

DIRECT TESTIMONY

of

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Finance Department  
Financial Analysis Division  
Illinois Commerce Commission

North Shore Gas Company and  
The Peoples Gas Light and Coke Company

Proposed general increase in rates for gas service

Docket Nos. 11-0280 and 11-0281  
(Consolidated)

June 15, 2011

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**WITNESS IDENTIFICATION**

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

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

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

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

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

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

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

A. The purpose of my testimony is to present the overall cost of capital and to recommend a fair rate of return on rate base for North Shore Gas Company (“North Shore”) and The Peoples Gas Light and Coke Company (“Peoples Gas”) (individually, the “Company” and collectively, the “Companies”). The overall cost of capital that I recommend for each Company incorporates the rate of return on

22 common equity recommended in the direct testimony of Staff witness Michael  
23 McNally (ICC Staff Exhibit 5.0).

24 **Q. Please explain the P and N suffixes that appear in your schedule numbers.**

25 A. These suffixes indicate the Company to which a particular schedule applies. The  
26 P suffix identifies a schedule that applies to Peoples Gas, and the N suffix  
27 identifies a schedule that applies to North Shore.

28 **COST OF CAPITAL**

29 **Q. Please summarize your findings.**

30 A. I recommend an overall cost of capital for North Shore of 7.03% and an overall  
31 cost of capital for Peoples Gas of 6.28%. The overall costs of capital for the  
32 Companies are shown on Schedule 4.1.

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

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

43 served when the authorized rate of return on rate base equals the utility's overall  
44 cost of capital.

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

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

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

55 **CAPITAL STRUCTURE**

56 **Q. What capital structure did the Companies propose for setting rates?**

57 A. North Shore and Peoples Gas each propose imputed capital structures  
58 comprised of 44% long-term debt and 56% common equity.<sup>1</sup>

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

60 A. Capital structure affects the value of a firm and, therefore, its cost of capital, to  
61 the extent it affects the expected level of cash flows that accrue to parties other  
62 than debt and stock holders. Employing debt as a source of capital reduces a

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<sup>1</sup> North Shore Schedule D-1; Peoples Gas Schedule D-1.

63 company's income taxes,<sup>2</sup> thereby reducing the cost of capital; however, as  
64 reliance on debt as a source of capital increases, so does the probability of  
65 default. As the probability of default rises, expected payments to attorneys,  
66 trustees, and other outside parties increase. Further, the expected cash flows  
67 decline as the company foregoes investment that would have been available to it  
68 had its financial condition been stronger, including the expected value of the  
69 income tax shield from debt financing. Beyond a certain point, a growing  
70 dependence on debt as a source of funds increases the overall cost of capital.  
71 Therefore, the Commission should not determine the overall rate of return from a  
72 utility's actual capital structure if the Commission concludes that capital structure  
73 adversely affects the overall cost of capital.

74 An optimal capital structure would minimize the cost of capital and maintain a  
75 utility's financial integrity. Unfortunately, determining whether a capital structure  
76 is optimal remains problematic because (1) the cost of capital is a continuous  
77 function of the capital structure, rendering its precise measurement along each  
78 segment of the range of possible capital structures problematic; (2) the optimal  
79 capital structure is a function of operating risk, which is dynamic; and (3) the  
80 relative costs of the different types of capital vary with dynamic market  
81 conditions. Consequently, one should determine whether the capital structure is  
82 consistent with the financial strength necessary to access the capital markets

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<sup>2</sup> The tax advantage debt has over equity at the corporate level is partially offset at the individual investor level. Debt investors receive returns largely in the form of current income (i.e., interest). In contrast, equity investors receive returns in the form of both current income (i.e., dividends) and capital appreciation (i.e., capital gains). Taxes on common dividends and capital gains are lower than taxes on interest income because common dividends and capital gains tax rates are lower, and taxes on capital gains are deferred until realized.

83 under most economic conditions, and if so, whether the cost of that financial  
84 strength is reasonable.

85 **Q. How did you evaluate the Companies' proposed imputed capital structure?**

86 I compared the Companies' proposed imputed capital structure to the actual  
87 2010 and 3-year average ratios for the Companies, the Gas Group<sup>3</sup> and their  
88 ultimate parent company, Integrys Energy Group, Inc. ("Integrys"), using the S&P  
89 risk matrix. S&P publishes a business risk and financial risk matrix to evaluate a  
90 company's total risk.<sup>4</sup> The financial ratios for the Companies imply a credit rating  
91 of A/A-. The ratios are shown in Table 1 below.<sup>5</sup>

92 Table 1<sup>6</sup>

		FFO/ Debt <sup>7</sup>	Debt/ EBITDA <sup>8</sup>	Debt/ Capital <sup>9</sup>	Implied Financial Risk <sup>10</sup>
Companies' Proposed Capital Structure				44%	
North Shore	2010	28.25%	2.88X	44.91%	Intermediate
	3-Year Avg.	26.68%	3.61X	44.41%	Significant
Peoples Gas	2010	34.52%	3.02X	43.14%	Intermediate
	3-Year Avg.	31.06%	3.78X	46.44%	Significant
Integrys	2010	25.67%	3.40X	54.18%	Significant
	3-Year Avg.	26.44%	5.15X	55.68%	Aggressive
Gas Group	2010	28.96%	3.08X	50.65%	Significant
	3-Year Avg.	24.70%	3.28X	52.62%	Significant

<sup>3</sup> The Gas Group is the sample used by Companies' witness Paul Moul and Staff witness Michael McNally to determine the cost of equity for the Companies.

<sup>4</sup> S&P Global Credit Portal, *Criteria Methodology: Business Risk/Financial Risk Matrix Expanded*, May 27, 2009.

<sup>5</sup> S&P Utility Compustat, Companies' 2010 Annual Reports, Companies' response to Staff data request SK 5.01.

<sup>6</sup> Cells with values that indicate Peoples Gas or North Shore are slightly riskier than the Gas Group are shaded.

<sup>7</sup> Higher values indicate lower risk.

<sup>8</sup> Lower values indicate lower risk.

<sup>9</sup> Lower values indicate lower risk.

<sup>10</sup> In order of increasing risk, the Standard & Poor's Financial Risk categories are: minimal, modest, intermediate, significant, aggressive, and highly leveraged.

93 The Companies and the Gas Group both have “Excellent” business risk profiles.<sup>11</sup>  
94 Whereas, Integrys has greater operating risk that is reflected in its “Strong”  
95 business risk profile.<sup>12</sup> The S&P matrix implies a credit rating of A/A- for the  
96 Companies, A- for the Gas Group, and A-/BBB+ for Integrys. As can be seen in  
97 the table above, the Companies have better (i.e., indicative of higher financial  
98 strength) cash flow ratios and much lower debt ratios than Integrys and similar if  
99 not better cash flow ratios and lower debt ratios than the Gas Group. Thus, the  
100 Companies’ capital structures contain more common equity than needed to  
101 support a financially strong gas distribution provider.

102 **Q. What capital structure do you propose for setting rates for North Shore?**

103 A. I propose using an imputed capital structure that contains 3.89% short-term debt,  
104 47.71% long-term debt, and 48.40% common equity, as shown on Schedule 4.1.

105 **Q. What capital structure do you propose for setting rates for Peoples Gas?**

106 A. I propose using an imputed capital structure that contains 2.48% short-term debt,  
107 49.12% long-term debt, and 48.40% common equity, as shown on Schedule 4.1.

108 **Q. Please explain why you use an imputed a capital structure for the**  
109 **Companies.**

110 A. In my opinion, the Companies’ proposed imputed capital structure, which  
111 comprises 44% debt and 56% equity, is not appropriate for determining the

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<sup>11</sup> S&P Global Credit Portal, *Issuer Ranking: U.S. Natural Gas Distributors And Integrated Gas Companies, Strongest To Weakest*, April 19, 2011.

<sup>12</sup> Integrys’ S&P business profile risk is “strong.” S&P Global Credit Portal, *Integrys Energy Group Inc.*, February 4, 2011. In increasing order of risk, the Standard & Poor’s business risk profiles are: excellent, strong, satisfactory, fair, weak and vulnerable.

112 Companies' costs of equity for two reasons. First, it would produce a rate of  
113 return that would violate Section 9-230 of the Act.<sup>13</sup> The effect of the Companies'  
114 affiliations with unregulated or non-utility companies on their costs of capital is  
115 evident in their current credit ratings. Moody's, which emphasizes the stand-  
116 alone strength of Integrys' subsidiaries,<sup>14</sup> has given the Companies an issuer  
117 credit rating of A3.<sup>15</sup> In comparison, the BBB+ issuer credit rating Standard &  
118 Poor's has given the Companies reflects the consolidated credit profile of  
119 Integrys.<sup>16</sup> That is, the Standard & Poor's credit ratings of the Companies reflect  
120 the business and financial risk of Integrys rather than the standalone business  
121 and financial risk of the Companies. The ratios presented in Table 1 indicate  
122 that the Companies have less financial risk than Integrys. The Companies'  
123 financial risk and business risk together imply a standalone S&P issuer credit  
124 rating of A/A-. Yet, the Companies actual S&P credit ratings match the BBB+ of  
125 their parent, Integrys.<sup>17</sup> All else equal, a company with less business risk can  
126 carry a lower percentage of equity on its balance sheet than a company with  
127 greater business risk. Nevertheless, the Companies' equity ratios of around 55%

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<sup>13</sup> The Illinois Public Utilities Act states, "In determining a reasonable rate of return upon investment for any public utility in any proceeding to establish rates or charges, the Commission shall not include any (1) incremental risk, [or] (2) increased cost of capital...which is the direct or indirect result of the public utility's affiliation with unregulated or non-utility companies." 220 ILCS 5/9-230.

<sup>14</sup> Moody's does not rate the Companies entirely on a stand-alone basis, however. For example, a recent Moody's report changing the outlook for Integrys and its subsidiaries cited "The change in the rating outlook reflects a reduced business risk profile driven by the recently completed restructuring of Integrys' non-regulated energy marketing business..." (Moody's Investors Service, *Rating Action: Moody's revises outlook for Integrys Energy and its subsidiaries to stable from negative*, May 27, 2010.)

<sup>15</sup> Moody's Investor Service, Credit Opinion: Peoples Gas Light and Coke Company, May 28, 2010

<sup>16</sup> Standard and Poor's Ratings Direct, Peoples Gas Light & Coke Co. (The), February 4, 2011 and Standard and Poor's Ratings Direct, North Shore Gas Co., February 4, 2011. Standard & Poor's BBB+ credit rating is equivalent to Moody's Baa1 credit rating, and as such is one notch lower than Moody's A3 credit rating.

<sup>17</sup> Standard and Poor's Ratings Direct, Integrys Energy Group Inc., February 4, 2011

128 are much higher than their riskier parent company's common equity ratio of only  
129 about 45%. Both the Companies' credit ratings and financial ratios indicate that  
130 their affiliation with unregulated or non-utility companies has increased their risk.  
131 Pursuant to Section 9-230 of the Act, the cost associated with that increased risk  
132 cannot be reflected in the Companies' rates.

133 Second, the Companies' proposed imputed capital structure indicates a relatively  
134 low degree of financial risk for a gas distribution utility. In comparison, the  
135 average capital structure of the Gas Group is not nearly so conservative. The  
136 mean equity ratio for the Gas Group is 47.2%, with a standard deviation (" $\sigma$ ") of  
137 7%.<sup>18</sup> Thus, the Companies' common equity ratios are much higher than the  
138 Gas Group average (approximately  $1\sigma$  above that average), which indicates a  
139 higher degree of financial risk for the Gas Group relative to the Companies. The  
140 Gas Group's cost of common equity is a fair rate of return on common equity for  
141 the companies only if the Gas Group's and the Companies' total risk (business  
142 risk + financial risk) are similar. Given the Gas Group's greater financial risk, its  
143 cost of common equity would exceed that for a company with a similar degree of  
144 business risk but with the lower financial risk implied in the Companies proposed  
145 imputed capital structure. Stated differently, if the Gas Group's average capital  
146 structure were equal to the Companies' proposed capital structure, the Gas  
147 Group's average cost of common equity would be lower than the 8.85% value

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<sup>18</sup> S&P Compustat.

148 Mr. McNally estimated. Therefore, I recommend imputing a capital structure for  
149 the Companies based on the financial risk inherent in the Gas Group.

150 **Q. How did you derive the imputed capital structures for North Shore and**  
151 **Peoples Gas?**

152 A. The imputed capital structures I used for the Companies are based on the 2010  
153 mean common equity ratio for the Gas Group that forms the basis of Mr. McNally's  
154 cost of equity estimate. The 2010 mean common equity ratio for the Gas Group  
155 is 48.4%. I used the actual proportion of short-term debt in the Companies'  
156 forecasted average 2012 capital structure. To calculate the Companies'  
157 respective long-term debt ratios, I subtracted each Companies' respective  
158 forecasted average 2012 short-term debt ratio from the imputed 51.6% (100% -  
159 48.4% common equity ratio) total debt ratio.

160 For North Shore, short-term debt composes approximately 3.9% of its forecasted  
161 average 2012 capital structure. Thus, long-term debt composes the remaining  
162 47.7% (51.6% - 3.9%) non-common equity capital in the imputed capital  
163 structure. The resulting imputed capital structure for North Shore is 3.9% short-  
164 term debt, 47.7% long-term debt and 48.4% common equity.

165 For Peoples Gas, short-term debt composes approximately 2.5% of its  
166 forecasted average 2012 capital structure. Thus, long-term debt composes the  
167 remaining 49.1% (51.6% - 2.5%) non-common equity capital in the imputed

168 capital structure. The resulting imputed capital structure for Peoples Gas is 2.5%  
169 short-term debt, 49.1% long-term debt and 48.4% common equity.

170 **Q. Why did you use average 2012 balances instead of year-end 2012 balances**  
171 **for the capital structure components?**

172 A. The Companies' proposed December 31, 2012 measurement date for the capital  
173 structure component balances is more than eighteen months beyond the  
174 February 15, 2011 date they filed new tariffs.<sup>19</sup> Consequently, their proposed  
175 capital structure measurement date does not comply with Illinois Administrative  
176 Code Section 285.4000, which states:

177 Forecasted capital structures. Average balances in a  
178 forecasted capital structure shall reflect any consecutive 12  
179 month period beginning no earlier than the date new tariffs  
180 are filed and ending no later than 24 months after the date  
181 new tariffs are filed. A forecasted capital structure  
182 comprising balances of long-term debt, preferred stock,  
183 and common equity from a single date shall reflect any  
184 date beginning no earlier than the end of the last calendar  
185 or fiscal year for which actual data are available at the time  
186 of filing new tariffs and ending no later than 18 months  
187 after the date new tariffs are filed.

188 83 Ill. Adm. Code 285.4000 (Emphasis added)

189 To comply with Ill. Adm. Code Section 285.4000, I used the average 2012  
190 balances of the capital structure components for the consecutive 12 month  
191 period ending December 31, 2012. Shifting the measurement date for the  
192 balances of long-term debt and common equity from December 31, 2012 to a  
193 2012 average has two further advantages. First, it aligns the measurement

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<sup>19</sup> North Shore Schedule D-1; Peoples Gas Schedule D-1.

194 period of long term debt and common equity balances with that of short-term  
195 debt balances. Second, it aligns the capital structure with the Companies'  
196 proposed 2012 test year.

197 **Q. How did you derive the Companies' dollar amounts of short-term debt**  
198 **presented on Schedules 4.2N and 4.2P?**

199 A. Since short-term debt balances tend to fluctuate substantially during a year, any  
200 single balance might not be representative of the typical amount employed  
201 throughout the year. Therefore, I averaged the end of month balances from  
202 December 2011 through December 2012 inclusive. To calculate the balance of  
203 short-term debt, I first calculated the monthly ending net balance of short-term  
204 debt outstanding from December 2011 through December 2012. The net  
205 balance of short-term debt equals the monthly ending gross balance of short-  
206 term debt outstanding minus the monthly ending balance of construction work in  
207 progress ("CWIP") accruing an allowance for funds used during construction  
208 ("AFUDC") times the lesser of (a) the ratio of short-term debt to total CWIP for  
209 the corresponding month or (b) one.

210 **Q. How did you derive North Shore's dollar amounts presented on Schedule**  
211 **4.3N, page 1?**

212 A. The dollar amounts presented on Schedule 4.3N, page 1, represent the simple  
213 average of North Shore's end-of-year 2011 and 2012 long-term debt schedules  
214 for all entries, presented on Schedule 4.3N, page 2.

215 **Q. How did you derive Peoples Gas' dollar amounts presented on Schedule**  
216 **4.3P, page 1?**

217 A. The dollar amounts presented on the Schedule 4.3P, page 1, represent the  
218 simple average of Peoples Gas' end-of-year 2011 and 2012 long-term debt  
219 schedules for all entries except the New Issue 2012 bonds, as shown on  
220 Schedule 4.3P, pages 2-3. The balances of the face amount outstanding and  
221 unamortized discount and debt expense for the New Issue 2012 bonds were  
222 weighted 10/12<sup>th</sup> to reflect the 10 months of 2012 that they are forecasted to be  
223 outstanding.

224 **Q. What adjustments did you make to the balance of long-term debt presented**  
225 **by Peoples Gas for 2011 and 2012?**

226 A. First, I reclassified the Series OO and PP \$51million debt issuances to reflect  
227 them as current debt outstanding instead of the former classification as loss on  
228 reacquired debt. Peoples Gas purchased the Illinois Finance Authority ("IFA")  
229 bonds backed by the Series OO and PP debt issuances instead of retiring the  
230 obligation issued to the IFA.

231 Since the Company has not received the required Commission authorization to  
232 purchase the IFA bonds that are backed by the Series OO and PP debt  
233 issuances, I also increased the original principal amount and the face amount

234 outstanding on Schedule 4.3P by \$102 million to reflect the inclusion of Series  
235 OO and PP.<sup>20</sup>

236 Next, I adjusted the two proposed debt instruments to reflect the Company's  
237 current expectations for the amount of the issuances and term of the issuances.  
238 The Company is expected to issue the proposed debt instruments in June of this  
239 year ("New Issue 2011"). The Company's current expectation is to issue \$50  
240 million New Issue 2011 bonds for five years.<sup>21</sup> The Company also changed its  
241 expectations regarding the proposed debt instruments it plans to issue in March  
242 of 2012 ("New Issue 2012"). The Company's current expectation is to issue \$75  
243 million New Issue 2012 bonds.<sup>22</sup> Therefore, I recommend using the Company's  
244 current expectations for its planned issuances.

245 **Q. What adjustments did you make to the balance of common equity for**  
246 **Peoples Gas for 2012?**

247 A. I removed the \$30 million common equity infusion expected in March of 2012.<sup>23</sup>  
248 As explained earlier, the Company's common equity ratio is strong relative to  
249 both Integrys and the Gas Group. Consequently, the forecasted \$30 million  
250 common equity infusion is not necessary for Peoples Gas to maintain its financial  
251 strength.

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<sup>20</sup> Interim Order, Docket No. 11-0269.

<sup>21</sup> Peoples Gas response to Staff Data Request SK 3.01.

<sup>22</sup> Peoples Gas response to Staff Data Request SK 3.01.

<sup>23</sup> Peoples Gas WPD-1(1), page 2.

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### Cost of Short-term Debt

253 **Q. What is the cost of short-term debt for each Company?**

254 A. The cost of short-term debt is 4.04% for North Shore and 2.62% for Peoples  
255 Gas. North Shore's short-term debt is in the form of inter-utility loans from  
256 Peoples Gas and Peoples Energy Corporation ("PEC"), which rate is based on  
257 comparable commercial paper rates.<sup>24</sup> Peoples Gas' short-term debt consists of  
258 commercial paper and inter-utility loans from North Shore and PEC; the rate on  
259 both is the commercial paper rate at the time of borrowing. To estimate North  
260 Shore's and Peoples Gas' cost of short-term debt, first I converted the May 12,  
261 2011, 0.10% discount rate on 30-day, commercial paper into an annual yield of  
262 0.101% using the following formula:<sup>25</sup>

$$\text{Annual yield} = \left( \frac{\text{discount rate} \times \left( \frac{\text{days to maturity}}{360} \right)}{1 - \text{discount rate} \times \left( \frac{\text{days to maturity}}{360} \right)} \right) \times \left( \frac{365}{\text{days to maturity}} \right)$$

263

264 Then, I added the annual percentage cost of bank commitment fees to the  
265 annual commercial paper yield. For North Shore, I determined that  
266 approximately \$268,208 in annual fees should be included in the cost of short-  
267 term debt. I divided that amount by the average balance of short-term debt  
268 outstanding, \$6,812,292, to derive the 394 basis point increase to my estimate of  
269 North Shore's cost of short-term debt of 4.04% (0.10% + 3.94% = 4.04%). For

<sup>24</sup> North Shore Schedule D-2; Peoples Gas Schedule D-2.

<sup>25</sup> "Commercial Paper," Money Rates, Wall Street Journal, [www.wsj.com](http://www.wsj.com), May 12, 2011.

270 Peoples Gas, I determined that approximately \$917,290 in fees should be  
271 included in the cost of short-term debt. I divided that amount by the average  
272 balance of short-term debt outstanding, \$36,450,292, to derive the 252 basis  
273 point increase to my estimate of Peoples Gas' cost of short-term debt of 2.62%  
274 (0.10% + 2.52% = 2.62%).

275 **Cost of Long-term Debt**

276 **Q. What is the embedded cost of long-term debt for each Company?**

277 A. As shown on Schedule 4.3N and 4.3P, North Shore's and Peoples Gas'  
278 embedded cost of long-term debt for average 2012 equals 5.51% and 4.02%,  
279 respectively.

280 **Q. What adjustments did you make to the embedded cost of long term debt**  
281 **presented by Peoples Gas in its Schedule D-3?**

282 A. First, I applied the most recently available auction rates for the Series OO and  
283 PP bonds. I used the 0.455% auction rate on Series OO bonds, which was set at  
284 the May 4, 2011 auction.<sup>26</sup> For Series PP I used the May 25, 2011 auction rate  
285 of 0.350%.<sup>27</sup> Next, I used the Company's updated expected interest rates for the  
286 New Issue 2011 of 2.9%.<sup>28</sup> Finally, for the New Issue 2012 I used the current  
287 rate on A rated utility bonds of 3.98%.<sup>29</sup> If the Company issues the proposed  
288 debt instruments before the evidentiary hearings in this case, it should reflect the

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<sup>26</sup> Peoples Gas Response to Staff Data Request FIN-1.05, May update.

<sup>27</sup> Peoples Gas Response to Staff Data Request FIN-1.05, May update.

<sup>28</sup> Peoples Gas Response to Staff Data Request SK 3.01.

<sup>29</sup> Citi, Bond Market Roundup: Strategy, Week of June 3, 2011, p 14.

289 actual interest rate and expenses of the issues in its average 2012 embedded  
290 cost of debt.

291 **RATE OF RETURN ON RATE BASE**

292 **Q. What is your recommended rate of return on rate base for North Shore?**

293 A. I recommend a 7.03% rate of return on North Shore's rate base. This rate of  
294 return incorporates the 8.75% rate of return Staff witness Michael McNally  
295 recommends for North Shore's common equity. The rate of return I recommend  
296 on North Shore's rate base is shown on Schedule 4.1.

297 **Q. What is your recommended rate of return on rate base for Peoples Gas?**

298 A. I recommend a 6.28% rate of return on Peoples Gas' rate base. This rate of  
299 return incorporates the 8.75% rate of return Staff witness Michael McNally  
300 recommends for Peoples Gas' common equity. The rate of return I recommend  
301 on Peoples Gas' rate base is shown on Schedule 4.1.

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

303 A. Yes, it does.

## Weighted Average Cost of Capital

### North Shore Gas Company

	<u>Percent of Total Capital</u>	<u>Cost</u>	<u>Weighted Cost</u>
Short-Term Debt	3.90%	4.04%	0.16%
Long-Term Debt	47.70%	5.51%	2.63%
Common Equity	48.40%	8.75%	4.24%
<b>Weighted Average Cost of Capital</b>			<b>7.03%</b>

### The Peoples Gas Light & Coke Company

	<u>Percent of Total Capital</u>	<u>Cost</u>	<u>Weighted Cost</u>
Short-Term Debt	2.50%	2.62%	0.07%
Long-Term Debt	49.10%	4.02%	1.97%
Common Equity	48.40%	8.75%	4.24%
<b>Weighted Average Cost of Capital</b>			<b>6.28%</b>

**North Shore Gas Company**

Balance of Short-term Debt  
December 31, 2012

Date (A)	Gross Short-term Debt Outstanding (B)	CWIP (C)	CWIP Accruing AFUDC (D)	(B) - (D)	(B) - ((B)/(C))* (D)	Net Short-term Debt Outstanding (E)	Monthly Average (F)
Dec-11	\$ 20,048,000	\$ 401,000	\$ -	\$20,048,000	\$20,048,000	\$20,048,000	
Jan-12	-	\$ 401,000	\$ -	\$0	\$0	\$0	\$10,024,000
Feb-12	-	\$ 401,000	\$ -	\$0	\$0	\$0	\$0
Mar-12	-	\$ 401,000	\$ -	\$0	\$0	\$0	\$0
Apr-12	-	\$ 401,000	\$ -	\$0	\$0	\$0	\$0
May-12	-	\$ 401,000	\$ -	\$0	\$0	\$0	\$0
Jun-12	-	\$ 406,000	\$ -	\$0	\$0	\$0	\$0
Jul-12	-	\$ 411,000	\$ -	\$0	\$0	\$0	\$0
Aug-12	-	\$ 401,000	\$ -	\$0	\$0	\$0	\$0
Sep-12	13,196,000	\$ 401,000	\$ -	\$13,196,000	\$13,196,000	\$13,196,000	\$6,598,000
Oct-12	21,147,000	\$ 401,000	\$ -	\$21,147,000	\$21,147,000	\$21,147,000	\$17,171,500
Nov-12	25,782,000	\$ 401,000	\$ -	\$25,782,000	\$25,782,000	\$25,782,000	\$23,464,500
Dec-12	23,197,000	\$ 401,000	\$ -	\$23,197,000	\$23,197,000	\$23,197,000	\$24,489,500
<b>Average</b>						<b>\$6,943,500</b>	<b>\$6,812,292</b>

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

**The Peoples Gas Light & Coke Company**

Balance of Short-term Debt  
December 31, 2012

Date (A)	Gross Short-term Debt Outstanding (B)	CWIP (C)	CWIP Accruing AFUDC (D)	(B) - (D)	(B) - ((B)/(C))*(D)	Net Short-term Debt Outstanding (E)	Monthly Average (F)
Dec-11	\$ 115,055,000	\$ 5,961,000	\$ -	\$115,055,000	\$115,055,000	\$115,055,000	
Jan-12	109,309,000	\$ 7,292,000	\$ -	\$109,309,000	\$109,309,000	\$109,309,000	\$112,182,000
Feb-12	33,676,000	\$ 7,594,000	\$ -	\$33,676,000	\$33,676,000	\$33,676,000	\$71,492,500
Mar-12	-	\$ 8,229,000	\$ -	\$0	\$0	\$0	\$16,838,000
Apr-12	-	\$ 10,091,000	\$ -	\$0	\$0	\$0	\$0
May-12	-	\$ 12,414,000	\$ -	\$0	\$0	\$0	\$0
Jun-12	-	\$ 15,416,000	\$ -	\$0	\$0	\$0	\$0
Jul-12	-	\$ 17,591,000	\$ -	\$0	\$0	\$0	\$0
Aug-12	-	\$ 18,718,000	\$ -	\$0	\$0	\$0	\$0
Sep-12	21,926,000	\$ 19,424,000	\$ -	\$21,926,000	\$21,926,000	\$21,926,000	\$10,963,000
Oct-12	65,720,000	\$ 19,511,000	\$ -	\$65,720,000	\$65,720,000	\$65,720,000	\$43,823,000
Nov-12	94,293,000	\$ 8,225,000	\$ -	\$94,293,000	\$94,293,000	\$94,293,000	\$80,006,500
Dec-12	109,904,000	\$ 2,174,000	\$ -	\$109,904,000	\$109,904,000	\$109,904,000	\$102,098,500
<b>Average</b>						<b>\$36,235,667</b>	<b>\$36,450,292</b>

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

**North Shore Gas Company**  
Embedded Cost of Long-Term Debt

Line No.	Debt Issuance Typ, Coupon Rate	Date Issued	Maturity Date	Date Reacquired	Original Principal Amount	Face Amount Outstanding	Unamortized Discount or (Premium)	Unamortized Debt Expense (Gain)	Carrying Value	Annual Coupon Interest	Annualized Amort. of Discount or (Premium)	Annualized Amort. of Debt Expense	Annualized Interest Expense
<b>Forecasted Year Ending December 31, 2011</b>													
1	First Mortgage Bonds:												
2	Series M - 5.00%	(1)	12/18/98	12/01/28	\$30,035,000	\$28,470,000	\$0	\$770,309	\$27,700,000	\$1,423,500	\$0	45,496	\$1,468,996
3	Series N-2 - 4.625%		04/29/03	05/01/13	40,000,000	40,000,000	4,271	107,100	39,889,000	1,850,000	3,201	80,270	1,933,470
4	Series O - 7.00%		11/03/08	11/1/2013	6,500,000	6,500,000	0	56,859	6,443,000	455,000	0	30,930	485,930
5	Sub-Total				\$76,535,000	\$74,970,000	\$4,271	\$934,268	\$74,032,000	\$3,728,500	\$3,201	\$156,695	\$3,888,396
6	Less: Amortization of Losses on Reacquired Bonds												
7	Series J - 8.00%		11/01/90	11/01/20	12/05/02	\$0	\$0	\$0	\$476,708	(\$476,708)	\$0	53,903	\$53,903
8	Series K - 6.375%	(1)	10/01/92	10/1/2028	01/19/99	0	0	0	964,580	(964,580)	0	57,537	57,537
9	Series M - 5.00%	(1)	12/18/98	12/01/28	Various	0	0	0	38,589	(38,589)	0	2,279	2,279
10	Sub-Total				0	0	0	1,479,877	(1,479,877)	0	0	113,719	113,719
11	Total				\$76,535,000	\$74,970,000	\$4,271	\$2,414,145	\$72,552,123	\$3,728,500	\$3,201	\$270,414	\$4,002,115
12	Embedded Cost of Long-Term Debt												5.52%
<b>Forecasted Year Ending December 31, 2012</b>													
13	First Mortgage Bonds:												
14	Series M - 5.00%	(1)	12/18/98	12/01/28	\$30,035,000	\$28,470,000	\$0	\$724,814	\$27,745,186	\$1,423,500	\$0	45,503	\$1,469,003
15	Series N-2 - 4.625%		04/29/03	05/01/13	40,000,000	40,000,000	1,070	26,830	39,972,100	1,850,000	3,201	80,933	1,934,134
16	Series O - 7.00%	0	11/03/08	11/01/13	6,500,000	6,500,000	0	25,930	6,474,070	455,000	0	31,031	486,031
17	Sub-Total				\$76,535,000	\$74,970,000	\$1,070	\$777,574	\$74,191,357	\$3,728,500	\$3,201	\$157,467	\$3,889,168
18	Less: Amortization of Losses on Reacquired Bonds												
19	Series J - 8.00%		11/01/90	11/01/20	12/05/02	\$0	\$0	\$0	\$422,805	(\$422,805)	\$0	53,922	\$53,922
20	Series K - 6.375%	(1)	10/01/92	10/1/2028	01/19/99	0	0	0	907,042	(907,042)	0	57,547	57,547
21	Series M - 5.00%	(1)	12/18/98	12/01/28	Various	0	0	0	36,310	(36,310)	0	2,280	2,280
22	Sub-Total				0	0	0	1,366,157	(1,366,157)	0	0	113,749	113,749
23	Total				\$76,535,000	\$74,970,000	\$1,070	\$2,143,731	\$72,825,199	\$3,728,500	\$3,201	\$271,216	\$4,002,917
24	Embedded Cost of Long-Term Debt (M / I)												5.50%
<b>Forecasted Average 2012</b>													
25	First Mortgage Bonds:												
26	Series M - 5.00%	(1)	12/18/98	12/01/28	\$30,035,000	\$28,470,000	\$0	\$747,562	\$27,722,593	\$1,423,500	\$0	\$45,500	\$1,469,000
27	Series N-2 - 4.625%		04/29/03	05/01/13	\$40,000,000	\$40,000,000	\$2,670	\$66,965	\$39,930,550	\$1,850,000	\$3,201	\$80,601	\$1,933,802
28	Series O - 7.00%	0	11/03/08	11/01/13	\$6,500,000	\$6,500,000	\$0	\$41,395	\$6,458,535	\$455,000	\$0	\$30,980	\$485,980
29	Sub-Total				\$76,535,000	\$74,970,000	\$2,670	\$855,921	\$74,111,678	\$3,728,500	\$3,201	\$157,081	\$3,888,782
30	Less: Amortization of Losses on Reacquired Bonds												
31	Series J - 8.00%		11/01/90	11/01/20	12/05/02	\$0	\$0	\$0	\$449,757	(\$449,757)	\$0	\$53,912	\$53,912
32	Series K - 6.375%	(1)	10/01/92	10/1/2028	01/19/99	\$0	\$0	\$0	\$935,811	(\$935,811)	\$0	\$57,542	\$57,542
33	Series M - 5.00%	(1)	12/18/98	12/01/28	Various	\$0	\$0	\$0	\$37,449	(\$37,449)	\$0	\$2,279	\$2,279
34	Sub-Total				0	0	0	1,423,017	(1,423,017)	0	0	113,734	113,734
35	Total				\$76,535,000	\$74,970,000	\$2,670	\$2,278,938	\$72,688,661	\$3,728,500	\$3,201	\$270,815	\$4,002,516
36	Embedded Cost of Long-Term Debt (M / I)												5.51%





