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	)	

SUMMARY OF POSITIONS OF THE CITIZENS UTILITY BOARD AND THE CITY OF CHICAGO

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SUMMMARY OF POSITIONS OF
THE CITIZENS UTILITY BOARD AND
THE CITY OF CHICAGO

Pursuant to Section 200.810 of the Rules of Practice of the Illinois Commerce Commission ("Commission" or "ICC") and the schedule established by the Administrative Law Judges, the CITIZENS UTILITY BOARD ("CUB"), by its attorneys and the CITY OF CHICAGO ("City") by its attorney, Mara S. Georges, Corporation Counsel, submit their Summary of Positions 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 their Summary of Positions, CUB and the City address issues raised by the Utilities' requested return on equity and their proposed capital structure. In addition, CUB and the City adopt the Rate Base, Operating Expenses, and Rate Design arguments (respectively, Sections III, IV, and 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 Summary of Positions.

The Summary of Positions 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

CUB and the City adopt the rate base arguments submitted by the Illinois Attorney General's Office on behalf Peoples of the State of Illinois in their Summary of Positions.

V. OPERATING EXPENSES

CUB and the City adopt the operating expenses arguments submitted by the Illinois Attorney General's Office on behalf Peoples of the State of Illinois in their Summary of Positions.

VI. RATE OF RETURN

A. Overview

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

B. Capital Structure

1. Peoples Gas

2. North Shore

CUB-City noted that Staff of the Illinois Commerce Commission ("Staff") and the Companies have now adopted for ratemaking purposes the Utilities proposed 44-56% hypothetical debt-equity ratio, with the cost of debt represented by the Companies' individual costs of long-term debt. CUB-City asserted that while Staff adopts the Companies' position, it does not abandon its conclusion that each Company "clearly uses short-tem debt to finance rate base." According to CUB-City the basis for Staff's decision is that there is little difference in overall returns resulting from more precise calculations that include short-term debt 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.

CUB-City argued that the Companies' and Staff's position should be rejected. These parties pointed out that 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.

According to CUB-City, the Companies rely on past 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. CUB-City asserted that the Utilities' argument ignores the Commission's later superseding disposition of this issue. CUB-City stated that the 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. 220 ILCS 5/9-201(c). In particular, CUB-City cited the Commission's Order in a recent Ameren rate case where we stated that "[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.

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. CUB-City witness Christopher Thomas testified "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, CUB-City concluded that those funds should be a discrete part of the capital structure used to set rates.

E. Cost of Common Equity

CUB-City addressed cost of equity issues for North Shore and Peoples Gas together.

1. Introduction

CUB-City argued that, in his Direct Testimony, CUB-City witness Edward C. Bodmer predicted the litigation strategy that the Utilities would use with respect to the appropriate return on equity ("ROE") Mr. Bodmer stated that the Companies would try to subordinate objective determinations of the market cost of equity capital to appeal to emotion. CUB-City asserted that such a strategy attempts to influence the Commission's determination on this issue by predicting dire consequences if Wall Street is not pleased with the Commission's ROE conclusion.

CUB-City claimed that Mr. Bodmer's testimony made 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. S*ee* CUB-City Ex. 3.0 at 7, LL 162-71. CUB-City claimed that the Companies relegated their quantitative analyses to secondary status, and to the extent they relied on their analyses, the Utilities inflated the results by incorporating improper adjustments.

In contrast, CUB-City claimed that the cost of equity experts for CUB-City -- and for the Staff -- eschewed emotional appeals, instead presenting analyses that relied on objective market indicators, the Commission's preferred estimation models, and fundamental principles of finance. In support of this assertion, CUB-City noted that the recommendations of CUB-City expert Christopher Thomas (8.58% - PGL and NS) and of Staff expert Michael McNally (PGL - 9.69%; NS - 9.79%) were relatively similar and that most of the differences between the numbers were due to questionable techniques Staff used in its cost of equity analyses. *See* CUB-City Ex. 4.0 (Rev.) at 17-18, LL 397-440. CUB-City added that while the recommendations of CUB-City and Staff experts lie within about 120 basis points of each other, the Companies' proposed ROE (11.87%) was more than 200 basis points higher than any other recommendation in this case. CUB-City argued that the Utilities' outlier position was due 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. CUB-City included in their Initial Brief a chart (reproduced below) showing the relative magnitude of the recommendations made by CUB-City, Staff, and the Companies.

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

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

Because of recent dramatic changes in the financial markets, 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). CUB-City submitted Mr. Bodmer's testimony not to make a pinpoint cost of equity recommendation, but rather to apply his expertise to survey current markets and to provide the Commission with an insightful analysis of the market conditions relevant to the Commission's ROE determinations for the Companies. Mr. Bodmer 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. Mr Bodmer added that 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.").

CUB-City stressed Mr. Bodmer's warning 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. CUB-City argued that 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.

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

CUB-City claimed that as Mr. Bodmer anticipated, the Companies' experts did not us the most objective available data in estimating a proper ROE. Rather, the Companies emphasized appeals to subjectivity and emotion -- fear of Wall Street, and comfort in not being different from other commissions.

CUB-City pointed to Mr. Bodmer's rebuttal testimony, where he 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.

CUB-City claimed that while Mr. Fetter "acknowledge[d] 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 nonetheless relied on his comparison of recent ROE awards to claim 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.

CUB-City argued that Mr. Fetter's table of recently-awarded ROEs actually undercuts the Utilities' ROE position and provides support for the respective ROEs recommended by Staff and CUB-City. At the outset, CUB-City claimed that 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 ROE 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).

CUB-City added that on cross-examination, Mr. Fetter insisted that he was not proposing that the Commission use the 30 recent ROE 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. CUB-City pointed out that 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, cited 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. CUB-City argued that 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. CUB-City argued that the Companies presented no persuasive reason why the Commission should deviate from that approach in these cases. Rather, CUB-City asserted that the Commission conclude as Staff witness Mr. McNally did that

> 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).

CUB-City went on to argue that 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. CUB-City claimed that 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…").

CUB-City argued that 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.

CUB-City also pointed out that 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. 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. CUB-City concluded that 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.

CUB-City argued that Mr. Moul and Mr. Fetter claimed that the ROE investors expect the Commission to grant 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. *See, e.g., Id*., at 3, LL 57-62. According to CUB-City Mr. Bodmer presented a hypothetical in his rebuttal testimony vividly illustrating why standards such as investor expectations and commission awards are the wrong approach to determining a utility's ROE. 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.

CUB-City asserted that the Commission's cost-of-service principles require a decision based on cost, as shown by the record evidence -- not on investor 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.

4. Correcting Traditional Analyses for the Current Environment

CUB-City explained that Mr. Bodmer's ROE 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.

CUB-City added that Mr. Bodmer's more specific recommendations are the end points of his exploration of deficiencies in the estimation approaches of NS-PGL 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. Together, CUB-City argued, they make Mr. Moul's recommended cost of equity wholly unsuitable for use in determining a risk-based cost of equity or setting cost-based rates.

a. Unbiased Betas

CUB-City stated that in his discussion of bias Mr. Moul's beta estimates, Mr. Bodmer analyzed 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 examined the stock price behavior for firms in Mr. Moul's proxy group. Mr. Bodmer 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. According to CUB-City, Mr. Bodmer's results 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.

Separately, 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. The chart is reproduced below.

	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**

CUB-City cited Mr. Thomas's observation that "Mr. Moul relies on only the reported Value Line betas, which have been adjusted for a questionable mean reversion assumption and which are more than 1.8 times higher than the average beta reported by publicly available sources." *Id*. at 7, LL 121-123. CUB-City argued that Mr. Moul's outlier CAPM result (12.25%) is a predictable consequence of such biased model inputs.

CUB-City asserted that Mr. Moul's preference for the Value Line data read by investors apparently blinded him to the large variance -- proved by hard stock price data -- between the Value Line betas and the actual 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. CUB-City concluded that 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.

CUB-City argued that the lengths Mr. Moul was willing to go to claim that the ROE should be set 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. Aug. 25, 2009 Tr. at 425. CUB-City asserted that 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

Cub-City noted that Mr. Bodmer testified "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. CUB-City witness Bodmer added that "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. CUB-City argued that the DCF cost of equity estimates developed by Mr. Moul used analysts' five-year growth forecasts that fail both tests. CUB-City claimed that Mr. Moul's forecasts are logically impossible and they are subject to significant bias.

CUB-City pointed out that Mr. Moul did not put to much focus on his insupportable growth rate forecast because, in his view, the validity and reliability of growth forecasts do not affect the subjective expectations of investors. CUB-City cited Mr. Moul's statement that "investors do not need these types of forecasts to make investment decisions" to support its argument. For further support, these parties pointed to Mr. Moul's statements that growth projections beyond five years are "pure conjecture," and 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.

CUB-City argued that Mr. Moul's focus on investor expectations was consistent with his overall approach in this case, but his complete disregard for the financial and economic principles supporting DCF estimates is stunning. CUB-City witness Bodmer stated that "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.

CUB-City argued that it is clear that Mr. Moul recognized the limitations of his chosen growth inputs -- analysts' five year forecasts -- but he uses them, contrary to the basic theory underlying the models. Mr. Moul conceded that growth rate assumptions "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>.

CUB-City asserted that Mr. Moul did not worry about the sustainability issue, he simply assumed that the analysts' forecasted five-year growth rates will persist forever. Mr. Moul's objective contravenes the Commission's duty to determine the market cost of capital for the Companies. CUB-City concluded that when logical, actually 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

According to CUB-City, yet another means Mr. Moul used to inappropriately inflate Companies' cost of equity was 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 CUB-City witness. 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.

CUB-City claimed that 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. <u>Check the Fundamentals and Use Common Sense</u>

CUB-City urged 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.

CUB-City argued that in addition to the challenges presented by current market conditions, 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).

CUB-City 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.

CUB-City asserted that 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.

CUB-City also pointed out that 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.

5. *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.*

North Shore-Peoples Gas witness Fetter testified that CUB-City's recommended return on equity fail to account for the significant risks that the Companies face. NS-PGL Ex. SMF 1.0 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. CUB-City argued that Mr. Fetter's slate of risks does not justify a higher return on equity for the Companies.

CUB-City noted that 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 earn a just and reasonable return on their investments dedicated to service. Unregulated companies have no such guarantee.

CUB-City added that, 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, result from imprudent actions by the utility. CUB-City argued that these facts make plain that 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.

CUB-City asserted that importantly, Mr. Fetter's claims regarding the risks facing Peoples Gas and North Shore 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 "Over 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.

CUB-City cited Mr. Bodmer's analysis of the impact on stock prices that the financial crisis had on the utility sample group Mr. Moul used 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.

CUB-City also cited Mr. Bodmer's 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. CUB-City stated that 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. CUB-City concluded that 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

CUB-City argued that the Commission should adopt Mr. Thomas's recommended return on equity for the Companies. CUB-City asserted that 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 Recognition in Cost of Equity Analyses

CUB-City noted that 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. Mr. Thomas testified that 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.

b. CUB-City's DCF Cost of Equity Analysis

CUB-City stated that 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 non-constant 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.

CUB-City stated that 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 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 and did not require payout ratios that were inconsistent with capital growth and returns. *Id*. at 12-13, LL 278-87. Mr. Thomas, relying on Mr. Bodmer's testimony and academic research confirms, testified that "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.

CUB-City added that Mr. Thomas 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 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.

CUB-City explained that 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.

CUB-City stated that 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. <u>CUB-City's CAPM Cost of Equity Analysis</u>

CUB-City argued that there are several well-known problems with both the theory and application of the CAPM 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.

CUB-City said 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, CUB-City recommended that the Commission use Mr. Thomas's (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

According to CUB-City, betas adjusted for an assumed mean reversion, a methodology commonly relied on by Value Line, is one of the principal sources of an upward bias of such adjusted betas. CUB-City argued that 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. CUB-City asserted that 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.

CUB-City explained that 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

CUB-City stated that 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.

CUB-City argued that 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 made an adjustment for size relative to the entire market that implicitly assumes that the Companies share risk characteristics with the entire market. *Id*. at 45, LL 1105-08. Neither adjustment is appropriate and serve only to increase Mr. Moul's cost of equity estimate.

CUB-City noted that Mr. Thomas chose to use the results of the research and analysis performed by unbiased academics over *ad hoc* calculations by interested litigation participants. 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

CUB-City stated that 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%, which incorporates Mr. Moul's inflated EMRP. However, CUB-City asserted that CAPM estimates are unreliable and strongly recommend their limited, judicious use by the Commission. *Id*. at 45-46, LL 1117-30.

2. Mr. Moul's Add-On Adjustments

CUB-City argued that in addition to Mr. Moul's error of using unsustainable near term analysts' growth forecasts in a single-stage, constant growth DCF analysis, his DCF estimate was further invalidated by two unsupported and inappropriate adjustments to his already inflated DCF results. Mr. Moul proposed 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. According to CUB-City, both adjustments are unnecessary and inflate the cost of equity. *Id*. at 24, LL 559-562.

a. Mr. Moul's Leverage Adjustment

CUB-City argued that the 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. CUB-City noted that recognizing that basic flaw, the Commission has consistently rejected this adjustment, in each of the many guises in which it has been presented, including the Companies' last rate case. There, the Commission stated "Market value is not utilized in this calculation because it typically includes appreciated value (as reflected in its stock price) <u>above</u> the Utilities' <u>actual</u> <u>capital</u> <u>investments</u>." *In re North Shore Gas Co., et al.*, Dockets 07-0241/07-0242 (cons.), Order (Feb 5, 2008) at 96 (emphasis added). CUB-City argued that "The 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

CUB-City explained that the Companies also propose to adjust their cost of equity to recover flotation costs allegedly unrecovered since the formation of the Companies. CUB-City argued that there is no proof that these alleged costs from outside the Companies' chosen test year have not been recovered. Mr. Thomas testified that 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

CUB-City explained that 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 Rider VBA required a separate adjustment.

A summary of Mr. Thomas' recommendations on cost of equity, capital structure, and overall cost of capital 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 Summary of Positions.

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Respectfully Submitted,

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