REBUTTAL TESTIMONY

of

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Finance Department
Financial Analysis Division
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North Shore Gas Company and
The Peoples Gas Light and Coke Company

Proposed General Increase in Gas Rates

Docket Nos. 09-0166 and 09-0167
(Consolidated)

August 4, 2009

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WITNESS IDENTIFICATION

Q. Please state your name and business address.

A. My name is Sheena Kight-Garlisch. My business address is 527 East Capitol Avenue, Springfield, Illinois 62701.

Q. Are you the same Sheena Kight-Garlisch who testified previously in this proceeding?

A. Yes, I am.

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

A. The purpose of my rebuttal testimony is to respond to the rebuttal testimony of The Peoples Gas Light and Coke Company's ("Peoples Gas") and North Shore Gas Company's ("North Shore") (individually, the "Company" and collectively, the "Companies") witness Bradley A. Johnson, NS-PGL Ex. BAJ-2.0. Specifically, I will address Mr. Johnson's testimony regarding the inclusion of short-term debt in the capital structure and the appropriate balances of the other components of the capital structure.

Q. Please summarize the remaining contested capital structure and cost of capital issues between the Companies and Staff.

A. Staff and the Companies continue to disagree on the cost of equity for both Companies and Peoples Gas' cost of Series OO long-term debt.

COST OF CAPITAL

Q. Please summarize your findings.

A. I recommend an overall cost of capital of 7.90% for North Shore and 7.75% for Peoples Gas. The overall cost of capital for both Companies is shown on Schedule 22.1.

CAPITAL STRUCTURE

Q. Do you have any changes to the capital structures you propose for setting rates?

A. Yes. I have updated the balance of short-term debt to reflect each Company's revised average balances for 2010. As a consequence of those revised average short-term debt balances, I have accepted the Companies' proposed hypothetical capital structure of 44% long-term debt and 56% common equity.

Q. Please explain why you revised the balance of short-term debt.

A. The Companies provided revised forecasts of short-term debt that reflect their "forecasts of gas in storage, capital expenditures, and net retirement benefit obligations" which where updated in Company witness John Hengtgen's rebuttal testimony and exhibits.[1] The updated short-term debt balances are shown on Schedule 22.2N and 22.2P.

[1] North Shore's response to Staff data request FIN 9.02; Peoples Gas' response to Staff data request FIN 9.02.

Q. What capital structure do you recommend for North Shore?

A. North Shore has an actual average 2010 capital structure comprising $72,476,045 long-term debt, $6,843,865 short-term debt, and $95,578,042 common equity, as shown in Schedule 22.3N. The Company proposed a hypothetical capital structure comprising 44% long-term debt and 56% equity. I re-evaluated the capital structures and their implied overall costs based on my updated cost of short-term debt and the North Shore's updated balance of short-term debt. The Company's proposed hypothetical, imputed capital structure, which excludes short-term debt, produces an overall rate of return of 7.90%. The Company's forecasted average 2010 capital structure, which includes short-term debt, produces an overall rate of return of 7.85%. The capital structures and overall cost of capital are presented in Schedule 22.3N. The overall rates of return produced by both capital structures are very similar. Therefore, to reduce issues in this case, I will accept for purposes of this proceeding North Shore's proposed hypothetical capital structure of 0% short-term debt, 44% long-term debt and 56% common equity even though North Shore clearly uses short-tem debt to finance rate base.

Q. What capital structure do you recommend for Peoples Gas?

A. Peoples Gas has an actual average 2010 capital structure comprising $532,238,953 long-term debt, $19,113,513 short-term debt, and $768,405,875 common equity, as shown in Schedule 22.3P. The Company proposed a hypothetical capital structure comprising 44% long-term debt and 56% equity. In direct testimony, I accepted the Company's proposed imputed common equity and total debt ratios. However, I divided the imputed total debt ratio into short and long-term debt components based on their relative magnitude in the Company's forecasted average 2010 capital structure.

I re-evaluated the capital structure and its implied overall cost based on my updated cost of short-term debt and the Peoples Gas' updated balance of short-term debt. The Company's proposed hypothetical, imputed capital structure, which <u>excludes</u> short-term debt, produces a lower overall rate of return for the Company than its forecasted average 2010 capital structure, which <u>includes</u> short-term debt. The capital structures and overall cost of capital are presented in Schedule 22.3P. In addition, the capital structure I recommended in direct testimony results in an overall cost of capital very similar to the overall costs from the actual average 2010 capital structure and Peoples Gas' proposed hypothetical capital structure. Therefore, to reduce issues in this case, I will accept for purposes of this proceeding Peoples Gas' proposed hypothetical capital structure of 0% short-term debt, 44% long-term debt and 56% common equity even though Peoples Gas clearly uses short-tem debt to finance rate base.

Peoples Gas Cost of Long-Term Debt

Q. Mr. Johnson argues that the insurance cost adjustment applied to Peoples Gas' insured tax exempt bonds should reflect the Company's split rating.[2] Please comment.

A. Although I do not agree with the manner in which Mr. Johnson calculated the insurance cost adjustment, for purposes of reducing issues in this case, I have adjusted my cost of debt to reflect half the adjustment proposed in my direct testimony. The revised cost of long-term debt for Peoples Gas of 5.28% is presented in Schedule 22.4P.

Q. Mr. Johnson argues that the interest rate applied to the Series OO auction rate bonds is "excessive" and "unreasonable".[3] Please comment.

A. The Series OO bonds have failed at auction since March of 2008. Therefore, Peoples Gas pays a default rate, which is 175% of LIBOR.[4] For my direct testimony I relied on the most recent, actual interest rate incurred for the Series OO auction rate bonds of 0.998%. In fact, the rate paid by the Company has been less than 1% since February of 2009. The Company's argument that my adjustment is excessive and unreasonable is without merit, since it is the actual current cost incurred by the Company.

The Company has proposed to remarket or refinance the Series OO issues with fixed rate debt at an interest rate of approximately 7.16%. The Company's

[2] NS-PGL Ex. BAJ-2.0, pp. 19-20.
[3] NS-PGL Ex. BAJ-2.0, pp. 15-16.
[4] NS-PGL Ex. BAJ-2.0, pp. 16-17.

arguments to refinance or remarket the debt issuance are nonsensical.[5] Specifically, it claims that it "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."[6] The Utility should not be concerned that investors in these bonds (some of which are the Company's core credit banks) are not earning a fair market rate. The investors in the bonds should have known the risk of investing in the auction rate securities. Now that interest rates have fallen and investors are not earning their desired return is not a valid reason for the Utility to remarket or refinance its debt at a considerably greater cost. Further, the Company's concern for the investors' earning their desired returns is misplaced. The Company is paying a very low interest rate on this debt issue, which the Company should embrace since it leads to a lower cost of debt for the Company. It makes no sense for the Company to want to refinance or remarket these bonds at this point in time, since it believes that the bonds will continue to fail in the auction market for the "foreseeable future."[7]

The Company also argues to refinance or remarket the bonds to fixed rate debt because of the risk of fluctuating interest rates. This risk existed when the Company decided to issue these auction rate bonds. If this was such a concern, then the Company should not have issued auction rate bonds, but instead should

[5] NS-PGL Ex. BAJ-2.0, p. 17.
[6] NS-PGL Ex. BAJ-2.0, p. 17.
[7] NS-PGL Ex. BAJ-2.0 Rev., p. 17.

have issued it as fixed rate debt in 2003 when the Series OO bonds were first issued.

Forecasted Interest Rates

Q. Mr. Johnson advocates for the use of a forecasted 3-month LIBOR rate to determine the cost of Peoples Gas' Series OO debt instead of Staff's proposed 1-month LIBOR spot rate.[8] Please comment.

A. Accurately forecasting interest rates is problematic, as illustrated by Schedule 22.5, which compares actual (spot) 3-month LIBOR rates to projections published by Mr. Johnson's source for interest rate projections, *Blue Chip Financial Forecasts ("BCFF").* Schedule 22.5 shows that *BCFF* interest rate projections have consistently exceeded the actual interest rates. Importantly, Schedule 22.5 illustrates that the accuracy of the forecasted yields diminishes as the forecast period lengthens. Although interest rates may currently be low on a historical basis, room exists for further interest rate declines. No one can predict with certainty when interest rates will begin to rise, the rate at which they will rise, how long they will rise before falling again, the rate at which they will fall, or even whether they will rise before they fall further. Therefore, the Commission should continue to use actual spot interest rates rather than forecasted interest rates to estimate the Companies' cost of debt.

Further, the Company wants to rely upon the forecasted 3-month LIBOR rate to determine the Series OO interest rate, even though the interest rate on the bonds

[8] NS-PGL Ex. BAJ-2.0 Rev., pp. 13-14, and 19.

is determined using the 1-month LIBOR rate.[9] The 3-month LIBOR rate has been consistently higher than the 1-month LIBOR rate for at least the past year. This is illustrated in Schedule 22.6. Thus, based on the foregoing, the spot commercial paper rate should be used to determine the cost of short-term debt and the spot 1-month rate LIBOR rate should be used to determine the interest rate for Series OO bonds.

RATE OF RETURN ON RATE BASE

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

A. I recommend a 7.90% rate of return on North Shore’s rate base. This rate of return incorporates the 9.79% rate of return Staff witness Michael McNally recommends for North Shore’s common equity. The rate of return I recommend on North Shore’s rate base is shown on Schedule 22.1.

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

A. I recommend a 7.75% rate of return on Peoples Gas’ rate base. This rate of return incorporates the 9.69% rate of return Staff witness Michael McNally recommends for Peoples Gas’ common equity. The rate of return I recommend on Peoples Gas’ rate base is shown on Schedule 22.1.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.

[9] Peoples Gas WPD-3(1), p. B-14.

Weighted Average Cost of Capital

North Shore Gas Company

	Percent of Total Capital	Cost	Weighted Cost
Long-term Debt	44.00%	5.49%	2.42%
Short-term Debt	0.00%	0.00%	0.00%
Common Equity	56.00%	9.79%	5.48%
Total Capital	100.00%		
Weighted Average Cost of Capital			**7.90%**

The Peoples Gas Light and Coke Company

	Percent of Total Capital	Cost	Weighted Cost
Long-term Debt	44.00%	5.28%	2.32%
Short-term Debt	0.00%	0.00%	0.00%
Common Equity	56.00%	9.69%	5.43%
Total Capital	100.00%		
Weighted Average Cost of Capital			**7.75%**

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ICC Staff Exhibit 22.0
Schedule 22.2N

North Shore Gas Company

Balance of Short-term Debt
December 31, 2010

Date (A)	Gross Short-term Debt Outstanding* (B)	CWIP (C)	CWIP Accruing AFUDC (D)	(B) - (D)	(B) - ((B)/(C)*(D))	Net Short-term Debt Outstanding (E)	Monthly Average (F)
Dec-09	$30,369,965	$ 195,000	$ -	$30,369,965	$30,369,965	$30,369,965	
Jan-10	$23,021,789	$ 205,000	$ -	$23,021,789	$23,021,789	$23,021,789	$ 26,695,877
Feb-10	$0	$ 214,000	$ -	$0	$0	$0	$ 11,510,895
Mar-10	$0	$ 214,000	$ -	$0	$0	$0	$ -
Apr-10	$0	$ 214,000	$ -	$0	$0	$0	$ -
May-10	$0	$ 305,000	$ -	$0	$0	$0	$ -
Jun-10	$0	$ 354,000	$ -	$0	$0	$0	$ -
Jul-10	$0	$ 354,000	$ -	$0	$0	$0	$ -
Aug-10	$0	$ 354,000	$ -	$0	$0	$0	$ -
Sep-10	$0	$ 430,000	$ -	$0	$0	$0	$ -
Oct-10	$0	$ 345,000	$ -	$0	$0	$0	$ -
Nov-10	$24,490,693	$ 194,000	$ -	$24,490,693	$24,490,693	$24,490,693	$ 12,245,347
Dec-10	$38,857,830	$ 194,000	$ -	$38,857,830	$38,857,830	$38,857,830	$ 31,674,262
Average							**$ 6,843,865**

Notes: Column (E) = the greater of [Column (B) - Column (C)] or [Column (B) - Column (B) / Column (C) * Column (D)]

* North Shore's Response to Staff data request FIN 9.02.

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ICC Staff Exhibit 22.0
Schedule 22.2P

Peoples Gas Light & Coke Company

Balance of Short-term Debt
December 31, 2010

Date (A)	Gross Short-term Debt Outstanding* (B)	CWIP (C)	CWIP Accruing AFUDC (D)	(B) - (D)	(B) - ((B)/(C)*(D))	Net Short-term Debt Outstanding (E)	Monthly Average (F)
Dec-09	$69,949,208	$ 195,000	$ -	$69,949,208	$69,949,208	$69,949,208	
Jan-10	$81,749,370	$ 205,000	$ -	$81,749,370	$81,749,370	$81,749,370	$ 75,849,289
Feb-10	$0	$ 214,000	$ -	$0	$0	$0	$ 40,874,685
Mar-10	$0	$ 214,000	$ -	$0	$0	$0	$ -
Apr-10	$0	$ 214,000	$ -	$0	$0	$0	$ -
May-10	$0	$ 305,000	$ -	$0	$0	$0	$ -
Jun-10	$0	$ 354,000	$ -	$0	$0	$0	$ -
Jul-10	$0	$ 354,000	$ -	$0	$0	$0	$ -
Aug-10	$0	$ 354,000	$ -	$0	$0	$0	$ -
Sep-10	$0	$ 430,000	$ -	$0	$0	$0	$ -
Oct-10	$0	$ 345,000	$ -	$0	$0	$0	$ -
Nov-10	$107,949,563	$ 194,000	$ -	$107,949,563	$107,949,563	$107,949,563	$ 53,974,782
Dec-10	$9,377,226	$ 194,000	$ -	$9,377,226	$9,377,226	$9,377,226	$ 58,663,395
Average							**$ 19,113,513**

Notes: Column (E) = the greater of [Column (B) - Column (C)] or [Column (B) - Column (B) / Column (C) * Column (D)]

* Peoples Gas' Response to Staff data request FIN 9.02.

North Shore Gas Company

Actual Average 2010 Capital Structure

	Balance	Percent of Total Capital	Cost	Weighted Cost
Long-term Debt	$72,476,045	41.44%	5.49%	2.28%
Short-term Debt	$6,843,865	3.91%	5.69%	0.22%
Common Equity	$95,578,042	54.65%	9.79%	5.35%
Total Capital	$174,897,952	100.00%		
Weighted Average Cost of Capital				**7.85%**

Company's Proposed Hypothetical Capital Structure

	Percent of Total Capital	Cost	Weighted Cost
Long-term Debt	44.00%	5.49%	2.42%
Short-term Debt	0.00%	0.00%	0.00%
Common Equity	56.00%	9.79%	5.48%
Total Capital	100.00%		
Weighted Average Cost of Capital			**7.90%**

The Peoples Gas Light & Coke Company's Capital Structure and Cost

Actual Average 2010 Capital Structure

	Balance	Percent of Total Capital	Cost	Weighted Cost
Long-term Debt	$532,238,953	40.33%	5.28%	2.13%
Short-term Debt	$19,113,513	1.45%	4.00%	0.06%
Common Equity	$768,405,125	58.22%	9.69%	5.64%
Total Capital	$1,319,757,591	100.00%		
Weighted Average Cost of Capital				**7.83%**

Company's Proposed Hypothetical Capital Structure

	Percent of Total Capital	Cost	Weighted Cost
Long-term Debt	44.00%	5.28%	2.32%
Short-term Debt	0.00%	0.00%	0.00%
Common Equity	56.00%	9.69%	5.43%
Total Capital	100.00%		
Weighted Average Cost of Capital			**7.75%**

The Peoples Gas Light and Coke Company

Embedded Cost of Long-Term Debt
Average 2010

	Debt Issue Type, Coupon Rate (A)		Date Issued (B)	Maturity Date (C)	Original Principal Amount (D)	Face Amount Outstanding (F)	Debt Discount or (Premium) (H)	Unamortized Debt Expense (Gain) (I)	Carrying Value (J)	Coupon Interest Expense (K)	Amortization of Debt Discount or (Premium) (L)	Amortization of Debt Expense (M)	Total Expense (N)
1	First and Refunding Mortgage Bonds:												
2	Series HH	4.75%	3/1/00	3/1/2030	50,000,000	50,000,000		1,407,999	48,592,001	2,375,000	-	71,552	2,446,552
3	Series KK	5.00%	2/6/03	2/1/2033	50,000,000	50,000,000	500,425	1,237,392	48,262,183	2,500,000	22,139	43,706	2,565,845
4	Series LL	3.75%	2/20/03	2/1/2033	50,000,000	50,000,000		871,917	49,128,083	1,875,000	-	34,900	1,909,900
5	Series MM	3.94%	2/27/03	3/1/2010	50,000,000	10,416,667	670	1,167	10,414,830	410,417	8,037	14,005	432,459
6	Series NN	4.57%	4/29/03	5/1/2013	75,000,000	75,000,000	17,011	429,184	74,553,805	3,426,250	6,002	151,428	3,583,680
7	Series OO	1.00%	10/9/03	10/1/2037	51,000,000	51,000,000		775,233	50,224,767	508,980	-	22,876	531,856
8	Series QQ	4.88%	11/25/03	11/1/2038	75,000,000	75,000,000		1,364,799	73,635,201	3,656,250	-	39,501	3,695,751
9	Series RR	4.30%	6/1/05	6/1/2035	50,000,000	50,000,000		787,699	49,212,301	2,150,000	-	28,563	2,178,563
10	Seiers SS	6.75%	11/3/08	11/1/2013	45,000,000	45,000,000		378,889	44,621,111	3,037,500		113,496	3,150,996
11	Series TT	7.70%	11/3/08	11/1/2018	5,000,000	5,000,000		52,492	4,947,508	385,000	-	6,293	391,293
12	New Issue	7.43%	10/1/09	10/1/2019	50,000,000	50,000,000		416,501	49,583,499	3,712,500	-	44,997	3,757,497
13	New Issue	7.58%	3/1/10	3/1/2020	50,000,000	39,583,333		341,029	39,242,305	2,998,438		45,025	3,043,463
14	ICC Issuance Fees for Long-Term debt							50,000	(50,000)	-	-		-
15	Sub-Total				601,000,000	551,000,000	518,106	8,114,301	542,367,593	27,035,334	36,178	616,343	27,687,854
16	Reaquired Debt												
17	Series LL	3.75%	2/20/03	2/1/33				1,712,669	(1,712,669)			75,768	75,768
18	Series HH	4.75%	7/1/04	3/1/30				377,327	(377,327)			19,175	19,175
19	Series KK	5.00%	2/6/03	2/1/33				1,309,402	(1,309,402)			57,928	57,928
20	Series QQ	4.88%	11/25/03	11/1/38				1,977,004	(1,977,004)			69,724	69,724
21	Series PP	4.85%	10/9/03	10/1/37				850,708	(850,708)			31,196	31,196
22	Series OO	2.52%	10/9/03	10/1/37				1,374,711	(1,374,711)			50,411	50,411
23	Series RR	4.30%	6/1/05	6/1/35				2,526,819	(2,526,819)			101,345	101,345
24	Sub-Total							10,128,640	(10,128,640)			405,547	405,547
25	Total				$ 601,000,000	$ 551,000,000	$ 518,106	$ 18,242,941	$ 532,238,953	$ 27,035,334	$ 36,178	$ 1,021,889	$ 28,093,401
26	Embedded Cost of Long-Term Debt												5.28%

Actual Vs. Forecasted 3-Month LIBOR Rates

	Actual Rate***	Forecasted Rate**
3Q 2007	5.45%	5.40%
4Q 2007	5.03%	5.40%
1Q 2008	3.26%	5.30%
2Q 2008	2.75%	5.30%
3Q 2008	2.91%	5.30%
4Q 2008	2.72%	5.20%

** The Forecasted rates are from Blue Chip Financial Forecasts for July 1, 2007.
*** The actual LIBOR rates are from www.wsjprimerate.us/libor/libor_rates_history.htm.

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Schedule 22.6

1-Month LIBOR Vs. 3-Month LIBOR Rates

	LIBOR	
	1-Month Rate*	3-Month Rate*
Jul-08	2.46%	2.79%
Aug-08	2.47%	2.81%
Sep-08	2.93%	3.12%
Oct-08	3.81%	4.06%
Nov-08	1.62%	2.28%
Dec-08	1.08%	1.83%
Jan-09	0.38%	1.21%
Feb-09	0.46%	1.24%
Mar-09	0.53%	1.27%
Apr-09	0.45%	1.11%
May-09	0.34%	0.82%
Jun-09	0.32%	0.62%

* The actual LIBOR rates are from
www.wsjprimerate.us/libor/libor_rates_history.htm.