CORRECTED REBUTTAL TESTIMONY

of

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

Proposed General Increase in Gas Rates

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

August 29, 2011

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WITNESS IDENTIFICATION

Q1. Please state your name and business address.

A1. My name is Sheena Kight-Garlisch. My business address is 527 East Capitol Avenue, Springfield, Illinois 62701.

Q2. Are you the same Sheena Kight-Garlisch who testified previously in this proceeding?

A2. Yes, I am.

Q3. What is the purpose of your rebuttal testimony in this proceeding?

A3. The purpose of my rebuttal testimony is to respond to the rebuttal testimony of The Peoples Gas Light and Coke Company's ("Peoples Gas") and North Shore Gas Company's ("North Shore") (individually, the "Company" and collectively, the "Companies") witness Lisa J. Gast, NS-PGL Ex. 18.0. Specifically, I will address Ms. Gast's testimony regarding the inclusion of short-term debt in the capital structure, long-term debt, capital structure, and forecasted interest rates.

COST OF CAPITAL

Q4. Please summarize your findings.

A4. I recommend an overall cost of capital of 7.1% for North Shore and 6.4% for Peoples Gas. The overall cost of capital for both Companies is shown on Schedule 13.1.

Short-Term Debt

Q5. Ms. Gast states that short-term debt should not be included in the Companies capital structure.[1] Do you agree?

A5. No. Due to the fungible nature (i.e., perfect substitutability) of capital, one cannot identify which capital sources fund which assets. Thus, the Commission has concluded that all assets, including assets in rate base, are assumed to be financed in proportion to total capital.[2] Since the Companies rely on short-term debt as a source of funds, short-term debt should be included in their capital structures unless it is shown that short-term debt does not support rate base. The Companies have not shown that short-term debt does not support rate base. In fact, the Companies have stated that they fund the difference between rate base and "permanent capital" with short-term debt.[3]

Long-Term Debt

Q6. Ms. Gast argues that Series OO and Series PP should be removed from the balance of long-term debt.[4] Please comment.

A6. I agree with Ms. Gast that Series OO should be removed from the 2012 forecasted amount of long-term debt for Peoples Gas, since the debt will be retired in November 2011. However, Series PP should only be removed if the Commission enters an Order in Docket No. 11-0476 approving the purchase of the tax-exempt securities backed by Series PP. Although Ms. Gast notes that

[1] NS-PGL Ex. 18.0, pp. 11-12.
[2] Order, Docket Nos. 02-0798, 03-008 and 03-0009 Consolidated, October 22, 2003, p. 67.
[3] North Shore's response to Staff data request SK 1.03 and Peoples Gas' response to Staff data request SK 1.03.
[4] NS-PGL Ex. 18.0, pp. 13-14.

Peoples Gas has filed a petition requesting Commission approval,[5] the mere filing of a petition does not guarantee that the Commission will grant approval of the requested transaction. Since the Commission has not entered a decision in Docket No. 11-0476, I recommend that Series PP remain in Peoples Gas' average 2012 balance and cost of long-term debt.

Q7. What changes have you made to your recommended average 2012 balance and cost of long-term debt for Peoples Gas?

A7. I removed Series OO for the reason given above. I also adjusted the interest rate on the 2011 new debt issuance to 2.21% from 2.9%.[6] The cost of long-term debt for Peoples Gas with both adjustments is 4.2%, which is shown on Schedule 13.2.

Since the outcome of Docket 11-0476 is unknown at this time,[7] I have presented Peoples Gas' average 2012 balance and cost of long-term debt excluding Series PP on Schedule 13.3. If the Commission grants the transaction requested in Docket No. 11-0476, then Series PP should be removed from Peoples Gas' average 2012 balance and cost of long-term debt.

[5] NS-PGL Ex. 18.0, p. 13.
[6] Companies' 2nd Supplemental Response to Staff data request SK 2.07. The interest rate of 2.21% is the actual rate for the 5-year debt issuance that was priced on August 9, 2011.
[7] Schedule 13.3 includes the changes shown in Schedule 13.2.

Capital Structure

Ratio Calculations

Q8. Ms. Gast contends that Goodwill should not be removed from the debt-to-capital ratio.[8] Please comment.

A8. Since Standard and Poor's ("S&P") does not adjust the debt-to-capital ratio of gas companies to remove goodwill, I recalculated the debt-to-capital ratios presented in my direct testimony.[9] The debt-to-capital ratios including goodwill are presented in Schedule 13.4. Accordingly, I updated the capital structures I recommend, which is discussed in questions 11 and 12 below.

Q9. Ms. Gast asserts that short-term debt should not be included in the debt-to-capital ratio.[10] Do you agree?

A9. No. S&P includes short-term debt in its calculation of debt ratios for the Gas Group and for both North Shore and Peoples Gas.[11]

Credit Ratings

Q10. Ms. Gast criticizes your "credit rating comparison."[12] Please comment.

A10. Ms. Gast's criticism is unwarranted. She claims that my "credit rating comparison" is irrelevant because I used the <u>issuer</u> credit ratings for the

[8] NS-PGL Ex. 18.0, p. 9.
[9] ICC Staff Ex. 4.0, p. 5.
[10] NS-PGL Ex. 18.0, pp. 9-10.
[11] S&P Global Credit Portal, North Shore Gas Co., CreditStats Direct; and S&P Global Credit Portal, Peoples Gas Light & Coke Co. (The), CreditStats Direct. S&P no longer presents ratios on a company specific basis for Peoples Gas as of 2007 or for North Shore as of 2010.
[12] NS-PGL Ex. 18.0, p 10-11. Ms. Gast refers to my evaluation of the Companies' proposed capital structure as a "credit rating comparison."

Companies instead of their Senior Secured Debt ratings, which are issue credit ratings. S&P defines an issue credit rating as:

> A Standard & Poor's issue credit rating is a current opinion of the credit worthiness of an obligor with respect to a specific financial obligation, a specific class of financial obligations, or a specific financial program.[13]

Whereas, S&P defines an issuer credit rating as:

> A Standard & Poor's issuer credit rating is a forward-looking opinion about an obligor's overall financial capacity (its creditworthiness) to pay its financial obligations.[14]

My credit rating comparison in ICC Staff Ex. 4.0 was based on the S&P matrix.[15] S&P uses issuer credit ratings as the baseline for issue credit ratings and then establishes the issue credit rating depending on S&P's assessment of the recoverability of outstanding interest and principal of an issue in the event of default.[16] The ratings based on the S&P risk matrix are issuer credit ratings.[17] Therefore, Ms. Gast's criticism of the issuer credit rating is baseless.

Imputed Capital Structure

Q11. Ms. Gast claims that your imputed capital structures for the Companies are not justified.[18] Do you agree?

[13] S&P Ratings Direct, Standard and Poor's Ratings Definitions, April 27, 2011, p.3.
[14] S&P Ratings Direct, Standard and Poor's Ratings Definitions, April 27, 2011, p.10.
[15] ICC Staff Ex. 4.0, pp. 5-6.
[16] S&P Global Credit Portal, *2008 Corporate Criteria: Rating Each Issue,* April 15, 2008.
[17] S&P Global Credit Portal, *Criteria Methodology: Business Risk/Financial Risk matrix Expanded,* May 27, 2009.
[18] NS-PGL Ex. 18.0, p. 5.

A11. No. The S&P financial risk ratios based on Staff's proposed revenue requirement, capital components and costs in this proceeding clearly show that it is necessary to impute capital structures for the Companies. Table 1 below shows the financial risk ratios and the implied financial risk of each ratio for 2012 based on Staff's proposed revenue requirement for North Shore and Peoples Gas at 50% (Gas Group average equity ratio) and 56% equity (Companies' proposed imputed equity ratio). The calculation of the ratios is presented in Schedule 13.5.

Table 1

Equity Ratio	FFO/Debt		Debt/EBITDA		Debt/Capital	
2012	Ratio	Implied Risk*	Ratio	Implied Risk*	Ratio	Implied Risk*
North Shore-50% (Gas Group)	28.1%	S	3.2X	S	50%	S/A
North Shore-56% (Companies' Proposal)	33.2%	I	2.7X	I	44%	I
Peoples Gas- 50% (Gas Group)	31.1%	I	3.1X	S	50%	S/A
Peoples Gas- 56% (Companies' Proposal)	36.5%	I	2.6X	I	44%	I
* I=Intermediate, S= Significant and A= Aggressive						

The implied financial risk was determined using the S&P business and financial risk matrix shown in Attachment A.[19] The Companies' proposed imputed capital structure would result in a relatively low degree of financial risk for a gas distribution utility. In comparison, the average capital structure of the Gas Group

[19] S&P Global Credit Portal, *Criteria Methodology: Business Risk/Financial Risk matrix Expanded,* May 27, 2009.

(including goodwill) is not nearly so conservative. The mean equity ratio for the Gas Group is 50.4% (including short-term debt but with no adjustment for goodwill), with a standard deviation (“σ”) of 4.8%.[20] Further, the Gas Groups’ other two financial risk ratios are also weaker than the Companies. Thus, the Gas Group’s financial risk ratios indicate that its risk is higher than that of North Shore and Peoples Gas. Financial theory posits that investors require higher returns to accept greater exposure to risk. Conversely, the investor-required rate of return is lower for investments with less exposure to risk. Thus, the cost of common equity estimated for the gas sample would exceed the costs of common equity for North Shore and Peoples Gas unless the financial risk of the Companies is brought in line with that of the gas sample. In my judgment, given the difference between the implied forward-looking financial risk for the Companies and the average financial risk of the Gas Group, it is necessary to impute a capital structure for the Companies.

Q12. What capital structures do you recommend for North Shore and Peoples Gas?

A12. For North Shore, the ratio analysis presented in Table 1 indicates that a capital structure containing 50% equity results in financial ratios that are consistent with the ratios for the Gas Group. Therefore, I recommend an imputed capital structure for North Shore that contains 50% equity. To calculate North Shore’s respective long-term debt ratio, I subtracted North Shore’s respective forecasted average 2012 short-term debt ratio of 3.9% from the imputed 50% (100% - 50%

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[20] S&P Compustat.

common equity ratio) total debt ratio. Thus, long-term debt composes the remaining 46.1% (50% - 3.9%) non-common equity capital in the imputed capital structure. The resulting imputed capital structure for North Shore is 3.9% short-term debt, 46.1% long-term debt and 50.0% common equity.

For Peoples Gas, the ratio analysis in Table 1 shows that it can support a greater amount of total debt in its capital structure than the Gas Group. Increasing the amount of total debt in Peoples Gas' capital structure from the 50% to 51%, as shown below in Table 2, results in financial ratios that reflect a "Significant" amount of financial risk, which is consistent with the Gas Group.

Table 2

	FFO/Debt		Debt/EBITDA		Debt/Capital	
2012	Ratio	Implied Risk*	Ratio	Implied Risk*	Ratio	Implied Risk*
Peoples Gas- 49% Equity	30.3%	I	3.2X	S	51%	A
* I=Intermediate, S= Significant and A= Aggressive						

Therefore, I recommend a capital structure that contains 49% equity. To calculate Peoples Gas' respective long-term debt ratio, I subtracted Peoples Gas' respective forecasted average 2012 short-term debt ratio of 2.6% from the imputed 51% (100% - 49% common equity ratio) total debt ratio. Thus, long-term debt composes the remaining 48.4% (51% - 2.6%) non-common equity capital in the imputed capital structure. The resulting imputed capital structure for Peoples Gas is 2.6% short-term debt, 48.4% long-term debt and 49.0% common equity.

Forecasted Interest Rates

Q13. Ms. Gast argues for the use of a forecasted interest rate for the proposed March 1, 2012 long-term debt issuance.[21] Do you agree?

A13. No. Ms. Gast proposes using a forecasted 10-year Treasury rate from Moody's DataBuffet.com.[22] However, accurately forecasting interest rates is problematic. This is illustrated by the various forecasted rates for the 10-year Treasury note in Table 3 below.

Table 3

Source	Date of Forecast	Forecast Period	Forecasted Rate
Moody's DataBuffet.com[23]	7/14/2011	1st Quarter 2012	4.25%
Blue Chip Financial Forecasts[24]	7/1/2011	1st Quarter 2012	3.6%
Forecasts.org[25]	8/10/2011	March 2012	3.1%
Wells FargoAdvisors[26]	8/10/2011	1st Quarter 2012	2.9%
FreddieMac[27]	7/2011	1st Quarter 2012	3.7%
EconomicOutlookgroup.com[28]	8/12/2011	1st Quarter 2012	3.4%
Survey of Professional Forecasters[29]	8/12/2011	1st Quarter 2012	3.31%

Further, Peoples Gas forecasted an interest rate of 2.9% for a 5-year debt issuance just three weeks before it was priced at 2.21%. No one can predict with certainty when interest rates will begin to rise, the rate at which they will rise, how long they will rise before falling again, the rate at which they will fall, or even

[21] NS-PGL Ex. 18.0, pp. 14-15.
[22] NS-PGL Ex. 18.0, p. 15.
[23] Companies' response to Staff data request SK 7.03.
[24] NS-PGL Ex. 19.0 WP 1.
[25] www.forecasts.org, August 10, 2011.
[26] Wells Fargo, Economics Group Monthly Outlook, www.wellsfargoadvisors.com, August 10, 2011, p. 3.
[27] Freddie Mac, July 2011 Economic and Housing Market, www.freddiemac.com, July 2011, p. 3.
[28] www.economicoutlookgroup.com, Key Economic Forecasts, August 12, 2011, p. 1.
[29] Federal Reserve Bank of Philadelphia, *Third Quarter 2011 Survey of Professional Forecasters*, www.phil.frb.org, August 12, 2011.

whether they will rise before they fall further. Therefore, the Commission should continue to use actual spot interest rates rather than forecasted interest rates to estimate the Companies' cost of debt.

RATE OF RETURN ON RATE BASE

Q14. What is your recommended rate of return on rate base for North Shore and Peoples Gas?

A14. I recommend a 7.1% rate of return on North Shore's rate base. I recommend a 6.4% rate of return on Peoples Gas' rate base. These rates of return incorporate the 8.75% cost of common equity Staff witness Michael McNally recommends for the Companies.[30] The rates of return I recommend on North Shore's and Peoples Gas' rate bases are shown on Schedule 13.1.

Q15. Does this conclude your rebuttal testimony?

A15. Yes, it does.

[30] ICC Staff Ex. 5.0, p. 2.