STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

NORTH SHORE GAS COMPANY	)	
	)	Dkt. 09-0166
Proposed general increase in natural gas rates (Tariffs filed on February 25, 2009)	)	
	)	
	)	
THE PEOPLES GAS LIGHT AND COKE COMPANY	)	Dkt. 09-0167
	)	(Consol.)
Proposed general increase in natural gas rates (Tariffs filed on February 25, 2009)	)	

REBUTTAL TESTIMONY OF CHRISTOPHER C. THOMAS ON BEHALF OF THE CITIZENS UTILITY BOARD AND THE CITY OF CHICAGO

CUB-City Exhibit 4.0

August 4, 2009

ICC DOCKET NOS. 09-0166/09-0167 (cons.)
REBUTTAL TESTIMONY OF CHRISTOPHER C. THOMAS

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I. INTRODUCTION AND PURPOSE OF TESTIMONY

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Christopher C. Thomas. My business address is 309 W. Washington Street, Suite 800, Chicago, IL 60606.

Q. ARE YOU THE SAME CHRISTOPHER C. THOMAS WHO PRESENTED DIRECT TESTIMONY IN THIS PROCEEDING?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my rebuttal testimony is to respond to the rebuttal testimony of the Peoples Gas Light and Coke Company ("Peoples") and North Shore Gas Company ("North Shore") (together, the "Companies" or "Utilities") witness Paul R. Moul. My testimony also responds to issues raised in the testimony of the Companies witness Bradley Johnson and Staff witnesses Michael McNally and Sheena Kight-Garlisch.

Q. PLEASE SUMMARIZE THE FINDINGS IN YOUR REBUTTAL TESTIMONY.

A. The Commission should not be persuaded by the testimony presented by Mr. Moul. His testimony in this proceeding relies largely on subjective opinion. He suggests that critical inputs to the standard models require his subjective approval, and he continues to rely on short-term subjective investor expectations as predictors of long-term sustainable growth. I continue to support the analysis I performed in my direct testimony and recommend that the Commission adopt the following weighted average cost of capital for Peoples and North Shore.

Weighted Average Cost of Capital

With No Riders

PGL	Capital Structure*	Cost*	Weight
Short-term Debt	3.39%	0.92%	0.03%
Long-Term Debt	40.61%	5.27%	2.14%
Equity	56.00%	8.58%	4.80%
		WACC	6.98%

NS	Amount*	Capital Structure	Cost*	Weight
Short-term Debt	$ 10,452,167	5.86%	0.33%	0.02%
Long-Term Debt	$ 72,476,045	40.60%	5.49%	2.23%
Equity	$ 95,578,042	53.54%	8.58%	4.59%
Total	$ 178,506,254		WACC	6.84%

With Riders VBA & UEA, and Stabilizing Changes in Rate Design

PGL	Capital Structure*	Cost*	Weight
Short-term Debt	3.39%	0.92%	0.03%
Long-Term Debt	40.61%	5.27%	2.14%
Equity	56.00%	8.255%	4.62%
		WACC	6.79%

NS	Amount*	Capital Structure	Cost*	Weight
Short-term Debt	$ 10,452,167	3.39%	0.33%	0.01%
Long-Term Debt	$ 72,476,045	40.61%	5.49%	2.23%
Equity	$ 95,578,042	56.00%	8.255%	4.62%
Total	$ 178,506,254		WACC	6.86%

* Capital Structure, long-term debt costs, and short term debt costs from Staff Ex. 8.1

Q. PLEASE SUMMARIZE YOUR DIRECT TESTIMONY.

A. Discontinuity or turmoil in the credit markets creates uncertainty in expectations about the future. This uncertainty, as CUB-City Witness Mr. Bodmer has described in more detail, is based on the inability of existing valuation models to predict deep, broad-scale declines in value, like the one that has recently occurred. Because of this, I have taken account of the guidance provided by Mr. Bodmer as I performed a clear and supportable return-on-equity analysis. The results of my analysis demonstrated that an 8.58% cost of common equity provides investors with a fair return on their investment in the Companies. I also used other supplemental checks to validate my results.

In addition, I recommended that if the Commission approves Rider UEA and rate design changes that stabilize the Companies' revenues, it should take two actions:

1. Reduce the cost of equity determined for both Peoples and North Shore by 22.5 basis points (for a total reduction of 32.5 basis points including the effect of Rider UEA, the stabilizing rate design changes, and the Commission's prior 10 point reduction resulting from it approval of Rider VBA in the Companies' prior rate cases); and
2. Approve a cost of equity that is at the low end of the range of reasonable estimates. Furthermore, if the Commission approves Rider ICR, it should find that the cost of capital for all investments made under Rider ICR is equivalent to the Companies' cost of debt.

Q. HAS THE TESTIMONY ON COST OF CAPITAL ISSUES IN THIS CASE CAUSED YOU TO RECONSIDER ANY OF THE CONCLUSIONS YOU PRESENTED IN YOUR DIRECT TESTIMONY?

A. No. However, I have updated the capital structure and debt cost figures I presented in my previous testimony to reflect the recommendations made by Staff witness Sheena Kight-Garlisch. I have adopted Ms. Kight-Garlisch's recommended capital structure and debt costs to isolate the impact that my cost of equity proposal has on the Companies' cost of capital.

II. <u>RESPONSE TO MR. MOUL</u>

Q. PLEASE SUMMARIZE YOUR RESPONSE TO MR. MOUL.

A. Mr. Moul's rebuttal testimony relies on the same sort of subjectivity that can be found throughout his direct testimony. He suggested that critical inputs to the standards models require his subjective approval, and he continues to rely on short-term subjective investor expectations as predictors of long-term sustainable growth.

II. A. <u>GENERAL ISSUES WITH MR. MOUL'S REBUTTAL TESTIMONY</u>

Q. MR. MOUL ARGUED THAT THE FINANCIAL COMMUNITY WOULD BE "EXTREMELY CONCERNED" IF THE COMMISSION SET THE COST OF EQUITY AT THE LEVEL PROPOSED BY STAFF AND WOULD BE "SHOCKED" IF THE COMMISSION ADOPTED YOUR RECOMMENDATION. NS-PGL EX. PRM 2.0 AT 2, LL 33-35. ARE THESE STATEMENTS RELEVANT TO THE COMMISSION'S DETERMINATION?

A. No. Mr. Moul has provided no objective support for his statements, and the Commission should not base its decision on such speculation. As Mr. Bodmer explains, Mr. Moul's argument is simply a fear tactic presented to encourage the Commission to abandon objectivity in determining the Companies' cost of equity and instead focus on short-term subjective expectations. Mr. Moul's preference for opinions over more objective market indicators can be found throughout his testimony. Specifically:

- Mr. Moul inexplicably relied excessively on data from Value Line, while ignoring comparable publicly available objective information.
- Mr. Moul argued that the short-term economic crisis has led investors to require higher long-term returns today than they did just two or three years ago.
- Mr. Moul argued that utilities are somehow entitled to higher returns because they must raise capital during all phases of the capital market cycle.

I refute these subjective judgments below.

Q. HOW DID MR. MOUL RELY EXCESSIVELY ON INFORMATION FROM VALUE LINE?

A. Mr. Moul relied on Value Line to the exclusion of other available comparable information. He argued that the true test of the relevance of Value Line rests on whether it is read by investors when they analyze stocks, and that, in his view, Value Line is an investor-influencing source of information. *See, e.g., id.* at 4, LL. 60-62. While Value Line publications may be read by investors, the published information must be used objectively, rather than simply assuming that Value Line's data and forecasts represent the market. Mr. Moul does not use the Value Line information in an objective way.

A reading of Mr. Moul's testimony suggests that he is the sole arbiter of what information investors review when they invest. Indeed, Mr. Moul criticizes Mr. McNally for calculating betas independently of those issued by Value Line. Also, in defending his exclusive reliance on Value Line data, Mr. Moul relies on his opinion of what investors read to condemn the inclusion in one's analysis of other objective information. "To augment the <u>Value</u> <u>Line</u> betas with other information investors do not use is not appropriate, regardless of the theoretical underpinnings of the modifications." NS-PGL Ex. PRM 2.0 at 26, LL. 492-94.

In defending his Value Line betas, Mr. Moul is implicitly arguing that investors don't calculate their own beta estimates (as Staff has done), and they do not rely on betas calculated by sources other than Value Line. This is simply another example of Mr. Moul's subjective bias. Evaluating the theoretical underpinnings of the models used to calculate the cost of equity capital is a critical undertaking. This is especially true given the uncertainty in the current financial environment.

As shown in the chart below, some of the information from Value Line Mr. Moul used without modification or explanation is disproportionately higher than information from other publicly available sources.

Beta Estimates

	Value Line Reported	Yahoo	Reuters	Google	Average
AGL	0.75	0.45	0.40	0.39	0.50
ATO	0.65	0.51	0.49	0.49	0.54
GAS	0.75	0.32	0.35	0.35	0.44
LG	0.60	-0.05	0.05	0.04	0.16
NJR	0.65	0.11	0.15	0.26	0.29
NWN	0.60	0.25	0.31	0.30	0.37
PNY	0.65	0.19	0.20	0.25	0.32
SJI	0.65	0.23	0.21	0.23	0.33
WGL	0.65	0.19	0.22	0.21	0.32
	0.66	**0.24**	**0.26**	**0.28**	**0.36**

Mr. Moul relies on only the reported Value Line betas, which have been adjusted for a questionable mean reversion assumption and which are more than 1.8 times higher than the average beta reported by publicly available sources. To be clear, my analysis does use data from Value Line. However, I have balanced the information from Value Line with other publicly available objective information.

Mr. Moul criticizes Staff's use of spot prices instead of a bigger sample of prices, because single data points are more susceptible to "gamesmanship" and error from short-term inefficiency. NS-PGL Ex. PRM 2.0 at 11, LL. 203-04. Mr. Moul did not heed his own advice when he relied solely on Value Line betas, which resulted in a significant overstatement of the Companies' cost of equity. Some might even consider ignoring publicly available information in favor of information from one source "gamesmanship."

Q. IN HIS REBUTTAL, MR. MOUL INCLUDED EXPECTED MARKET VALUE RETURNS REPORTED BY VALUE LINE AS SUPPORT FOR HIS RETURN-ON-EQUITY RECOMMENDATION. NS-PGL EX. PRM 2.0 AT 2-3, LL 44-51. DO THESE RETURNS HAVE ANY RELEVENCE TO THIS PROCEEDING?

A. No. The Commission must look at objective information instead of simply adopting reports of investors' supposed expectations from a single source. As the testimony presented by both Staff witness McNally and by me indicates, objectively determined returns are significantly below the subjective expectations Mr. Moul used in performing his analysis. If the Commission could reasonably rely on alleged investor expectations to make the Commission's ultimate determination, the market cost of equity, then this entire debate in regulatory proceedings would be moot. The Commission, as appears to be Mr. Moul's preference, would simply plug in the Value Line numbers for the cost of equity for the Companies and move on to the next issue. There would be no need to evaluate the evidence or to determine what is a just and reasonable cost of equity. Of course, that approach is not rational ratemaking policy or consistent with the standards that govern ratemaking.

Q. MR. MOUL ASSERTED THAT INVESTORS REQUIRE HIGHER RETURNS TO ACCEPT RISK TODAY THAN THEY DID JUST TWO OR THREE YEARS AGO. NS-PGL EX. PRM 2.0 AT 6, LL 109-11. HE ARGUED THAT THIS MEANS THE COMMISSION CANNOT ACCEPT THE RECOMMENDATIONS MADE BY YOU AND STAFF. DO YOU ARGEE?

A. No. This argument further highlights the subjective bias inherent in Mr. Moul's logic and analysis. Mr. Moul tries to obfuscate the connection between short-term and long-term capital costs. Short-term variations in utility earnings, stock prices, and capital costs are not new or unusual. A familiar example of such variation is the weather normalization of billing units used in rate setting. Utilities experience the effects of fluctuations in weather, capital market prices and costs, and operational expenses. However, the Commission's task is to set rates that allow the utility to recover its costs, including the cost of capital, over time. In a utility rate case the Commission does not determine the cost of capital for a discrete time period. Rather, the Commission sets a long-term cost of capital. Accordingly, the Commission's determination should not be influenced by statements based on fear about the short-term financial outlook, when setting rates must meet a long-term standard.

Q. MR. MOUL ARGUED THAT UTILITIES ARE UNIQUELY EXPOSED TO THE VOLATILITY OF THE EQUITY MARKETS BECAUSE THEY MUST CONTINUE TO INVEST DURING TIMES OF BOTH FINANCIAL BOOM AND FINANCIAL BUST. NS-PGL Ex. PRM 2.0 AT6, LL 113-116. IS THIS A VALID ARGUMENT?

A. No. Utility managers have been exposed to economic volatility for decades. This risk is neither new nor unique to utilities. Recently, utilities have taken active steps to reduce the risk of their business, as the Companies do in this case with their proposals for various risk-reducing riders.

II. B. <u>CRITICISM OF MY DCF ANALYSIS</u>

Q. HOW DID MR. MOUL CRITICISE YOUR DCF ANALYSIS?

A. Mr. Moul criticizes my analysis in several ways. He takes issue with:

- my use of a non-constant growth DCF model;
- the use of GDP growth as a steady state growth rate; and,
- my testimony regarding the effect that a declining dividend payout ratio has on DCF results.

Q. MR. MOUL ARGUED THAT THE NON-CONSTANT GROWTH DCF MODEL IS INNAPPROPRIATE TO USE WHEN CALCULATING THE RETURN ON EQUITY FOR A PUBLIC UTILITY. NS-PGL Ex. PRM 2.0 at 16, LL 330-2. DO YOU AGREE?

A. No. Mr. Moul argued that the non-constant DCF approach is less objective because it somehow “divorces” the DCF model from the analysis undertaken by investors when forming their return expectations. NS-PGL Ex. PRM 2.0 at 16, LL 330-2**.** Mr. Moul’s argument is an oversimplification of investor expectations and is completely subjective in nature. The core of Mr. Moul’s supposition is his contention that investors rely so heavily on growth rate expectations published by analysts that more complete analyses (even if conducted by other analysts) do not have a significant effect.

Discontinuity or turmoil in the credit markets creates uncertainty in expectations about the future. In the current environment, investors are focused on short-term changes in the equity markets, and as a result, both forecasted and historical growth rate information become unreliable measures of expected near-term growth for individual firms. It is, therefore, difficult to predict with accuracy a sustainable constant growth rate for companies. Mr. Bodmer provides more evidence on this point. However, as Mr. Bodmer and I discussed in our respective direct testimonies, while the current market discontinuity affects short-term expectations for different companies, there are still expectations that over the long run that the entire economy will continue to grow at a reasonable rate. While there may be short-term variations, long term growth in the US economy, as measured by the historic growth in real gross domestic product (real GDP), is a reasonable expectation. This has implications for the Commission because of the uncertainty that exists today following a recent financial crisis. Both Staff Witness McNally and I have recommended that the Commission recognize that utility returns will trend towards the long-term growth in the economy. Only Mr. Moul has testified that the expectations created by the short-term financial crisis are sustainable indefinitely.

Mr. Moul did acknowledge that, over time, growth is cyclical – it ramps-up and ramps-down over time. However, rather than select a sustainable long-term growth rate, Mr. Moul relied on short-term growth rates calculated during a time of short-term financial distress as substitutes for more realistic long-term growth rates. To assume that growth will always be at the level of a near-term forecast is not a reasonable or objective analysis of expected growth or the cost of equity.

Q. MR. MOUL ARGUED THAT THE FEDERAL ENERGY REGULATORY COMMISSION ("FERC") HAS REJECTED THE USE OF THE NON-CONSTANT GROWTH DCF MODEL. IS HE CORRECT?

A. Mr. Moul is correct that FERC determined that use of a two-stage DCF model would not be appropriate for electric utilities at that time. As he reported, "FERC declined to use the two-stage DCF because electric companies did not display the growth characteristics that fit the two-stage model characteristics." NS-PGL Ex. PRM 2.0 at 16, LL 367-9**.** However, Mr. Moul neglected to inform the Commission that in the same proceeding FERC concluded:

> we believe that significant differences exist in the electric utility industry and the natural gas pipeline industry which warrant the continued use of different growth rates in the DCF models for each. (92 FERC ¶61,070 (July 27, 2000))

The relatively stable industry structure for gas pipelines, which FERC relied on in reaffirming two-stage models for those firms, is exceeded by the stability of the gas distribution industry.

Q. MR. MOUL ARGUED THAT GDP GROWTH IS NOT AN APPROPRIATE MEASURE OF LONG-TERM EARNINGS GROWTH FOR USE IN THE DCF. NS-PGL EX. PRM-2.O AT 16-17, LL. 338-54. DO YOU AGREE?

A. No. Mr. Moul argues that GDP growth does not appropriately consider expectation for the growth in corporate profits. This is simply not true. The historic growth in GDP includes growth in corporate profits. Therefore, GDP growth does include an expectation that corporate profits will continue to grow as they have historically. This is a reasonable assumption for long-term growth. This is especially so given the subjectivity of growth forecasts, as I have identified in my direct testimony.

Q. MR. MOUL ARGUED THAT NATURAL GAS UTILITIES CAN ACHIEVE EARNINGS GROWTH THAT EXCEEDS LONG-TERM GROWTH IN GDP. NS-PGL EX. PRM-2.O AT 19, LL. 384--95. IS THIS A REASONABLE EXPECTATION?

A. No. It is simply unreasonable to expect that regulated public utilities will achieve sustainable earnings growth that exceeds the long-term growth rate of GDP. It is hard to believe that regulated natural gas utilities will grow more quickly than the entire economy, especially in an energy climate that is focused on the impacts of climate change and is increasingly turning to energy efficiency to meet energy needs.

Q. MR. MOUL ARGUED THAT YOUR ANALYSIS DOES NOT ACCURATELY REFLECT INVESTORS' EXPECTATION IN THE TEST YEAR. DO YOU AGREE?

A. No. Mr. Moul's argument is subjective and does not add anything to this proceeding. The actual return required to induce investors to make a particular investment is not a directly observable number – that is why estimates are necessary. Similarly, investors' requirements for future dividends and rates of growth cannot be found in the pages of the Wall Street Journal and plugged into the model (although this is an approach that Mr. Moul seems to favor).

As Mr. Bodmer explained in his direct testimony, the growth rates used in the DCF model should be sustainable and satisfy three basic criteria:

- Earnings growth rate inputs must be reasonable in light of the anticipated growth in GDP and other limiting factors;
- The long term growth rate must not implicitly require continued earnings above the regulated firm's cost of equity, as derived in the analysis; and
- The long term growth rates must not require dividend payout ratios that are not consistent with the capital expenditure growth rate and the return on equity.

As Mr. Bodmer's testimony showed, current analysts' 3 to 5 year growth projections do not meet these simple, common sense tests. *See*, *e.g.,* CUB-City Ex. 1.0 at 23-25, LL 433-88. As I discussed in my direct testimony, this is not a new revelation, as the financial literature has looked at analysts' growth rates dubiously for a number of years. CUB-City Ex. 2.0 at 13-14, LL 290-323. This literature reveals that many researchers have found that analysts tend to be optimistic about future growth and produce forecasts that are upwardly biased. This upward bias translates into DCF cost of capital estimates that are above the true required cost of capital. Estimates based on such forecasts, in Mr. Moul's analysis short-term forecasts, should be given little or no weight.

The Commission should not accept mechanistic replications of quantitative modeling used in past, more stable periods of the economy. Rather, in light of the financial crisis, the Commission should carefully scrutinize the reasonableness of re-using old forms of financial models and ensure that its determination in this case is consistent with current financial circumstances.

II. C. <u>EFFECT OF DECLINING DIVIDEND PAYOUT RATIOS</u>

Q. MR. MOUL ARGUED THAT YOU ARE INCORRECT IN YOUR TESTIMONY THAT USING EARNINGS GROWTH RATES IN THE DCF ANALYSIS OVERSTATES THE COST OF EQUITY WHEN THE DIVIDEND PAYOUT RATIO IS EXPECTED TO DECLINE. NS-PGL EX. PRM-2.O AT 34, LL 680--85. IS HIS ARGUMENT PERSUASIVE?

A. No. Mr. Moul asserted that with a declining dividend payout ratio, using the dividends per share growth rate in the DCF will underestimate the return. Mr. Moul further claimed that growth will only occur at the higher earnings per share growth rate, and therefore earnings-per-share growth must be used in the DCF model. However, when the dividend payout ratio is declining, using earnings per share growth in the DCF produces biased results. Because the dividend payout ratio is declining, using earnings growth will overstate the real growth expected in the company. This type of selective analysis further highlights Mr. Moul's subjective bias. As shown in the chart below, blindly using earnings-per-share growth in the DCF, regardless of how the dividend payout ratio is projected to change, will lead to inaccurate results.

The Impact of Declining Dividend Payouts on DCF Model Results

	100% Dividend Payout	50% Dividend Payout	100% Declining to 50% Dividend Payout
ROE	8%	8%	8%
Earnings	$2	$2	$2
Payout Ratio	100%	50%	100% Declining to 50%
Current Dividend	$2	$1	$2
Share Price	$25	$25	$25
Yield	8%	4%	8%
Earnings Growth	0%	4%	4%
DCF Results	**8%**	**8%**	**12%**

As I discussed in my direct testimony, I have corrected this problem by using the internal growth rate in the first stage of my DCF analysis.

Q. MR. MOUL CRITICISED THE EXCLUSION OF EXTERNAL GROWTH IN YOUR DCF ANALYSIS BECAUSE HE CLAIMS THAT COMPANIES CAN SELL NEW COMMON STOCK. NS-PGL EX. PRM-2.O AT 35, LL 692--94. IS THIS A VALID REASON TO INCLUDE EXTERNAL GROWTH IN THE DCF FOR A REGULATED PUBLIC UTILITY?

A. No. As I stated in my direct testimony, additional equity sales create growth in the common equity of a company only when market prices exceed book values, because the premium over book value on the new shares shows up on the company's books as increased equity. The Commission sets rates based on the book value of investment, and a mere increase in share prices does not change the amount actually invested in the firm, as higher prices on old shares represent gains for sellers, not actual new investment for the utility. Consequently, adjusting for the difference between market and book values only serves to inflate the cost of equity the Commission grants to a regulated utility.

As Mr. Bodmer explained, there is no reason to assume that market prices should remain significantly above or below book values for the indefinite future, although there are circumstances that can cause minor deviations in the two values. When, as here, the dividend payout ratio is expected to change because more capital is being retained by the business, the use of the fundamental growth formula **–** Earnings Growth = (Retention Rate) x ROE -- is a more reasonable method for estimating growth rates for use in the DCF formula. Whether the dividend payout ratio increases or decreases, such change (if not taken into account) creates distortions in DCF model results.

Q. MR. MOUL TAKES ISSUE WITH YOUR TESTIMONY REGARDING MARKET AND BOOK VALUES BECAUSE HE ARGUES THAT THERE ARE MANY FACTORS WHICH CAN DRIVE MARKET AND BOOK VALUES TO DIVERGE. IS THIS A VALID REASON TO ACCEPT A HIGHER COST OF EQUITY?

A. No. A basic tenet of utility cost of capital theory is that, if a company's sustainable earnings exactly match its cost of capital, the market value of the company will equal the book value of its assets. In terms of the DCF model, the present value of the company's cash flows, discounted at the cost of capital, will be exactly the same as the value of the assets in rate base. The same cash flow analysis shows that a market-to-book ratio that exceeds 1.0 indicates that a utility is earning more than its cost of capital. I am not advocating a strict methodology that requires a market-to-book ratio of exactly 1.0 at all times, instead, I am recommending that the Commission not make adjustments based on the divergence of market and book values. Mr. Moul's attempts to include external growth in my DCF analysis and his proposed leverage adjustments to both the DCF and CAPM are simply inconsistent with the basic tenets of ratemaking.

The Commission has repeatedly concluded that there is no reason to adjust market-based DCF model results before applying them to the book value of assets in rate base. It has traditionally been the Commission's practice to apply unadjusted market-based DCF results to the book value rate base assets, and Mr. Moul has not presented any evidence that should persuade the Commission that the market has not already taken this information into account or to change its long-standing policy.

II. D. <u>CAPM</u>

Q. MR. MOUL ARGUED THAT THE RESEARCH YOU HAVE PRESENTED WITH RESPECT TO THE CAPM PREDATES THE RECENT SIGNIFICANT INCREASE IN MARKET VOLATILITY AND IS THEREFORE NOT RELEVANT TODAY. NS-PGL EX. PRM-2.O AT 38, LL 775-77. IS THIS A REASONABLE CONCLUSION?

A. No. First, Mr. Moul has not provided evidentiary support for his supposition that the research I have relied upon is not relevant. Second, if the research I have relied on is somehow not relevant today, simply because it pre-dates the recent financial crisis, then the research Mr. Moul relied upon is similarly flawed. Assessing the record as Mr. Moul suggests would leave the Commission in an untenable position. It would toss out most of the analytical foundation on which the Commission has previously relied. A better course is to approach issues objectively, as Mr. Bodmer and I have recommended. The Commission should undertake an analysis of all relevant issues, like the broad, more objective examination I have presented.

III. RESPONSE TO MR. McNALLY

Q. HAVE YOU REVIEWED THE TESTIMONY OF STAFF WITNESS McNALLY?

A. Yes. The largest single difference in Mr. McNally's analysis and the analysis that I performed is the growth rates we used. Mr. McNally uses analysts' forecasts of short-term growth for his first stage growth rate, while my analysis relies on historic fundamental growth for the first stage, for the reasons that I have identified. The effect of this difference on the DCF model results is approximately 117 basis points.

Q. IF THE COMPANIES PROPOSED RIDERS ARE ACCEPTED, MR. MCNALLY PROPOSED A 30 BASIS POINT REDUCTION FOR NORTH SHORE GAS'S APPROVED RETURN ON EQUITY AND A 75 BASIS POINT REDUCTION FOR PEOPLES GAS. HOW DOES MR. MCNALLY'S ANALYSIS COMPARE TO YOURS?

A. In addition to the 10 basis point adjustment already accepted in the Companies' last rate case for Rider VBA, Mr. McNally conducted three different analyses to support his adjustment. He calculated the impact of the Rider UEA on the Companies Credit ratings, variability in each of the Companies' operating incomes as measured by the CAPM beta factor, and an analysis of operating incomes both with and without Rider UEA. Mr. McNally's analysis produced the following results:

	North Shore	Peoples Gas
Implied Moody's ratings	10 basis points	10 basis points
Beta adjustment	30 basis points	120 basis points
Operating income adjustment	26 basis points	107 basis points

Based on the midpoints of these ranges, Mr. McNally recommend adjustments to North Shore's and Peoples Gas's costs of common equity of 20 basis points and 65 basis points, respectively, should the Commission authorize the implementation of Rider UEA. He also adopted the 10 basis point adjustment the Commission already accepted for Rider VBA.

I recommended in my direct testimony that if the Commission approves Rider UEA and rate design changes that stabilize the Companies' revenues it should take two actions:

1. Reduce the ROE granted to both Peoples and North Shore by 22.5 basis points (for a total reduction of 32.5 basis points from Riders VBA and UEA and the stabilizing rate design changes); and
2. Adopt an ROE at the low end of any range of reasonable estimates.

Mr. McNally and I agree that the impact of Riders VBA and UEA on the Companies' revenues are substantive and require a significant adjustment to their returns on equity. Only Mr. Moul and Mr. Fetter disagree.

IV. RIDER ICR

Q. PGL WITNESS JOHNSON CRITICIZED YOUR PROPOSAL TO SET THE RATE OF RETURN ON ALL INVESTMENTS MADE UNDER RIDER ICR AT THE UTILITIES' COST OF DEBT. ARE HIS ARGUMENTS PERSUASIVE?

A. No. Mr. Johnson argues that equity investors always assume more risk than debt investors, and that it is not accurate that the expected equity returns on these assets would be the same as the debt rate. What Mr. Johnson fails to acknowledge is that Rider ICR eliminates both the regulatory lag and the risk of non-recovery (for prudent costs). This level of assurance is significant and has a huge value to investors. Staff witness McNally made similar recommendations

> That is, while Rider ICR eliminates the risk of non-recovery of prudent and reasonable costs, the prudency and reasonableness of Rider ICR investments is still subject to annual reviews. Thus, there remains some degree of risk of non-recovery of costs. Staff Ex. 7.0 at 35, LL 698--701

I do not share Mr. McNally's view that the risk associated with the prudency and reasonableness of investments made under Rider ICR represents a significant risk to management. As long as the Companies are not extravagant in their expenditures, they will likely argue that the Commission's earlier approval of their proposal to accelerate main replacement demonstrates the prudence of their investments. However, if the Commission believes that these risks are significant because the Commission will examine these issues without a predisposition, then it should adopt Mr. McNally's

V. CAPITAL STRUCTURE

Q. STAFF AND THE COMPANY DISAGREE OVER THE APPROPRIATE CAPITAL STRUCTURE FOR USE IN THIS PROCEEDING. WHICH CAPITAL STRUCTURE DO YOU BELIEVE IS MOST APPROPRIATE?

A. I agree with Ms. Kight-Garlisch that short-term debt must be included in the capital structure for ratemaking purposes, as I testified in my direct testimony. I have adopted Ms. Kight-Garlisch's recommended capital structure and debt costs to isolate the impact that my cost of equity proposal has on the Companies' cost of capital.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.