns pertaining to each.

One can directly observe the proportions of debt, preferred stock and common stock in the capital structure. One can also directly observe the fair returns on debt and preferred stock. Only the fair rate of return on common equity cannot be directly observed. The individual fair rate of return on common equity must be derived indirectly

with reference to other market indicators. For this reason, I focus on the determination of the fair rate of return on common stock equity only.

Q. How are the individual fair returns or costs of capital pertaining to debt and preferred stock observed directly in a rate case?

A. Fixed payment obligations accompany both debt and preferred stock: interest on the former, preferred dividends on the latter. Calculating the dollars needed to cover interest or preferred stock dividend payments currently or over the period of time in which the rates in question for a utility will be in effect is not difficult. The *embedded* cost of debt and preferred stock proceeds directly from these calculations.

I highlight the word "embedded" because, for debt and preferred stock, all that we need in a base rate case is the embedded cost of these financial instruments (the payments to investors proceeding from existing agreements accompanying the existing bonds and preferred shares). Thus, parties in rate cases seldom significantly disagree over the embedded cost of debt and preferred stock capital. One can compare the promised interest and preferred dividend payments with the company's proceeds from the sale of those securities. The current market is irrelevant for such embedded cost calculations.

Q. Can a current (as opposed to embedded) cost of debt and preferred stock capital be observed in the market?

A. Yes. Since we know the schedule of interest and preferred stock dividends, and since we know the current market price for these financial instruments (a bond or share of preferred stock), we can observe the current (as opposed to embedded) cost of capital for both types of financing. The current cost of debt and preferred stock capital,

reflecting investors' required return, is the discount rate that equates the present value of the known stream of interest (and principal) payments, or preferred dividend payments, with the observed price of those securities.

In other words, a relatively straightforward way to determine the current cost of debt and preferred stock securities is to observe the known market price and the known stream of interest and preferred dividend payments and to calculate the discount rate that equates the two. The derived discount rate is equivalent to the current cost of debt and preferred stock capital.

Q. Can we calculate the current cost of common equity capital in the same way?

A. No. An essential component to that calculation is knowledge of the (fixed) interest and preferred stock dividend payments. Dividend payments on common stock equity are not fixed, nor is their growth rate measured with certainty. They are generally expected to grow as the company in question grows. This growth rate is not observable—the growth rate is embodied in unobservable equity investor expectations regarding the future performance of the company in question. Because this growth rate is not observable, the future stream of dividend payments is not known. There is therefore no known stream of payments that may be used directly to find the discount rate equating the present value of the future stream of dividend payments with the observed common stock price.

Q. How can we estimate the cost of common equity in Nicor Gas' capital structure?

A. One way to estimate the cost of equity capital (generally the most popular method among regulatory commissions) is to determine what stream of common dividends

investors expect. This determination entails observing the current dividend and engaging in the difficult task of estimating what investors expect regarding the growth in that dividend. After the growth expected by investors is estimated, the cost of common equity can be calculated by equating the present value of the estimated stream of dividend payments with the observed common stock price. The calculated cost of capital resulting from this method is entirely dependent on the quality and dependability of the estimates of investor expectations regarding dividend growth. This type of estimation, which I shall later describe in detail as the DCF method, is a method that I use to estimate the fair rate of return for Nicor Gas.

B. ESTIMATING THE COST OF EQUITY CAPITAL

Q. How do you determine the fair rate of return on common equity for Nicor Gas that is consistent with the standards you described and that addresses the difficulties inherent in estimating the cost of equity capital?

A. Estimating the cost of capital involves theoretical and empirical components. I focus on both of these aspects in my cost of capital calculation.

The theoretical component relies on the standard financial literature to develop cost of capital methods that are consistent with what we know and observe about the way that financial markets work. All of the cost of capital models that appear in the financial literature result from theoretical investigations. The most important theoretical consideration when determining the cost of capital for Nicor Gas is to employ a method that provides an accurate reflection of the market for the Company's common stock.

The empirical component includes the collection of the data to be used with the theoretical cost of capital methods. The most important empirical consideration is to gather data that are: (1) consistent with the theoretical models employed; (2) timely; and (3) unbiased. It is also important that the calculations made with the empirical data be reliable and stable. In other words, the resulting cost of capital measure should not be highly sensitive to minor or judgmental changes in the type or source of the data used.

Q. What theoretical methods do you use in your evaluation of Nicor Gas' cost of capital?

A. As I mentioned in the previous section, I employ the DCF and CAPM methods. The DCF method makes use of the relationship between the current stock price and the expected future stream of dividends in order to calculate investors' estimated discount rate, or cost of equity. The DCF method has a long history of being used to derive the cost of equity for both regulatory and market investment purposes. It is a sound, reliable, easy-to-understand and easy-to-reproduce method for determining the fair rate of return. Furthermore, it is unique among rate of return determination methods in that the model's results become stable and reliable when it is applied to a group of similar utilities. I also use the CAPM methodology. The CAPM is the sum of two components: (1) a risk free rate applicable to all companies; and (2) a company specific risk premium (the product of a company-specific beta and a market risk premium). The CAPM is one of the methods used to determine the cost of common equity in Illinois and I use CAPM as one method to set the cost of common equity for Nicor Gas.

III. THE DCF METHOD

A. DESCRIPTION OF THE DCF METHOD

Q. Please describe the DCF method.

A. The DCF method is used to estimate the cost of common stock equity by determining the present value of all future income expected to be received from a share of common stock. As such, the DCF method is the common stock equity analogue to the way in which debt and preferred stock equity cost rates are calculated. With the DCF method, the cost of common stock equity is computed as the discount rate that equates a stock's current observed market value with the present value of all future expected returns from holding the common stock (*i.e.*, dividends and capital gains). The prevailing common stock price is assumed to reflect investors' expectations of the value of common stock, including future dividends and price appreciation.

The DCF methodology grew out of Professor Myron J. Gordon's work on stock valuation models, which was first published in complete form in 1962.[1] I adopt the specification of the DCF model that has been used by Commission Staff in recent Nicor Gas' rate cases.

B. SELECTION OF COMPARABLE COMPANY GROUP

Q. Do you use a comparable group of natural gas distribution utilities to determine the fair return on equity for Nicor Gas?

[1] *See*: Myron J. Gordon, *The Investment, Financing and Valuation of the Corporation* (Homewood, IL: Richard D. Irwin Inc., 1962; reprint, Westport, CT: Greenwood Press, Publishers, 1982).

A. Yes, I do. I use a comparable group that includes eight natural gas LDC and combination gas and electric utilities.

Q. Please explain why comparable groups of companies are useful in this context?

A. When I perform a DCF analysis to determine the fair rate of return on equity, I prefer to use data from multiple firms, even if company-specific data are available. This is because: (1) a group of companies produces a more *reliable* and *objective* estimate of the current cost of capital required by capital markets; (2) the computation of the comparable group's fair rates of return gives substance to the *Hope* decision's finding that a reference should be made to return on *investments with corresponding risks*; and (3) a specific jurisdiction's regulatory process affects investor expectations regarding the company whose fair rate of return is being set. This effect leads to the problem of "*circularity*." Circularity is particularly problematic in states where primary weight is given to the "sustainable dividend growth rate" in determining a company's fair rate of return on equity. This growth rate is a function of the proceeding that supposedly estimates this growth rate. The use of a proxy group will assuage the circularity problem.

Q. Why should circularity be a concern to the regulator?

A. Circular reasoning has long been considered a serious problem in the determination of a fair rate of return for investors. For example, the principle of "fair value" rate regulation (which dominated public utility regulation at both the state and Federal level before the 1940s) gave way to "cost-based" rate regulation in large part because of a problem of circularity. As Professor Bonbright stated: "[a]ny attempt to test the fairness of the rates by reference to a valuation of the properties is an attempt to reason in a

circle, or, if you like, to put the cart before the horse."[2] After all, a valuation of the properties will be based on the present value of the cash flows that the property will provide in the future, which, of course, will depend on the rates that can be charged to customers.

Whenever a commission uses a formula for determining a fair return that depends on investors' expectations of future growth, circularity arises because we know that investors' expectations depend on the return that the regulator is expected to allow. The path of supposed causation proceeds in *both directions simultaneously*, which, of course, is the source of circular reasoning. Another example of the circularity problem in the determination of the fair rate of return is the practice of using other public utilities' returns in a "comparable earnings" analysis. If the past earnings of the comparable group are low, it will likely result in a lower awarded rate of return on equity for the company under consideration. This company will, in turn, become part of another comparable group and will contribute to lower rates of return for other companies, creating a cycle from which it is difficult to escape. By the same token, there is a circularity problem inherent in using a sustainable dividend growth formula for calculating the dividend growth in a DCF analysis when the principal components of that growth (*i.e.*, the expected return and the retention ratio) are a function of the rates to be awarded. This practice is an impediment to the objective and impartial determination of a fair rate of return for a regulated utility.

[2] J.C. Bonbright, *Principles of Public Utility Rates*, (New York: Columbia University Press, 1961), p. 164.

Proxy group DCF calculations are far less likely to depend on the anticipated return granted in this case and, therefore, are far less likely to be susceptible to problems of circularity.

Q. What comparable companies do you employ in your DCF analysis?

A. The eight-company group of comparable companies is listed on **Exhibit 10.3**. **Exhibits 10.4** and **10.5** summarize the screening process that I used to select my comparable group.

Q. What criteria do you use to determine that the companies you choose are comparable to Nicor Gas?

A. I define what I conclude are the minimum number of criteria that satisfy two basic objectives. The first basic objective is to assemble a group of companies with publicly-traded stock that are representative, on average, of the business risk faced by Nicor Gas' natural gas LDC operations. The second basic objective is to assemble a group of companies with stock price and dividend payment data that could be readily applied to the quarterly DCF model I use in this proceeding. I have used this approach to select comparable companies for a number of years, most often for electric utilities.

Q. What criteria satisfy your first basic objective—that of mirroring the business risk faced by Nicor Gas' investors?

A. Nicor Gas operates a natural gas local distribution utility. Nicor, Inc. ("Nicor") is the parent holding company of Nicor Gas. The type of business, in this case a regulated gas distribution utility, helps to define the business risks faced by those who invest in a

natural gas LDC and is recognized by investment analysts as a pertinent factor in evaluating the risk of an equity investment.

I select gas utility companies which are covered by Value Line and derive at least 80 percent of operating revenues from regulated utility operations. The average proportion of total operating revenue from regulated utility operations in 2006 for the proxy group was 90.78 percent. Nicor derived 82.85 percent of its operating revenues from regulated natural gas distribution activities. However, due to the recent trend of mergers and diversification, only four gas LDCs satisfy my traditional criteria.

Q. What criteria satisfy your second basic objective—to assemble a group of companies with stock price and dividend payment data that can be readily applied to the annual DCF model?

A. I establish two additional criteria to ensure that the data collected from the assembled proxy group companies can be used reliably in a DCF analysis. *First,* I restrict the group to utilities for which no explicit concern was raised in my financial data sources regarding the ability of the company to maintain its existing dividend. Because the DCF model I employ assumes a constant long-term dividend growth rate, it is inappropriate to apply the model to companies where a dividend decrease is expected. Such an expectation will affect the price that investors are willing to pay for the stock of such a company, which will render the use of the periodic, single growth rate DCF model suspect.

Second, I exclude from the analysis any companies that are the known targets of possible takeovers or are involved in mergers. Tender offers associated with takeovers

generally affect stock prices in a temporary way unrelated to the overall cost of capital and make the use of those stock prices in a DCF analysis suspect.

Using a proxy group provides a means to estimate the return that investors require for investing in Nicor Gas. Those proxy groups must be selected in a way that ensures that the companies in the proxy groups are comparable in terms of risk to Nicor Gas and have stock price and dividend payment data that meet the requirements of the standard DCF model.

Q. What is the result of applying your criteria?

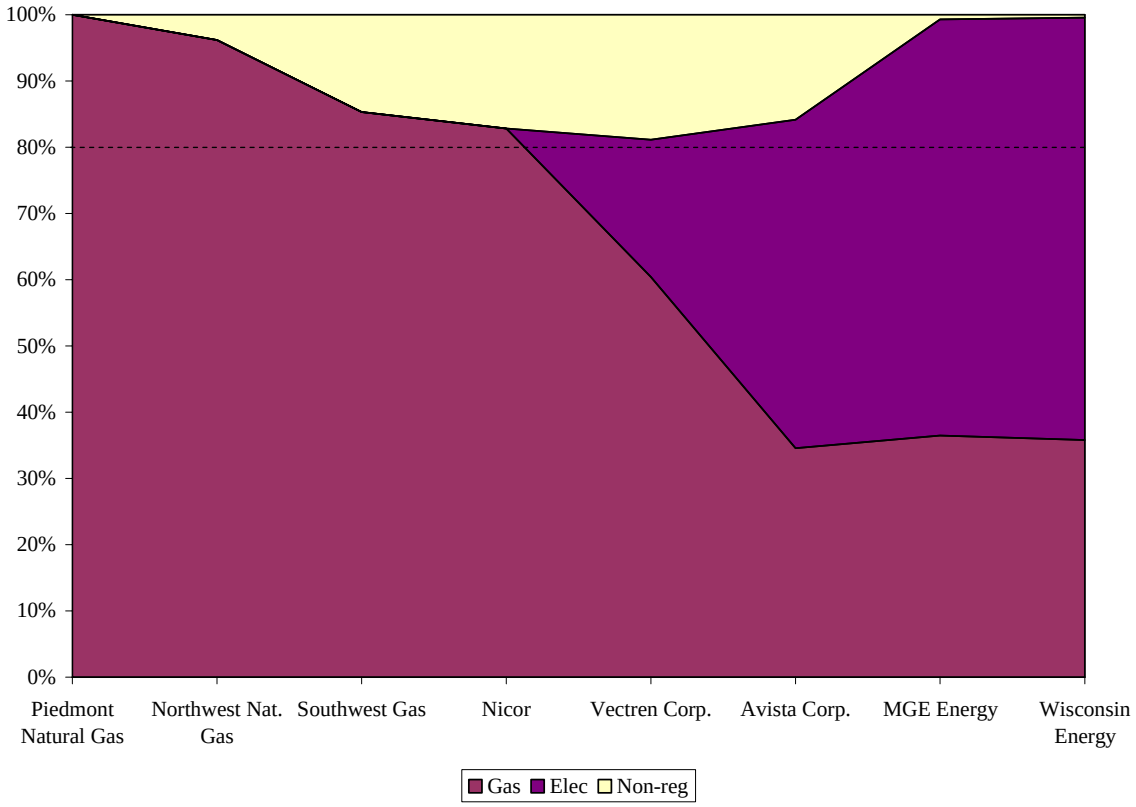
A. The result of applying the four criteria is a group of four gas LDC utilities, listed on **Exhibit 10.3**. This is down from the six gas LDC utilities that I relied upon in my rebuttal testimony in the last Nicor rate case. The number has declined from six at the start of the last Nicor rate case to four because of merger and diversification activity. The decline to four companies poses a dilemma, both because of the small number to start with and the prospect (as happened in the last case) that the number might drop further during the duration of the case for the same reason companies departed from the objective proxy group before.

There are two ready avenues to expand the proxy group: (1) relax the criterion associated with at least 80 percent regulated revenues with the 12 natural gas utilities reported in *Value Line* appearing on **Exhibit 10.4**; or (2) look to combination gas and electric utilities reported by *Value Line*, which have at least 80 percent regulated revenues, with the highest percentage of gas revenues to the total.

I chose the latter because widening the selection criteria to include regulated electric activities does a better job of reflecting business risk than widening the selection criteria to include unregulated activities. For example, by starting with the gas group but relaxing the 80 percent regulated criterion, WGL Holdings would join the group, with 62 percent revenues from regulated gas operations. But starting with the combination gas/electric group and maintaining the 80 percent regulated criterion, Vectren, which is 81 percent "regulated" with 60 percent of its total revenues from gas distribution, would join the proxy group instead. Comparing the two, WGL and Vectren, I conclude that the latter is better representative of the business risk of running a regulated gas utility, as WGL is roughly two-fifths unregulated while Vectren is roughly only one-fifth unregulated.

Applying the same four criteria from the original gas utility group to the combination gas/electric group, with the additional criterion that the combination utilities must derive at least one-third of their revenues from gas operations admits four additional companies, for a total of eight. **Exhibits 10.4** and 10**.5** explain the section of these two groups of four companies. **Figure 1** illustrates the shares of gas, electric and unregulated activities in the revenues of the companies in my eight company proxy group.

Figure 1: Shares of Gas, Electric and Unregulated Activities in the Revenues of Companies in the Proxy Group



Q. Would it be preferable to use different selection criteria (such as bond ratings) or to use a larger proxy group?

A. No. Bond ratings measure the default risk associated with a firm's debt securities, such as its first mortgage bonds.[3] Bond ratings do not necessarily accurately measure the firm's equity risk.

While it might be possible to begin to select a proxy group by using a group of all utilities with a certain bond rating (say, all utilities with A or better rated bonds), it

[3] Indeed, a utility's various debt securities (*e.g.*, senior mortgage bonds, subordinated debt, etc.) are likely to have slightly different bond ratings. Further, different bond rating agencies (*e.g.*, Fitch, Moody's, and S&P) will sometimes have different bond ratings for a particular utility's first mortgage (or other) bonds.

would still be necessary to use a screening process to eliminate: (1) firms that are highly diversified; (2) firms that are involved in mergers; and (3) firms that cannot be used in the standard DCF model (*e.g.*, firms that have recently cut their dividend). In addition, if a comparable group included only companies with the same bond rating, the result would likely be a small group, given consolidation trends in the industry. Further, given that bond ratings measure default risk rather than equity risk, it is not at all clear that you would end up with a group that is more comparable to the risk of Nicor Gas than the groups that I have used in my testimony.

It is generally desirable to have a larger rather than smaller comparable group, although it is also very important to have comparable groups that accurately reflect the subject utility's risks and that meet the requirements of the DCF model. It would certainly not be appropriate to simply add back companies—perhaps by relaxing the selection criteria—in order to obtain a larger group. My comparable group, which was selected using a methodology that I have consistently used for many years, provides the best available basis for estimating the return on equity required by investors in Nicor Gas' common equity.

C. INPUTS INTO THE DCF CALCULATIONS

Q. Please turn now to your description of the data you use to determine the fair rate of return for Nicor Gas' gas delivery service operations.

A. The DCF analysis requires three data inputs: (1) current stock prices, P_0; (2) the current annual dividends, D_0; and (3) estimated dividend growth rates, g. I will deal with each of these DCF inputs in turn.

1. Calculation of the Stock Price, P_0

Q. What data do you use for the stock price input, P_0, in your DCF calculations?

A. I use stock prices obtained from *Yahoo! Finance*. It is my normal practice to use stock prices on the latest day consistent with the filing, which in this case was January 30, 2008, because only the latest stock prices are consistent with up-to-date investor expectations. This is because the informative value (with regard to investor expectations) of yesterday's stock prices will be completely superseded by today's stock prices. This is a widely held tenet of efficient markets. If today's stock prices embody all of the expectations regarding the value of those stocks, then yesterday's prices represent "old news." Yesterday's prices, therefore, are useless as a gauge to investors' current expectations.

Q. Do you adjust the observed stock prices?

A. Yes. I perform an "ex-dividend date" adjustment on all of the stock prices to remove the known effect that the next quarterly dividend payment has on the stock price. Failing to remove this effect would make the stock price used inconsistent with the DCF formula.

This adjustment is necessary because of the assumption in all standard DCF models that the next quarterly dividend will be received one full period from the date the stock price is measured. The problem with this assumption is that the next quarterly dividend is usually closer than one full quarter from the day the stock price is observed. This affects the stock price in a known way and must be corrected in order to avoid a downward bias in the calculated result.

Q. What is the ex-dividend date and how can ignoring it bias the DCF calculations downward?

A. The ex-dividend date is the date on which the right to the next dividend no longer accompanies a stock. In other words, if you purchase a share of stock the day before the ex-dividend date, you will receive the next quarterly dividend paid by the Company. If you purchase that share one day later, you will not receive that dividend. Because dividends are an important part of the return to utility shareholders and in view of the relatively high payout ratios involved, the ex-dividend date is an important determinant of the stock price. Utility stock prices, like other stock prices, are observed to drop by an amount approximately equal to the quarterly dividend on the ex-dividend date.[4]

All of the DCF models that I outline in my testimony apply *only on the ex-dividend date*. In other words, all of these models assume that future dividends begin a full period hence. Failure to adjust the stock price observed at an arbitrary date to account for the ex-dividend date will bias the applicable stock price upward (by approximately the amount of the "accrued" portion of the quarterly dividend), and the resulting DCF calculation downward.

Q. Have regulators accepted the ex-dividend date adjustment?

[4] A discussion of the importance of the ex-dividend date appears in most financial texts. See for example: E.F. Brigham, *Financial Management Theory and Practice*, 3rd Edition, (New York: The Dryden Press, 1982), p. 687. Empirical evidence on this phenomenon can be found in articles written by J.A. Campbell and W. Beranek, "Stock Price Behavior On Ex-Dividend Dates," *Journal of Finance*, 10, 4, (Dec. 1955), pp. 425-29; D. Durand and A.M. May, "The Ex-Dividend Behavior of American Telephone and Telegraph Stock," *Journal of Finance*, 15, 1 (March 1960), pp. 19-31; and E.J. Elton and M.J. Gruber, "Marginal Stockholder Tax Rates and the Clientele Effect," *Review of Economics and Statistics*, (February 1970), pp. 68-74.

A. Yes. For example, the New York State Public Service Commission has performed such adjustments as a regular component of its determination of the fair rate of return. When it accepted the adjustment for the first time, in a case where I participated as a rate of return witness, the Commission used the following reasoning:

> The Judge adopted a company proposal, to which staff agreed, which increases the yield component in the DCF calculation to account for the temporary stock price increases as quarterly dividend payment dates approach . . . [The adjustment] is designed to produce the correct yield given the DCF formula. . . . [T]he method has been sufficiently developed on this record to warrant adoption of the adjustment.[5]

Q. Should the adjustment be used in Illinois?

A. Yes. Wherever the DCF model is used, it assumes stock prices are one full period away. If the adjustment is not made, the analysis will always yield an underestimate of the fair rate of return on equity.

Q. How precisely do you make the adjustment in the stock price?

A. I traditionally make the adjustment by removing from the stock price the portion of the dividend that has already accrued. I make this adjustment to the P_0 term before performing the DCF calculations for a proxy group. In cases where I employ a single day's stock price, the adjustment is straightforward. That is, I subtract from the stock price a proportion of the last dividend payment. That proportion is the number of days since the last ex-dividend date, divided by 90 (*i.e.*, a full quarter). I make this

[5] State of New York Public Service Commission, (The Brooklyn Union Gas Company) Opinion No. 90-29, October 17, 1990, pp. 21-22.

adjustment to the P_0 term before performing the DCF calculations, as shown on **Exhibit 10.6**.

2. Calculation of the Dividend, D_1

Q. How do you measure the dividend, D_1?

A. The DCF model requires that $D_1 = D_0*(1+g)$, where D_0 is equal to the sum of the four most recent dividend payments. Thus, my starting point is to obtain the data for D_0. I obtain the sum of the past four quarterly dividend per share payments from *Value Line Investment Survey*. I use the sum of the four most recent dividend per share payments for each company in the proxy group, which is the D_0 term shown on **Exhibit 10.7**.

3. Calculation of Growth, g

Q. How do you estimate the dividend per share growth term, g?

A. I use three different prospective growth measures to estimate dividend growth from which I then take the simple average. The first is a measure of sustainable growth that examines Value Line projections of the separate components of dividend growth—that is, retained earnings and expected returns to book equity, as well as the possibility of issuing new shares at prices in excess of book values. The second measure is calculated using the forecasts of earnings per share published by *Value Line* in the issues listed above. The third measure uses analysts' estimates of earnings, as summarized by Zacks Investment Research ("Zacks").

Q. Please describe the first method you use to calculate growth for the companies in your comparable group.

A. The first method is known as either the "retention growth" or "sustainable growth" method. This method produces a forward-looking, sustainable growth rate by multiplying the fraction of earnings expected to be retained by a company by the expected return on book equity. The sustainable growth method also allows for growth stemming from new issuances of stock at premiums over book value. This is a valid way of estimating future dividend growth, because future growth in the dividend can only occur if: (1) a portion of the expected equity return is reinvested instead of being paid out in the form of dividends; or (2) if new common stock is issued at prices above current book values (causing existing shares to appreciate in value).

I estimate a sustainable growth rate for each company using the following formula:

$$g = B * R + S * V$$

Where:

B	=	expected retention ratio
R	=	expected return on equity
S	=	percent new equity expected
V	=	1 - book–to-market ratio

This formula for estimating sustainable growth is explained in more detail in **Exhibit 10.8**. This theoretical growth measure shows that investors can expect growth through both retained earnings and the sale of new stock at a premium of book. For all the publicly traded stocks in the comparable company group, investors can currently expect both forms of growth, as the market-to-book ratio for all is above one. If the $S*V$ term is ignored in the sustainable growth calculation, the resulting formula will not

accurately represent investor perceptions of growth. The results of implementing the sustainable growth formula are presented on **Exhibit 10.9**, **Exhibit 10.10**, and **Exhibit 10.11.**

Q. Is the use of forecasts in your second and third methods, which use information provided by Value Line and Zacks, advisable?

A. Yes. The practice of using forecast growth rates provides a good basis for estimating the long-term growth of the utility. Financial analysts exert considerable influence over the many investors who do not possess the resources to make their own forecasts. The accuracy of these forecasts, in the sense of whether they turn out to be correct, is not the issue as long as they reflect widely held expectations. **Exhibit 10.11** summarizes the Value Line and Zack's growth rates. **Exhibit 10.11** also provides the details of the calculation of the Value Line EPS growth rates.

Analysts' forecasts are sometimes criticized on the ground that it is very difficult to forecast growth rates accurately in the short term, let alone in the long term. However, this general objection is irrelevant to a DCF analysis because this method is based upon present investor expectations. Widely distributed forecasts influence both the current stock price and DCF cost of equity, not what the future will actually turn out to be.

Q. Are the five-year annual projected growth rates in earnings published by Value Line and Zacks reasonable indicators of long-term growth?

A. They are reasonable in the context of proceedings in which rate of return is being examined. It would be naïve to assume that the growth rates forecasted by Value Line

and those summarized by Zacks are applicable far into the future. However, there are two strong reasons for employing such forecasts in the present proceeding. First, to the extent that investors employ forecasts like those published by Value Line and Zacks as long-term growth rates, these forecasts accurately reflect the current expectations of long-term growth included in the cost of capital. Second, Value Line and Zacks forecast growth rates might not be substantially different, on average, from what investors believe long-term growth prospects to be, given that the forecast is widely distributed in the financial community. In addition, a study by Brown and Rozeff shows that Value Line analysts make better forecasts than could be obtained by employing historical data only.[6]

Q. Do you use mean averages when calculating growth rates and the cost of equity capital?

A. Yes, I do. Proxy groups are constructed to be representative of the company that is being investigated. There is therefore no reason to prefer the median to the mean average. Simple mean averages are a better—and vastly more widely used—statistical measure where all of the firms in the sample are comparable to the subject company, and there is no basis for not averaging each of these companies equally.

4. Selling and Issuance Cost Adjustment

Q. Do you make any adjustments to your DCF results?

[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), pp. 1-16.

A. Yes. I make an adjustment for selling and issuance costs when calculating the DCF costs in **Exhibit 10.12**.

Q. Why do you make such an adjustment?

A. The issuance of common equity, as well as long-term debt and preferred stock, involves costs. These costs are often measured as a percentage of the total debt, preferred stock or common equity issuance. Because of issuance costs, the net proceeds of a debt, preferred stock or common equity issuance will always be less than the total purchase price of the securities issued. Unless an adjustment is made to reflect this phenomenon in the fair rate of return—an adjustment consistent with the issuance cost adjustment already made for debt and preferred stock—the resulting fair rate of return calculations will be too low. The same problem will result if selling and issuance costs are ignored in calculating embedded debt costs.

Q. Is such an adjustment generally made by regulators to the embedded costs of debt and preferred stock?

A. Yes. An adjustment to include selling and issuance costs is made as a traditional part of computing the embedded cost of debt and preferred stock.

Q. Please explain.

A. Basing required returns on net, rather than gross, proceeds is standard regulatory practice when the capital is in the form of debt or preferred stock. It is inconsistent—and the source of improper DCF calculations—to exclude the same type of issuance cost allowance from outstanding common stock balances if those costs were incurred in the issuance of that common stock and were not reflected as a current expense in rates

at the time the issuance was made. For long-term debt and preferred stock issuances, these costs are capitalized by calculating a required rate of return on the net proceeds to Nicor Gas. It would be inconsistent to allow the capitalization and collection of these costs on long-term debt and preferred stock issuances and not to allow the collection of the same kind of costs on common stock issuances.

Q. What is the most common way for regulatory commissions to compensate for issuance costs?

A. The most common way to compensate utilities for necessary issuance costs related to common stock, as well as for preferred stock and long-term debt, is to allow a return *on* these costs for any one year and a return *of* these costs over the life of the issue. For common stock, because the life of the issue is, in essence, perpetual, the return component to recover the return on these costs is permanently a part of the return on equity. The only way these costs will "go away" is if they are paid off as a current expense. Failing to compensate a utility for its issuance costs will assure the under-recovery of its prudently incurred costs of raising capital.

Q. Is there more than one way that a commission can deal with selling and issuance costs?

A. Yes. A commission appropriately can handle these costs in one of three ways. *First*, the commission can allow the company to recover these costs automatically in the year they are incurred as an expense component of the revenue requirement (or the expense could be amortized over a number of years—with a return on the outstanding balance).

582 *Second*, a commission can allow the issuance costs to be included in the rate
583 base (like the treatment of interest charges on construction work in progress). This will
584 allow the company to earn a return *on* the costs, as opposed to a return *of* the costs.

585 *Third*, the commission can adjust the cost of capital upward over the life of the
586 issue. This adjustment in effect allows the company to earn a return *on* the issuance
587 costs, even though the costs are not in the rate base. The financial result and the
588 revenue requirement are the same as for the second method.

589 All of these methods would compensate the utility for the actual issuance costs
590 incurred. Utilities like Nicor Gas collect the costs of issuing debt and preferred stock as
591 a part of traditional regulatory practice. There is no basis, in my opinion, for treating
592 common stock issuance costs separately. Therefore, in **Exhibit 10.13**, I make the
593 adjustment consistent with the collection of these costs when computing the DCF
594 results.

595 **Q. How do you make your issuance and selling expense adjustment?**

596 A. It is proper to include an issuance expense return adjustment for the entire equity
597 component of the capital structure.[7] Therefore, I use the conventional form of the
598 issuance expense adjustment:[8]

[7] Support for using total common equity appears in: Eugene F. Brigham, *et al.*, "Common Equity Flotation Costs and Rate Making," *Public Utilities Fortnightly*, (May 2, 1985), pp. 28-36.

[8] This formula appears in Roger A. Morin, *Utilities' Cost of Capital*, (Arlington Virginia: Public Utilities Reports, Inc., 1984), 106; and Eugene F. Brigham, *et al.*, "Common Equity Flotation Costs and Rate Making," *Public Utilities Fortnightly*, (May 2, 1985), pp. 28-36.

$$r = \frac{D_1}{P_0 * (1 - f)} + g$$

Where:

r = required return adjusted for issuance expenses
f = flotation cost percentage

For the purpose of choosing an appropriate value for f, the flotation cost percentage, I refer to a publication by Victor Borun and Susan Malley as well as information specific to Nicor Gas' most recent public equity issuances.[9] Borun and Malley conclude that total flotation costs for electric utilities are about 5.5 percent. As shown on **Exhibit 10.12**, the average of the last two equity offerings that provided capital that supports Nicor Gas' rate base is 2.86 percent. The average of the two is **4.18 percent**, which I use as the issuance cost percentage for the DCF calculations in this case, according to the formula above.

Q. Please explain why the issuance expense adjustment should be made to total common equity.

A. Investors are entitled to earn the expected cost of capital on their investment. The DCF model illustrates that this expected cost is equal to dividend payments plus capital gains on the value of their shares. The cash paid in by investors is greater than the net proceeds that the company takes in. Therefore, the company must earn a greater return

[9] Victor M. Borun and Susan L. Malley "Total Flotation Costs for Electric Company Equity Issues," *Public Utilities Fortnightly*, (February 20, 1986), pp. 33-39.

on the smaller net proceeds balance to compensate investors adequately for their expected cost of capital. But the money paid to the investors in any year, the dividend, reflects only a portion of the returns on equity. Retained earnings represent the other portion, or the funds used to finance future growth. If retained earnings do not receive a selling and issuance return adjustment, they will not grow at a rate sufficient to allow for the payments of dividends at investors' expected growth rate in the future and the company will not earn its true cost of capital.

D. EMPIRICAL DCF CALCULATIONS FOR PROXY GROUP

Q. How do you calculate a DCF cost of common equity for the proxy group?

A. Using the ex-dividend date adjusted stock prices for January 30, 2008, the most recent four actual dividend per share payments, the average of the sustainable growth and forecast earnings growth estimates, and the issuance cost method shown above, I estimate a DCF cost of common equity for the combined gas and electric proxy group of **10.01 percent** as shown on **Exhibit 10.13**. My DCF cost of equity recommendation is summarized on **Exhibit 10.2**.

IV. CAPM ANALYSIS

Q. Please provide your overall evaluation of the CAPM.

A. The CAPM is the sum of two components: (1) a risk-free rate applicable to all companies; and (2) a company-specific risk premium (the product of a company-specific beta and a market risk premium). There are a wide variety of risk-free rates from which to choose (*e.g.*, long-term/short-term/average of both). Furthermore, because the same risk-free rate applies as an additive term to all companies' cost of

equity estimates, there is no measure of central tendency in the result. In short, we cannot resolve the question of uncertainty surrounding short-term versus long-term rates by repeated sampling.

The CAPM is one of the methods used to determine the cost of common equity in Illinois and, therefore, I use CAPM as one method to set the cost of common equity for Nicor Gas.

Q. Is there more than one way to calculate the CAPM model?

A. Yes. The CAPM formula itself is rather straightforward. Its components are: (1) the risk free rate of return; (2) the market rate of return; and (3) the beta. Yet despite this algebraic simplicity, experts have applied different methods to obtain each of these components and to compute the required rate of return. The effects of choosing one method over another can be to substantially change the required cost of capital.

Q. Have you calculated a CAPM ROE?

A. Yes. I have derived CAPM return on equity estimates. My CAPM results for my comparable group and for Nicor Gas are shown on **Exhibit 10.14.**

I use a risk-free rate of 4.31 percent, which is the yield on 30-year treasury bonds, as reported in the *Value Line Selection and Outlook* (February 1, 2008). I use the most up-to-date Value Line betas for the companies in my comparable group and for

Nicor Gas. *Value Line* data are unique in that *Value Line* is not affiliated with any bank, broker, or insurance company."[10]

Two approaches are used to calculate the appropriate risk premium: (1) I calculate a "top-down" return on the market (the S&P 500) using analysts' estimates; and (2) I use historical Ibbottson and Sinquefield data.

Forward-looking measures of the market risk premium are available. A forward-looking market risk premium can be calculated by subtracting the risk-free rate from the estimated 14.72 percent "top-down" cost of equity capital of the S&P 500. Rueters provides a 12.42 percent estimate of the "top-down" estimated five-year earnings growth rate of the S&P 500, and S&P[11] provides a 1.96 percent estimate of the current dividend yield of the S&P 500. Combining these inputs using the standard DCF model provides a forward-looking, top-down DCF cost of common equity for the S&P 500 of 14.72 percent, as shown on **Exhibit 10.15**. As shown in **Exhibit 10.14**, p. 1 of 2, this method of estimating the risk premium produces a 13.87 percent result for the proxy group using CAPM.

While Ibbottson and Sinquefield's market risk premium data is a useful source of information on the historical risk premium of large company stocks relative to long-term government bonds, it is backward looking. As shown on **Exhibit 10.14**, p. 1 of 2,

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

[11] From Standard & Poors S&P 500 Earnings and Estimate Report at http://www2.standardandpoors.com/NASApp/cs/ContentServer?pagename=sp/Page/IndicesIndexPg&l=EN&b=4&f=1&s=6&ig=48&i=56&r=1&xcd=500&fd=IndicesMonthEnd_500 (Accessed on January 30, 2008).

this method of estimating the risk premium produces a 10.33 percent result for the proxy group using CAPM.

Q. What conclusion do you draw on CAPM cost of common equity for the proxy group?

A. I estimate a CAPM cost of common equity for the combined gas and electric proxy group of **12.10 percent** as shown on **Exhibit 10.2**.

V. RECENT ALLOWED RETURNS ON EQUITY

Q. What check of reasonableness of your return recommendations do you perform?

A. I review the most recent rate of return decisions for gas utilities (from January 2005 through January 30, 2008), as summarized by Regulatory Research Associates.

Q. Please explain how you develop the allowed return on common equity comparison.

A. Page 1 of **Exhibit 10.16** presents the individual state commissions' allowed returns that make up the figure on page 2. Page 2 of that exhibit provides a graph that shows the range of natural gas utilities' returns on equity that have been authorized by regulatory commissions throughout the country between January 2007 and January 30, 2008. My data base covers 46 decisions. Page 2 also shows the number of decisions associated with each allowed return on common equity figure.

Q. Does this conclude your direct testimony?

A. Yes.