

DIRECT TESTIMONY

of

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Financial Analysis Division
Illinois Commerce Commission

MidAmerican Energy Company

Proposed general increase in rates for gas service

Docket No. 09-0312

September 17, 2009

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1 **WITNESS IDENTIFICATION**

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

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

5 **Q. What is your current position with the Illinois Commerce Commission**
6 **(“Commission”)?**

7 A. I am currently employed as a Senior Financial Analyst in the Finance Department
8 of the Financial Analysis Division.

9 **Q. Please describe your qualifications and background.**

10 A. In May of 1998, I received a Bachelor of Business degree in Finance and
11 Marketing from Western Illinois University in Macomb, Illinois. I earned a Master
12 of Business Administration degree, with a concentration in Finance, also at
13 Western Illinois University in May of 2001. I have been employed by the
14 Commission since January of 2001. I was promoted to Senior Financial Analyst
15 on October 1, 2004.

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

17 A. The purpose of my testimony is to present the overall cost of capital and to
18 recommend a fair rate of return on rate base for MidAmerican Energy Company
19 (“MEC” or the “Company”). The overall cost of capital that I recommend for the
20 Company incorporates the rate of return on common equity recommended in the
21 direct testimony of Staff witness Janis Freetly (ICC Staff Exhibit 6.0).

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COST OF CAPITAL

Q. Please summarize your findings.

A. I recommend an overall cost of capital for MEC of 7.54%, as shown on Schedule 5.1.

Q. Why must one determine an overall cost of capital for a public utility?

A. Under the traditional regulatory model, ratepayer and shareholder interests are balanced when the Commission authorizes a rate of return on rate base equal to the public utility's overall cost of capital, as long as that overall cost of capital is not unnecessarily expensive. If the authorized rate of return exceeds the cost of capital, then ratepayers bear the burden of excessive prices. Conversely, if the authorized rate of return is lower than the overall cost of capital, the financial strength of the utility could deteriorate, making it difficult for the utility to raise capital at a reasonable cost. Ultimately, the utility's inability to raise sufficient capital would impair service quality. Therefore, ratepayer interests are best served when the authorized rate of return on rate base equals the utility's overall cost of capital.

In authorizing a rate of return on rate base equal to the overall cost of capital, all costs of service are assumed reasonable and accurately measured, including the costs and balances of the components of the capital structure. If unreasonable costs continue to be incurred, or if any reasonable cost of service component is measured inaccurately, then the allowed rate of return on rate base will not balance ratepayer and investor interests.

44 **Q. Please define the overall cost of capital for a public utility.**

45 A. The overall cost of capital for a public utility equals the sum of the costs of the
46 components of the capital structure (i.e., debt, preferred stock and common
47 equity) after weighting each by its proportion to total capital.

48 **CAPITAL STRUCTURE**

49 **Q. What capital structure did the Company propose for setting rates?**

50 A. MEC proposed a December 31, 2008 capital structure comprised of 51.536%
51 long-term debt, 0.206% short-term debt, 0.512% preferred stock, and 47.746%
52 common equity.¹

53 **Q. What capital structure do you propose for setting rates for MEC?**

54 A. I propose using a December 31, 2008 capital structure that comprises 50.67%
55 long-term debt, 1.87% short-term debt, 0.50% preferred stock, and 46.95%
56 common equity, as shown on Schedule 5.1.

57 **Q. How was the balance of short-term debt measured?**

58 A. Since short-term debt balances tend to fluctuate substantially during a year, any
59 single balance might not be representative of the amount employed throughout
60 the year. The balance of short-term debt I recommend is based on the balances
61 over the July 2008 through June 2009 period because it is centered in time at
62 December 31, 2008, the measurement date for the other components of the
63 capital structure. The balance of short-term debt was calculated as follows: first,
64 the monthly ending balance of construction-work-in-progress ("CWIP") accruing

¹ MidAmerican Exhibit JMB 1.1, Schedule 1.

65 an allowance for funds used during construction (“AFUDC”) was subtracted from
66 the monthly ending balance of short-term debt outstanding each month. That
67 adjustment recognizes the Commission’s formula for calculating AFUDC
68 assumes short-term debt is the first source of funds financing CWIP² and
69 addresses the double-counting concern the Commission raised in a previous
70 Order.³ Next, the twelve monthly averages were calculated from the adjusted
71 monthly ending balances of short-term debt. Finally, the twelve monthly average
72 balances of short-term debt for July 2008 through July 2009 were averaged.
73 Schedule 5.2 presents the calculation of the average adjusted balance of short-
74 term debt.

75 **Q. Did you adjust the other capital components to recognize the**
76 **Commission’s formula for calculating AFUDC?**

77 A. Yes. As noted above, the Commission’s formula for calculating AFUDC
78 assumes short-term debt is the *first* source of funds financing CWIP; however, it
79 is not necessarily the *only* source. That formula also assumes that any CWIP not
80 funded by short-term debt is funded proportionally by the remaining sources of
81 capital (i.e., long-term debt, preferred stock, and common equity). Thus, to avoid
82 double counting the portions of long-term debt, preferred stock and common
83 equity that the AFUDC formula assumes is financing CWIP, I subtracted

² *Uniform System of Accounts for Gas Utilities Operating in Illinois*, Gas Plant Instruction 3(A)(17). Long-term debt, preferred stock and common equity are assumed to finance CWIP balances in excess of the short-term debt balance according to their relative proportions to long-term capital.

³ Order, Docket No. 95-0076 (Illinois-American Water Company, general rate increase), December 20, 1995, p. 51.

84 \$133,704,694 from the balance of long-term debt, \$1,327,460 from the balance
85 of preferred stock, and \$123,878,784 from the balance of common equity.

86 **Q. How did you calculate those amounts?**

87 A. The Company forecasts a higher balance of CWIP than short-term debt during
88 the months of July through November of 2008. Therefore, a portion of CWIP is
89 assumed to be funded by the long-term sources of capital during those months.
90 After adjusting the monthly short-term debt balances to remove the portion of
91 short-term debt reflected in the calculation of AFUDC, any remaining amount of
92 CWIP accruing AFUDC was allocated on the basis of the proportion of total long-
93 term capital that each long-term capital component represents. The average
94 monthly balance of the remaining amount of CWIP accruing AFUDC for 2009
95 was \$258,910,938, as presented in Column (H) on Schedule 5.4. Long-term
96 debt, preferred stock, and common equity compose 51.64%, 0.51%, and 47.85%
97 of long-term capital, respectively, based on their balances discussed below.
98 Thus, 51.64% of \$258,910,938, or \$133,704,694, was subtracted from the
99 balance of long-term debt; 0.51% of \$258,910,938, or \$1,327,460, was
100 subtracted from the balance of preferred stock; and 47.85% of \$258,910,938, or
101 \$123,878,784, was subtracted from the balance of common equity.

102 **Q. What balance of long-term debt did you include in your recommended
103 capital structure?**

104 A. I began with the December 31, 2008 debt balance of \$2,839,395,796, as
105 presented on Schedule 5.3. That balance reflects the carrying value for the

106 Company's long-term debt, including unamortized loss on reacquired debt
107 issues. Then, I subtracted \$133,704,694 to reflect the amount of long-term debt
108 already incorporated in the calculation of AFUDC, as explained previously. This
109 produced a long-term debt balance of \$2,705,691,102.

110 **Q. What balance of non-redeemable preferred stock did you include in your**
111 **recommended capital structure?**

112 A. I began with the Company's preferred stock balance as of December 31, 2008 of
113 \$28,190,371, as presented on MidAmerican Exhibit JMB 1.1, Schedule 4. That
114 balance reflects the net proceeds available to the Company. I then subtracted
115 \$1,327,460 to reflect the amount of preferred stock already incorporated in the
116 calculation of AFUDC, as explained previously. This produced a preferred stock
117 balance of \$26,862,911.

118 **Q. What balance of common equity did you include in your recommended**
119 **capital structure?**

120 A. I began with the Company's common equity balance of \$2,630,729,622, as
121 presented on MidAmerican Exhibit JMB 1.1, Schedule 1. Then I subtracted
122 \$123,878,784 to reflect the amount of common equity already incorporated in the
123 calculation of AFUDC, as explained previously. This produced a common equity
124 balance of \$2,506,850,838.

125 **Q. How does capital structure affect the overall cost of capital?**

126 A. Capital structure affects the value of a firm and, therefore, its cost of capital, to
127 the extent it affects the expected level of cash flows that accrue to parties other

128 than debt and stock holders. Employing debt as a source of capital reduces a
129 company's income taxes,⁴ thereby reducing the cost of capital; however, as
130 reliance on debt as a source of capital increases, so does the probability of
131 default. As the probability of default rises, expected payments to attorneys,
132 trustees, and other outside parties increase. Further, the expected cash flows
133 decline as the company foregoes investment that would have been available to it
134 had its financial condition been stronger, including the expected value of the
135 income tax shield from debt financing. Beyond a certain point, a growing
136 dependence on debt as a source of funds increases the overall cost of capital.
137 Therefore, the Commission should not determine the overall rate of return from a
138 utility's actual capital structure if the Commission concludes that capital structure
139 adversely affects the overall cost of capital.

140 An optimal capital structure would minimize the cost of capital and maintain a
141 utility's financial integrity. Unfortunately, determining whether a capital structure
142 is optimal remains problematic because: (1) the cost of capital is a continuous
143 function of the capital structure, rendering its precise measurement along each
144 segment of the range of possible capital structures problematic; (2) the optimal
145 capital structure is a function of operating risk, which is dynamic; and (3) the
146 relative costs of the different types of capital vary with dynamic market
147 conditions. Consequently, one should determine whether the capital structure is

⁴ The tax advantage debt has over equity at the corporate level is partially offset at the individual investor level. Debt investors receive returns largely in the form of current income (i.e., interest). In contrast, equity investors receive returns in the form of both current income (i.e., dividends) and capital appreciation (i.e., capital gains). Taxes on common dividends and capital gains are lower than taxes on interest income because common dividends and capital gains tax rates are lower, and taxes on capital gains are deferred until realized.

148 consistent with the financial strength necessary to access the capital markets
149 under most economic conditions, and if so, whether the cost of that financial
150 strength is reasonable.

151 **Q. How did you evaluate your proposed capital structure for MEC?**

152 A. I compared the proposed common equity ratio for MEC to common equity ratios
153 in the gas distribution industry. In the fourth quarter of 2008, the mean common
154 equity ratio for the gas distribution industry was 50.90% with a standard deviation
155 of 10.3%.⁵ MEC's 50.67% forecasted common equity to total capital ratio
156 compare favorably with the other companies in the gas distribution industry.
157 Further, I considered Ms. Freetly's analysis of the effect of Staff's proposed
158 revenue requirement on the Moody's guideline ratios. Ms. Freetly concludes that
159 under Staff's proposed revenue requirement, the financial strength is
160 commensurate with a Baa2 rating for the Company.⁶ The above suggests that
161 MEC's capital structure is commensurate with an adequate degree of financial
162 strength.

163 **Cost of Short-term Debt**

164 **Q. What is the Company's cost of short-term debt?**

165 A. MEC's cost of short-term debt, as of April 2009, is 1.59%.⁷

⁵ Standard & Poor's Compustat database.

⁶ Staff Ex. 6.0, pp. 24-25.

⁷ Company Schedule D-2, page 1, footnote 1. The interest rate was the rate paid by MEC within 60 days of filing this case in accordance with 83 Ill. Adm. Code 285.4020.

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Cost of Long-Term Debt

167 **Q. What is the embedded cost of long-term debt for MEC Gas?**

168 A. MEC's embedded cost of long-term debt is 5.47%, as shown on Schedule 5.3.

169 **Q. Please describe the adjustments you made to the Company's debt**
170 **schedule.**

171 A. I made two adjustments to the Company's proposed cost of long-term debt
172 presented in MidAmerican Exhibit JMB 1.1, Schedule 3. First, I updated the
173 interest rates on the adjustable rate pollution control bonds to the Company's
174 current rates as presented in its Schedule D-3.⁸ Next, I adjusted the annualized
175 amortization of debt discount, premium, and expense to reflect a straight-line
176 amortization of the respective unamortized balances over the remaining life for
177 the 5.30% MTN Series and the Pollution Control Variable rate IFA A and B
178 Series bonds.

179

RATE OF RETURN ON RATE BASE

180 **Q. What is your recommended rate of return on rate base for MEC?**

181 A. I recommend a 7.54% rate of return on MEC's rate base. This rate of return
182 incorporates the 10.05% rate of return that Staff witness Janis Freetly
183 recommends for the Company's common equity. The rate of return I recommend
184 on MEC's rate base is shown on Schedule 5.1.

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

186 A. Yes, it does.

⁸ Company Response to Staff Data Request SK-2.03.

Weighted Average Cost of Capital

Staff's Proposal MidAmerican Energy Company

	<u>Balance</u>	<u>Percent of Total Capital</u>	<u>Cost</u>	<u>Weighted Cost</u>
Long-term Debt	\$2,705,691,102	50.63%	5.47%	2.77%
Short-term Debt	\$104,940,240	1.96%	1.59%	0.03%
Preferred Stock	\$26,862,911	0.50%	4.63%	0.02%
Common Equity	<u>\$2,506,850,838</u>	<u>46.91%</u>	10.05%	<u>4.71%</u>
Total Capital	\$5,344,345,091	100.00%		
Weighted Average Cost of Capital				7.54% *

Mid American Energy Company's Proposal

	<u>Balance</u>	<u>Percent of Total Capital</u>	<u>Cost</u>	<u>Weighted Cost</u>
Long-term Debt	\$2,839,517,201	51.54%	5.59%	2.88%
Short-term Debt	\$11,348,158	0.21%	2.11%	0.00%
Preferred Stock	\$28,190,371	0.51%	4.63%	0.02%
Common Equity	<u>\$2,630,729,622</u>	<u>47.75%</u>	11.25%	<u>5.37%</u>
Total Capital	\$5,509,785,352	100.00%		
Weighted Average Cost of Capital				8.28%

* Difference in total weighted cost due to rounding.

MidAmerican Energy Company

Balance of Short-term Debt
 December 31, 2008

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)	Remaining CWIP Accruing AFUDC (G)	Monthly Average (H)
Jun-08	\$0	\$ 551,442,907	\$ 509,014,246	-\$509,014,246	\$0	\$0		\$ 509,014,246	
Jul-08	\$0	\$ 650,696,365	\$ 583,154,612	-\$583,154,612	\$0	\$0	\$ -	\$ 583,154,612	\$ 546,084,429
Aug-08	\$131,000,000	\$ 805,801,847	\$ 710,631,017	-\$579,631,017	\$15,472,016	\$15,472,016	\$ 7,736,008	\$ 595,103,033	\$ 589,128,822
Sep-08	\$235,000,000	\$ 979,041,769	\$ 886,705,860	-\$651,705,860	\$22,163,445	\$22,163,445	\$ 18,817,730	\$ 673,869,305	\$ 634,486,169
Oct-08	\$395,225,000	\$ 1,083,008,567	\$ 991,178,616	-\$595,953,616	\$33,511,732	\$33,511,732	\$ 27,837,588	\$ 629,465,348	\$ 651,667,326
Nov-08	\$415,635,000	\$ 836,914,981	\$ 736,694,682	-\$321,059,682	\$49,772,157	\$49,772,157	\$ 41,641,944	\$ 370,831,839	\$ 500,148,593
Dec-08	\$456,596,000	\$ 233,303,423	\$ 184,240,207	\$272,355,793	\$96,021,172	\$272,355,793	\$ 161,063,975	\$ -	\$ 185,415,920
Jan-09	\$484,275,000	\$ 224,439,600	\$ 211,100,515	\$273,174,485	\$28,781,843	\$273,174,485	\$ 272,765,139	\$ -	\$ -
Feb-09	\$451,205,000	\$ 232,469,026	\$ 217,851,176	\$233,353,824	\$28,372,154	\$233,353,824	\$ 253,264,155	\$ -	\$ -
Mar-09	\$322,687,000	\$ 236,645,516	\$ 222,835,486	\$99,851,514	\$18,831,192	\$99,851,514	\$ 166,602,669	\$ -	\$ -
Apr-09	\$277,300,000	\$ 243,415,283	\$ 226,110,206	\$51,189,794	\$19,714,037	\$51,189,794	\$ 75,520,654	\$ -	\$ -
May-09	\$218,500,000	\$ 87,546,729	\$ 72,983,849	\$145,516,151	\$36,346,181	\$145,516,151	\$ 98,352,973	\$ -	\$ -
Jun-09	\$207,000,000	\$ 85,593,396	\$ 81,156,056	\$125,843,944	\$10,731,311	\$125,843,944	\$ 135,680,048	\$ -	\$ -
Average							\$ 104,940,240		\$ 258,910,938

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

