STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

NORTH SHORE GAS COMPANY	:	
	:	
Proposed General Increase	:	
In Rates For Gas Service	:	Nos. 09-0166, 09-0167
	:	Cons.
THE PEOPLES GAS LIGHT	:	
AND COKE COMPANY	:	
	:	
Proposed General Increase	:	
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Rebuttal Testimony of

BRADLEY A. JOHNSON

Treasurer

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

July 8, 2009

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I. INTRODUCTION AND BACKGROUND

A. Witness Introduction

Q. Please state your name.

A. My name is Bradley A. Johnson.

Q. Are you the same Bradley A. Johnson who submitted pre-filed Direct Testimony on behalf of The Peoples Gas Light and Coke Company ("Peoples Gas") and North Shore Gas Company ("North Shore") (together, "the Utilities") in this consolidated Docket?

A. Yes.

B. Purpose of Testimony

Q. What is the purpose of your Rebuttal Testimony in this proceeding?

A. The purpose of my rebuttal testimony is to respond to the proposed adjustments to the Utilities' requested overall rates of return on their proposed rate base ("rate of return") contained in the direct testimony of Illinois Commerce Commission ("Commission") Staff ("Staff") witness Sheena Kight-Garlisch (Staff Ex. 5.0), including her proposed adjustments to the Utilities' requested capital structures and the cost of debt components of their rates or return. The Utilities' witness Paul R. Moul will respond specifically to Staff's and Interveners' proposed adjustments to the Utilities' requested return on equity component of their rates of return. The Utilities' rebuttal witness Steven Fetter will respond to the testimonies of Staff witness Mr. McNally and CUB/City witness Mr. Bodmer regarding the Utilities' return on equity and the impact of the ROE on the Utilities' ability to obtain capital on reasonable terms.

C. Summary of Conclusions

Q. Please summarize the conclusions of your rebuttal testimony.

A. First, Staff's proposal to adopt hypothetical capital structures for the Utilities by imputing short-term debt should be rejected. Ms. Kight-Garlisch's arguments for artificially adding short-term debt to the Utilities' capital structures are not supported by the data, especially if the Commission accepts the Utilities' significantly reduced Rate Base proposed in their Rebuttal Testimony, Staff's adjustments to the Utilities' respective rate bases, or a combination thereof. If Staff's proposal is adopted, it would represent a dramatic departure from longstanding Commission precedent including its prior decisions concerning the Utilities' capital structure in the last 20 years. Adopting Staff's hypothetical capital structures would also weaken the Utilities' financial strength and credit quality.

Second, Staff's use of a "spot" short-term debt rate selected on an arbitrary date several months ago should be rejected. As I show in NS-PGL Ex. 2.3, short-term interest rates are very near historic lows that are unsustainable not only over the long term, but even in the shorter term, especially as the economy begins to recover. Furthermore, using a historical "spot" rate is not consistent with forecasting the Utilities' costs for ratemaking purposes. The Utilities propose using a forecasted short-term debt rate that more accurately reflects the future economic outlook for the test year and years following when the Utilities' new rates will become effective.

Third, Staff's adjustments to the Utilities' cost of long-term debt should themselves be adjusted to account for the fact that the Utilities had split credit ratings (AA/A) at the time the debt was issued. Also, given the current financial turmoil, the adjustment to Peoples Gas' auction rate securities is excessive and unreasonable. The rate should be set to reflect Peoples Gas' option of remarketing the securities under their existing documents as I explain later in my rebuttal testimony.

D. Itemized Attachments to Direct Testimony

Q. Are you sponsoring any exhibits?

A. Yes, I am sponsoring the following exhibits:

Exhibit No.	Corresponding 83 Ill. Admin. Code Part 285 Schedule
NS-PGL Ex. BAJ-2.1P&N	Updated Schedule D-1; Rate of Return Summary
NS-PGL Ex. BAJ-2.2P&N	Updated Schedule D-3; Embedded Cost of Long-Term Debt
NS-PGL Ex. BAJ-2.3	Chart of Historical and Forecasted 1-Month AA Commercial Paper Rates
NS-PGL Ex. BAJ-2.4P&N	Adjusted Short-Term Debt Rates
NS-PGL Ex. BAJ-2.5P	Historical Auction Rates for Peoples Gas Series OO 2003C Bonds
NS-PGL Ex. BAJ-2.6P	Forecasted 3-Month LIBOR Rates for 2010

II. CAPITAL STRUCTURE

Q. What is the basis for the Utilities' proposed capital structure in this case?

A. The Utilities' proposed capital structure is based on their forecasted average capitalization in the 2010 test year, prior to the impact of their proposed rate increases.

Q. Why is the proposed capital structure reasonable and appropriate for the Utilities?

A. The Utilities' obligation to provide safe, adequate and reliable service to its customers at just and reasonable rates requires that they maintain their financial integrity and ability to readily access the capital markets on reasonable terms and conditions. Because they are utilities and are obligated to provide service to their customers, the Utilities must be prepared to raise capital at all time, regardless of the state of the financial markets. A strong capital structure, like that proposed by the Utilities', is consistent with the capital structure authorized by the Commission for the Utilities in Docket Nos. 07-0241 and 07-0242. Current market expectations clearly do not warrant approval of a weaker and more leveraged capital structure than was authorized and found appropriate last year. A strong capital structure is also important in maintaining the Utilities' investment grade credit ratings, and protecting the Utilities and its customers from financial shocks. A strong capital structure is especially important in this time of financial market turmoil as discussed in greater detail in the testimony of the Utilities' witness Steven Fetter.

Q. Has the Commission previously opined on the use of a hypothetical capital structure for ratemaking purposes, as proposed by Staff, rather than using a company's actual capital structure?

A. Yes. The Commission has previously stated that "imputing a hypothetical capital structure to determine a utility's rates is a serious adjustment, and should only be adopted when a utility's actual capital structure is found to be unreasonable, imprudent, or unduly affected by such circumstances as double leverage so as to unfairly burden the utility's customers." Docket No. 87-0032, Order at 26 (Jan. 20, 1988).

Q. Has any party in this case provided evidence that Peoples Gas' or North Shore's forecast of its capital structure for the 2010 test year is not accurate, reasonable, or prudent?

A. No.

Q. Does Ms. Kight-Garlisch's testimony show that a short-term debt component should be imputed into the Utilities' capital structure for rate-making purposes?

A. No. The Utilities use short-term debt to finance the temporary, seasonal cash requirements. The Utilities finance their permanent assets with permanent capital consisting of long-term debt and common equity. Over the past 20 years, the Commission has consistently recognized this fact and has only approved rate orders that did not include short-term debt in the Utilities' capital structures. The Utilities' financing policies and use of short-term debt is consistent with that past practice, which served as a basis for past Commission decisions. Additionally, Counsel has not made me aware of any law changes that would affect this issue.

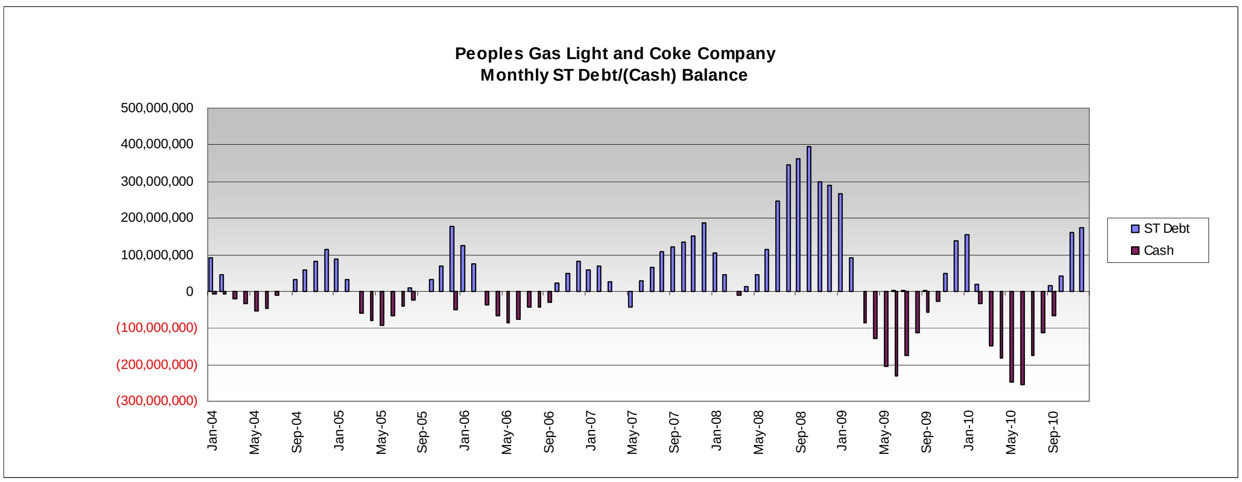
Q. Please describe the nature of the Utilities' seasonal borrowing needs.

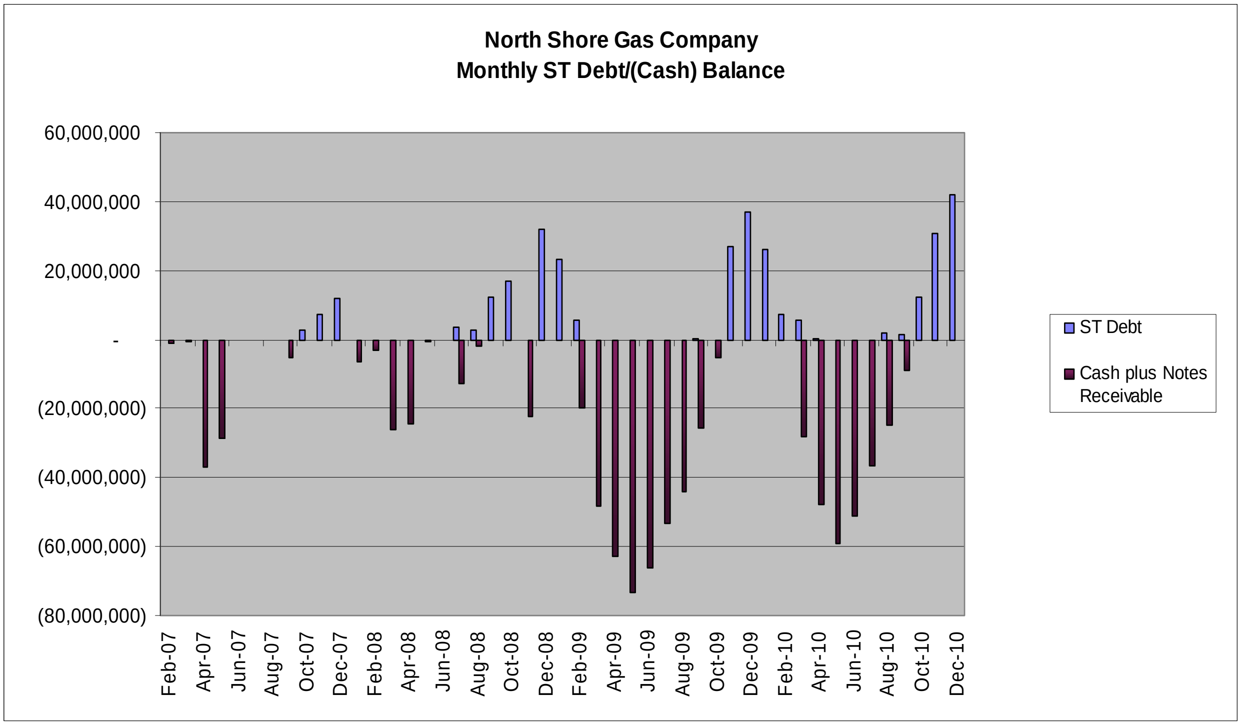
A. The Utilities' seasonal borrowing needs are driven by a variety of factors affecting cash flows. These factors include customer consumption patterns, revenue billing and collection patterns, natural gas storage injection/withdrawal cycles, natural gas prices, and the timing of other receipts and expenditures. These factors result in seasonal cash flow patterns that re-occur from year to year. In order to manage this variability in cash flows, the Utilities issue short-term debt on a temporary basis and retire it when the temporary conditions that drove its issuance end. The Utilities thereby avoid having to maintain excess amounts of more expensive long-term capital on a year-round basis.

Q. Could you describe the seasonal short-term borrowing pattern for Peoples Gas and North Shore?

A. Yes. Figure 1 and Figure 2 below (data provided in response to data request PGL FIN-1.03 and NSG FIN-1.03) show Peoples Gas actual month-end short-term debt and cash balances for 2004 through 2008, North Shore's balances for 2007 through 2008, and the forecasted short-term debt and cash balances for 2009 and 2010 for both Utilities. As shown, short-term debt balances generally peak at year-end, when higher winter revenues have not yet been collected and seasonal cash requirements are at their highest levels.

However, short-term debt balances decline rapidly as winter revenues are collected and by early spring the Utilities generally have a net cash position (i.e. net cash generally means no short-term debt outstanding. For the test year, Peoples Gas and North Shore are forecasted to have net cash for 8 months and 7 months respectively). Due to low spring and summer revenues, the Utilities generally begin to utilize short-term borrowing again during the late summer months, but only after exhausting less expensive cash reserves.





Q. Do the Utilities utilize short-term debt any differently today than they have in past periods during which the Commission did not include short-term debt in their capital structures?

A. No. Short-term borrowing continues to be used in the same manner it always has – to meet temporary seasonal cash needs. While annual peak and average levels of short-term debt have varied from year-to-year depending on a variety of factors as discussed earlier, including natural gas prices, the Utilities historically have had no short-term borrowing for prolonged periods in nearly every calendar year, and this practice is expected to continue. Given those facts – which continue today - the Commission has concluded repeatedly that the Utilities use short-term debt to meet seasonal cash requirements and not to finance long-term assets. If Ms. Kight-Garlisch's proposal were adopted, it would represent a dramatic departure from prior Commission policy, findings, and decisions regarding the Utilities' capital structures and would serve to weaken the Utilities' financial strength and credit quality.

Q. The first reason provided by Ms. Kight-Garlisch for including short-term debt in rate base is the differences between the Utilities permanent capital and proposed rate bases. Has the Commission addressed differences between capital structure and rate base in prior decisions?

A. The Commission has long recognized that, for ratemaking purposes, rate base is not required to equal capitalization, nor has the Commission attempted to reconcile the two. Furthermore, the Commission has rejected claims that differences between rate base and capital structure demonstrate that short-term debt is being used to finance rate base, noting in Nicor's 1987 test year rate case that "the difference between Respondent's capitalization and rate base is not prima facie evidence that short-term debt is financing rate base." Docket No. 87-0032, Order at 26 (Jan. 20, 1988). The Commission further ruled in that case that "there was no reason to require the reconciliation of rate base and capitalization either through a rate base adjustment or the inclusion of other capitalization components." Docket No. 87-0032, Order at 26 (Jan. 20, 1988).

Q. Ms. Kight-Garlisch asserts that because the Utilities' proposed rate bases exceed the long-term capital (i.e. long-term debt and common equity) in their proposed capital structure, short-term debt must be financing rate base. Is she correct?

A. No. In addition to the fundamental problem with misusing rate base – capital structure comparisons, this inference is wrong for two additional reasons: Ms. Kight-Garlisch fails to consider proposed adjustments to the Utilities' rate bases and she assumes that any difference in her comparison had to be financed with short-term debt. I will address these problems in order.

First, Ms. Kight-Garlisch's comparison uses unadjusted rate base values and fails to compare the rate bases currently proposed – even by Staff – to the Utilities' proposed capital structure. Taking into account Staff's proposed adjustment to rate base, Peoples Gas' permanent capital would exceed rate base by over $136 million, thus negating the argument that short-term debt is being used to fund rate base. For North Shore, rate base exceeds permanent capital but only by about $7 million or $3 million in excess of the amount of short-term debt Staff wishes to impute in North Shore's capital structure.

Additionally, the Utilities' have proposed a revised Rate Base of $1,298,740,000 and $178,936,000 for Peoples Gas and North Shore, respectively (See Hengtgen rebuttal testimony, NS-PGL Ex. JH-2.0). Comparing the Utilities' proposed capital structures their revised proposed Rate Base would show that permanent capital exceeds rate base by about $2.7 million, once again negating the argument that short-term debt is being used to fund rate base. For North Shore, a comparison between its revised proposed rate base and permanent capital would show that on average, Rate Base exceeds permanent capital by about $10.9 million.

Second, Ms. Kight-Garlisch makes an erroneous assumption that any difference is being financed with short-term debt. This assumption is erroneous because it fails to consider a longer term view that demonstrates that, over time, the Utilities are funding differences between rate base and capital structure with cash. For Peoples Gas for the 2010 test year, the originally proposed rate base is expected to exceed the 13-month average total permanent capital by $46,651,578 for Peoples Gas. However, the 13-month average cash balance is forecasted to be $101,429,994 while the 13-month average short-term debt outstanding is forecasted to be $45,660,783. This indicates that the Utility is forecasting an average net cash balance during the year of over $55 million (Cash of $101 million less Short-term debt of $46 million) which will be the source for funding the difference between rate base and capital structure on an ongoing basis.

Similarly, for North Shore for the 2010 test year, the originally proposed rate base is expected to exceed the 13-month average total permanent capital by $10,907,752. In addition, the 13-month average cash balance is forecasted to be $21,372,028 while the 13-month average short-term debt outstanding is forecasted to be $10,480,174. This indicates that the Utility is forecasting an average net cash balance during the year of almost $11 million (Cash of $21 million less Short-term debt of $10 million) which will be the source for funding the difference between rate base and capital structure on an ongoing basis.

It is important to take a longer term view since the Utilities must finance their operations on a long-term basis. If the Utilities financed their operations based on a point estimate as Ms. Kight-Garlisch is suggesting, this would likely result in higher costs to ratepayers and shareholders alike as additional more costly long term debt would have to be used to finance the Utilities' peak capital needs.

Q. Ms. Kight-Garlisch also argues that short-term debt should be included in rate base because of a correlation between the amount of short-term funding and net-working capital and the inclusion of cash working capital in the Utilities' respective rate bases. Is this a valid reason to replace the Utilities actual capital structure with one that imputes short-term debt?

A. No. It is not surprising that a correlation exists between monthly changes in the balances of the Utilities' short-term debt and monthly changes in their balance sheet working capital accounts. As I have already discussed, the Utilities use short-term debt to help meet temporary seasonal cash needs, including those resulting from seasonal fluctuations in working capital requirements. Ms. Kight-Garlisch incorrectly concludes, that because cash working capital is included in rate base and there is a correlation between changes in net working capital and changes in short-term debt and cash, that short-term debt must be funding rate base. This conclusion fails to recognize the differences between the cash working capital included in rate base and net working capital. Ms. Kight-Garlisch is attempting to create a relationship between cash working capital and net working capital that does not exist and, essentially arguing that net working capital should be included in rate base instead of cash working capital. Because there is no relationship between these two items, it cannot be assumed that because cash working capital is included in rate base that short-term debt is funding rate base.

Q. What is the difference between cash working capital included in rate base and net working capital?

A. The cash working capital component of rate base represents the permanent funds necessary for the day-to-day operation of the utility, in addition to other rate base assets, due to the ongoing lag in time between when costs are incurred and payment is received. This amount of such funds is estimated by a lead-lag study using the Utilities' forecasted revenues and expenses, and is the common method employed by the Commission to determine the working capital component of rate base in Illinois. It is recognized as a year-round, long-term investment that must be supported on a permanent basis, no differently than the Utilities' other rate base assets. Peoples Gas and North Shore forecast $47,260,000 and $397,000, respectively, as cash working capital components their 2010 test year rate bases.

In contrast, the Utilities define Net Working Capital, as Current Assets (with the exception of Gas in Storage and Cash) net of Current Liabilities (with the exception of debt related items -ST Debt, Commercial Paper, LT Debt Due within One Year, Accrued Interest - Customer Deposits and Customer Credit Balances). The forecasted average 12 month balance of net working capital for Peoples Gas in 2010 is $144,208,890 and $31,735,529 for North Shore. The Utilities finance net working capital first with cash reserves and then with short-term debt as needed.

Q. Do you have any other comments regarding Staff's claims that short-term debt is funding rate base assets?

A. Yes. Ms. Kight-Garlisch concedes that cash is fungible and cannot be traced to specific uses. However, she then argues that because cash is fungible and cannot be traced to specific uses of funds, that the Utilities cannot support their claim that short-term debt does not support rate base. This argument faults the Utilities for not being able to do what even she agrees is impossible and argues for a standard that would add short-term debt to a utility's capital structure unless this impossible feat is accomplished. In fact, Ms. Kight-Garlisch's candid admission that cash is fungible and cannot be traced to specific uses destroys her attempt to claim that the Utilities' must have used short-term debt to finance rate base. Finally, as I noted at the beginning of this section of my testimony, her argument is inconsistent with past Commission decisions, including for the Utilities.

III. COST OF SHORT-TERM DEBT

Q. In addition to increasing the Utilities' financial risk, does Ms. Kight-Garlisch's proposal to include short term debt in the Utilities' capital structure impede in other ways the Utilities' ability to earn a fair return on their rate base investments?

A. Yes. First, Ms. Kight-Garlisch proposes using a cost of short-term debt for Peoples Gas of 0.92% and 0.33% for North Shore based on an annualized "spot" rate for highly-rated commercial paper as of May 14, 2009. There are several reasons why this is inappropriate.

First, as illustrated in Exhibit NS-PGL Ex. BAJ-2.4, short-term debt rates are currently at historically low and unsustainable levels. The May 14, 2009, spot rate is not a reasonable or accurate representation of what the Utilities' short-term debt costs will or, under her hypothetical view of how short-term debt is used, would be.

Second, Ms. Kight-Garlisch's use of an historical spot rate for commercial paper taken at a single point in the past is also inconsistent with the forecasted rate that has been used in past rate cases and that is most consistent with the Utilities' forecasted test year.

Third, Ms. Kight-Garlisch's determination of the credit facility fees for Peoples Gas and North Shore is incorrectly based on historical costs for credit and not current costs. In fact, based on today's extremely tight credit markets and the actual cost Integrys Energy Group recently incurred to renew a 1-year credit facility, credit facility fees are forecasted to be significantly higher than those reflected in the original filing as well as those determined by Staff.

Fourth, the rates referenced by Ms. Kight-Garlisch are indicative of 30-Day AA Commercial Paper and is simply the published rate per the Federal Reserve Data Download service. This is not the rate that Peoples Gas would actually receive from its broker-dealer.

Q. Why does the data Ms. Kight-Garlisch uses not accurately estimate the actual cost of short-term debt for the Utilities?

A. The rates referenced by Ms. Kight-Garlisch are indicative of 30-Day AA Commercial Paper and is simply the published rate per the Federal Reserve Data Download Program. Since Peoples Gas was rated A-2/P-1 during that time period, the rates charged were greater than the AA rate used by Ms. Kight-Garlisch. NS-PGL Ex. BAJ-2.3 shows the spread between the average monthly 30-Day AA Commercial Paper rate as published by the Federal Reserve and the actual rate incurred by Peoples Gas from January 2007 through March 2009. This spread is used to adjust the forecasted short-term debt rates as discussed below.

Q. Considering the factors just cited, what is the Utilities' updated estimate?

A. As shown in NS-PGL Ex. BAJ-2.3, the Utilities now estimate a cost of short-term debt of 5.469% for Peoples Gas and 5.420% for North Shore for the 2010 test year. These rates appropriately reflect the current forecasted commercial paper rates for 2010 (as of May 7, 2009) as shown in NS-PGL Ex. BAJ 2.4, adjusted by 137 basis points to reflect the actual spread between the Utilities' short-term borrowing rates and 30-Day AA Nonfinancial Commercial Paper Interest Rates. These rates also reflect an increase in credit facility fees of $296,000 to $1,500,000 or 3.341% for Peoples Gas and $6,000 to $344,000 or 3.291% for North Shore.

Q. What is the reason for the increase in credit facility fees?

A. The primary driver of the increase in credit facility fees is the increase in costs of credit facilities, another outcome of today's extremely tight credit markets. The existing PGL credit facility expires in July 2010 and will be replaced with a facility at rates that we expect to be upwards of 4 times the cost of the current facility. NSG will share in 20% of the costs of this facility. In addition, PGL and NSG each receive an allocation of parent company costs related to their share of overall credit support.

IV. <u>COST OF LONG-TERM DEBT</u>

Q. What positions have Staff and interveners taken on the Utilities' forecasted cost of long-term debt respectively?

A. Staff stands alone in its proposed downward adjustments from 5.96% to 5.27% for Peoples Gas and from 5.58% to 5.49% for North Shore. CUB and the City have accepted the Utilities' proposed costs. In addition, no other intervener addressed any concern over the long-term debt costs submitted by the Utilities.

Q. Are Staff's adjustments to the Utilities forecasted cost of long-term debt appropriate and reasonable? Please summarize?

A. No, they are not reasonable or accurate for several reasons. While the Utilities agree with Ms. Kight-Garlisch's adjustments to the rates on the Utilities' taxable debt issues, the rate adjustment to Peoples Gas' auction rate securities is excessive considering the current market for auction rate debt and the fact that current rates are at record lows. Also, Staff used a historical rate from one failed auction to determine the projected cost of these securities, which is inappropriate and certainly unrealistic given current volatile market conditions. Furthermore, Staff's adjustments to the insurance costs on Peoples Gas' tax-exempt debt are excessive and do not consider the split ratings of the Utility at the time of the debt issuances as Staff's similar adjustments did in the Utilities' last rate cases.

Q. Why are Staff's adjustments to the rate applied to the Peoples Gas' auction rate securities inappropriate and unreasonable?

A. In addition to being excessive, Staff's adjustment to Peoples Gas' auction rate securities is unreasonable. Staff used a rate from one historical failed auction to determine the projected cost of these securities in the future. A historical failed auction rate is not a market rate of interest, but rather the debt default rate for a failed auction at one point in time. By using such a rate, Ms. Kight-Garlisch is essentially assuming that the Utility's auction rate securities will continue to fail and the historical LIBOR rate will not change from its current record low levels. While the Utility does not disagree with Ms. Kight-Garlisch's assumption that the Peoples Gas debt will likely continue to fail in the auction rate market, it does not agree with Staff's prediction that interest rates will not increase from their abnormally low current levels.

Q. Why does the Utility agree with Ms. Kight-Garlisch's assumption that Peoples Gas' auction rate securities auctions are likely continue to fail?

A. As a result of the turmoil in the financial markets, the auction rate securities market continues to shrink and has been virtually frozen to Peoples Gas. When a debt auction fails, the holders of the securities cannot sell them and are compensated with an interest rate based on the terms of the security. This is called the failed auction rate. In the case of Peoples Gas, this rate is set very low compared to other auction rate securities outstanding in the market. Under the Peoples Gas debt agreements, the failed auction rate is set at 175% of LIBOR, with an interest rate cap of 14%. Because LIBOR is currently very low, investors are not interested in Peoples Gas' auction rate securities when higher yielding investment options are available. Peoples Gas does not see this situation changing in the foreseeable future. Since investors have lost confidence in the auction rate market and Peoples Gas' auction rate securities bear such a low interest rate upon auction failure, the Utility anticipates these auctions will continue to fail.

Q. Does Peoples Gas have any concerns over continuing to have the auction rate securities outstanding when the auction rate security market is failing?

A. Yes. The market for buying and selling auction rate securities was intended to serve short-term debt needs and be a highly liquid market for investors. However, when the auction rate securities market began to dry up and auctions began to fail, the liquidity of the auction rate securities also dried up. When an auction fails, it means there are no clearing bids or market for trading these securities. The existing holders of the securities are forced to hold the debt. Thus, the investor's desire for a highly liquid investment is not being met and the holders are essentially stuck with holding the bonds and are forced to accept the failed rate of interest.

Peoples Gas' auction rate securities are largely being held by 3 of their core credit banks. Peoples Gas is concerned that forcing investors, including some of the Utility's core credit banks, to continue holding this debt in an auction rate mode with a calculated failure rate versus a fair market rate of interest may be detrimental to the Utility in the long-run. Since there is no foreseeable market option for these securities, unless the Company takes action in regard to these bonds, investors are essentially held hostage to holding Peoples Gas' debt for an unknown period of time or until the securities mature in

2037. The Utility is concerned with the potential ill will that could develop between their investors, including their core credit banks and themselves.

Q. What is the Company's recommendation for addressing their concerns over maintaining the Series OO bonds in the auction rate mode?

A. Peoples Gas requests the Commission to support the Company's remarketing or refinancing of the Series OO tax-exempt auction rate securities with fixed rate debt due at the end of the original term on October 1, 2037. Current indicative rates show that this can be accomplished at a rate of 7.16%, as reflected in Exhibit NS-PGL Ex BAJ 2.2P.

Q. Why is the Utility making this recommendation?

A. Peoples Gas is recommending remarketing the auction rate debt in another mode to eliminate the risks associated with keeping the debt in the auction rate mode and to take advantage of using the existing documents that would support a quicker and less expensive remarketing process than a full tender and refinancing would require. Remarketing also allows the Company to maintain the tax-exempt status of the debt.

Q. What are the risks to Peoples Gas if it does nothing and continues to hold the Series OO auction rate securities in their current mode?

A. In addition to the risks already identified, if Peoples Gas does nothing and continues to hold the auction rate securities in an environment where no market exists and the auctions continue to fail, Peoples Gas will be exposed to market fluctuations impacting the LIBOR rate and rising interest rates. Schedule NS-PGL Ex. BAJ-2.5P reflects the history of the auction rate securities. As you can see, there is a significant amount of volatility in the closing auction rates for these securities regardless of the success or failure of the auctions. Just as the interest rates have declined during the current recession and market crisis, they will rise again. The Utilities have been advised by their core bank group that interest rates cannot be sustained at their current levels and history tells us that interest rates will rise. Thus, Peoples Gas could be exposed to much higher interest expense due to the 175% of LIBOR multiplier. For example, if the LIBOR rate used by Ms. Kight-Garlisch in her testimony were to increase by only 2%, the resulting failed auction rate would be 4.5% versus the 1% used in her testimony. As you can see, even slight increases in the LIBOR rate can have significant consequences due to the 175% multiplier. However, the debt documents do provide for an interest rate cap of 14%.

Q. If Peoples Gas were to continue holding these securities in their current auction rate mode, what interest rate should be used to determine the cost of the auction rate securities in this rate case?

A. The Utility proposes using a forecasted 3-month LIBOR rate of 1.35% for purposes of projecting the cost of the auction rate securities. This rate would be multiplied by 175% resulting in a rate of 2.3625% for the 2010 test year. The forecasted 3-month LIBOR rates are shown in NS-PGL BAJ Ex. 2.6P. Using this type of calculation will better reflect the actual rates likely to be demanded in the market. By contrast, Ms. Kight-Garlisch's approach of using one historical failed auction rate to set the interest rate for future failed auction rate securities is unreasonable.

Q. Is Ms. Kight-Garlisch's adjustment to the cost of the insured tax exempt Peoples Gas Series KK, LL, OO, and RR bonds to reflect the reduced cost of the insurance premiums if Peoples Gas' S&P rating had remained at AA- appropriate and reasonable?

Q. As with the cost of the 2003, 2008, and projected 2009 and 2010 bond issuances, Peoples Gas agrees with the concept of this adjustment, but does not agree with the size of the adjustment. As with the adjustments made to the rates on the Utilities' taxable debt, the adjustment should take into account the fact Peoples Gas had a split rating, single "A" by S&P and double "A" by Moodys, at the time these bonds were issued. Because of the small adjustments and associated revenue requirements involved, the Utilities' propose the same, simple approach they proposed and Staff accepted in their last rate cases. The Utilities propose that the split rating be reflected by taking only half the adjustment that Ms. Kight-Garlisch calculated. These adjustments are reflected in the Utilities' revised Schedules D-3 as shown in NS-PGL Ex. BAJ 2.2 P&N.

Q. Are Staff's adjustments to the Utilities' rates on taxable long-term debt based on an assumed AA rating by S&P appropriate and reasonable?

A. The Utilities agree that it is reasonable to adjust their cost of long-term debt to reflect their stand-alone financial strength, if and to the extent that it differs from Integrys' financial strength. The Utilities also agree with Ms. Kight-Garlisch that although these adjustments are small in this case, it is still important to reflect the Utilities' stand-alone financial strength in their rates. Therefore, based on the methodology applied by Ms. Kight-Garlish, the Utilities' agree with the adjusted rates on the Utilities taxable long-term debt.

Q. Are the proposed adjustments to the Utilities' long-term debt costs you propose reflected in the Utilities' updated revenue requirement estimates provided by Ms. Moy?

A. Yes they are. Our proposed adjustments to Staff's adjusted figures result in a long-term debt cost for Peoples' Gas of 5.95% and 5.48% for North Shore for the 2010 test year.

This calculation is provided in my revised D-3 schedules, NS-PGL Exs. BAJ-2.2 P&N. The adjusted long-term debt costs are reflected in Ms. Moy's revised C-1 Schedules, NS-PGL Exs. SM-2.9P and SM-2.9N.

V. COST OF COMMON EQUITY

Q. What positions have the Staff and interveners taken on the Utilities' cost of common equity?

A. Compared to the Utilities' originally proposed return on equity of 12.0%, Staff recommends 9.79% for North Shore and 9.69% for Peoples Gas. If proposed rider UEA is approved Staff recommends a return on equity of 9.59% for North Shore and 9.04% for Peoples Gas. Staff also recommends a return on equity factor for Rider ICR of 8.06%. CUB and the City argue for a return on equity between 8% and 9%. No other intervener addressed the Utilities' cost of equity.

Q. Has the testimony by Staff witness Kight-Garlisch or CUB/City witnesses Bodmer and Thomas caused the Utilities to change their proposed cost of equity?

A. No. However, Mr. Moul's rebuttal testimony provides updated information and support for a revised cost of equity of 11.87% assuming the Utilities' proposed Riders VBA and UEA are approved. This revised cost of equity is the result of updating the source data used for his calculations with more current data. Mr. Bodmer attempts to support extraordinarily low returns on equity by criticizing the accepted and appropriate methods for assessing required returns. As discussed by the testimonies of Mr. Moul and Mr. Fetter, his methods and proposal are unsupported and result in unrealistically low ROEs that would damage the Utilities' financial strength.

Q. CUB/City witness Thomas also makes a brief proposal to set the rate of return on "all investments made under Rider ICR" at the Utilities' "cost of debt." (CUB/City Ex. 2.0 at p. 53). Is that recommendation reasonable or appropriate?

A. No. In the real world, you simply do not see equity costs behave in this way, no matter how stable a company's revenue. This is because equity investors assume much greater risks than debt investors even with respect to those assets funded in whole or part through a rider like Rider ICR. The differences include not only a fundamentally different right to actually collect the expected return – debt holders are typically legally entitled to defined returns; holders of common equity are not. In addition, holders of debt enjoy a right to be paid ahead of common equity holders. Holders of secured debt also have strong rights in underlying assets, rights that equity investors do not. Therefore, it is not accurate that even a theoretically "perfectly assured" revenue stream – which Rider ICR far from guarantees – would lower to the cost of debt the investor expected returns on equity committed to support these assets. The notion that Rider ICR would, in fact, lower the required return on the equity investments in these assets to the debt rate is even less plausible.

VI. SUMMARY

Q. In summary, what are your conclusions regarding the proposals by Staff concerning the Utilities' overall rate of return on rate base in this case?

A. My conclusions are as follows:

- Based on (a) the Utilities' proposed capital structure, (b) their updated cost of equity, and (c) their updated cost of long-term debt, the allowed overall rate of return on rate base should be 9.27% for Peoples Gas and 9.06% for North Shore.

- The Utilities' proposed capital structure, which is based on their forecasted capital structure for the 2010 test year, is consistent with current and historical financing practices and the capital structures approved for the Utilities' by the Commission in prior cases. No party in this case has questioned the accuracy, reasonableness, or prudency of the proposed capital structures.

- The Utilities have demonstrated that short-term debt continues to be used as it has in the past – to manage their temporary seasonal cash needs, and not as a permanent source of financing long-term rate base assets. The Utilities have disproven Staff's claims to the contrary by showing that neither Staff's proposed rate base nor Peoples Gas revised proposed rate base exceeds permanent capital. Furthermore, on an average basis, Peoples Gas and North Shore would fund any differences between rate base and permanent capital with cash. On the basis of the evidence presented and on the previous standards consistently applied by the Commission, the Commission should reject the inclusion of short-term debt in the Utilities' capital structure.

- The cost of short-term debt proposed by Staff is unreasonably low based on historical and forecasted short-term debt rates. The Commission should utilize the rates for short-term debt as proposed by the Utilities which are based on current forecasted commercial paper rates and incorporate the Utilities updated projections for credit facility fees.

- The cost of long-term debt proposed by Staff does not entirely reflect the split ratings on the Utilities. In addition, the rate for Peoples Gas' auction rate securities is unreasonably low given the abnormal market conditions. Peoples Gas is planning on refinancing this debt to fixed rate debt as reflected in the revised Schedule D-3. The Utilities urge the Commission to utilize the rates for long-term debt as proposed by the Utilities in the revised Schedule D-3 (NS-PGL Ex. BAJ-2.2) of my rebuttal testimony.

- As discussed in the rebuttal testimony of Mr. Moul and the testimony of the Utilities rebuttal witness, Mr. Fetter, the cost of equity proposals made by Staff and CUB are inadequate and inconsistent with market expectations as measured by the proxy group of companies used in Mr. Moul's return on equity study. Mr. Moul provides an update to the Utilities' proposed cost of equity proposed in his rebuttal testimony. Mr. Moul also demonstrates in his testimony that any adjustment to return on equity resulting from approval by the Commission of any of the Utilities' proposed riders is inappropriate and erroneous.
- Mr. Thomas' proposal to set the rates of return on "all investments made under Rider ICR" at the Utilities' "cost of debt" should be rejected as the notion that Rider ICR would lower the required return on equity investments in these assets is simply not plausible.

Q. Does this complete your rebuttal testimony?

A. Yes.