STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

NORTH SHORE GAS COMPANY	)	
	)	
Proposed General Increase	)	No. 09-0166
In Rates for Natural Gas Service	)	
	)	
	)	
THE PEOPLES GAS LIGHT AND	)	
COKE COMPANY	)	
	)	
Proposed General Increase	)	No. 09-0167
In Rates for Natural Gas Service	)	

JOINT INITIAL BRIEF OF THE CITIZENS UTILITY BOARD AND THE CITY OF CHICAGO

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Pursuant to Section 200.800 of the Rules of Practice of the Illinois Commerce Commission ("Commission" or "ICC") and the briefing schedule established by the Administrative Law Judge, the CITIZENS UTILITY BOARD ("CUB"), by its attorneys and the CITY OF CHICAGO ("City") by its attorney, Mara S. Georges, Corporation Counsel, submit their Joint Initial Brief in this proceeding. This case was initiated by petitions from the Peoples Gas Light and Coke Company ("Peoples" or "PGL") and North Shore Gas Company ("North Shore" or "NS") (collectively, the "Companies" or the "Utilities") for Commission approval of general rate increases based on a 2010 future test year. In this brief, CUB and the City address issues raised by the Utilities' requested return on equity, their proposed capital structure, and various accounting proposals. In addition, CUB and the City adopt the rate design arguments (Section XII in the brief outline submitted to the Administrative Law Judges on September 9,

2009) submitted by the Illinois Attorney General's Office on behalf Peoples of the State of Illinois in their Initial Brief.

The brief uses section headings from the agreed topic outline for briefs in this case. Headings that relate to issues not addressed by CUB and the City in the brief have been omitted, but the order of topics has been preserved.

ARGUMENT

IV. RATE BASE

B. Uncontested Issues (All Subjects Relate to NS and PGL Unless Otherwise Noted)

5. Gas in Storage

The Companies' proposed working capital allowance for gas in storage is based on a 13-month average for calendar year 2010 only as the rate base amount. NS-PGL Ex. JH-3.0 at 6. However, gas in storage inventories are affected by the forecast of the price of gas in the test year. Since the price of gas has decreased significantly since the Companies filed their direct testimony in this proceeding, witnesses for Staff, CUB/AG and the Companies' all agree that the test year gas in storage inventories should be modified to reflect the updated forecast of gas prices. AG/CUB/City Ex. 1.0 at 10; NS-PGL Ex. JH 2.0 at 8 LL. 129-133 and Staff Ex. 13.0 at 8 LL. 125-130. In his Direct Testimony, Mr. Effron proposed that the Companies revise their requested working capital gas amounts to account for known price changes of their gas in storage. Originally, the gas in storage calculation reflected an average of the 13 month average for calendar year 2009 and 2010, but NS-PGL witness Hengtgen has corrected this and proposed that the gas in storage should be updated based on the gas prices as described in Mr. Gregor's testimony. NS-PGL Ex. JH-3.0 at 5-6.

While there is agreement in principle that the price of gas should be updated to reflect more recent pricing information, there is not an agreement as to the proposed amounts. Because the Companies use the LIFO method of accounting, the forecast of 2010 gas prices affects the balances for only a few months in the test year. AG/CUB/City Ex. 1.0 at 10. Therefore, the updated forecast of gas prices has a relatively limited effect on the average balance of gas inventory over the year. *Id*. As such, both AG/CUB/City witness Effron and Staff witness Seagle recommend that the Companies use the more up-to-date gas pricing information that reflects the current forecast of gas prices. Staff Ex. 13.0 at 6.

Mr. Effron recommends to decrease the Peoples Gas test year average of gas in storage inventory by $1,190,000 and the North Shore test year average balance of gas in storage inventory by $999,000 (as shown on AG/CUB/City Schedule B-1 reflecting the most recent actual experience of forecasted volumes of gas in storage). AG/CUB/City Ex. 1.0 at 10.

C. Plant (All Subjects Relate to NS and PGL Unless Otherwise Noted)

1. Forecasted Plant Additions

The Company requests to include forecasted plant additions for the 2010 test year in rate base for both People's Gas and North Shore. In response to Staff Data Request NS MHE 12.01, North Shore provided updated forecasts of capital additions in 2009 and 2010: 2009 is $9,638,000 and 2010 is $10,154,000. With these changes to the forecast of plant additions in 2009 and 2010, the average balance of gross utility plant in the 2010 test year is $393,430,000. This is $5,374,000 less than the gross utility plant included in rate base by North Shore.

AG/CUB/City Ex. 1.0 at 7, LL. 155-158. Peoples Gas also provided updated forecasts of capital additions in 2009 and 2010: 2009 is $72,390,000 which is approximately $57 million less than the forecast reflected in Peoples Gas Part 285 Schedule B-5 and for 2010 the forecast is $80,129,000 which is $103 million less than the forecast reflected on Part 285 Schedule B-5. With these modifications to the forecast of plant additions in 2009 and 2010, the average balance of Peoples Gas's gross utility plant for the test year is $2,549,045,000. This is $116,343,000 less than the plant included in Peoples Gas rate base. AG/CUB/City Ex. 1.0 at 6-7.

AG/CUB/City witness Mr. Effron proposes to adjust the test year utility plant included in rate base by the Companies because in the Companies' description of the assumptions used in their forecasts (Part 285, Schedule G-5), the Companies stated that they "will likely reduce their 2009 capital expenditures in response to the current economic slowdown and may make reductions in 2010 if the current economic status does not significantly improve." *Id.* at 5-6. These reductions to their forecasted capital additions should be taken into account in the determination of the test year rate bases. Thus, the Commission should disallow $5,374,000 from rate base for North Shore, and $116,343,000 from rates base for Peoples Gas..

H. Pension Asset (PGL) / Liability (NS) and OPEB Liabilities

The Company seeks to include prepaid pensions or the accrued liability for pension costs and the accrued liability for future post retirement benefits other than pensions ("OPEB") in rate base. Because this asset was created with ratepayer paid funds, the Commission should disallow the OPEB liability from rate base.

Accrued OPEB liabilities represent expenses accrued but not paid. To the extent that the cumulative accruals are greater than the actual cash disbursements for post-retirement benefits, the Companies will have accrued liabilities for OPEB. NS-PGL Ex. AF 1.0 at 7. . Thus, the accrued liabilities represent expenses accrued in accordance with accounting rules, but not actually paid out for OPEB. *Id.* at 8. As of the end of the test year in these cases, the accrued liability for OPEB was $10,700,000 for North Shore and $87,200,000 for Peoples Gas. *Id.* at 7. Neither North Shore nor Peoples Gas recognized the accrued OPEB liability (a negative asset) in the calculation of its respective rate base. *Id.* at 15.

In Docket Nos. 07-0241 and 07-0242, the Companies did not take into account the accrued pension and OPEB balances in the determination of rate base. The Commission in these cases found that the "accrued OPEB liability should be deducted from rate base but that the pension balances should not be recognized in the determination of rate base." AG/CUB/City Ex. 1.0 at 12. Further, in Docket 95-0219, the Commission rejected the inclusion of the then-forecast net pension asset in Nicor Gas' proposed net rate base. Specifically, the Commission found, in relevant part, "[T]he Commission finds that the proposal to eliminate the net Pension Asset from rate base is consistent with past Commission orders which found that the overfunded pension asset was created from ratepayer supplied funds . . ." ICC Docket No. 95-0219, Final Order at 9. In Docket Nos. 06-0070, et al. (cons.) (AmerenCILCO, AmerenCIPS, AmerenIP), the Commission confirmed this precedent, finding that the accrued OPEB liability should be removed from rate base:

> Ameren shows on its books an accrued liability for excess funds contributed for OPEB. While Staff and the AG indicate that each company's rate base should be reduced by the amount of this excess, as it reflects an excess of contributions by ratepayers, Ameren contends that the excess actually results from payments by Ameren. Staff believes that it is improper to single out any particular component of the cost of service and analyze that item in

> isolation, as it contends Ameren is doing in this case. The Commission agrees with Staff and the AG's analysis to remove these amounts from each utility's rate base. To look at this item in isolation from the other components of the cost of service, as Ameren attempts, and to then believe that the excess is solely attributable to Ameren is inappropriate. Ratepayers are not paying this cost of service as a separate line item, and it is inappropriate to treat it as such. The AG also notes other Commission decisions which have analyzed this issue, where it has been determined that as long as the company continues to control the ratepayer supplied OPEB funds, this deduction should be recognized in rate base. (See Docket No. 95-0219) Ameren has failed to provide any reason why the Commission should deviate from this position. The Commission therefore will reduce CILCO's rate base by $28,659,000, CIPS' rate base by $2,740,000, and IP's rate base by $1,217,000.

ICC Docket 06-0070, et al., Order at 27.

Again, in Nicor's 2004 rate proceeding, ICC Docket 04-0779, the Commission agreed with Staff that ratepayers should not be denied the benefits associated with the previous overpayment for pension expense which they funded. Consistent with the Commission's findings in ICC Docket 95-0219, the Commission again in ICC Docket 04-0779 eliminated Nicor's prepaid pension asset from rate base. ICC Docket No. 04-0779, Final Order at 21. In sum, in both of those cases, the Commission found that the net pension asset should be eliminated from rate base.

In this case, the Companies have failed to present any reason why the Commission should deviate from its established policy. Accordingly, consistent with the Commission's findings in the above listed ICC dockets, Mr. Effron eliminates the pension balances from rate base, as well as the accumulated deferred income taxes related to the prepaid or accrued pensions. AG/CUB/City Ex. 1.0 at 12.

The total effect of these adjustments is a reduction of Peoples Gas "Retirement Benefits, Net" by $143,240,000 (AG Exhibit 1.1, Schedule B) and related accumulated deferred income taxes $57,438,000 (AG Exhibit 1.1, Schedule B-3) for a net reduction to the Peoples Gas rate base of $85,802,000. *Id.* at 15.

With regard to North Shore, the net effect of Mr. Effron's proposed adjustment is a reduction of rate base deduction for "Retirement Benefits, Net" by $3,022,000 (AG Exhibit 1.1, Schedule B) and to increase the related accumulated deferred income taxes by $228,000 (AG Exhibit 1.1, Schedule B-3), for a net increase to the North Shore rate base of $3,250,000. *Id.*

V. OPERATING EXPENSES

C. Contested Issues

1. Incentive Compensation (Falls in Multiple Categories of O&M)

Peoples Gas seeks to include $5,620,000 of incentive compensation in its 2010 test year operation and maintenance expenses, and North Shore includes $1,072,000 of incentive compensation in its 2010 test year operation and maintenance expenses. AG/CUB/City Ex. 1.0 at 19.These amounts include financial measures like market-based compensation programs and non-financial measures like customer satisfaction, employee safety, environmental impact measures, reduction in system leaks and reduction in third-party damages. NS-PGL Ex. JCH 1.0 at 5. However, neither Peoples Gas nor North Shore has shown that the entirety of its incentive compensation program confers specific savings or other tangible benefits on ratepayers nor has it demonstrated that the entirety of its incentive compensation plan reduces expenses and creates greater efficiencies in operations. Therefore, People's Gas and North Shore have both failed to meet their burden of proving that the cost of their incentive compensation programs are just and reasonable.

The Commission has consistently disallowed incentive compensation programs where the utility cannot demonstrate any benefit to ratepayers, *i.e.* cannot show recovery of such program costs are just and reasonable. In ICC Docket No. 04-0779, the Commission held:

> Costs related to incentive compensation are recoverable in rates **only if the utility demonstrates tangible benefits to ratepayers**. (*See*, e.g., 03-0403 at 15 ("[T]o recover incentive compensation, **the plan must confer upon ratepayers specific dollar savings or other tangible benefits.** Furthermore, the degree of benefit that accrues directly to ratepayers, rather than to other stakeholders, is a significant factor in determining whether incentive compensation should be recovered in rates.

ICC Docket No. 04-0779, *Northern Illinois Gas Company Proposed general increase in natural gas rates ("Nicor Order")*, Order, September 20, 2005 at 44 (emphasis added). I think it is better to take this paragraph out.

In fact, of the incentive compensation paid directly to employees of the Companies, the record makes clear that 50% relates to operational goals, such as customer satisfaction and safety, and 50% relates to net income, which is a shareholder goal. NS-PGL Ex. JCH 1.0 at 8.With regard to the incentive compensation allocated from affiliates, 100% relates to shareholder-oriented financial goals. AG/CUB/City Ex. 1.0 at 21, ll. 449-453. Simply put, neither Company has made the necessary showing to justify inclusion of the portion of its incentive compensation program relating to shareholder goals in rates. Therefore, AG/CUB witness Effron recommends 50% of the incentive compensation paid directly to employees of the Companies and 100% of the incentive compensation allocated from affiliates should be eliminated from the incentive compensation included in the Companies' revenue requirements. This adjustment results in a $4,567,000 reduction to the Peoples Gas test year O & M expense and a $944,000 reduction to the North Shore test year O & M expense. AG/CUB/City Ex. 1.0 at 21, Schedule C-2.

3. Headcounts (Falls in Multiple Categories of O&M)

The Companies are forecasting test year payroll expense of $85,102,000 for Peoples Gas and $12,204,000 for North Shore. PGL Schedule C-11 and NS Schedule C-11. Embedded in this calculation is the assumption that the Peoples Gas employee count would increase from 1,080 as of early 2009 to that of 1,139 in the 2010 test year, and the North Shore employee count would increase from 167 as of 2009 to 170 in 2010. The Companies' head count projections are premised on the Companies' assumption that all authorized positions would be filled in the test year, in addition to assuming that the number of employees in the present economic circumstances will continue increase. NS-PGL Ex. ED 3.0 at 3 and AG/CUB/City Ex. 1.0 at 17. The record does not, however, support such assumptions. In fact, the increase in the number of employees being forecasted by Peoples Gas is uncertain and the North Shore employee complement does not appear to be increasing. *Id.* at 18.

Mr. Effron points out that the actual number of Peoples Gas employees in the last half of 2008 and the first three months of 2009 was steady at about 1,080, and for the months of April 2009 through June 2009, the average level of total full time equivalent employees was 1,074. AG DR 7.08. AG/CUB/City Ex. 4.0 at 8. This is actually lower than the number Mr. Effron uses to base his proposed adjustment (1,080). Similarly, for North Shore, the actual number of North Shore employees in the last half of 2008 and the first three months of 2009 was steady at

167 (this number has not changed from September 2008 through June 2009). *Id.* While Company witness Doerk describes Peoples Gas' intent to increase its employee level by 47, NS-PGL Ex. ED-2.0 at 6, there has been no evidence presented that the Companies are actually doing this. Therefore, the Company's forecasted average number of employees in the 2010 test year should be reduced to bring it more in line with actual experience.

Mr. Effron recommends the Peoples Gas test year payroll expense be adjusted to reflect 1080 employees rather than the forecast of 1139, and the North Shore 2010 test year payroll expense should be adjusted to reflect 167 employees rather than the forecast of 170. This adjustment allows for some increase in the number of employees from the early months of 2009, just not as large an increase as the Company currently forecasts.

As a result, the Peoples Gas test year payroll operation and maintenance expense should be reduced by $2,987,000, and the North Shore test year payroll operation maintenance expense should be reduced by $137,000. AG/CUB/City Exhibit 1.0, Schedule C-2.1.

F. Income Taxes (Including Interest Synchronization) (Uncontested Except for Derivative Adjustments from Contested Adjustments)

North Shore seeks recovery of $8,677,000 for income taxes for the forecasted 2010 test year, and Peoples Gas seeks recovery of $62,720,000 for income taxes. Section 285.3005. Schedule C-1. AG/CUB/City witness Effron proposes adjustments to taxable income, other adjustments to operating income, and adjustments to interest expenses. AG/Cub Ex. 1.0 at 28, Exhibit 1.1, Sch. C-5. Further, Mr. Effron adjusted his interest expense resulting from his proposed adjustment to rate base based on the cost of capital computed by Mr. Thomas. *Id.*

In fact, Mr. Effron argues that the state income tax rate should be applied to the adjustments to taxable income to calculate the adjustment to state income tax expense, and apply the federal income tax rate to the adjustments to taxable income net of state income taxes to calculate the adjustment to federal income tax expense.

VI. RATE OF RETURN

A. Overview

CUB-City challenge two elements of the Companies' proposed overall rate of return -- the excessive recommended cost of equity and the omission of short-term debt from the capital structure.

B. Capital Structure

1. Peoples Gas

2. North Shore

The Staff and the Companies have now adopted, for both Companies, identical positions on the single capital structure issue in dispute -- whether short-term debt should be included in the capital structure used for setting rates in this case. Each of those parties accepts, for ratemaking purposes, use the Companies' proposed 44-56% hypothetical debt-equity ratio, with the cost of debt represented by the Companies' individual costs of long-term debt. In accepting that agreement, Staff does not abandon its conclusion that each Company "clearly uses short-tem debt to finance rate base." Staff accepts the Companies' proposed hypothetical capital structure because it has concluded that the difference in overall returns resulting from more precise calculations that include short-term debt are minor, and because the Companies' proposed hypothetical capital structure yields a small comparative benefit for ratepayers. Staff Ex. 22 at 3, LL 39-54; at 3-4, LL 56-77.

Even as Staff accepts an agreement on capital structure and debt cost with the Companies, Staff expressly restates its agreement with CUB-City's position that the Companies do use short-term debt to finance rate base. The Companies do not dispute the existence of or their plans to use short-term debt in the test year. NS-PGL Ex. BAJ 2.0 (Rev.) at 7, LL 122-27. Nor do they deny that at least one of their (revised) rate bases will exceed permanent financing (equity plus long term debt), even if total permanent financing covers the combined rate bases total. *Id.* at 9, LL 162-69. They simply deny that short-term debt is used to finance rate base, asserting that cash covers any shortfall. *Id.* at 10, LL 184-88. The Companies argue that their short-term debt proceeds are used only to cover operational expenses, and no capital costs, with any shortfall for capital needs covered by cash. *Id.* at 9, LL 171-73.

Faced with these circumstances, the Companies first argument is a variation on the appeals to emotion prominent in its cost of equity testimony. "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." *Id*. at 4, LL 68-70. To bolster that appeal, the Companies rely on two inapposite Commission decisions from the 1980s. Relying on a 1987 Commission decision, the Companies contend that the excess of their capital needs over available permanent financing does not indicate the use of short-term debt to fill the gap. *See id*. at 8, LL 137-46. That argument ignores the Commission's later superceding disposition of this issue. That later ruling is (a) directly on point and (b) more consistent with the burden of proof the Public Utilities Act imposes on utilities in rate cases: "[d]ue to the fungible nature of capital, it is generally assumed that all assets, including assets in rate base, are financed in proportion to total capital." *Re Ameren Illinois Utilities*, Docket 02-0798 *et al.* (cons.), Final Order at 67; 220 ILCS 5/9-201(c). The Companies also erroneously suggest that their forecast (hypothetical) capital structure is equivalent to an actual capital structure to invoke an inapposite 1988 Commission decision that favors actual over hypothetical capital structures. NS-PGL Ex. BAJ 2.0 (Rev.) at 4, LL 74-81.

In the view of CUB-City, the Commission is obliged to use the best available data in setting cost-based rates. Here, the Commission should find that the Companies use their short-term debt to finance rate base. "The Companies have consistently relied on short-term debt as a source of funds and they forecast a continued need to do so." CUB-City Ex. 2.0 (Rev.) at 54, LL 1384-85. Accordingly, those funds should be a discrete part of the capital structure used to set rates.

E. Cost of Common Equity

CUB-City will address cost of equity issues for North Shore and Peoples Gas together. Accordingly, the individual utility subheading numbers are reassigned.

1. Introduction

In his direct testimony, CUB-City witness Edward C. Bodmer presented a prescient description of a litigation strategy designed to subordinate objective determinations of the market cost of equity capital to appeal to emotion. That strategy incorporates attempts to influence the Commission's determination of the cost of equity by predicting dire consequences if Wall Street is not pleased with the Commission's return on equity ("ROE") award and diminished Wall

Street standing if the Commission’s cost of equity determination is lower than those of other commissions. Peoples and North Shore have pursued just such an approach in this case.

The insights provided by Mr. Bodmer's testimony make transparent the Utilities' efforts to persuade the Commission to rely on (a) signals from the self-interested investment community and (b) cost of equity determinations by other commissions -- determinations for non-Illinois utilities, for periods other than the Utilities' chosen test year, and for different market circumstances, with consequential differences neither identified nor explored by the Companies. S*ee* CUB-City Ex. 3.0 at 7, LL 162-71. The Companies' quantitative analyses appear secondary, even though market-based evidence should be the Commission's focus. The Companies' analyses also incorporate improper adjustments that inflate their recommended cost of equity, yielding results that are outliers worthy of little consideration in the Commission's deliberations.

In contrast, the cost of equity experts for CUB-City -- and for the Commission Staff (“Staff”) -- have presented analyses that highlight and rely on objective market indicators, the Commission’s preferred estimation models, and fundamental principles of finance. Though there are differences between the analyses and recommendations of CUB-City expert Christopher Thomas (8.58% - PGL and NS) and of Staff expert Michael McNally (PGL - 9.69%; NS - 9.79%), most of the difference can be explained by certain questionable techniques the Staff has persistently applied in its cost of equity analyses. *See* CUB-City Ex. 4.0 (Rev.) at 17-18, LL 397-440. It is particularly noteworthy that despite the differences in their analytical techniques, the recommendations of CUB-City and Staff experts lie within about 120 basis points of each other. The Companies propose a cost of equity (11.87%) more than 200 basis points higher than any other recommendation in this case. The distance to this outlier recommendation is directly attributable to improper inputs and upwardly biased adjustments the Commission has previously rejected. NS-PGL PRM 2.0(Rev.) at 8, LL 140-43; CUB-City Ex. 1.0 at 43-44, LL 910-12; CUB-City Ex. 2.0 (Rev.) at 3, LL 57-59. As discussed later in this brief, the Companies' recommended cost of equity also exceeds the unlawful standard they advance, almost as an equal to legal requirements -- *viz.*, the returns other commissions have recently allowed, for gas distribution utilities (10.15%). Staff Ex. 21 at 29, LL 632-33; NS-PGL SFM 1.0 at 7. The relative magnitude of the recommendations are shown below.

8.58%	< 9.00%	9.69%	9.79%	10.15%	11.87%
Thomas	Bodmer	(PGL)	(NS)	*2009 Gas Average -*	Moul
		McNally		*Other Commissions*	

With a single exception (Staff), each party's cost of equity recommendation is the same for both PGL and NS. Accordingly, the discussion of cost of equity issues in this brief applies equally to PGL and to NS. The Staff's singular risk adjustment is discussed separately, and only briefly.

2. The Context of the Commission's Cost of Equity Determination

The recent dramatic changes in the financial markets have "created conditions in the equity markets that must be accounted for when setting rates for the Companies." CUB-City Ex. 1.0 at 7-8, LL 130-34. Because of the importance of these changes, CUB-City presented the testimony of Mr. Bodmer. Mr. Bodmer has extensive experience and expertise in banking, in utility regulation (especially cost of capital issues), and in teaching finance and valuation to industry professionals in the U.S. and internationally. (CUB-City Ex. 1.1). His purpose in this case was not to make a pinpoint cost of equity recommendation. Rather, using his expertise to survey current markets, Mr. Bodmer provided an insightful analysis of the market conditions relevant to the Commission's determination of the Companies' risk-based cost of equity in this case. Providing context for the cost of equity analyses and testimony of other witnesses, he described the unusual circumstances of the current post-financial crisis market, reviewed lessons learned from the recent market upheaval, and identified new dangers of that environment.

> My testimony (a) identifies the most important of those perils and provides information on how they can be addressed, (b) provides context for the Commission's examination of the cost of equity analyses and recommendations presented in this case, and (c) offers quantitative validation for the corrective steps I recommend to take account of the lessons of the financial crisis.

CUB-City Ex. 1.0 at 3, LL 27-31.

One peril of the current environment that Mr. Bodmer emphasized is the danger of having the Commission's attention diverted from financial fundamentals, common sense, and objective evidence of the Companies' risk-based market cost of capital. *See*, *e.g.*, *id*. at 3, LL 25-27; at 3, LL 35-44; at 7, 115-17 ("the current crisis actually requires the Commission to return to the basics, rather than to repeat past approaches that take no account of, or are inconsistent with, very different prevailing market circumstances."). Accurately determining the cost of equity for the Companies requires that the Commission subordinate methods that are inadequate to the challenges of the current environment in favor of approaches more attuned to the undeniable changes in the markets. *Id*. at 7, LL 120-26.

Mr. Bodmer cautioned further that "the rather chaotic state of the financial markets must not be used as a false basis for excessive ROE recommendations." *Id*. at 3, LL 37-39. In fact, Mr. Bodmer testified that the recent market chaos has produced objective evidence that utility stocks are less risky than predicted by some of the inputs selected as inputs for the Companies' analyses. Particularly striking was the "flight to quality" that saw investors seeking safe utility stocks during the market turmoil. This and other findings from his review of objective market indicators are properly reflected in the quantitative analyses and recommendation of CUB-City's witness Chris Thomas.

3. The Commission Must Reject the Companies' Suggested Subjective, Non-Market Approach to Cost of Equity Determinations

The CUB-City experts sought to use the most objective available data in estimating the Companies' cost of equity. As Mr. Bodmer's testimony anticipated, the Companies pursued a very different strategy. Rather than refine their cost of equity analyses for the current market environment, the Companies have emphasized appeals to subjectivity and emotion -- fear of Wall Street, and comfort in not being different from other commissions. Indeed, on rebuttal, the Companies brought in an additional witness (Mr. Fetter) to implement this strategy. (Mr. Fetter's testimony is discussed in detail later in this brief.)

Predictably, the Companies' cost of equity analyses do not incorporate the lessons Mr. Bodmer identified from his review of data from the recent financial upheaval. *See id*. at 9, LL 168-71. In his rebuttal testimony, Mr. Bodmer commented on the Companies' response to his testimony and his admonitions to focus on what unbiased market indicators have to offer. "First, Messrs Moul and Fetter asserted that the Commission should focus on what other regulatory bodies have done, rather than on deriving the Companies' real cost of capital from objective market data." CUB-City Ex. 3.0 at 3, LL 50-52. The Companies' witnesses also warned that the Commission should be concerned about Wall Street's reaction if its determination (no matter how well-founded) does not follow what other commissions are doing. *Id*. at 3, LL 53-55.

Even though Mr. Fetter "acknowledge[s] that ROEs recently approved in other jurisdictions should not be used to set the Utilities' ROEs here" (NS-PGL Ex. SMF 1.0 at 6, LL. 120-21), he contends that his comparison of recent ROE awards supports the Companies' assertions that the CUB-City and Staff recommendations are out of the mainstream and would have negative Wall Street consequences for Illinois. *Id*. at 6, LL 122-29. In fact, those assertions are disproved by the same data Mr. Fetter presented.

Mr. Fetter relies on comparisons to risk-based awards for firms that have faced risks that are very different from the Companies' risk. Though Mr. Fetter does not discuss those differences, Mr. Bodmer analyzed the information presented. Mr. Fetter's chart of recent determinations by other commissions includes a significant number of electric utility companies that own generating plants and natural gas companies that have marketing operations. CUB-City Ex. 3.0 at 4, LL 90-92. The average return in 2009 for natural gas distribution companies like the Companies was 10.02%. (Please note, Staff witness Mr. McNally conducted a similar exercise and found that the average return on equity for gas utilities was 10.15%. Staff Ex. 21 at 29, LL 632-33. Apparently, Mr. Bodmer and Mr. McNally did not use the same companies in calculating their respective averages. To be conservative, in the line shown earlier in this brief laying out the various ROE recommendations in this case, CUB-City used Mr. McNally's 10.15% average for gas utilities.) Further, Mr. Fetter's own data show that (a) returns for natural gas distribution companies in 2009 have been far lower than the almost 12% estimate made by Mr. Moul, (b) the most recent returns for gas distribution utilities were below 10%, with the latest shown at 9.31%, and (c) the returns for gas utilities are much closer to the recommendations of CUB-City and Staff than to Mr. Moul's. *See*, NS-PGL Ex. SMF 1.0 at 7. Yet, according to the Companies' witnesses, returns like those recommended by CUB-City and Staff would engender negative reactions from Wall Street. *See, e.g., id*. at 6, LL 125-34.

In fact, as the line graphic above in this brief well illustrates, it is Mr. Moul's 11.87% recommendation that is out of the mainstream. In any case, as the Commission itself has noted, the actions of other commissions are unlawful, irrelevant, and likely dangerous influences on its determination of the cost of equity.[1] *In re North Shore Gas Co., et al.*, Dkt. 07-0241 (cons.), Order (Feb 5, 2008) at 89-90.

The same testimonies identified the rate of return investors expect the Commission to grant and (derivatively) the return they expect the utility to earn as a key factor that should drive the Commission's rate-of-return determination, again warning that a lower-than-expected determination may lower the Companies' credit rating and cause the Commission to be looked upon unfavorably by Wall Street. *Id*., at 3, LL 57-62. Indeed, Mr. Moul identifies a major task of his rebuttal testimony as ascertaining whether "costs of equity proposed by Messrs. McNally and Thomas are consistent with the current expectations of investors." NS-PGL Ex. PRM 2.0 (Rev.) at 2, LL 23-25 (emphasis added).

In his rebuttal testimony Mr. Bodmer presented a hypothetical that illustrated vividly why standards such as investor expectations and commission awards are the wrong approach to determining a utility's cost of capital. The hypothetical makes the point that even when potential investors rationally expect a certain return based on past behavior or commitments of governing authorities, the return required by the market is still based on the level of risk associated with the investment. CUB-City Ex. 3.0 at 12, LL 286-96.

> A generous state, say Alaska, with an AAA bond rating decides to guarantee that the return earned by a natural gas distribution company will be 25% through using a series of riders and other mechanisms. Because of the State's AAA bond rating, assume that Alaska can borrow money at an interest rate of 4%. Further, the State enacts a law that mandates the rate of return will be set at 25% and the government will step in to guarantee the return even if all ratepayers leave the system. In this case the expected rate of return is 25% while the cost of capital is the interest rate Alaska pays on AAA debt of 4%. If the example were changed so that Alaska guarantees a rate of return of 15% instead of 25%, the cost of capital would still be the interest rate on AAA debt of 4%.

Id. Mr. Bodmer summarized the implications of this example

> In the above hypothetical, the rate of return that is granted is irrelevant to determining cost of capital. The rate of return earned is also irrelevant to determining the cost of capital. Finally, the rate of return expected to be earned is also irrelevant. The only thing that is relevant to the cost of capital determination is the risk of the cash flows, which in this case is driven by the guarantee from the State. The cost of capital in the example is 4%.

Id. at 13, LL 298-06.

The Commission's cost-of-service principles require a decision based on cost, as shown by the record evidence -- not on expectations or actions of another commission. The record evidence in this case shows that the range of reasonable estimates for the market cost of equity is bounded by the CUB-City and Staff estimates, with the Companies' recommendation far outside that range. As Mr. Bodmer stated, "Fair and efficient rates are geared to providing a return equal

[1] "Mathematically, as more regulators grant a rate of return at or above the average of past awards, the average itself increases, and the difference between the awarded rates of return and the real cost of capital widens." CUB-City Ex. 3.0 at 8, LL 188-90.

to the Companies' respective costs of capital, not happiness on Wall Street or for particular ratepayers. *Id*. at 8, LL 181-83.

4. Correcting Traditional Analyses for the Current Environment

Mr. Bodmer's cost of equity recommendations are not the usual dose of heavy mathematical computations. His testimony takes a different form. He recommends generally "that the Commission use more caution, greater scrutiny, and firmer transparency requirements when evaluating recommendations derived from data and models whose significant defects and limitations have recently been revealed more clearly than ever before. Moreover, while some of these deficiencies have always been present, more attention is warranted now because, in the current market environment, they can produce greater distortions." CUB-City Ex. 1.0 at 11, LL 222-27.

Mr. Bodmer's more specific recommendations are the end points of his exploration of deficiencies in the estimation approaches of PGL-NS witness Paul Moul, focusing mainly on elements of his Discounted Cash Flow ("DCF") and Capital Asset Pricing Model ("CAPM") analyses. "Mr. Moul does not test the basic logic of three key variables in his analyses, the growth rate in the DCF model, the growth rate used to derive the return expected by the overall market, and the risk premium in the CAPM." *Id*. at 10, LL 183-185. Each of these deficiencies biases Mr. Moul's analyses to increase his cost of equity estimate. Each has a significant effect on the related derived estimate. Together, they make his recommended cost of equity wholly unsuitable for use in determining a risk-based cost of equity or setting cost-based rates. These issues with Mr. Moul's analyses are discussed individually below.

a. Unbiased Betas

In his discussion of bias in the beta estimates used by the Companies' witness, Mr. Bodmer discussed his analysis of the behavior of utility stock prices during the financial crisis. Market data from that period prove some traditional cost of equity theories and models to be flawed. Among them are assumptions about the riskiness of utility stocks relative to the market (the CAPM beta), the illogic of using demonstrably upwardly biased analysts' earnings forecasts, and assumptions about the behavior of credit spreads on corporate and utility bonds. *See id*. at 7-8, LL 130-34.

Mr. Bodmer presented the factual bases for his conclusions in considerable detail. He examined stock price behavior for firms in the risk-defined proxy group selected by the Companies' cost of equity witness. He compared the actual performance of those utility firms to the published Value Line betas that purport to reflect stock price behavior relative to the market. *See id*. at 15-22, LL 307-409; CUB-City Ex. 1.2. His results (also presented in a series of graphic representations in his testimony) demonstrate that the Value Line betas that Mr. Moul used in developing his CAPM estimate are substantially above the beta estimates implied by actual market behavior of the utilities in his sample.

CUB-City expert Mr. Thomas conducted an examination of the Value Line betas in comparison to beta estimates from other market observers. Mr. Thomas confirmed the same bias, which he captured in a chart of his findings. CUB-City Ex. 4.0 (Rev.) at 6, LL 119-20.

As Mr. Thomas observed, "Mr. Moul relies on only the reported Value Line betas, which

	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**

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." *Id.* at 7, LL 121-123. Mr. Moul's outlier CAPM result (12.25%) is a predictable consequence of such biased model inputs.

Mr. Moul used the Value Line betas because he believes that is what investors read. "It is well known that investors use the Value Line data." He also rejects Staff's calculation from objective market data, apparently because investors do not read Mr. McNally -- "[t]here is no evidence that the betas calculated by Mr. McNally have any bearing on investor expected returns." NS-PGL Ex. PRM 2.0 (Rev.) at 26, LL. 485-88.

Mr. Moul's preference for Value Line data that is read by investors apparently blinded him to the large variance -- proved by hard stock price data -- between the Value Line betas and the performance of stock prices the betas are supposed to reflect. *See* CUB-City Ex. 1.0 at 15-

22, LL 307-409; CUB-City Ex. 1.2. Given the evidence of record showing a large variance between market performance and Value Line betas and Value Line's outlier position among reported beta estimates, the Commission cannot give weight to estimates based on those data.

Mr. Moul's surprisingly explicit move from risk-based returns to subjective expectations and evaluations has implications far beyond the selection of betas, and it should be rejected by the Commission in all contexts. Despite his fleeting suggestion that "expected returns" have an objective market-based meaning (Aug. 25, 2009 Tr. 431-432), Mr. Moul repeatedly returns -- as here, respecting the beta measurement of stock price performance -- to a reliance on his sense of <u>subjective</u> investor sentiments and subjective preferences in the face of conflicting objective market indicators. *See also id*. at 432 ("If we ignore the expected returns investors have in their mind when they price the stocks, we wind up breaking the link between the expectation and the stock price."); *id*. at 428 ("Expected returns aren't a financial concept."). He also acknowledges that there is only one cost of capital determined by the market, and it is not the expected return. *Id*. at 448.

The lengths Mr. Moul is willing to go to maintain that link (*i.e.*, to satisfy investors) and to maintain stock prices at the levels investors expect is shown most dramatically by his outlier return on equity recommendation. His high recommendation is consistent with his candid admission that he believes "the Commission needs to incorporate in its deliberations investor expectations" and that the result could be a return above that required to induce an investment. *Id*. at 425. Moreover, Mr. Moul's commitment to investor expectations impelled him to endorse a return intended to maintain a market-to-book ratio above one, lest stocks fall, although he adamantly opposes regulation on that basis in other circumstances. *Id*. at Tr. 460 ("What we're seeking to do is to maintain the price as we find it when we measure the cost of equity.”).

It is clear that Mr. Moul’s objective is not the same as that of other parties and the Commission: seeking the market cost of equity for the Companies.

b. Sustainable Growth Rates

“A growth rate that logically cannot persist for an indefinite period is an invalid input to the estimation models.” CUB-City Ex. 1.0 at 22, LL 417-18. “The Commission cannot rely with confidence on earnings growth rate projections made by financial analysts who share the financial community’s bias favoring higher utility earnings and whose forecasts have been demonstrably in error.” *Id.* at 23, LL 426-28. These statements are touchstones for testing the validity and reliability of DCF cost of equity estimates in the current market environment. The DCF cost of equity estimates developed by Mr. Moul used analysts’ five-year growth forecasts that fail both tests. They are logically impossible and they are subject to significant bias.

However, as was the case with Mr. Moul’s use of demonstrably flawed beta estimates, the validity of this input is not problematic for him because -- in his view -- the validity and reliability of growth forecasts do not affect the subjective expectations of investors. He asserts that “investors do not need these types of forecasts to make investment decisions.” Though he states that growth projections beyond five years are “pure conjecture,” Mr. Moul also asserts (impossibility notwithstanding) that if investors needed such estimates “some analyst would provide them to fulfill this demand.” NS-PGL Ex. PRM 2.0 (Rev.) at 41, LL 845-47.

The primacy Mr. Moul gives to subjective investor sentiment is well documented, but his complete disregard for the financial and economic principles supporting DCF estimates is stunning. “Projected growth rates are central to the DCF model. They also can figure in one of the difficult-to-measure factors in the CAPM, namely the expected market risk premium." CUB-City Ex. 1.0 at 22, LL 413-15.

> The DCF model estimates the cost of equity capital by assuming that investors who purchase stock are paying a price that reflects the present value of the cash flows they expect to receive from the stock in the future. Using information about the current stock price and expected future cash flows from dividend payments and earnings growth, the model, which is based on the relationships among various factors, estimates the return that investors expect to receive on their investment.

CUB-City Ex. 2.0 (Rev.) at 8, LL 163-168.

It is clear that Mr. Moul recognizes the limitations of his chosen growth inputs -- analysts' five year forecasts -- but he uses them, contrary to the basic theory underlying the models. "[A]ssumptions concerning growth beyond the five-years typically considered in the analysts forecast are pure conjecture." NS-PGL Ex. PRM 2.0 (Rev.) at 41, LL 841-42. Such growth rate forecasts are not intended to represent rates of growth that can persist indefinitely as the DCF model <u>requires</u>.

Mr. Moul, however, takes a different view of the DCF model's required inputs. "[I]f analyst's forecasts fall generally within the bounds of forecasts that are being published for similarly situated companies, . . . there is no need to speculate whether a growth rate is sustainable in perpetuity." *Id*. at 41-42, LL 847-50. His analyses do not worry over the sustainability issue, they simply assume that the analysts' forecasted five-year growth rates will persist forever. Mr. Moul's objective is clearly distinct from the Commission's duty to determine the market cost of capital for the Companies, and that his results are outliers thus should not be surprising. When logical, sustainable growth rates are used, they produce dramatically different – and lower -- estimates of the cost of capital than the inputs used in Mr.

Moul's analysis. CUB-City Ex. 1.0 at 31, LL 635-37.

c. Undistorted Bond Spreads

One of the methods Mr. Moul uses to compute People Gas' cost of equity is to sum the premium of A-rated bonds over government bonds and the premium of the cost of equity over A-rated bonds. CUB-City Ex. 1.0 at 32, LL 645-50. However, as Mr. Bodmer testified, the anomalous circumstances of the current financial market difficulties have distorted some assumed relationships among market variables. As a result, Mr. Moul's premium addition to derive a cost of equity may not yield a valid measure risk of common equity in the today's financial markets. *Id*. at 32-33, LL 650-66.

In the current environment, there has been a dramatic increase in the credit spreads on A-rated bonds (from about 1% to 3%). The accepted explanations for the spread would require that of the probability of default or probability of loss in the event of default has changed as dramatically. *Id*. at 34, LL 692-94. However, "[f]or a company such as Peoples Gas, which has significant regulatory protections ranging from revenue decoupling to the ability to request rate increases, the supposition that default risk has increased is not a plausible explanation for the increased credit spreads." *Id*. at 34, LL 694-97. Also, in the current environment, where there is considerable uncertainty about future inflation (which affects equity less than debt) and where taxes on dividends are lower than those on interest income, the traditional relationship between debt and equity costs is unsettled. *Id*. at 33, LL 660-66. Mr. Bodmer therefore concluded that:

> Given the anomalous increase of credit spreads in the current market environment, and the uncertainty about the future rate of inflation, the Commission should not set rates using an anomaly in the financial markets data without examining its causes and whether it actually affects the cost of equity for Peoples [G]as.

Id. at 33, LL 668-71.

d. Check the Fundamentals and Use Common Sense

Ultimately, with respect to the principles of finance and economics that guide valid cost of equity determinations, Mr. Bodmer recommended that the Commission require analyses that: (1) use unbiased beta estimates that accurately account for the movement of regulated utility shares relative to the current overall market; (2) use sustainable growth rates that are realistic and do not assume continuous returns above the regulated utility's cost of capital; and (3) correct bond credit spread analyses for anomalies in the current financial markets. *Id*. at 12, LL 234-40. These are aspects of checking proposed quantitative analyses and recommended cost of capital estimates against fundamental financial and economic principles.

In addition to the challenges presented by current market conditions, which distort Mr. Moul's application of the risk premium model, the Companies' analyses offer problems of their own making. For instance, the Companies' DCF and the CAPM models are not applied in a traditional manner. The leverage adjustment proposed by Mr. Moul is not part of the DCF model supported by its associated theoretical underpinnings. Similarly, his size adjustment for increasing beta is not typical in rate proceedings; nor is the method used to derive his risk premium in the CAPM. CUB-City Ex. 2.0 (Rev.) at 26, LL 648-52, *citing In re North Shore Gas Company*, *et. al.*, ICC Dockets 07-0241/07-0242 (cons. Final Order at 95-96 (Feb. 5, 2008).

Mr. Bodmer also recommended that the Commission acknowledge that the recent market upheaval has distorted historical relationships and appropriately adjust its scrutiny of cost of equity analyses. The steps outlined immediately above are aspects of checking recommended cost of capital estimates against fundamental financial principles and common sense. CUB-City

Ex. 1.0 at 12, LL 234-240.

Common sense should play a larger part in the Commission review in this case, because traditional assumptions and data relationships may no longer hold. Commission review of Mr. Moul's significant divergences from customary applications of the estimation models, especially in the aftermath of chaotic security market conditions, will require a healthy dose of common sense. The combination of challenging markets and models presents problems for which there is little or no precedent.

Finally, there are strong indications that market entities usually relied upon for objective information may have failed in that role, with serious consequences for the national economy. The Commission should therefore be aware of the biases of parties and sources of relied upon information. Ratepayers generally favor lower rates, but are constrained by a need for assured provision of essential utility services. Some sources of market data and analyses share the Utilities' economic interest in higher returns. The influence of either class of stakeholders is harder to identify and manage, and the Commission is the sole potentially-effective control.

Assessing current market data and following his own recommendations, Mr. Bodmer concluded that current circumstances in the equity markets warrant a cost of equity for the Companies of less than 9.00%. *Id*. at 43-44, LL 910-12.

5. *Response to Mr. Fetter*

In its rebuttal case, the utilities submitted the testimony of Steven M. Fetter, a former chairman of the Michigan Public Service Commission. NS-PGL Ex. SMF 1.0 at 1, LL 17-19. The main thrust of Mr. Fetter's testimony was to assert that the returns on equity recommended by CUB-City witness Edward C. Bodmer and Commission Staff witness Michael McNally "are out of sync with the market and current expectations." *Id*. 5-6, LL 114-16. To support his assertion, Mr. Fetter essentially made two arguments. First, he listed 29 recent returns on equity approved by other public utility commissions and the Commission's approved return for Northern Illinois Gas and found that "both the Staff and CUB/City recommendations fall among the bottom three of the thirty ROE determinations issued so far during 2009 – meaning that 90% of all ROE determinations made in 2009 would be higher." *Id*. at 6, LL 129-32. Based on this, Mr. Fetter concluded that "Investors would, in my opinion, view [Mr. Bodmer's and Mr. McNally's] ROEs as extremely low were they to be adopted by the ICC in this proceeding." *Id*. at 6, LL 132-34. Mr. Fetter's second argument was that the returns on equity recommended by Mr. Bodmer and Mr. McNally fail to recognize the significant risks faced by the Companies, and, therefore, understate the utilities required returns on equity. *Id*. at 14, LL 284-87; NS-PGL Ex. SMF 2.0 at 4, LL 79-84.

Neither of Mr. Fetter's arguments is persuasive. In fact, Mr. Fetter's comparison of Mr. Bodmer's and Mr. McNally's returns on equity to the 30 recent return on equity decisions is far more damaging to the Companies' witness Mr. Moul's testimony than it is to either Mr. Bodmer's or Mr. McNally's recommendations. In any event, Mr. Fetter's testimony provides little, if any, support to the Companies' proposed return on equity and should be rejected.

a. Mr. Fetter's Comparison of Mr. Bodmer's and Mr. McNally's Recommended Returns on Equity Has No Evidentiary Worth. Moreover, the Comparison Is Far More Damaging to the Companies' Case than It Is to CUB-City's <u>and Staff's Respective Positions.</u>

As noted above, Mr. Fetter testified that Mr. Bodmer's and Mr. McNally's respective returns on equity are out of sync compared to 30 recent return on equity decisions. The

Commission has rejected such facile comparisons in the past. In Commonwealth Edison Company's ("ComEd") penultimate rate case – Docket 05-0597 – the utility submitted a chart showing 19 returns on equity approved by the ICC and other regulatory agencies during 2004 and 2005. *In re Commonwealth Edison Company*, ICC Docket 05-0597, ComEd Ex. 38.0 at 13, LL. 284-88; ComEd Ex. 38.1. The utility argues that the proposal submitted by Mr. Bodmer in that case was out of line with the 19 recent return on equity decisions. The Commission rejected ComEd's argument, finding that

> ComEd asserts its cost of equity should reflect the costs of equity recently approved for electric utilities in the United States. The cost of equity appropriate to ComEd, however, is specific to that utility. ComEd may not simply adopt the cost of equity set for other utilities scattered around the country, for which the facts and circumstances are not necessarily similar. Rather, pursuant to Section 9-201 of the Act, ComEd must prove that its proposed cost of equity is just and reasonable.

In re Commonwealth Edison Company, ICC Docket 05-0597, Final Order at 154 (July 26, 2006).

On cross-examination, Mr. Fetter insisted that he was not proposing that the Commission use the 30 recent return on equity decisions as a basis for setting the proper returns on equity for Peoples Gas and North Shore in these cases. Aug. 25, 2009 Tr, at 497. The Commission addressed a similar point in the Companies' last rate cases – Dockets 07-0241/07-0242 (cons.). In those cases, the utilities, like ComEd did in Docket 05-0597, cite 54 recent return on equity decisions, and argued that the Staff and CUB-City respective return on equity recommendations were too low. *In re North Shore Gas Company/ In re The Peoples Gas Coke and Light Company*, ICC Dockets 07-0241/07-0242 (cons.), Final Order at 86, (Feb. 5, 2008). Like Mr. Fetter did here, North Shore and Peoples Gas asserted that they offered the 54 recently approved return on equity decisions as "guideposts" for the Commission's analysis and "insist[ed] that they 'are not arguing that their returns should be based on the authorized returns of other utilities.'" *Id*. at 89, *citing*, North Shore-Peoples Gas Brief on Exceptions at 25. The Commission saw through the Companies' argument in that case, concluding that "[t]he Commission doubts that the Utilities' return comparisons were offered without the expectation that our decision-making would be affected by them. The Utilities are presumably reluctant to directly press for comparison-based ratemaking because of our previous rejection of that approach" in ComEd's rate case in Docket 05-0597. *Id* at 89. The Companies have presented no persuasive reason why the Commission should deviate from that approach in these cases. Rather, as Mr. McNally testified, like ComEd's analysis in Docket 05-0597,

> Mr. Fetter does not identify the relative risk, as exemplified by credit rating or any other metric, of each of the utilities involved in those return decisions. Nor does he identify the capital structure that was adopted or the amount of the common stock flotation cost adjustment, if any, that was included in each of those decisions. Without such data, any evaluation of the return recommendations in this proceeding via comparison to the returns authorized in the 30 cases Mr. Fetter cites is ***useless***....

Staff Ex. 21.0 at 29, LL 625-31 (emphasis added).

Moreover, to the extent the 30 recent return on equity decisions have any evidentiary value, they are more harmful to the Companies' witness Mr. Mouls recommended return on equity than they are to Mr. Bodmer's or Mr. McNally's respective proposed returns on equity. On cross-examination, Mr. Fetter admitted that the average of the 30 recently-approved returns on equity is 10.36%. Aug. 25, 2009 Tr. at 483. Mr. Fetter also agreed that Mr. Moul's revised return on equity proposal – 11.87% -- is 151 basis points higher than the average of the 30 returns on equity included in his testimony. *Id*. at 486. The high end of Mr. Bodmer's range of adequate returns on equity – 9% – is only 136 basis points lower from the average of the 30 return on equity decisions. When confronted with that fact, Mr. Fetter essentially admitted that Mr. Moul's recommendation is out of sync with the 30 most recent return on equity decisions, stating that he recommended that the Administrative Law Judges and "the Commission [] look closely and evaluate Mr. Moul's argument and reasoning within his testimony." *Id*. at 492; *see also id*. at 494 ("I think it's important that [the Administrative Law Judges] and the Commission look very closely at both the testimony of Mr. McNally and also Mr. Moul and put it to the test of the type of analysis that this Commission has done since the early 1980s…").

Mr. Moul's recommendation looks even worse when one removes electric utilities from the list of 30 returns on equity. Mr. McNally calculated that the average return on equity for the gas utilities included in the list of 30 recent return on equity decisions is 10.15%. Staff Ex. 21.0 at 29, LL 632-33. As Mr. McNally pointed out, his recommendations for North Shore and Peoples Gas – 9.79 and 9.69, respectively – are 46 and 36 basis points lower than the average for gas utilities included in the list. *Id*. at 29, LL 633-35. The high end of Mr. Bodmer's proposed range, 9%, is 115 basis points lower than the gas utility average. In comparison, Mr. Moul's updated recommendation, 11.86%, is a whopping 172 basis points higher than the gas utility average.

Mr. Moul's number fares no better when compared to the only Commission decision included in Mr. Fetter's list. According to Mr. Fetter, the Commission approved a 10.17% return on equity for Northern Illinois Gas ("NI Gas") on March 25, 2009. NS-PGL Ex. SMF 1.0 at 7. Mr. McNally's recommendations for Peoples Gas and North Shore are only 48 and 38 basis points, respectively, lower than the Commission's decision in the NI Gas case. Mr. Bodmer's high end number is 117 basis points lower. Mr. Moul's number is 169 basis points higher. It appears that Mr. Fetter's list does a far better job of demonstrating that Mr. Moul's recommendation is out of sync with recent return on equity decisions than it does in undermining the recommendations advanced by Mr. Bodmer and Mr. McNally.

b. The Evidence Shows that the Risks Faced by the Companies Identified by Mr. Fetter Are Mostly Addressed by Existing Utility Riders. Moreover, Mr. Bodmer's Analysis Showed that Utility Stock Prices Fared Much Better than Stock Prices Generally During the Recent Financial Crisis.

Mr. Fetter testified that Mr. Bodmer's recommended range of returns on equity fail to account for the significant risks that the Companies face. *Id*. at 14, LL 284-87; NS-PGL Ex. SMF 2.0 at 4, LL 79-84. Mr. Fetter identified such risks as "operational risks, commodity risks, contract counterparty risks, regulatory risks (including regulatory lag and under-recovery of capital costs), capital markets volatility, unforeseen event risk (including infrastructure degradation, or gas explosion risk), and the like" as the types of risks the utilities face. NS-PGL Ex. SMF 2.0 at 4, LL 81-84. Mr. Fetter's slate of risks does not justify a higher return on equity for the Companies.

At the outset, it is important to note that we are talking about two regulated monopoly gas delivery companies. Unlike unregulated companies, Peoples Gas and North Shore face no competition. Also, unlike unregulated companies, Peoples Gas and North Shore are guaranteed an opportunity to an opportunity to earn a just and reasonable return on their investments dedicated to service. Unregulated companies have no such guarantee.

Moreover, in terms of dollar impact, the largest risk that the Companies face is commodity risk, which Mr. Fetter defined as the cost of natural gas. Aug. 25, 2009 Tr. at 476. It is routinely estimated that the cost of gas is usually two-thirds to three-fourths of customers' total bills. Mr. Fetter admitted that each utility has in place a purchased gas adjustment clause ("PGA"). *Id*. PGAs allow the Companies to recover their respective costs as such costs are incurred. To be sure, utilities face the risk of disallowances during PGA reconciliation proceedings, but such disallowances are rare and, by definition, are the result of imprudent actions by the utility. In short, commodity risk is not nearly as great as Mr. Fetter asserted. Also, to the extent that utilities do incur disallowances, they should not be awarded a higher return on equity because of their imprudent actions.

More importantly, Mr. Fetter's claims regarding the risks facing utilities generally, and Peoples Gas and North Shore specifically, are belied by Mr. Bodmer's analysis of how utility stocks fared during the recent financial crisis. Mr. Bodmer testified that after the collapse of Lehman Brothers, stock prices (as measured by the S&P 500) fell by more than 50% (from its high in the fall of 2007 to its low in March 2009). CUB-City Ex. 1.0 at 8, LL. 141-43. Mr. Bodmer added that "[o]ver the same period, many regulated utility companies have had much smaller stock price declines or have even had stock price increases." *Id*. at 8, LL 143-45.

Mr. Bodmer also analyzed the impact on stock prices that the financial crisis had on the utility sample that Mr. Moul included in his utility sample group in his rate of return analysis. Mr. Bodmer showed that during the impact of the financial crisis the stock price of the utility group (excluding NICOR, which has shipping assets) fell only 4%. *Id*. at 17, LL 334-36; Table 2. In contrast, the overall market fell 53% during that same period. *Id*. at 17, LL 336-37.

Mr. Bodmer also presented an analysis of the stock price of every utility in Mr. Moul's sample group for the period from January, 1995 through April, 2009. *Id*. at 18-22, LL 349-409; CUB-City Ex. 1.2. It is not necessary to replicate Mr. Bodmer's extensive analysis here, but Mr. Bodmer's testimony and the graphs included in his direct testimony conclusively show that utility stocks are far less risky than stocks generally. And as noted above, during the greatest market upheaval since the Great Depression, stock prices of the utilities in Mr. Moul's sample group (excluding NICOR) fell only 4% compared to a 53% decline in the overall market. Such statistics make it difficult to take Mr. Fetter's claim that the Companies face difficult and far-reaching risks seriously.

6. CUB-City's Cost of Equity Analyses and Recommendation

Through analyses that take proper account of the current market conditions and of the lessons learned from the recent economic upheaval, CUB-City expert Mr. Thomas presents a quantitative analysis of the Companies' cost of capital. Incorporating recommendations from Mr. Bodmer, Mr. Thomas avoids the problematic technical inputs and adjustments identified by Mr. Bodmer (and discussed above).

Based on his quantitative analyses Mr. Thomas recommends an 8.58% cost of equity based on the DCF and CAPM estimation models preferred in recent Commission decisions, applied to the proxy group of firms identified by Mr. Moul. CUB-City Ex. 2.0 (Rev.) at 7, LL 138-39. His analyses also support his recommendations for an appropriate capital structure, an overall cost of capital, and appropriate conditional adjustment if the Commission approves additional riders for the Companies. *Id*. at 3-4, LL 48-75.

a. Changes in Recent and Current Market Conditions Require <u>Recognition in Cost of Equity Analyses</u>

Aware of the recent discontinuity or turmoil in the credit markets and of the inability of existing valuation models to predict deep, broad-scale declines in value, like the one that recently occurred, Mr. Thomas took account of Mr. Bodmer's guidance in his analysis, including supplemental checks to validate his results. *Id*. at 3, LL 52-60.

The market changes since the Companies' last rate cases have been dramatic: a fall of more than 50% in stock prices; smaller, disparate change price changes for utilities; increased demand for low-risk shares (like utility stocks); and Treasury Bond yields below 3% for most of the year. These changes have "created conditions in the equity markets that must be accounted for when setting rates for the Companies." *Id*. at 7, LL 126-133.

Mr. Thomas has made appropriate accommodations in his analyses (where required) for market conditions and other factors. Among the more significant adjustments are Mr. Thomas' application of a multi-stage DCF model to deal with the current uncertainty about future rates of growth, multiple sources for market estimates to mitigate the effects of any bias in a single source, and the conditional adjustments to address the risk-reducing effect of riders, if any are approved.

b. <u>CUB-City's DCF Cost of Equity Analysis</u>

Mr. Thomas used the DCF model as his primary cost of equity estimation tool. Id. at 7, LL 144-45. Taking account of the credit crisis and the discontinuity it has created in the financial markets, especially the uncertainty about future growth rates, Mr. Thomas changed his approach from a single-stage, or constant growth DCF model, to apply a multi-stage or nonconstant growth DCF model to the proxy group selected by Mr. Moul. *Id*. at 9, LL 191-95. The multi-stage model better accommodated investors' near term focus, future uncertainty from market discontinuities, and the economic and logical ceilings on long term growth rates. *Id*. at 10LL 202-14.

In making the judgmental selections that are a part of a DCF analysis, Mr. Thomas was mindful of Mr. Bodmer's cautions and avoided the identified errors of Mr. Moul's approach. The growth rate inputs to his DCF were sustainable indefinitely, as the model requires. In addition, they were reasonable in the current market context, did not require a failure of regulation to allow perpetual earnings above the cost of capital, and did not require payout ratios that were inconsistent with capital growth and returns. *Id*. at 12-13, LL 278-87. As Mr. Bodmer's testimony demonstrated and academic research confirms, "the current analysts' 3 to 5 year growth projections used by Mr. Moul do not meet these simple common sense tests." *Id*. at 13, LL 289, 301-323.

Mr. Thomas also corrected for the upward bias in DCF results that flows from Mr. Moul's use of current dividends and growth estimates with a proxy group that has a trend of declining payout ratios, which works diminishes both dividend and growth. *Id*. at 17, LL 402-405. Instead, Mr. Thomas calculated an internal growth rate that reconciles the tension between payout ratios on the one hand and dividend levels and growth on the other. *Id*. at 19, LL 429-431.

Mr. Thomas' multi-stage growth analysis assumed (a) short-term (first five years) growth for the proxy group at their average internal growth rate over the last five years, (b) a five-year transition period where growth trends toward the historical average growth rate in real GDP, and

(c) the DCF's perpetual long term period, with a very conservative growth rate equal to GDP growth, the maximum sustainable rate. *Id*. at 22, LL 505-509, 516-518.

The estimate produced through Mr. Thomas' DCF analysis on the proxy group of comparable risk firms chosen by the Companies' witness Mr. Moul was 8.58%. *Id.* at 30, LL 744-52.

c. CUB-City's CAPM Cost of Equity Analysis

Mr. Moul presented a CAPM analysis because the Commission has traditionally relied upon such estimates. However, there are several well-known problems with both the theory and application of the model that have been the subject of extensive academic study. Those problems encompass each of the three main inputs to the model -- the beta (a measure of firm-specific risk), the expected market risk premium or EMRP (a measure of market risk), and the risk-free rate (the minimum return for any investment). *Id*. at 32, LL 797-78. Each is discussed below.

Mr. Thomas briefly recounted the gist of the academic literature, before concluding that CAPM estimates are best used only as a check on the results of DCF model estimates. *Id*. at 31-32, LL 786-95. Ultimately, Mr. Thomas recommends that the Commission use his (partially) corrected version of Mr. Moul's CAPM estimate (5.85% - 7.12%), if it is used at all, as a basis for selecting a cost of equity estimate at the lower end of any range of valid estimates.

i. Beta

Although the Commission has in the past accepted betas adjusted for an assumed mean reversion, a methodology commonly relied on by Value Line, that adjustment is one of the principal sources of an upward bias such adjusted betas. In particular, the Value Line betas used by Mr. Moul are biased in this way. The assumed reversion of utility betas toward 1.00 means that such low-risk firms, which usually have betas below 1.00, are assumed to become more risky over time. The reversion assumption is essentially an assumption that either management will work to make that so or the firm's regulator will fail to do its job. Moreover, empirical research has not validated that assumption, and it is questioned in the academic literature. *Id*. at 34, LL 859-66. This unwarranted adjustment has the effect of improperly increasing betas and the CAPM estimate of the cost of equity. *Id*. at 34, LL 851-854, 857.

Mr. Thomas made two adjustments to mitigate identified problems with beta estimates. First, he recalculated the betas of the proxy firms to remove the mean reversion adjustment. Second, he used an average of beta estimates from several financial reporting services to recognize the variability among estimates, a common technique preferred over single source inputs. *Id*. at 36, 37, LL 906, 917. In contrast, Mr. Moul began with the mean adjusted Value Line beta estimates, then adjusted them further upward based on the difference between the market and book value capital structures (his leverage adjustment). *Id*. at 43, LL 1067-68.

ii. EMRP

There are two approaches to specifying an EMRP input to CAPM analyses -- academic research and market performance. The superiority of either is a matter of considerable debate. *Id*. at 38, LL 947-49. Though the continuing debate suggests that *ad hoc* calculations are unlikely to be superior to prior efforts, the available empirical research does show that such calculations from selective samples of historical data exceeds investors' EMRP. *Id*. at 38, 39, LL 949-51, 960-62.

Notwithstanding the unreliability of using analysts' forecasts, Mr. Moul used a combination of historical data and analyst's forecasts to compute an EMRP of 8.95%. *Id*. at 44, LL 1092-93. He also makes an adjustment for size relative to the entire market that assumes implicitly that the Companies share risk characteristics with the entire market. *Id*. at 45, LL 1105-08. Neither adjustment is appropriate, but both serve to increase Mr. Moul's cost of equity estimate.

Mr. Thomas chose to use the results of the research and analysis performed by unbiased academics over *ad hoc* calculations by interested litigation participants. He saw the choice as between (a) relevant financial theory and research and (b) regulatory habit. *Id*. at 39, LL 951-53. To accommodate the Commission's past acceptance of calculated EMRP estimates, Mr. Thomas used a range of estimates defined by the high end of academic research results (5%) and Mr. Moul's calculated 8.95% estimate. *Id*. at 41-42, LL 1040-42.

iii. Risk-Free Rate

Mr. Thomas found that the current Treasury bond rate Mr. Moul used to represent the minimum return on the safest available security (4.25%) was reasonable.

Using his selected range of EMRPs (5% to 8.95%), and a beta of 0.31 produced a range of CAPM estimates of the cost of equity of 5.79% to 7.01%. This CAPM estimate incorporates Mr. Moul's inflated EMRP. However, as noted, Mr. Thomas regards the CAPM estimates as unreliable and strongly recommends their limited, judicious use by the Commission. *Id*. at 45-46, LL 1117-30.

2. Mr. Moul's Add-On Adjustments

Mr. Moul's error of using unsustainable near term analysts' growth forecasts in a single-stage, constant growth DCF analysis has been discussed in several places in this brief. Mr.

Moul's DCF estimate is also invalidated by two unsupported and inappropriate adjustments to his already inflated DCF results. He proposes a market value, or leverage, adjustment to reflect the difference between the market and book values of the companies in his proxy group and a separate adjustment that purports to account for previously unrecovered flotation costs. Both adjustments are unnecessary and serve only to overstate the cost of equity. *Id*. at 24, LL 559-562.

a. Mr. Moul's Leverage Adjustment

The very basic flaw in Mr. Moul's leverage adjustment is that changes in market value do not change the amount actually invested in rate base and on which the utility is entitled to earn. Therefore, no adjustment is necessary. Moreover, market value in excess of book value means a utility's earnings already have exceeded its cost of equity capital. *Id*. at 25, LL 592-595. Recognizing that basic flaw, the Commission has consistently rejected this adjustment, in each of the many guises in which it has been presented. "Market value is not utilized in this calculation because it typically includes appreciated value (as reflected in its stock price) above the Utilities' actual capital investments." *Id*. at 26, LL 614-66, *quoting In re North Shore Gas Co., et al.*, Dockets 07-0241/07-0242 (cons.), Order (Feb 5, 2008) at 96.

On cross-examination, in the context of a discussion of market-to-book ratios, Mr. Moul confirmed the real objective of his cost of equity estimations. "What we're seeking to do is to maintain the price as we find it when we measure the cost of equity." Aug. 25, 2009 Tr. 460. As Mr. Thomas commented "[t]he Commission was correct to reject attempts to inflate the cost of equity capital to maintain the Utilities' market-to-book ratios above 1.0. It should do so again here." CUB-City Ex. 2.0 (Rev.) at 27, LL 654-57.

b. Mr. Moul's Flotation Cost Adjustment

The Companies also propose to adjust their cost of equity to recover flotation costs allegedly unrecovered since the formation of the Companies. Moreover, that these alleged costs from outside the Companies' chosen test year have not been recovered is unproven. Given that the Utilities earned above their authorized return level for a number of years after the costs were allegedly incurred, the claim that these costs have not been recovered is dubious. *Id*. at 28, LL 699-712. "The Commission should not approve a forward-looking cost of equity that includes backward-looking floatation costs." *Id*. at 29, LL 712-14.

F. Weighted Average Cost of Capital

1. Peoples Gas

2. North Shore

The weighted average cost of capital (debt and equity) for the Companies is a function of their cost of equity and cost of debt, weighted according to their capital structure. Mr. Thomas estimated a single cost of equity for both utilities, and he did not dispute the cost of debt. But the capital structures of the utilities differed in the amount of short-term debt, yielding different weighted averaged capital costs. In addition, his recommendation to recognize the risk-reducing effects of the proposed riders required a separate adjustment.

A summary of Mr. Thomas' recommendations on cost of equity, capital structure, and overall cost of capital was presented in Table 1 of his direct testimony, along with the cost of equity effects of the proposed riders. Id. at 4-5 LL 73-75. That table is reproduced below.

Table 1: Weighted Average Cost of Capital

With No Riders

PGL		Amount	Capital Structure	Cost	Weight
Short-term Debt		$ 54,176,231	3.87%	5.12%	0.20%
Long-Term Debt		$ 581,474,000	41.53%	5.96%	2.48%
Equity		$ 764,563,000	54.60%	8.58%	4.68%
	Total	$ 1,400,213,231		WACC	7.36%

NS		Amount	Capital Structure	Cost	Weight
Short-term Debt		$ 12,670,308	7.01%	4.25%	0.30%
Long-Term Debt		$ 72,785,000	40.28%	5.58%	2.25%
Equity		$ 95,255,000	52.71%	8.58%	4.52%
	Total	$ 180,710,308		WACC	7.07%

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

PGL		Amount	Capital Structure	Cost	Weight
Short-term Debt		$ 54,176,231	3.87%	5.12%	0.20%
Long-Term Debt		$ 581,474,000	41.53%	5.96%	2.48%
Equity		$ 764,563,000	54.60%	8.255%	4.51%
	Total	$ 1,400,213,231		WACC	7.18%

NS		Amount	Capital Structure	Cost	Weight
Short-term Debt		$ 12,670,308	7.01%	4.25%	0.30%
Long-Term Debt		$ 72,785,000	40.28%	5.58%	2.25%
Equity		$ 95,255,000	52.71%	8.255%	4.35%

	Total	$ 180,710,308		WACC	6.90%	

XII. RATE DESIGN

CUB and the City adopt the rate design arguments submitted by the Illinois Attorney General's Office on behalf Peoples of the State of Illinois in their Initial Brief.

XIII. CONCLUSION

CUB and the City respectfully request the Commission adopt the positions presented in this brief.

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Respectfully Submitted,

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