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	)	

BRIEF ON EXCEPTIONS OF THE CITIZENS UTILITY BOARD AND THE CITY OF CHICAGO

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BRIEF ON EXCEPTIONS
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THE CITIZENS UTILITY BOARD AND THE CITY OF CHICAGO

Pursuant to Section 200.830 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 joint Brief on Exceptions to the Proposed Order issued in this case on November 6, 2009 ("Proposed Order" or "PO"). This Brief on Exceptions addresses errors of law or fact in the Proposed Order and proposes language modifications to correct omissions or to provide needed clarifications . In particular, CUB and the City (collectively, "CUB-City") dispute the factual evidentiary support and reasoning underlying the Proposed Order's determination of an appropriate cost of equity for Peoples Gas Light and Coke Company ("Peoples" or "PGL") and North Shore Gas Company ("North Shore" or "NS") (collectively, the "Companies" or the "Utilities") and various accounting issues. CUB-City also adopt the rate design arguments and exceptions the brief outline submitted to the Administrative Law Judges ("ALJs") on September 9, 2009 submitted by the Illinois Attorney General's Office on behalf Peoples of the State of Illinois ("AG") in its Brief on Exceptions.

For the convenience of the Commission, each Exception presented repeats relevant section headings from the agreed topic outline for briefs in this case, and the order of topics has been preserved.

ARGUMENT

EXCEPTION #1:

C. Contested Issues

1. Incentive Compensation

The Proposed Order correctly adopts Staff of the Illinois Commerce Commission's (Staff") adjustments to the executive and non-executive plans, but then erroneously departs from the "long line of Commission precedent" requiring demonstrable ratepayer benefit by allowing incentive compensation costs for goals unlikely to be achieved. The Proposed Order concludes that, "Although the goals might not have been achieved in the past, we doubt that cutting the incentive compensation would increase that likelihood." PO at 60. This conclusion ignores the evidence that demonstrates these goals are unlikely to be achieved and therefore improperly inflates the Companies' revenue requirement. The Proposed Order mistakenly assumes that by allowing these costs to be collected in rates, the Company will have a greater incentive to meet these operational goals. PO at 59-60 ("We agree with the Company that these include operational goals that the Commission would like to see achieved."). However, if it is unlikely that the goals will be achieved, then incentive compensation associated with those goals should not be included in the revenue requirement.

The Proposed Order clearly articulates the relevant legal and policy guidelines regarding recoverable incentive compensation expense, but misapplies its own standard. The Proposed Order cites to a 2001 Illinois Power rate case, in which the Commission determined that a utility must demonstrate that "its incentive compensation plan has reduced expenses and created greater efficiencies in operations." *See* PO at 59, *citing* ICC Docket No. 01-0432 at 42-43. In this case, however, there is insufficient evidence that the operational goals at issue are likely to actually be achieved.

The Commission has not previously allowed incentive compensation expenses because they *might* benefit ratepayers or the Commission *might* want to see these goals achieved. The Commission has correctly insisted upon a demonstration of such benefits. The Proposed Order's decision here fails to conform to the very standard itself cites, which clearly requires a demonstrable benefit to ratepayers as a condition for the recovery of salary-related expense. *PO at 59.* Accordingly, in the absence of the required proof of record, and to conform with the adoption of Staff's incentive compensation expense adjustment, the PO should be modified to adopt Staff's adjustment for goals unlikely to be achieved.

The third paragraph on page 59 and 60 of the Proposed Order should be modified as follows:

> Staff's adjustments to the executive and non-executive plans are adopted~~, except for the adjustment for goals unlikely to be achieved. We agree with the Company that these include operational goals that the Commission would like to see achieved. Although the goals might not have been achieved in the past, we doubt that cutting the incentive compensation would increase that likelihood. Accordingly, that portion of Staff's adjustment to the~~

> ~~executive and non-executive incentive plans is not adopted.~~ These adjustments are consistent with the Commission's policy to disallow incentive compensation plan costs when the plans do not provide a ratepayer benefit.

EXCEPTION #2:

3. Employee Headcounts

The Commission should cut Peoples Gas' employee payroll expense based on employee headcounts because Peoples Gas has not met its burden of establishing that this expense is both reasonable and will be prudently incurred. The PO suggests that with regard to Peoples Gas, the forecast of its employee level is designed to address specific Liberty Audit recommendations. Mr. Effron understood this when he reviewed the evidence presented by the Company, but while may be PGL's intent to increase its employee level by 47, there is no evidence that they are actually doing it. AG/CUB Ex. 4.0 at 8. The evidence shows that the Company's employee counts has been and remains stable and therefore it is reasonable to posture that no forecasted increase in the number of employees for the 2010 test year will actually occur. AG/CUB/City Ex. 1.0 at 17-18; AG/CUB Ex. 4.0 at 8.

Mr. Effron testified that Peoples Gas' actual number of employees from the last half of 2008 and the first three months of 2009 held constant at about 1,080 (although the actual number of employees in March 2009, the last month was slightly lower at 1,075). *Id*. Mr. Effron recommended that the Peoples Gas 2010 test year payroll expense be adjusted to reflect 1,080 employees rather than the Peoples Gas forecast of 1,139. *Id*. The evidence in this proceeding therefore demonstrates that Peoples Gas' proposed, estimated payroll expense is unreasonably inflated and should be adjusted.

The first paragraph on page 65 of the Proposed Order should be modified as follows:

> The Commission finds that Peoples Gas' proposed head count is not supported by the evidence ~~and also not contested by Staff~~. While the forecast is designed to address specific Liberty Audit recommendations, Peoples Gas has not shown that their proposed payroll expenses are reasonable and prudent. North Shore did not provide evidence in response to the AG's adjustment. Accordingly, AG witness Effron's head count adjustment for North Shore is adopted.

EXCEPTION #3:

8. Revenues- Sales Revenues Adjustment

The Proposed Order rejects Mr. Effron's adjustment to sales revenues, despite acknowledging a deficient record with regard to the impact of the recent economic downturn in its sales forecasts. The Proposed Order essentially concludes that, since Mr. Effron did not adjust every conceivable factor in the sales model, his adjustment should be rejected, while the Companies' forecasts, which have not been updated to reflect more recent estimates of the test year price of gas, should be adopted. This appears to be a form over function debate. Although the Proposed Order acknowledges the incompleteness of the Companies' evidence, its sales forecasts are at least uniformly out-of-date. Mr. Effron's analysis adjusts for the current forecast of the 2010 price of gas, which is significantly lower than the projected prices at the time the sales forecasts were originally prepared. AG/CUB/City Ex. 1.0 at 14. To ignore the effect of the significant change in the price of gas for purposes of setting the test year sales forecast would result in ratepayers paying excessive rates. Therefore, as Mr. Effron posited, the sales forecasts should be modified to reflect the current forecast of 2010 gas prices.

The PO claims that Mr. Effron did not update the "Efficiency Improvements" group of variables. But, the Utilities provided absolutely no data or analysis to support the claimed effects of updating the "Efficiency Improvements" group of variables or the impact of the economic downturn. The Companies' assertion that other variables in the forecast need to be adjusted should be rejected as speculation, since those adjustments were not quantified.

In sum, Mr. Effron's proposed sales revenues adjustment based on the current 2010 forecasted gas prices should be adopted. The North Shore test year base revenues should by increased by $550,000, and the Peoples Gas test year base revenues should by increased by $4,441,000 to reflect the increased sales related to lower gas prices.

The third paragraph on page 89 of the Proposed Order should be modified as follows:

> Mr. Effron's proposal ~~improperly selects~~ highlights one factor out of the sales models to update as the most crucial factor ~~and ignores all other factors~~. The Commission notes evidence presented by the Utilities that Mr. Effron did not update the "Efficiency Improvements" group of variables, which includes the state of the economy and is more powerful than the price factor and drives down usage per customer. NS-PGL Ex. DWC-2.0 at 1, 2-5; NS-PGL Ex. DWC-3.0 at 1-2. The Utilities' claim that the group of variables should be adjusted is immaterial since the Utilities did not quantify those adjustments. ~~Because of timing,~~ Further, the economic downturn was not captured in the Utilities' sales forecasts used in their filings. Updating all of the variables, not just a single results-driven factor, would perhaps result in lower sales forecasts, but there is no evidence to support this assertion. ~~Although~~ It would ~~probably~~ have been helpful for the Utilities to have updated everything based on the drop in the price of gas, and it is important to note that evidence is not before us. ~~The record as it stands does not support the AG's adjustment.~~ As a result, Mr. Effron's proposed adjustments based on the current forecast of 2010 gas prices should be considered.

<u>EXCEPTION # 4 -- Capital Structure</u>

VI. RATE OF RETURN

A. Overview

B. Capital Structure

The Proposed Order's entire treatment of the capital structure issue is set out immediately below.

> To reduce issues in this case, Staff contends that the Commission should adopt the Utilities' proposed capital structure which contains no short-term debt component because it will result in a lower revenue requirement for Peoples Gas and make little difference in North Shore revenue requirements. In short, Staff sees a small benefit. CUB-City claim that the utilities do not deny that the existence of their plans for using short-term debt in the test year and they claim the Companies use their short-term debt to finance rate base. The Utilities assert that they issue short-term debt only temporarily to manage short-term case flows at certain lines, typically at year-end when higher winter revenues have not been collected and season cash requirement are at their highest and in late summer months when revenues are at their lowest. Altogether, the stronger showing in this case comes from the Utilities and Staff.
>
> It was claimed that the Utilities must be using short-term debt to finance rate base because their estimated rate bases exceed the long-term capital in their proposed capital structures. This argument proceeds on the notion that if a utility's rate base exceeds its long-term capital, it is using short-term debt to finance rate base. But, this Commission does not necessarily accept this proposition as a foregone conclusion. And, particular to this case, we are shown that PGL's capitalization is larger than its rate base and North Shore's capitalization is about the same size as its rate base.
>
> Just as significant is that only two years ago, the Commission approved the same capital structure that the Utilities propose in this case. And the records show no differences in how the Utilities use short term debt today and how it was used at that time.

PO at 94.

The PO's conclusion is inconsistent with stated Commission policies disfavoring hypothetical capital structures and rejecting unproven claims that effectively deny the fungible nature of funds. Each of the stated bases for the PO's approval the Companies' proposed hypothetical capital structure, which does not incorporate its short-term debt, lacks adequate support in the articulated analysis, in Commission policy, or in the record evidence.

First, the Proposed Order does not provide a complete summary of the relevant evidence. Though it notes Staff's acceptance of the Companies' proposed hypothetical capital structure, excluding short-term debt, the Proposed Order does not state the fact that Staff and CUB-City each concluded from the evidence of record that the Companies clearly use short-term debt to finance rate base. PO at 92. In fact, Staff was insistent in making that point in connection with its acceptance of the hypothetical capital structure. *Id.* The Proposed Order's finding that "the stronger showing in this case comes from the Utilities and Staff" is entirely dependent on an unwarranted presumption that fungible funds are used in precisely the manner the Utilities claim.

All the "evidence" the Companies present is of claimed intentions. The hard evidence of record shows that, despite their claims, the Utilities are not even capable at all times of doing what they claim, as the individual Companies do not always have an excess of cash over capital needs. NS-PGL Ex. BAJ 2.0 (Rev.) at 9:162-169. That is, rate base sometimes exceeds permanent financing. The Companies do not dispute either the existence of their short-term debt or their plans to use short-term debt in the test year. NS-PGL Ex. BAJ 2.0 (Rev.) at 7:122-27. Even the Proposed Order acknowledges that at least one of their (revised) rate bases will exceed permanent financing (equity plus long-term debt). PO at 94. The Companies simply claim that they do not use short-term debt to finance rate base, asserting that they use cash to cover any shortfall in covering capital costs. *See* PO at 91. A firm behaving prudently does not take out short-term loans that are not needed. The Companies' position is, in essence, that they had cash to cover their seasonal expenses, but chose to use short-term debt instead and fund any capital needs with cash.

The Proposed Order accepts that fungible money is, in fact, used in whatever fashion the utility claims. At this critical point in its analysis, the Proposed Order, without acknowledgment or explanation, ignores Commission precedent that is directly on point and consistent with the burden of proof the Public Utilities Act imposes on utilities in rate cases. 220 ILCS 5/9-201(c). This Commission has held 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; 220 ILCS 5/9-201(c). The Proposed Order does not identify any evidence of record to overcome that rational, intuitively obvious presumption. The Companies' claim prevails only because the Proposed Order unilaterally adopts a <u>contrary</u> presumption in the Companies' favor. The Proposed Order offers no explanation for its departure from existing Commission policy.

The determination whether to include short-term debt in the Companies' capital structure directly affects customers' rates and should use the best available, most accurate information. The Commission, therefore, should use the Companies' actual capital structures, including short-term debt, to set rates in this case.

To correct the Proposed Order's errors regarding capital structure, the "Commission Analysis and Conclusion" section beginning at the bottom of page 93 and carrying over to the top of page 94 should be deleted. The following language should be inserted in its place.

Staff and the Companies agreed on the use 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. However, while Staff adopts the Companies‘ position, it stands by its finding that each Company uses short-tem debt to finance rate base. The stated basis for Staff‘s agreement that there is little difference in overall returns resulting from more precise calculations that include short-term debt and the Companies‘ proposed hypothetical capital structure yields a small comparative benefit for ratepayers. CUB-City argue that the hypothetical capital structure should nonetheless be rejected.

The Companies do not dispute that they have short-term debt or that they will use short-term debt in the test year. Nor do they deny that at least one of their (revised) rate bases will exceed permanent financing (equity plus long term debt), even though total permanent financing may cover the combined rate bases of the Companies. The Companies, however, deny that short-term debt is used to finance rate base, asserting that cash covers any shortfall and 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.

The Companies contend that an excess of capital needs over available permanent financing does not indicate that the use of short-term debt to fill the gap. This Commission has previously encountered situations where the use of untraceable, fungible capital is at issue. *In Re Ameren Illinois Utilities*, Order at 67, Docket 02-0798 et al. (cons.), this Commission held 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. We continue to hold that this is the better rule, since it is consistent with the burden of proof imposed on utilities in rate proceedings. If a utility presents evidence to overcome this presumption, it will be considered, but mere claims of intent or theoretical capabilities do not meet the questions of what the utility actually does.

The determination whether to include short-term debt in the Companies’ capital structure directly affects customers' rates and should use the best available, most accurate information. The Commission, therefore, consistent with our prior ruling on this precise issue, will use the Companies' actual capital structures, including short-term debt, to set rates in this case.

EXCEPTION # 5 -- Cost of Common Equity

VI. RATE OF RETURN

E. Cost of Common Equity

1. Introduction

As background for any consideration of the cost of equity recommendations in this case, the Commission should recall the cost of equity estimates in the record ,and the relationships among them. For that purpose, this introduction includes a useful graphic CUB-City presented in response to the Companies' emphasis on the allowed returns in other jurisdictions. CUB-City Init. Br. at 15.

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

Astonishingly, the Proposed Order gives no consideration to any element of the 8.58% and < 9.00% estimates from CUB-City, but gives equal weight to the 9.69 and 9.79 estimate analyses of the Staff and its treatments of pieces of the analyses producing the clear outliner estimate of 11.87% from the Companies' Mr. Moul. Contrary to the mandate of the Public Utilities Act[1] that the Commission take account of the entire record (220 ILCS 5/10-10), the non-substantive reasons given for the PO's refusal even to consider CUB-City's evidence have no basis in law, logic, or Commission policy.

[1] 220 ILCS 5/1-101 *et seq.* ("PUA" or the "Act").

Equally astonishing is the PO's absolute refusal to take any account of the extraordinary events in the financial markets. Current circumstances in the markets have had direct and significant effects on the operation of the models on which the Commission has traditionally relied and on the cost of equity for relatively low-risk entities like utilities, as investors seek safe harbors in the financial market storms. These unjustified, unsustainable positions taken in the Proposed Order are more fully addressed in the immediately following sections of CUB-City's brief on exceptions.

2. *Despite Uncontradicted Testimony By Every Cost of Equity Expert That Current Financial Market Circumstances Are Extraordinary, the Proposed Order wrongly Concludes That It Must Ignore Those Circumstances In Favor of Ordinary Analyses*

a. The Unrebutted Evidence of Record Shows that Current Financial Circumstances Affected the Cost of Equity for Lower Risk Utility Stocks

As part of its case regarding the appropriate return on equity for Peoples Gas and North Shore, CUB-City submitted the testimony of Edward C. Bodmer. Mr. Bodmer has presented testimony to the Commission on many occasions regarding rate design and return on equity. Unlike his return on equity testimony in past cases, Mr. Bodmer did not conduct the detailed quantitative discounted cash flow ("DCF") testimony and capital asset pricing model ("CAPM") analyses to ascertain the proper returns on equity for the Utilities.[2] Instead, the objective of Mr. Bodmer's testimony was to provide context for the Commission to use in making its return on equity decisions. Specifically, Mr. Bodmer explained that the deep financial problems in the world economy that culminated in financial crisis in Fall, 2008, and led to what has been called

[2] CUB-City witness Christopher Thomas conducted DCF and CAPM analyses in his testimony. Mr. Thomas's quantitative analyses are discussed later in this section of the brief.

the “Great Recession,” cannot be ignored as the Commission sets the returns on equity for Peoples Gas and North Shore.

There is no denying that the effects of the financial crisis were widespread and are enduring. To avoid insolvency, financial firms that had been in business for many decades such as Bears Stearns were sold at fire sale prices. Ross, Andrew (March 17, 2008). "JP Morgan Pays $2 a Share for Bear Stearns". The New York Times. http://www.nytimes.com/2008/03/17/business/17bear.html. Other financial firms, such as Lehman Brothers, were not so fortunate, and, after having been in business since 1850, filed for Capter 11 bankruptcy on September 15, 2008. "Lehman Bros files for bankruptcy". News.bbc.co.uk 15 September 2008. http://news.bbc.co.uk/1/hi/business/7615931.stm. Other firms, such as AIG and Citibank, “were deemed too large to fail”and required tens of billions of dollars in federal government aid to avoid bankruptcy. http://www.federalreserve.gov/newsevents/press/other/20080916a.htm; “Government unveils bold plan to rescue Citigroup.” Associated Press. November 24, 2008.

In addition, on October 3, 2008, the Emergency Economic Stabilization Act of 2008 (“EESA”) was signed into law. EESA created the Troubled Asset Relief Program (“TARP”). According to the United States Department of Treasury (“Treasury”), TARP was created “with the specific goal of stabilizing the United States financial system and preventing a systemic collapse.” http://www.financialstability.gov/roadtostability/programs.htm. The Office of the Special Inspector General of the Troubled Asset Relief Program stated in its October 21, 2009 quarterly report to Congress that “Treasury had announced commitments to spend $636.9 billion of the $699 billion maximum available for the purchase of troubled assets under TARP as authorized by Congress in EESA."

http://www.sigtarp.gov/reports/congress/2009/October2009_Quarterly_Report_to_Congress.pdf.

The effects of the financial crisis are still being felt today. According to the United States Department of Labor's Bureau of Statistics (the "Bureau of Statistics"), the unemployment rate in the United States reached 10.2% in October, 2009, the first time the rate has been at or above 10% since April, 1983, more than a quarter-century ago. http://www.bls.gov/cps/. According to the Bureau of Statistics, "Since the start of the recession in December 2007, the number of unemployed persons has risen by 8.2 million, and the unemployment rate has grown by 5.3 percentage points." http://www.bls.gov/news.release/pdf/empsit.pdf.

The Utilities' return on equity witness Paul R. Moul made many of these same points in his Direct Testimony. There, Mr. Moul described many of the cataclysmic events that sent the national and world economies into a prolonged tailspin. PGL Ex. PRM 1.0 Rev. at 30-31, LL 642-670. Mr. Moul added that "In the months since these events disrupted the capital markets, the financial market turmoil has continued into early 2009." Id. at 31, LL 670-71.

Indeed, few would -- or could -- deny that the impact of the financial crisis has been profound and that its far-reaching effects have touched almost every corner of America's economy. Yet, the Proposed Order, in a handful of sentences, dismisses what is universally regarded as the greatest financial crisis since the Great Depression as mere background noise, irrelevant to the Commission's determination of how the cost of equity has been affected by the turmoil in the financial markets. In particular, the Proposed Order states

> In this proceeding, there were five witnesses testifying on the issue of cost of equity. Only three of these witnesses, however, applied and gave account of, their financial modeling results. We

> appreciate that both CUB-City and the Utilities, each in their own way, have provided additional witness testimony that we perceive to be and would term as "context" for our decision-making. And, as prudent regulators, we are neither oblivious to this information nor the debate that it inspires. In the end, however, the Commission needs to singularly focus on the results of the financial models that we have traditionally relied on, that have no substitute in the decision-making process, and that will provide the best information of what we need for the purposes at hand.

Proposed Order at 124-25. In other words, the Proposed Order concludes that it is compelled to put on blinders and pretend that it is "business as usual." In particular, the Proposed Order rigidly clings to the idea that financial models and model results must look like those the Commission has seen in more normal times. The financial disruption that sent -- and continues to send -- shock waves through the United States' and the world's economies warrants no recognition -- despite the evidence from CUB-City and the Companies that something with significant consequences for equity returns is in play. Ultimately, the Proposed Order concludes, the financial crisis has no real effect on the Commission's determination of the single most important financial issue in this case. To reach that conclusion, the Proposed Order rejects the evidence of record showing that fundamental assumptions of stability and predictable normalcy underlying "the financial models that we have traditionally relied on, that have no substitute in the decision-making process, and that will provide the best information of what we need for the purposes at hand" are no longer valid. According to the Proposed Order, the Commission's deliberations and decisions must be insulated from the effects of the financial crisis. The Commission's work is not a contest of economic models that is disconnected from the world in which ratepayers and utilities live. The Commission cannot determine an appropriate cost of equity for the Companies if pretends that the greatest economic upheaval in 80 years is just not happening.

Mr. Bodmer explained the significance of the financial crisis to the Commission's deliberations of the Utilities' respective returns on equity. Mr. Bodmer testified that setting the return on equity in public utility rate cases is an opaque exercise in which public utility commissions are obliged to "estimate[e] a number that is not directly observable and [to] measure[e] something that is nearly impossible to quantify -- risk." CUB-City Ex. 1.0 at 4, LL 50-51. In the past, as the Proposed Order states, the Commission has relied on the DCF and CAPM models to estimate the "number that is not directly observable" and to measure risk, the concept that "is nearly impossible to measure." Mr. Bodmer testified that the financial crisis should give the Commission pause as the

> financial crisis has shown that many financial professionals need to go back to harbor and take a hard look at everything from models that supposedly measure cost of capital to the basic question of what constitutes risk. A number of theories, models, and financial strategies relevant to traditional regulatory cost of equity determinations have proven to be erroneous during this financial crisis. 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. Conversely, blind adherence to financial theories and models that do not work when fundamental assumptions are upset should not be acceptable to the Commission.

Id. at 7, LL 117-26. Mr. Bodmer went on to say that "The current crisis has revealed more clearly than ever before that financial information from rating agencies and other financial industry sources (like Value Line) can be dramatically wrong and strongly biased. (For instance, Lehman Brothers had an "A" bond rating, just before it became the largest bankruptcy in history.)" Id. at 8-9, LL 155-58. The Proposed Order ignores Mr. Bodmer's advice and, chooses to adhere blindly to financial models that have proven unreliable in extraordinary conditions like we face today.

Mr. Bodmer testified that that the relevance of the financial crisis to the determination of the returns on equity in these cases can be gleaned from the fact that while the stock prices of the Standard and Poor's ("S&P") 500 declined by more than 50% from its high in October, 2007 through March, 2009, "many regulated utility companies have had much smaller stock price declines or have even had stock price increases." Id. at 8, LL 141-45. Mr. Bodmer added that during that same period "investor demand for shares of low-risk companies such as utilities has increased and yields on ten-year Treasury Bonds have been below 3% for most the year." Id. at 8, LL 145-47.

Mr. Bodmer stated that rather than relying solely on complex models that produce some theoretical numbers, the Commission can look to easily accessible data for a real-world check on the various return on equity proposals made in the cases. For example, Mr. Bodmer pointed out that the S&P 500 fell by 52% from the beginning of the financial crisis through March, 2009. Pairing that market decline with Utilities witness Moul's beta -- 0.82 – suggests that the stock price of his utility sample should have declined by 43% (0.82 x 52%). In reality, over that same period, the stock prices of Mr. Moul's sample fell by a relatively meager 5%. Id. at 11, LL 210-14. Mr. Bodmer explained that it is the performance of stock prices when the world is turned upside down that investors look to as an indicator of the risks they are taking on, not complex financial models that produce theoretical numbers that may have little connection to reality when, as now, market behavior assumed by economic models is no longer the norm. Id. at 11, LL 214-15. Mr. Bodmer added that it is this type of common sense test that the Commission should look to as it conducting its analysis. Id. at 11, LL 216-17.

Mr. Bodmer confirmed the relevance of his observations by tracking the stock price movement of the individual utilities in Mr. Moul's proxy sample (which was also used by the other cost of equity witnesses in this case) during the 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 the S&P 500 dropped by an astonishing 53%. Id. at 17, LL 336-37. In other words, the decline in the S&P 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."[3] Id. at 22, LL 406-08.

It should not be 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

[3] Mr. Bodmer's analysis was completely un-rebutted. Peoples Gas and North Shore had two opportunities - in its rebuttal testimony and its sur-rebuttal testimony -- to challenge Mr. Bodmer's assertions. But neither Mr. Moul nor Mr. Fetter mentioned, much less challenged, Mr.

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.

It is this type of common sense analysis that should inform the Commission's deliberations. Mr. Bodmer's analysis shows that when America's economy was foundering, investors flocked to the safe harbor that utilities represent. The Commission's return on equity determination should reflect the fact that Peoples Gas and North Shore have much less risk than companies that do have the benefit of being a monopoly provider of an essential service.

3. The Proposed Order Selectively and Unlawfully Mixes and Matches Unsupported <u>Extracts</u> From the Cost of Equity Analyses, Maintaining High Return Levels

Instead of examining the evidentiary merits of the cost of equity recommendations of record, the Proposed Order considers uses selective, unsupported <u>extracts</u> from the analyses of record assessed and baseless novel standards of proximity and popularity as determinants of the validity of cost of equity recommendations. The effect is to maintain higher than justified returns for the Companies. The dubious logic and lawfulness of the Proposed Order's selective mix and match of unsupported snippets of experts' analyses to develop its cost of equity determination are explored below.

a. The PO's Preference for Familiar Results, Even in Uncommon Financial Circumstances, Led to An Inflated Cost of Equity Determination That Was Never Subjected to Common Sense Validity Checks

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Bodmer's analysis. Nor did the Utilities cross-examine Mr. Bodmer, and, therefore, his analysis is unchallenged in the record.

At the same time that the Proposed Order went to great lengths to rescue pieces of the Companies' cost of equity estimate (which was nearly 200 basis points higher than any other of record), it rejected in its entirety the more central cost of equity estimate of CUB-City. And the Proposed order rejected any consideration of the abundant evidence of the impact of current financial market circumstances on the reliability of cost of equity estimation models and on the Companies' cost of equity. PO at 124. No party disputed that this case coincides with exceptional financial market circumstances that bear on the determination of the Companies' cost of equity. *See, e.g.*, CUB-City Ex. 2.0 at 3:53, 7:126-133, NS-PGL Ex. SMF-1.0 at 9:174; Staff Ex. 7.0 at 4:84. Yet, the Proposed Order was unwilling even to consider cost of equity analyses and estimates that do not look like those from the unexceptional periods of past cases, despite the evidence of that such rigid conformity is ill-suited to current conditions. *See, e.g.*, PO at 124 (reducing the financial crisis to "context" excluded from its substantive analysis), 125 (endorsing use of a constant growth DCF model). CUB-City addressed the broader failings of the Proposed Order above. However, the Proposed Order's implementation of its blinkered approach to determining an appropriate cost fo equity occasioned additional errors.

Rushing past all evidence of its fundamental error -- *i.e.*, ignoring evidence that the assumptions underlying past cost of equity determinations do not hold in today's exceptional circumstances -- the Proposed Order turns to the familiar, the ALJs' perception of what the Commission has done in the past. The Proposed Order claims to "singularly focus on the results of the financial models that we have traditionally relied on." In fact, the Proposed Order does not do even that.

The Proposed Order's cost of equity determination rests on a novel process that the Proposed Order developed and applied without citing any supporting legal authority or any <u>unaltered</u> evidence of record. The Proposed Order (a) uses a selective mix of unsupported <u>extracts</u> from experts' actual analyses and recommendations, (b) makes findings based on the proximity or popularity of estimates and approaches, and (c) employs new, subjective criteria for assessing the relevance of market data -- instead of assessing the merits of the evidence and analyses supporting parties' cost of equity estimates. The development of the Proposed Order's cost of equity incorporates none of the common sense checks that Mr. Bodmer testified are essential to validate estimates of the cost of equity in current markets.

As Mr. Bodmer explained, "[r]egulators must use logical, common sense tests . . . when examining statistical adjustments that purport to quantify risk, rather than simply accepting model results." CUB-City Ex. 1.0 at 11:215. Financial markets have been turned upside down, and past results are not necessarily predictive. There can be no credible argument that the Commission should not "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." CUB-City Ex. 1.0 at 11:222. Despite its insistence on rigid adherence to business as usual in these most unusual circumstances, the Proposed Order did not check its determination with "logical common sense tests" that are advisable in the most ordinary of times.

b. The Proposed Order's Selective Mix and Match of <u>Pieces</u> of Analyses Lacks Record Support and Legal Authority

The Proposed Order uses a mix and match approach to develop a cost of equity. The only apparent objective is to achieve cost of equity results -- despite the current abnormal financial circumstances -- that the Proposed Order deems "normal" and acceptable. The Proposed Order's preference for the familiar ignores the near universal acknowledgment that current financial circumstances have taken the markets into unfamiliar terrain. The most serious evidentiary challenge to such familiar results was Mr. Thomas' estimate of the Companies' cost of equity. CUB-City's witness presented an estimation analysis that expressly and directly took into account the recent, dramatic changes in the financial markets.

Mr. Thomas's DCF estimate was not considered by the Proposed Order, because it found "a great disparity" (of 165 and 208 basis points, respectively) from the estimates of Staff and the Companies. PO at 126. That comparison is fiction.

In the clearest possible example of the Proposed Order's selective rescue efforts, Mr. Thomas' entire DCF estimate was summarily dismissed as an outlier. PO at 126. At the same time, the Companies's more extreme DCF estimate (11.87%) was first stripped of elements the sponsoring witness (Paul Moul) called essential to its validity and his support. NS-PGL Ex. 1.0 at 22:470 ("the market-derived cost rate cannot be used without modification"). The orphan estimate thus generated by the Proposed Order (10.67%) -- which no testimony of record supports -- was then used for the Proposed Order's comparison and considered in the Proposed Order's cost of equity determination. PO at 125-126. A comparison of the DCF estimates the parties' experts <u>actually</u> supported is quite different. *See* PO at 112. Because those estimates (CUB-City - 8.58%: Staff - 10.23%; Companies - 11.41%) are roughly evenly spaced, even the Proposed Order's unlawful criteria for excluding evidence would not justify its action. A comparison of the final cost of equity estimates recommended and supported by the testimony shows that the Companies' 11.87% recommendation was nearly 200 basis points above the next highest estimate and nearly 330 basis points above Mr. Thomas' estimate. (CUB-City refer the Commission to the line graph at the beginning of this section of the brief.)

More troubling is the fact that the Proposed Order took such extraordinary measures to salvage a Companies estimate that, according to the evidence of record, was of dubious worth. Mr. Moul's DCF estimate was based on a constant growth DCF model, which assumes that current growth rates will persist forever. Every other witness presenting a DCF model estimate found a constant growth assumption inappropriate in the current circumstances. Mr. Moul's DCF model also incorporated a growth estimate that even Mr. Moul admits is not sustainable, as the model requires. Mr. Moul excuses his use of an inappropriate model and an invalid input by asserting that the model is at fault. He maintains that the constant growth DCF model contains "an unrealistic assumption," based (inexplicably) on his subjective view of what investors read. He also claims that analysts' current five-year growth projections are more relevant than the sustainable perpetual rate required for a valid application of the model. NS-PGL Ex. PRM-1.0 at 18:380-197. Mr. Moul's constant growth model choice and its results were viewed skeptically by the other cost of equity experts in this case, including Mr. Moul's fellow witness for the Companies, Mr. Fetter. Aug. 25, 2009 Tr. at 492, 494 (Fetter); *also see* PO at 104-105 (McNally), 122 (Thomas). Mr. Moul's model results merit little or no weight in the Commission's consideration. His DCF model was explicitly based on his disregard of the economic theory underlying the model he purports to apply and that was supposedly a singular focus of the Proposed Order.

The foundation of Mr. Moul's application of a constant growth DCF model is his outright rejection of the theoretical bases of the model itself. Mr. Moul declared that he knew his growth rate input was not a sustainable rate or correct for use as a long-term growth rate. NS-PGL Ex. PRM-1.0 at 17:346. But he used it anyway - invalidating his DCF model estimate. Thus, his expert opinion on the cost of equity is admittedly <u>not</u> based on a model with a recognized, sound theoretical or scientific basis. Because his application of the model used to support his opinion deviates from the model's theoretical and operational requirements, his opinion on the cost of equity fails even to meet the threshold requirements for expert testimony under Illinois law.

The Proposed Order discarded from its analysis any consideration of changed market circumstances and any investigation of whether past approaches continue to be reliable today. Thus, the Proposed Order justifies its acceptance of Mr. Moul's constant growth model estimate as simply "consistent with approach (sic) Staff used in the Utilities' last rate cases" and "accepted by the Commission . . . in that proceeding." PO at 125. However, there is no dispute that the current analysts' growth rate projections Mr. Moul used are not sustainable; the evidence is overwhelming. The Proposed Order's finding that it is an acceptable estimate thus has no support on the record as a whole.

The Proposed Order's use of an extract or interim result (instead of the final result) from the Companies' DCF analysis is not the only instance where the Proposed Order rescues a flawed cost of equity recommendation of the Companies. The Proposed Order performs the same rescue operation for the Companies' CAPM estimate. The Proposed Order finds that the "<u>unadjusted</u> CAPM result that Mr. Moul arrived at from all three parameters is 10.86%." PO at 128 (emphasis added). But Mr. Moul does not support this unadjusted estimate. In fact, he expressly rejects the unadjusted CAPM estimate the Proposed Order uses as his estimate. NS-PGL Ex. PRM-1.0 at 41:867 ("Absent such an adjustment, the CAPM would understate the required return"). Nonetheless, as with its orphan DCF estimate, the Proposed Order gives this orphan CAPM estimate equal weight with Staff's estimate, while refusing even to consider Mr. Thomas' lower estimate, simply because it is significantly lower.

Though the Commission has on occasion developed its own cost of equity, in this case the witness the Proposed Order relies on has expressly disavowed support for the estimates the Proposed Order attributes to him. Thus, there is no record support for the modified DCF estimate that the Proposed Order uses in its DCF analysis and no record support for the unadjusted CAPM estimate the Proposed Order attributes to the Companies' expert. Yet, in each instance, the Proposed Order's orphan estimate (unsupported by testimony of record) accounts for fully one-half of the Proposed Order's determination. In neither instance does the Proposed Order consider whether its use of interim estimates or extracts from full analyses is a valid exercise under the constraints of the model or applicable economic theory.

Thus, there is no actual evidentiary support for the extracted pieces of the Companies' analyses that the Proposed Order salvages from discredited models that even it would not accept. But the Proposed Order's cost of equity determination rests on that pseudo-evidence. This absence of evidence on these elements of the Proposed Order's analysis is compounded by evidence that affirmatively undermines the Proposed Order's replication of past determinations. The Proposed Order's preference for familiar processes and results cannot overcome the record evidence showing that in current financial conditions different processes or results may be appropriate. A cost of equity determination built from pieces that not only are unsupported on the record by any witness, but expressly disavowed by the witness to whom the Proposed Order attributes them, is legally unsustainable.

The Proposed Order considered only the results of DCF and CAPM analyses. PO at 125. In each instance, however, the Proposed Order refused to consider the recommended estimate of CUB-City witness Thomas then averaged an estimate inaccurately attributed to the Companies with the Staff result. Thus, 50% of the determinants of the determined cost of equity are estimates cobbled together from pieces of weak or invalid analyses of the Companies. The only effect of this extraordinary intervention is to salvage a portion of the Companies' high cost of equity estimate.

c. The Proposed Order's Elevation of Proximity or Popularity Over the Merits of Evidence of Record Is Arbitrary and Unlawful

The Proposed Order establishes a novel proximity standard: estimates that are close to each other are preferred over estimates that differ, irrespective of the supporting evidence. The Proposed Order's adoption of that standard is seemingly pervasive, but, on closer investigation, it is not. As the Proposed Order notes, three expert witnesses recommended a cost of equity estimate as the appropriate cost of equity for the Companies. PO at 124. Each used a combination of models to develop the cost of equity recommended to the Commission. The relationship of results of those analyses is shown on the line graph at the beginning of this section -- ranging from CUB-City estimates of 8.58% and ,9% through the Staff's 9.69% and 9.79% estimate to the Companies' 11.87%. PO at 112. The Companies' 11.87% recommendation is clearly the outlier in any comparison -- being nearly 200 basis points above the next highest estimate. A range of only 121 basis points encompasses all other recommended estimates in the record. The proximity standard the Proposed Order applies later would have excluded the Companies' estimate from consideration at this initial stage. However, the Proposed Order makes no comparison at this point in its analysis. The Proposed Order does not provide any reason for withholding application of its main analytical criterion to the actual final cost of equity recommendations of the parties.

Instead, the Proposed Order proceeds to conduct separate reviews of the DCF and CAPM estimates from the parties. The results of the parties' DCF analyses, according to their respective testimonies, were: CUB-City - 8.58%: Staff - 10.23%; Companies - 11.41%. At this point, the estimates are nearly equidistant, and application of the proximity criterion the Proposed Order uses presumably would result in all three estimates being considered. However, again the Proposed Order makes no comparison at this stage of its analysis. The Proposed Order again does not provide any reason for withholding application of its proximity criterion at this stage.

At this point in its analysis, the Proposed Order modifies the Companies' DCF result to obtain a 10.67% result "produced under Mr. Moul's approach." The Proposed Order removed a leverage adjustment that Mr. Moul stated was a necessary adjustment for his DCF result to be correct and acceptable to him. NS-PGL Ex. 1.0 at 22:470 ("the market-derived cost rate cannot be used without modification"). The Staff and CUB-City estimates were not adjusted. At this point the proximity test is applied, and the Proposed Order finds a "great disparity" that it uses to disqualify the CUB-City estimate. The CUB-City estimate was not taken into account (even on the piecemeal basis the Proposed Order used to rescue the Companies' estimates). As a result of the its arbitrary exclusion of CUB-City's DCF result, the Proposed Order fails to base its determination on the entire record, as the PUA requires. 220 ILC 5/10-103, 10-201(e)(iv);

Business and Professional People for the Public Interest v. Illinois Commerce Comm'n, 136 Ill. 2d 192, 201, 227 (1989).

The Proposed Order followed a similar path in its review of the parties' CAPM estimates, but extended the reach of its novel proximity standard from analysis results to inputs into the CAPM analysis. "At this juncture, the Commission is compelled to note the disparity of the beta parameter as used in the CAPM. We see the Staff beta at 0.59 to be within 10 points of the Utilities' 0.69 beta. Far removed and away is CUB-City's beta at 0.31." PO at 127. That simplistic comparison neither acknowledges nor rationally considers the evidence CUB-City presented that shows that the Value Line betas given such prominence in the analyses of Staff and the Companies are themselves outliers that would be excluded under the PO's novel proximity test. The following table of reported betas is self-explanatory, but was ignored by the Proposed Order.

	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**

The sole basis for the PO's treatment of the CUB-City beta estimate is the proximity of the Staff and Companies' betas, even though each has as its focus a Value Line-based beta estimate that the unrebutted evidence of record shows to be an outlier in the industry.[4] While the Proposed Order found it noteworthy that Staff combined two published betas with his own calculated figure, Mr. Thomas' combination of all the major published betas was dismissed, simply because the mathematical result was not like Staff's and the Companies' or like those seen in more normal times. PO at 127. Mr. Bodmer's hard data showing stock price behavior that confirmed Mr. Thomas' lower beta for the utilities in Mr. Moul's proxy group was also ignored.

The Proposed Order next reviews the experts' estimates of the expected market risk premium. As the Proposed Order notes, this is an item of considerable debate in the financial

[4] The Proposed Order's apparent acceptance of Mr. Moul's assertion that Value Line is the only source that publishes its methodology is simply incorrect. As CUB-City pointed out in their Reply Brief, 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.

community and is “either specified as an estimate derived from academic studies of market performance or on the basis of estimates calculated for particular situations.” PO at 127. The Proposed Order purports to resolve this long-simmering issue using a popularity contest, not through analysis of the data or consideration of the potential for bias in “estimates calculated for particular situations.” The Proposed Order concludes that Mr. Thomas favors the estimate based on academic studies, “but it is a view that does not appear to be shared by either Mr. McNally or Mr. Moul.” PO at 127.

The Proposed Order preferred the results of calculations performed specifically for this litigation, because of their similarity and because they used data from sources that (according to Mr. Moul) are used by investors and analysts.[5] These groups, whose imprimatur the Proposed Order seems to covet, have a direct economic interest in utility performance, but no economic stake in ratepayer protection. Ignoring the plain raw facts that show the Value Line beta as an outlier, the Proposed Order instead finds comfort in the proximity of other beta estimates and the relative popularity (2 to 1) of their approach. “While not identical, there is a similarity and a heightened sense of reasonableness in the way that both Mr. Moul and Mr. McNally prepared the respective estimates their inputs (*sic*).” These factors were deemed so compelling that the Proposed Order opined that results would be “correspondingly be more telling and reliable for it.” PO at 128.

[5] Mr. Moul’s suggestion that investors are focused on these measures of relative volatility of time series of stock price data (and other arcane market variables) that are used mainly in regulatory proceedings is simply not credible.

In the end, the Proposed Order excludes Mr. Thomas' CAPM estimate from consideration. "Given the disparity between Mr. Thomas' estimate and the results produced by Staff and the Utilities, we will not consider CUB-City's estimate." PO at 128.

The legal arbitrariness of the Proposed Order's decision-making based on proximity or popularity and further logical inconsistencies are evident in looking at the Proposed Order's treatment of DCF and CAPM estimates. The Proposed Order refuses to consider CUB-City's DCF estimate that it calculated as 165 basis points from the nearest other estimate, but considers Mr. Moul's CAPM estimate (11.80%), which is nearly 185 basis points above the nearest other estimate; CUB-City's. In addition, while the CUB-City DCF estimate is totally excluded, the Companies' CAPM estimate is wholly included, getting equal weight with the Staff estimate almost 200 bass points away. The disparate application of the Proposed Order's proximity test is neither acknowledged or explained by the Proposed Order. These inconsistent treatments, however, have a consistent upward effect on the calculated averages that determine the Propsoed Order's cost of equity.

Ultimately, there is no legal authority or Commission precedent for decisions that give primacy to proximity of results or popularity of approaches instead of to the PUA's requirement for an articulated, reasoned analysis of the evidence of record. At best, factors such as the proximity of results or inputs -- which may be purely coincidental -- are merely factors that support or challenge a the results of the Commission's <u>substantive</u> review of the record evidence. Assuming, *arguendo*, that determinations such those the Proposed Order made were permitted by the courts to continue, the Proposed Order's applied criteria would effect a dramatic change in the Commission's decision making.. Under proximity or popularity criteria like the Proposed

Order's, Commission decisions would become subject to manipulation. Any party with adequate resources could present a set of estimates that would define the proximity cluster or simply outnumber the advocates of opposing positions, pre-determining the outcome of a proximity/popularity analysis, if not the Commission decision itself. In such a contest, ratepayers are unlikely to match the resources of utilities.[6] Moreover, under the Proposed Order's analysis, the clustered estimates are never subjected to the substantive analysis or tests the PUA requires or to appropriate reasonableness checks.

d. *Opinions About Subjective Investor Characteristics or Behavior Are Invalid Criteria for Considering or Weighing Evidence*

At several points in its assessment of cost of equity recommendations, the Proposed Order appears to treat the Companies' witnesses' assertions that their subjective beliefs that certain material is read or used by investors, or that investors hold particular subjective expectations or feelings are appropriate screening criteria for consideration in a cost of equity determination or as measures of credibility or evidentiary weight. See, e.g., PO at 125 ("Because the Utilities' common stock is not publicly traded, their cost of equity must be estimated using capital market and financial data relied on by investors to assess the relative risk of other natural gas utilities."), 127 ("Mr. Moul averaged forecast data from Value Line, and the S&P 500 composite and historical data from Ibbotson Associates, all of which he noted, are used by investors, accordance and analysts.").

[6] However, the process of the Proposed Order raises the possibility that closeness at one level, actual recommendations for example, may be superseded by proximity at another level, like the modified disaggregated estimates in this case.

There is no legal or evidentiary basis for using an unsupported opinion on what investors read or feel as a criterion for what information the Commission considers in its cost of equity determinations. The Commission's task is to examine all market evidence to determine the market-required cost of capital. Moreover, as testimony in this case showed, publications and opinions relied on in the past by investors recently have been exposed as providing data that may not be worthy of the Commission's reliance. Mr. Bodmer suggests that the Commission must employ common sense cautions and direct review of objective market indicators, and not rely excessively on the potentially biased interpretations of Wall Street intermediaries. The Proposed Order dangerously elevates the presumed actions and feelings of investors to new, unjustified prominence.

The better indicators of the market-required cost of equity are the objective market results themselves. If the market is an efficient economic mechanism, as all experts relying on economic models implicitly accept, then its results will reflect investors' real demands, obviating any need to rely on less reliable witnesses' opinions about the actions and subjective characteristics of investors.

For the reasons stated above, the “Commission Analysis and Conclusions” section beginning on page 124 through the carry-over paragraph at the top of page 130 should be deleted. The following language should be inserted in its place.

4. Commission Analysis and Conclusions

A. Introduction

At the outset, the Commission notes that it cannot conduct its analysis of the appropriate return on equity in a vacuum. There can be no denying that we are living in extraordinary circumstances. Both the Companies and CUB-City detailed the numerous cataclysmic events that have sent shockwaves through America's and the world's economies. Some of these events and their effects are described below.

Financial firms that had been in business for many decades such as Bears Stearns being sold at fire sale prices. Ross, Andrew (March 17, 2008). "JP Morgan Pays $2 a Share for Bear Stearns". *The New York Times*. http://www.nytimes.com/2008/03/17/business/17bear.html.

Other financial firms, such as Lehman Brothers, after having been in business since 1850, filing for Capter 11 bankruptcy on September 15, 2008. "Lehman Bros files for bankruptcy". News.bbc.co.uk. 15 September 2008. http://news.bbc.co.uk/1/hi/business/7615931.stm.

Other firms, such as AIG and Citibank, being deemed "too large to fail"and requiring tens of billions of dollars in federal government aid to avoid bankruptcy. http://www.federalreserve.gov/newsevents/press/other/20080916a.htm ; "Government unveils bold plan to rescue Citigroup." Associated Press. November 24, 2008.

The enactment on October 3, 2008 of the Emergency Economic Stabilization Act of 2008 ("EESA"). EESA created the Troubled Asset Relief Program ("TARP"). According to the United States Department of Treasury ("Treasury"), TARP was created "with the specific goal of stabilizing the United States financial system and preventing a systemic collapse." http://www.financialstability.gov/roadtostability/programs.htm.

The Office of the Special Inspector General of the Troubled Asset Relief Program stated in its October 21, 2009 quarterly report to Congress that "Treasury had announced commitments to spend $636.9 billion of the $699 billion maximum available for the purchase of troubled assets under TARP as authorized by Congress in EESA." http://www.sigtarp.gov/reports/congress/2009/October2009_Quarterly_Report_to_Congress.pdf.

The United States Department of Labor's Bureau of Statistics (the "Bureau of Statistics") reported that the unemployment rate in the United States reached 10.2% in October, 2009, the first time the rate has been at or above 10% since April, 1983, more than a quarter-century ago. http://www.bls.gov/cps/. According to the Bureau of Statistics, "Since the start of the recession in December 2007, the number of unemployed persons has risen by 8.2 million, and the unemployment rate has grown by 5.3 percentage points." http://www.bls.gov/news.release/pdf/empsit.pdf.

The Companies' return on equity witness Paul R. Moul made many of these same points in his Direct Testimony. There, Mr. Moul described many of the cataclysmic events that sent the national and world economies into a prolonged tailspin. PGL Ex. PRM 1.0 Rev. at 30-31, LL 642-670. Mr. Moul added that "In the months since these events disrupted the capital markets, the financial market turmoil has continued into early 2009." *Id*. at 31, LL 670-71.

The Commission would be remiss if it pretended that events of such magnitude have no impact on the most important financial it must make in this case. The Commission cannot simply conduct "business as usual." Extraordinary times require extraordinary responses.

Moreover, as CUB-City witness Edward C. Bodmer testified the financial models – like the discounted cash flow ("DCF") model and the capital asset pricing model ("CAPM") -- that the Commission has relied on in the past to estimate the appropriate returns on equity for utilities have proven to be not terribly relevant in explaining recent market behavior. CUB-City Ex. 1.0 at 9, LL 160-62. Rather, the record includes many common sense checks on the various return on equity proposals in this case. These common sense checks exclusively concern the return on equity proposal submitted by Companies witness Moul.

For example, CUB-City witness Bodmer testified that Mr. Moul's original recommendation7 that the Companies' return on equity be set at 12% represented a 9% premium over Ten-Year Treasury Bonds. *Id* at 5, LL 80-86. Mr. Bodmer explained that such a premium means that "If the government bond earned a yield of 3% each year and Peoples Gas re-invested the interest proceeds in new bonds also yielding 3%, the $100 investment would grow to $235 97 in thirty years…. On the other hand, if the $100 investment in a piece of pipe earned a return of 12% that was re-invested in more pipe, Integrys [Peoples Gas's and North Shore's parent company] would ultimately receive a whopping $2,675 in thirty years." *Id*. at 6, LL 96-100. Such testimony makes the Commission suspicious of Mr. Mouls' number.

Mr. Bodmer's analysis of Mr. Moul's preference to use Value Line data to estimate the Companies' beta also casts doubt on Mr. Moul's recommendation. Mr. Bodmer testified that

> My reading of the Value Line publications suggests that Value Line is generally supportive of higher rate increases, which it calls "rate relief," and that Value Line betas are significantly higher than comparable reported data. The dramatic difference between betas for Mr. Moul's sample companies reported by Value Line and corresponding betas reported by Yahoo.finance and the Google finance website is shown … below.

	Value Line	Yahoo	Google
ATG	0.75	0.45	0.43
ATO	0.65	0.51	0.51
LG	0.65	-0.05	0.09
NJR	0.70	0.11	0.16
GAS	0.70	0.33	0.37
NWN	0.60	0.25	0.29
PNY	0.70	0.19	0.24
SJI	0.75	0.23	0.23

In his rebuttal testimony, Mr. Moul reduced his return on equity recommendation to 11.87%. NS-PGL Ex. PRM 2.0 at 8, LL 140-43.

WGL	0.75	0.10	0.21
Median	**0.70**	**0.23**	**0.24**
Average	**0.69**	**0.24**	**0.28**

> Without understanding any fancy statistical analysis, the validity of the Value Line betas can be tested. If the Value Line betas were correct, market share values falling by 50% would mean that utility shares should fall by 35%. This is simply the beta of 0.7 from the table above multiplied by the 50% movement in the market. In fact, as [Mr. Bodmer discussed later in his testimony] …, the decline in utility shares for Mr. Moul's sample was less than 6% when the market fell by 52%. And, that 6% includes companies such as NICOR that experienced declines because of non-utility operations such as shipping, which is very sensitive to overall economic conditions. Even worse, Mr. Moul increases the already suspect Value Line beta to 0.82, using a leverage adjustment that contains the type of illogical complexities that should no longer be taken seriously. The key point about Mr. Moul's analysis is that he would predict a 41% decline in utility shares when the actual decline was 6%.

Id. at 13-14, LL 272-89. The disparity between Mr. Moul's preferred Value Line beta and the performance of the stocks of his sample group acts as another common sense check for the Commission.

Perhaps even more informative is Mr. Bodmer's analysis of the performance of Mr. Moul's sample group and the S&P 500 during the recent financial tumult. Mr. Bodmer found that during the financial crisis, 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*, i*d.*, 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 the S&P 500 dropped by an astonishing 53%.

Id. at 17, LL 336-37. In other words, the decline in the S&P 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."8 *Id*. at 22, LL 406-08. The Commission agrees.

The Commission also finds persuasive CUB-City's comparison of the different return on equity recommendations. In particular, 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

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Mr. Bodmer's analysis was completely un-rebutted. Peoples Gas and North Shore had two opportunities – in its rebuttal testimony and its sur-rebuttal testimony -- to challenge Mr. Bodmer's assertions. 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.

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)	(NS)	*2009 Gas Average -*	Moul
		McNally		*Other Commissions*	

Like the portions of Mr. Bodmer's testimony described above, CUB-City's comparison of the different proposals provide a common sense check for the Commission's deliberations.

A. Commission Analysis of Mr. Moul's Recommendation

i. Mr. Moul's Beta

As discussed earlier, 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. CUB-City Ex. 1.0 at 7-8, LL 130-34.

In particular, 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. CUB-City Ex. 4.0 (Rev.) at 6, LL 119-20. Mr. Thomas observed 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. The Commission agrees with CUB-City that Mr. Moul's outlier CAPM result (12.25%) is a predictable consequence of such biased model inputs.

The Commission also agrees with CUB-City's argument 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. The Commission finds that Mr. Moul's objective is not the same as what we are trying to capture here -- the market cost of equity for the Companies.

ii. Sustainable Growth Rates

The Commission rejects Mr. Moul's use of five-year growth forecasts. As 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. Mr. 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. The Commission finds that Mr. Moul's use of a five-year growth forecasts are logically impossible and they are subject to significant bias.

The Commission finds troubling that Mr. Moul's complete disregard for the financial and economic principles supporting DCF estimates. 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.

It seems that Mr. Moul recognized the limitations of his chosen growth inputs -- analysts' five-year forecasts -- but he used 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 requires. 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.

iii. Undistorted Bond Spreads

The Commission further finds Mr. Moul's summing the premium of A-rated bonds over government bonds and the premium of the cost of equity over A-rated bonds was yet another means Mr. Moul used to inappropriately inflate the Companies' cost of equity. As CUB-City witness. Bodmer testified, the anomalous circumstances of the current financial market difficulties have distorted some assumed relationships among market variables. The Commission concludes that 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.

iv. The Risks the Companies Face

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.

The Commission does not find Mr. Fetter's arguments persuasive. 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.

The Commission notes 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 billsEach utility has in place a purchased gas adjustment clause ("PGA"). 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. These facts make plain that commodity risk is not nearly as great as Mr. Fetter asserted.

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.

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 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. In short, these facts make it difficult to take Mr. Fetter's claim that the Companies face difficult and far-reaching risks seriously.

b. Commission's Analysis of Mr. Thomas's Recommendation

CUB-City argued that the Commission should adopt Mr. Thomas's recommended return on equity for the Companies. Mr. Thomas recommends an 8.58% cost of equity based on the DCF and CAPM estimation models as 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.

1. 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 Commission agres with Mr. Thomas's testimony that 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 10, LL 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.

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.

The Commission finds that Mr. Thomas's DCF analysis is supported by the record and should be adopted.

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

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.

(a) 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. As discussed earlier, the Commission finds Mr. Moul's use of Value Line data to be problematic. 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.

The Commission finds that Mr. Thomas's beta estimate to be persuasive.

(b) 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.

The Commission finds Mr. Thomas's EMRP estimate to be persuasive.

(c) 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.

<u>EXCEPTION # 6 -- Weighted Cost of Capital</u>

VI. RATE OF RETURN

F. Weighted Cost of Capital

1. North Shore

2. Peoples Gas

To be consistent with CUB-City's proposed changes to the capital structure and return on equity sections, the Proposed Order's conclusion regarding the Companies' respective weighted costs of equity at page 130 should be deleted. The following language should be inserted in its place.

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. As discussed above, the Commission finds that the results of Mr. Thomas's DCF analysis establish the appropriate cost of equity for both utilities. Using that number and the Companies' cost of debt yields a weighted cost of capital of 7.36% for Peoples Gas and 7.07% for North Shore. The differences in the two weighted costs of capital are due to the amount of short-term debt used by the two utilities. In addition, the Commission adopts Mr. Thomas's recommendation to recognize the risk-reducing effects of Rider VBA.

A summary of the Commission's conclusions regarding cost of equity, capital structure, and overall cost of capital is set forth 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	[redacted]	
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	[redacted]	
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	[redacted]	

<u>EXCEPTION # 7 -- Rate Design</u>

XII. Rate Design

CUB and the City adopt the rate design arguments and exceptions e Illinois Attorney General's Office on behalf Peoples of the State of Illinois in its Brief on Exceptions.

XIII. CONCLUSION

For the reasons discussed in this Brief on Exceptions, the City and CUB respectfully request that the Commission modify the Proposed Order as specified in the above Exceptions and the associated replacement language.

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Respectfully Submitted,

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