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	)	

REPLY 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 one of its attorneys and the CITY OF CHICAGO ("City") by its attorney, Mara S. Georges, Corporation Counsel, submit their joint Reply Brief in this proceeding. This brief responds to the arguments and positions in the initial briefs filed by the Peoples Gas Light and Coke Company ("Peoples Gas" or "PGL") and North Shore Gas Company ("North Shore" or "NS") (collectively, the "Companies" or the "Utilities"). CUB and the City address issues raised by the Utilities' arguments on 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 its Reply Brief.

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 its Reply Brief.

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 its Reply Brief.

VI. RATE OF RETURN

A. Overview

CUB-City continue to challenge two basic 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 Companies' brief concludes -- erroneously -- that "The Utilities' proposed capital structure, which would remain the same as the Commission approved in the Utilities' last rate case, appears to be uncontested." In his direct testimony, CUB-City expert witness Christopher Thomas examined this issue and concluded that "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, he recommended that the Companies be required to use their actual capital structure instead of the hypothetical structure they propose.

In their initial brief, the Companies rely entirely on their non-unanimous agreement with the Staff of the Illinois Commerce Commission ("Staff"). Neither Staff nor the Companies dispute the existence of short-tem debt in the Companies' capital structures. In fact, in its initial brief, Staff confirms that, as noted in CUB-City's initial brief, the Companies' proposed capital structure is "a hypothetical capital structure comprising 44% long-term debt and 56% equity". Staff Init. Br. at 91. Contrary to the Companies' argument, their proposed capital structures are entitled to no special consideration in the Commission's determination of the Companies' appropriate capital structures. S*ee* CUB-City Init. Br. at 13. In fact, since the Commission should favor actual capital structures over hypothetical ones ("us[ing] the best available data in setting cost-based rates"), the Companies' hypothetical structures should be discarded. *See id.* The Companies have presented testimony that they may have some limited, theoretical capability and intent not to use short-term debt to finance rate base. However, "[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' testimony about speculative possible allocations of capital (especially in light of the impossibility of meeting their burden of proving such restricted use of capital) is inadequate to overcome the common sense presumption the Commission expressed in Docket 02-0798. *Id.*

Though they are in complete agreement that both Companies "clearly use[] short-tem debt to finance rate base" (CUB-City Init. Br. at 91, 92), Staff's expert Sheena Kight-Garlisch and CUB-City's expert Mr. Thomas reached different conclusions about the level of short term debt in the Companies' actual capital structures. *Compare*, CUB-City Init. Br. at 44 and Staff Init. Br. at 91, 92. However, that issue is secondary to the inclusion of short-term debt in the Companies' capital structure, and it should not serve as a distraction from the use of the best available, most accurate information in setting rates. As CUB-City argued in their initial brief, "the Commission is obliged to use the best available data in setting cost-based rates." CUB-City Init. Br. at 13. The Commission, therefore, should use the Companies' actual capital structures to set rates in this case.

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

As background for any consideration of the cost of equity recommendations in this case, the Commission should recall the estimates in the record and the relationships among them. For that purpose, CUB-City have reproduced below this useful graphic from their initial brief. *Id.* at 15.

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

With what CUB-City assumes is mock indignation, Peoples Gas-North Shore exclaim that CUB-City's and Staff's respective recommended returns on equity are "*literally incredible*." Companies' Init. Br. at 76 (emphasis added). CUB-City assume that the source of the Companies' outrage comes from the fact that Staff witness McNally recommends returns on equity for Peoples Gas and North Shore that are, respectively, 50 and 20 basis points lower than what the Commission approved for those Utilities in their last cases, while CUB-City witness Thomas's 8.58% recommendation for both Companies is, respectively, 161 and 141 basis points lower than what the Commission granted in Dockets 07-0241/07-0242 (cons.). *Id*.

CUB-City also assume that the Companies are feigning their indignation because, whatever the merits of CUB-City's and Staff's respective recommended returns on equity – and the record shows there are many – it is Mr. Moul's proposed rate of return that strains credulity. Mr. Moul's eventual recommendation – 11.87%, a meager 13 basis points lower than his original 12% recommendation – is, respectively, a staggering *168 and 188 basis points* higher than the returns on equity approved for Peoples Gas and North Shore in their last rate cases. That is, Mr. Moul's recommendation deviates from the Commission's decision in Dockets 07-0241/07-0242 (cons.) even more than CUB-City's recommendation, which the Utilities characterized as out of "sync with the market and current investor expectations." NS-PGL Ex. SMF at 5-6, LL 114-16.

Using the Companies "literally incredible" phraseology as a gauge, compared to Mr. McNally's recommendation, Mr. Moul's proposed return on equity is absurd. The 168 basis point difference between Mr. Moul's recommendation for Peoples Gas and that approved in the last rate case is more than more than three and one-half times greater than the 50 basis point difference between Mr. McNally's proposal in this case and the return on equity awarded the utility in the last case. For North Shore, the 188 basis point difference between Mr. Moul's recommendation and the return approved for that utility in the last rate case is a mind-bending nine-plus times greater than the 20 basis point difference between Mr. McNally's 9.79% recommendation in this case and the 9.99% return granted in the prior case.

Like Mr. Fetter, who did not include Mr. Moul's recommendation in his review of 30 public utility commission returns on equity decisions in 2009 (Aug. 25, 2009 Tr. at 485), perhaps the Companies failed to realize how out-of-line Mr. Moul's recommendation is compared to the returns on equity the Commission approved in Dockets 07-0241/07-0242. That seems to be the only explanation, because otherwise it is hard to fathom how the Companies could not see the irony in terming Mr. McNally's and Mr. Thomas's respective proposed returns as "literally incredible."

The irony of the Utilities' claim is amplified because at least Mr. Thomas and Mr. McNally have each other's company in concluding that Peoples Gas and North Shore should receive lower returns on equity than they did in their previous rate cases. Mr. Moul is by himself. He was the only rate-of-return witness who recommended that the Utilities should have their returns on equity increased.

And Mr. Moul did not recommend that the returns be increased just a bit or maybe modified around the edges. Mr. Moul's 11.87% return on equity represents an almost 16.5% increase over the 10.19% rate of return Peoples Gas received in the last case. His 11.87% recommendation would increase North Shore's return on equity by almost 19% compared to the 9.99% return granted in Dockets 07-0241/07-0242.

Perhaps even more telling is that the Companies' own witness, Mr. Fetter, ultimately concluded that Mr. Moul's recommendation is an outlier. Mr. Fetter, a former Chairman of the Michigan Public Utilities Commission, was brought in by the Companies as part of its rebuttal case to respond to Mr. Bodmer's and Mr. McNally's respective testimonies. NS-PGL Ex. SMF 1.0 at 4-5, LL 85-99; Aug. 25, 2008 Tr. at 485. Mr. Fetter described Mr. Bodmer's and Mr. McNally's respective recommended returns on equity as "out of sync with the market and current investor expectations." NS-PGL Ex. SMF 1.0 at 5-6, LL 114-16. To support his view, Mr. Fetter presented 30 return on equity determinations public utility commissions have made for gas and electric utilities in 2009, alleging that Mr. Bodmer's and Mr. McNally's recommendations diverge from "market norms."[1] *Id*. at 6, 116-20. On cross-examination, Mr. Fetter admitted that Mr. Moul's proposed return on equity deviates further from the average of the 30 approved returns on equity than do either Mr. Bodmer's or Mr. McNally's respective recommendations. Aug. 25, 2009 Tr. at 486. When asked to comment on that information, Mr. Fetter added Mr. Moul's recommended return on equity to those of Mr. Bodmer and Mr. McNally as proposals the Commission should review with suspicion. *Id*. at 492.

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[1] In our initial brief, CUB-City explained in detail the many deficiencies with Mr. Fetter's list of 30 approved returns on equity for gas and electric utilities in 2009. *See,* CUB-City Brief at 30-34.

CUB-City witness Bodmer nicely explained why Mr. Moul's return on equity recommendation is the real outlier in this case. When asked in his direct testimony to describe his initial reaction to the Companies' request for a 12% return on equity (subsequently reduced to 11./87%), Mr. Bodmer said

> I was struck by the disparity between a utility's low risk and the premium implicit in the requested 12% cost of equity. Peoples Gas submitted its testimony in February 2009 when the yield on ten-Year Treasury Bonds, a low risk investment compared to most equity securities and even debt instruments, was hovering between 2.75% and 3%. This means that with a straight face, People Gas is suggesting that a the utility, which also has little risk (by virtue of a statutory earnings opportunity, its delivery service monopoly, a stable customer base, and a revenue decoupling mechanism) somehow should be entitled to earn a premium of 9% over government bonds. It is not necessary to prepare sophisticated financial analyses to see that this premium is out of proportion to the minimal incremental risk associated with a local gas distribution company.

CUB-City Ex. 1.0 at 5, LL 79-88.

Alluding to the "deep worldwide recession" the Companies assert that the Mr. Thomas's and Mr. McNally's "literally incredible" return on equity recommendations fail to account for the risks that the utilities are facing. Companies Init. Br. at 76. While it may be possible that the deep worldwide recession affected Peoples Gas and North Shore, the record evidence shows that gas distribution companies fared very well compared to the stock market as a whole during the financial upheaval of the past year. Mr. Bodmer analyzed the stock price performance of the gas distribution companies in Mr. Moul's proxy group during the recent financial crisis. Mr. Bodmer found that the stock prices for Mr. Moul's proxy group fell only 4% when NICOR, which owns shipping assets, is excluded. *Id*. at 16-17, LL 328-39; *see also*, *Id.*, at 15-22, LL 305-404, CUB-City Ex. 1.2. When NICOR is included, the gas distribution companies in Mr.

Moul's sample group fell a relatively paltry 6%. CUB-City Ex. 1.0 at 17, LL 338-39. In contrast, during the same time period, the stocks in Standard and Poor's 500 Index ("S&P 500") dropped by a staggering 53%. *Id*. at 17, LL 336-37. In other words, the decline in the S&P during the during the financial crisis was almost ***nine times greater*** than the gas utilities in Mr. Moul's proxy group when NICOR is included. Without NICOR, the drop in the S&P 500 soars to more than ***13 times greater*** than Mr. Moul's sample utility. Mr. Bodmer concluded, "If there is any doubt that utility companies have dramatically lower risk than the market in general, that doubt should disappear by looking at the performance of these stock price values in stressful times." *Id*. at 22, LL 406-08.

Importantly, Mr. Bodmer's testimony on this point was completely unrebutted. Peoples Gas and North Shore had two opportunities – in its rebuttal testimony and its sur-rebuttal testimony -- to challenge Mr. Bodmer's analysis. But neither Mr. Moul nor Mr. Fetter mentioned, much less challenged, Mr. Bodmer's analysis. Nor did the Utilities cross-examine Mr. Bodmer, and, therefore, his analysis is unchallenged in the record.

In reality, it is not surprising that gas distribution companies are viewed by investors as less risky than other companies. Peoples Gas, North Shore, and other similarly-situated gas utilities are not internet start-up companies. They are mature monopolies. They have state-granted service areas and have ***no competition.*** As Mr. Bodmer commented, "The real definition of risk – what happens to your investment when the world falls apart – demonstrates that the risk measure of regulated utility companies must be much lower than those of other companies that do not have the safety net of the regulatory regime." *Id*. at 13, LL 254-57.

2. *The Companies's Reliance on Comparisons to Cost of Equity Estimates in Other Cases Are Flawed, Inapposite, and Inappropriate.*

Looking consistently to results in other cases and to expectations in investors' minds -- instead of to the market indicators most pertinent to this case -- the Companies' initial brief presents a series of comparisons designed to induce the Commission to "follow the herd" (CUB-City Ex. 1.0 at 38, LL 796-98) or to conform to an alleged trend (Companies' Init. Br. at 9), instead of relying on the evidence of record.

The Companies begin their defense of the outlier recommendation of their witness Paul Moul by suggesting that there has been a "flight of capital from the financial markets" that "caused debt costs to climb, stock prices to fall, and the government to offer its securities at nearly zero cost." *Id*. at 7. The Companies' unqualified assignment of adverse consequences to all market participants is an over-simplification of the current market.

What has actually happened in the recent market upheaval is a flight of capital to low-risk securities. CUB-City expert Edward Bodmer analyzed the market behavior of the stocks of specific comparable firms selected by the Companies' Mr. Moul for his proxy group. That analysis showed that, in the movement to low-risk securities, those comparable utilities have fared better than the market. *See* CUB-City Ex. 1.0, LL 388-392, 406-409; City Ex. 1.2. Mirroring the error of Mr. Moul's DCF analysis (*see* CUB-City Init. Br. at 41-42), the Companies wrongly equate the short-term reaction to the financial upheaval (higher short-term cost of capital) with a change in the long-term cost of capital.

To support their argument, the Companies offer a comparison of <u>selected</u> cost of equity estimates from the record to selected estimates from the Companies' last rate case. Companies' Init. Br. at 8. Note that the comparisons are -- at best -- subsidiary components of experts' recommendations, without the weighting those experts applied to their estimates. The comparisons are severely flawed, and the results are not persuasive.

The Companies first compare (a) a calculated constant growth DCF estimate attributed to (though not produced or presented by) Staff and (b) the Companies' constant growth estimates from the two cases -- ignoring the acknowledged rejection of constant growth results by Staff. Companies' Init. Br. at 8, n. 9 ("Staff did not use a constant growth DCF model in this case, but rather a non-constant growth DCF model. However, Mr. Moul calculated the result of using Staff's constant growth DCF model from the Utilities' last rate cases with Staff's DCF model inputs in these cases. Moul Reb., NS-PGL Ex. PRM-2.0 Rev. at 14:290-292").[2] The experts in this case who considered constant growth DCF models (all except Mr. Moul) saw fit to exclude the results of such models from their analyses and recommendations, because of the clear inappropriateness of the constant growth assumption in today's market environment.

The Companies argue that the Commission should nonetheless rely on a constant growth DCF model rejected by most experts in this case because "It would be poor public policy … to depart from accepted ratemaking approaches used throughout the nation at a time when markets are already unsettled . . ." Companies' Init. Br. at 81. In fact, when the <u>absence</u> of such unsettled markets is an underlying assumption of the traditional

[2] Note that although the Companies calculated a constant growth estimate and attributed it to Staff, the Companies did not do the same for the non-constant growth approach. Companies' Init. Br. at 8, n.9 ("Because Staff did not present a non-constant growth DCF result in the Utilities' last rate cases, there is no result to compare to Staff's non-constant growth DCF result in these cases.").

application of the models, an unsettled market is precisely the time to depart from those approaches. As Mr. Bodmer advised in his testimony: "There is nothing wrong with admitting that past approaches are not adequate to the challenges of the current environment and examining the pertinent risk and financial issues using approaches more attuned to the undeniable changes in the markets. CUB-City Ex. 1.0 at 7, LL 122-124.

Mr. Moul's approach was dictated by the primacy he gave to investors' total return expectations over the plain requirements of the model. Companies' Init. Br. at 85. As Mr. Thomas explained, use of near term constant growth assumptions is especially inappropriate, not only because of the optimistic nature of analysts' forecasts of near-term growth, but also because those near term forecasts cannot be sustained indefinitely, as the constant growth DCF model requires.[3] *See, e.g.,* CUB-City Ex. 2.0 (Rev.) at 13, L 281-82. The Companies argue that no ceiling on DCF growth rates should be imposed because the analysts' growth forecasts have not been shown to be unreasonable. Companies Init. Br. at 91. No party has argued that the analysts's growth rates are unreasonable as what they purport to be -- near term forecasts. They are unreasonable as perpetual growth rates, which is how Mr. Moul improperly uses them.

Staff's expert also deemed a constant growth DCF estimate inappropriate, and he excluded it from his estimation. Staff Init. Br. at 101. Mr. Thomas, whose estimates are entirely excluded from the Companies' very selective comparisons, also rejected the constant growth DCF model in this case. Mr. Moul's estimate is affected by the same factors that caused the other analysts to reject the constant growth model for use in the

[3] Mr. Moul apparently appreciates the importance of a sustainable growth rate. "The important point is not whether a company has an above-average growth rate, but whether the growth rate to be used in the DCF model is within a reasonable range that can be viewed as sustainable." NS-PGL Ex. PRM 3.0 (Rev.) at 5, LL 103-05. He simply chooses not to act on that knowledge when he insists on a constant growth rate that exceeds (forever) the growth rate of the economy.

current environment. Although it is equally flawed, Mr. Moul alone refused to drop his constant growth estimate.

The Companies' comparison of risk premium estimates also warrants no consideration. The Commission has regularly rejected proposals to have it rely on the results of risk premium analyses, and the Companies have provided no reason for a change in Commission policy here. Neither the constant growth DCF nor the risk premium comparison assists the Commission's deliberations.

When the Companies' inapposite comparisons are eliminated, the comparison of return on equity estimates actually made and supported by experts actually disproves the Companies' claims of uniform and sometimes significant increases in the estimates between the Companies' last case and this case. Moreover, when the estimates of CUB-City's experts (which the Companies arbitrarily excluded) are taken into account, the comparisons show constancy or a decrease in the level of cost of equity estimates.

The table below demonstrates that conclusion. It is a reproduction of the table at page 8 of the Companies' initial brief -- with CUB-City's estimates included. It also indicates (a) the elimination of risk premium estimates, in accord with the Commission's consistent rulings and (b) the elimination of constant growth DCF estimates using short-term forecasts, which the record evidence establishes as inappropriate. It also shows that only the Companies retained these inappropriate estimates in their estimation analyses.

Financial Model	2007	2009	Difference
~~Utility Constant Growth DCF~~	~~9.01~~	~~10.67~~	~~+166 BP~~
Utility CAPM	10.79	10.86	+7 BP
~~Utility Risk Premium~~	~~11.25~~	~~12.25~~	~~+100 BP~~
~~Staff Constant Growth DCF~~	~~8.23~~	~~11.76~~	~~+353 BP~~
Staff Non-Constant Growth DCF		10.23	N/A
Staff CAPM	11.34	9.95	-138 Bp
~~CUB-City Constant DCF~~	~~8.11~~		~~N/A~~
CUB-City Non-Constant DCF		8.58	N/A
CUB-City CAPM	8.43	5.85-7.12	-258 to -131 BP

In the table above, the Companies' positions in their last rate cases and the current cases that (a) the Commission has rejected in the past or (b) based on the evidence in this case, it should reject here, are stricken out in red. Staff's constant growth DCF is stricken out because, although Mr. McNally calculated it, he concluded that it was inappropriate to include in his return on equity analysis. The CUB-City constant growth DCF is stricken because, like Mr. McNally, Mr. Thomas concluded that it was inappropriate to include it in his cost of common equity calculation. The clear implication of this revised table is that, contrary to the Companies' claim, it is not surprising, but indicated by the valid models, that their returns on equity are lower in this case compared to the last. In fact, the record dictates that result.

In developing his recommendation, Mr. Moul used both constant growth DCF and Risk Premium estimates. Given the Commission repeated rejection of Risk Premium estimates, the only apparent function served by the Companies' 12.25% "updated Risk Premium result," (Companies' Init. Br. at 95) is to raise the level of the mathematical combination of his estimates. *See, e.g., Re Commonwealth Edison Company*, ICC Dkt. 07-0566, Order at 98 (Sep 10, 2008) ("consistent with our ruling in Docket 07-0241/0242, we are not convinced risk premium analysis is an appropriate tool in rate making"). "Mr. Moul weighted his results, assigning 25% weight to his DCF results and

75% to his CAPM and Risk Premium results, which yielded his 11.87%." Companies' Init. Br. at 83. The Companies do not explain or attempt to justify this seemingly arbitrary weighting, but its effect is clear – a higher recommended cost of equity.

The Companies next offer a comparison of the recommendations in this case to the Commission determinations in other gas and non-gas utility decided cases since the Companies' last rate cases. Companies' Init. Br. at 9. According to the Companies, "The Commission's authorized returns since the Utilities' last rate cases likewise show a general trend of increasing public utility costs of equity." The Companies then claim to recommend a cost of equity (11.87%) "at the high end of recent returns," even though it is almost 100 basis points higher than any of the comparative figures offered.

Apparently assuming that there is only one direction for changes in cost of equity determinations, the Companies complain that the non-utility experts in this case recommend cost of equity determinations "below any rate of return that this Commission has set for any gas utility since at least 1972." *Id*. at 10, 76. Not having strayed far enough from the cost-based determination the law requires, with its comparisons to findings in other cases and from other commissions, the Companies offer yet another cryptic (likely meaningless) measure that has no basis in Illinois law: "The true test of reasonableness is how the analyst's result fares in the context in which it is made." *Id*. at 10. Despite the diversions the Companies offer, Illinois law requires a determination of the risk-based, market-required cost of equity, not a determination that looks like one of the Companies' chosen alternatives to record evidence.

Finally, the Companies return to Mr. Moul's home base, investor sentiment, as the determinant of fact. The Companies complain that Staff and CUB-City experts "reject objective data that investors routinely rely upon." *Id*. at 10. First, the "data" identified are analysts' forecasts and adjusted market data, not unvarnished market indicators. Second, Mr. Moul's presumptive identification of what information investors do or do not rely on is not a substitute for the Commission's own evaluation of the objective market indicators.

3. *The Companies' Criticisms of CUB-City Positions and Expert* <u>Testimony Are Misguided.</u>

In their initial brief, the Companies claim that Mr. Bodmer has advocated that the Commission "set returns based not on investor-required returns at all but on the returns that the Commission decides investors should be satisfied with." *Id*. at 11, 106. Predictably, the Companies cite no record evidence for this assertion -- because there is none. This fabrication (or at the very least, strained interpretation), unsupported by a single citation to the record, merely provides an easier target than CUB-City's actual evidence, positions, and arguments. Flimsier straw men are rarely seen.

The Companies also assert that "the Staff and CUB-City recommendations should be rejected because they stray from a zone of reasonableness to the degree that they offer unreliable estimates of the appropriate ROE." *Id*. at 11. This is an absolutely astonishing statement from the advocates for a cost of equity estimate that is more than 200 basis points above any other estimate in the record. As the earlier presented graphic depiction of the cost of equity estimates in this case shows, the Companies are the parties straying beyond the zone of reasonableness.

The Companies dismiss out of hand the possibility that their cost of equity could be "lower now, in the middle of a deep worldwide economic recession and sharp contractions in the capital market, than it has at any time in the last 30 years." *Id*. at 76.

The Companies appear to suggest that bad economic times mean utilities should earn more. However, as Mr. Bodmer explained, the effects of the financial crisis has not been as uniform or simple as the Companies would like the Commission to infer. The crisis has resulted in a flight to quality and low-risk investments. Some of that movement has benefited utilities, including specifically those Mr. Moul identified as comparable to the Companies. As Mr. Bodmer's analyses of Mr. Moul's proxy firms' stock price performance during the crisis shows, utility risk (relative to the risk of other firms in the market) is more attractive now. *See, e.g.,* CUB-City Ex. 1.0 at 15-22, LL 305-404; CUB-City Ex. 1.2. Consequently, the cost of equity for better performing, low-risk stocks (like utilities) can be lower than when low-risk stocks were not in such demand.

The Companies claim that the cost of equity adjustment for Rider VBA that the Commission approved in their last rate case "was designed to accommodate the perceived <u>change</u> in risk when the Utilities adopted Rider VBA." Companies' Init. Br. at 103. Moul Reb., NS-PGL Ex. PRM-2.0 Rev. at 32:638-640 (emphasis in original). They argue further that "Now that Rider VBA has been in place in two years, there is no need for the adjustment because there is no additional change in the Utilities' risk." *Id.* Thus, they oppose the adjustment recommended in this case by CUB-City's cost of equity expert, Mr. Thomas. The Companies cite no Commission decision that supports their self-serving interpretation of the risk-based adjustment the Commission ordered.

The revenue stability that VBA provides for the Companies causes was not a one-time event, but a continuing characteristic of the Companies' revenue streams for as long as the rider is in place. The Commission recognized this fact when it ordered annual reports on the rider's effect on earnings for the entire period of the rider experiment. *Re*

North Shore Gas, et al., ICC Dkt. 07-0241 (cons.), Order at 99 (Feb 5, 2008). In addition, the Commission stated that it "expect[ed] the parties to quantify thoroughly the effect of Rider VBA on ROE in future cases." *Id.* Those steps would not be required for a one time event or if the risk reducing effect of the rider vanished after the event of Commission approval.

CUB-City note that the Companies did not challenge any aspect of Mr. Thomas' cost of equity analysis or estimate in their initial brief. Any critique that is not directly responsive to CUB-City's initial brief is improper and denies City-CUB any opportunity for reply and the Commission its objective of a full record.

4. *Mr. Moul's Adjustments Distort His Models' Estimates* Investors' Expectations.

In more than one instance, the emphasis Mr. Moul and the Companies place on investors' expectations distorts the results of the estimation models on which Mr. Moul purports to rely, often through the inputs he selects or his adjustments to market data inputs. For example:

- The Companies claim that "Commission precedent supports the consideration of general market conditions and trends because these considerations are central to investor expectations." Companies' Init. Br. at 81.
  - The more plausible explanation is that the Commission supports consideration of market conditions because that is where the cost of equity is determined -- not through investors' subjective expectations, but through (A) buy/sell actions that set stock prices, leaving

objective market indicators (like price, performance relative to the entire market, Treasury rates) and (B) management actions (*e.g.*, dividend policy) that increase or decrease the attractiveness of an investment in the Companies.

- Mr. Moul places great significance in his opinion about Value Line and other selected sources that "These are the data relied upon by those who ultimately determine the cost of equity in the real world." *Id*. at 96.
  - Mr. Moul prefers to look to the information he believes investors read (and on his interpretation of how they used those data) instead of at investors' actions in the market and the objective indicators of those actions other analysts rely upon.

Mr. Moul acknowledges that there is a distinction between investor expectations and investor requirements. Aug. 25, 2009 Tr. 428, 431-432, 448. The Companies and the Commission are also aware of the distinction, as shown by the following quotation from the Companies initial brief: "The Commission, in authorizing a rate of return, makes an estimate of what the investor is **demanding**." Companies' Init. Br. at 81 (*quoting Re Illinois Bell Tel. Co.*, ICC Dkt. 92-0448, 93-0239 (Cons.), at 103 (Order Oct. 11, 1994) (emphasis added). As the Commission emphasized, it is what investors require or demand that determines the cost of equity, not what they expect.

Leverage Adjustment. The Companies' initial brief clings to and defends the discredited notion of a leverage adjustment -- for both its DCF and CAPM estimates. *See* Companies' Init. Br. at 85-87, 93. As utilities constantly seek a new guise for this boost to cost of equity estimates, the Companies have chosen a fatuous argument that was easily exposed by Staff witness Michael McNally.

> Mr. Moul argued that, when a company's book value exceeds its market value, the risk of a company increases if the capital structure is measured with book values of capital rather than market values of capital. Such a notion is absurd. The intrinsic risk level of a given company does not change simply because the manner in which it is measured has changed.

Staff Init. Br. at 110, *citing* ICC Staff Ex. 7.0 (Rev.) at 42, LL 841-45.

The Commission's consistent rejection of l adjustments based on the relationship of market and book valuations (*see e.g.*, *Re Ameren Illinois Utilites*, ICC Dkt. 06-0700, Order at 141 (Nov. 21, 2006), often for DCF estimates, is supported by simple, unassailable logic rooted in the Public Utilities Act. The law authorizes the Commission to include only investment dedicated to public service in rate base, and a utility can lawfully earn only on that actual investment. 220 ILCS 5/9-211. The Companies' equity <u>investment</u> (warranting the equity return) is not changed as the market price of shares changes. Consequently, the aggregate of those changes, a change in market value, also does not change the amount of equity actually invested. The Companies' adjustment for the CAPM is even more inexplicable. The betas on which the CAPM depends for its estimate of the cost of equity are a measurement of the movement of a firm's stock prices relative to the market. Mr. Moul has offered no explanation of how the relative sizes of book investment and market investment affect stock price movements relative to the entire market.

Even before his return boosting adjustment to his CAPM estimate, Mr. Moul struggled to explain his stubborn reliance on a single biased source of beta estimates for his CAPM analysis. *See* CUB-City Ex. 1.0 at 13-14, LL 272-292. His best attempt was to claim an inability to ascertain the methodology of other sources. Companies' Init. Br. at 93 ("as Mr. Moul explained at the hearing, Value Line is the only beta source that publishes its methodology"). Apparently, the methodology of other beta estimators is not a mystery. Staff witness Mr. McNally was able to find that information and use it to evaluate and to select the betas he used. *See* Staff Init. Br. at 103, *citing* Staff Ex. 7.0 (Rev.) at 16-20, LL 319-73. The inaccuracy (an upward bias) in Value Line's beta estimates that Mr. Bodmer demonstrated is a more likely explanation for Mr. Moul's choice. *See* CUB-City Ex. 1.0 at 13-14, LL 272-292.

Mr. Moul's argument that the Commission must adjust its cost of equity determination for such price changes also assumes implicitly that Mr. Moul's "sophisticated investors" (Companies' Init. Br. at 81) do not recognize that the Companies' authorized return will be applied to the Companies' actual invested amounts (book capital structure), as the Commission has done for decades. Even if that were a credible supposition, protecting "sophisticated investors" from themselves or the market is not the Commission's charge. No matter how PGL slices the leverage apple (here, being careful to adjust the equity return instead of rate base), the undeniable mathematical fact is that Moul's adjustment is just another way to express an unlawful, boost in rate base above the level that Section 9-211 permits.

The Companies argue that "The Commission's decision was based on the misconception, repeated by Staff and CUB-City in these cases, that Mr. Moul's financial leverage adjustment is intended to maintain a particular market-to-book ratio of the Utilities' equity value." *Id*. at 87. They conclude "The market-to-book ratio plays no role in the adjustment, nor does the adjustment Mr. Moul proposes have the effect of maintaining any particular market-to-book ratio." *Id.* Mr. Moul was more candid about his intention: "What we're seeking to do is to maintain the price as we find it when we measure the cost of equity." August 25, 2009 Tr. 460. The purpose of Mr. Moul's adjustment is clear -- and unlawful.

Size Adjustment. The Companies also defend Mr. Moul's size adjustment to his CAPM estimate, arguing that it "makes common sense because a larger firm enjoys both a greater financial cushion against shocks and a greater ability to diversify, including over time." Companies' Init. Br. at 94. However, those factors are not significant for the Companies because they are monopoly suppliers of essential utility services, with limited or no need to diversify to avoid the effects of competition and inconstant demand.

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 its Reply Brief.

XIII. CONCLUSION

For the reasons discussed in this Reply Brief and their Initial Brief, the City and CUB respectfully request that the Commission find as CUB-City recommend on the issues addressed.

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Respectfully Submitted,

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