STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

NORTH SHORE GAS COMPANY	:	
	:	
Proposed General Increase In Rates For Gas Service.	:	No. 12-0511
	:	and
THE PEOPLES GAS LIGHT AND COKE COMPANY	:	No. 12-0512 Consol.
	:	
Proposed General Increase In Rates For Gas Service.	:	

Rebuttal Testimony of

LISA J. GAST

Manager
Financial Planning and Analysis
Integrys Business Support, LLC

On Behalf of
North Shore Gas Company
The Peoples Gas Light and Coke Company

TABLE OF CONTENTS

I. INTRODUCTION AND BACKGROUND

A. Identification of Witness

Q. Please state your name and business address.

A. My name is Lisa J. Gast. My business address is Integrys Energy Group, Inc. ("Integrys"), 700 North Adams Street, P.O. Box 19001, Green Bay, WI 54307-9001.

Q. Are you the same Lisa J. Gast who submitted direct testimony and supplemental direct testimony on behalf of The Peoples Gas Light and Coke Company ("Peoples Gas") and North Shore Gas Company ("North Shore") (together, "the Utilities") in these consolidated dockets?

A. Yes.

B. Purpose of Rebuttal Testimony

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

A. The purpose of my rebuttal testimony is to respond to the proposed adjustments to the Utilities' requested overall rates of return on their proposed rate bases contained in the direct testimony of Illinois Commerce Commission ("Commission") Staff ("Staff") witness Michael McNally (ICC Staff Exhibit 5.0), including the cost of debt components of their rates of return. The Utilities' rebuttal witness Paul R. Moul (NS-PGL Ex. 24.0) will respond to Staff's and the Illinois Attorney General's ("AG") proposed adjustments to the Utilities' proposed Return on Equity ("ROE") component of their rates of return.

I will also present updated capital structure and cost of capital schedules for each Utility to reflect financing adjustments that result from (1) the Staff and Intervenor adjustments accepted by the Utilities and (2) updates to Utilities' Test Year 2013 rate case budget presented in NS-PGL Exs. 26.2N and 26.2P (revised Schedule C-2) of

Utilities' witness Ms. Sharon Moy's rebuttal testimony as well as updates to the forecasted interest rates on short-and long-term debt. The adjustments and updates leading to these financing adjustments are discussed by other of the Utilities' witnesses.

C. <u>Summary of Conclusions</u>

Q. Please summarize the conclusions of your rebuttal testimony.

A. First, Staff's and AG's forecasted rate for the Utilities' respective 2013 long-term debt issuances is unreasonably low. Given the forecasted continuation of the current low interest rate environment, the Utilities are planning to issue 30-year term long term debt for their respective forecasted issuances in 2013 instead of the 10-year term assumed in Staff's calculations. The Utilities' respective updated D-3 Schedules incorporate the forecasted rates for 30-year long-term debt.

Second, Staff's use of historical spot-day rates for variable rate debt and forecasted new long-term debt issues should be rejected. Using historical rates is not consistent with forecasting the Utilities' costs in a future test year. Furthermore, Staff's objection to the use of forecasts is misplaced when Staff is effectively using historical spot-day rates to forecast the economic conditions and rates that will prevail and impact rates during the test year. There is no reason to believe that interest rates from a single day in 2012 are a better forecast of interest rates that will prevail in 2013 than the published forecasts from sources that are routinely relied upon by bankers, credit issuers and, for certain purposes, even Staff.

Third, Staff's adjustments to the Utilities' respective costs of long-term debt for additional expenses related to an interest rate swap are unwarranted. The Utilities entered into the swap to hedge the interest rate risk associated with a long-term debt issuance in order to lock in then historically low interest rates. The costs from this reasonable and prudent transaction should be included in the Utilities' respective costs of long-term debt, just as any savings achieved by it would have been included.

Fourth, as discussed in the rebuttal testimony of the Utilities' witness Mr. Moul, the cost of equity proposals made by Staff and the AG are unrealistically low and inconsistent with market expectations.

Fifth, as shown in Revised Schedule D-1 Cost of Capital Summary (NS-PGL Ex. 23.1P), Peoples Gas calculates an updated cost of capital and rate of return on rate base for the 2013 test year of 7.48%, which reflects a capital structure consisting of 50.42% common equity, 43.62% long-term debt and 5.96% short-term debt, a cost of equity of 10.75%, an embedded cost of long-term debt of 4.52% and an embedded cost of short-term debt of 1.47%.

As shown in Revised Schedule D-1 Cost of Capital Summary (NS-PGL Ex. 23.1N), North Shore calculates an updated cost of capital and rate of return on rate base for the 2013 test year of 7.53%, which reflects a capital structure consisting of 50.31% common equity, 42.35% long-term debt and 7.34% short-term debt, a cost of equity of 10.75%, an embedded cost of long-term debt of 4.66% and an embedded cost of short-term debt of 2.00%.

D. <u>Itemized Attachments to Rebuttal Testimony</u>

Q. Please describe the attachments to your Rebuttal testimony

A. I am submitting the following attachments:

Exhibit No.	Schedule
NS-PGL Ex. 23.1P	Revised Schedule D-1
NS-PGL Ex. 23.2P	Revised Schedule D-2
NS-PGL Ex. 23.3P	Revised Schedule D-3
NS-PGL Ex. 23.1N	Revised Schedule D-1
NS-PGL Ex. 23.2N	Revised Schedule D-2
NS-PGL Ex. 23.3N	Revised Schedule D-3
NS-PGL Ex. 23.4	Interest Rate Hedge Plan Documentation
NS-PGL Ex. 23.5	Interest Rate Forecast Assumptions

II. <u>LONG-TERM DEBT</u>

Q. What positions have Staff and the AG taken on the Utilities' forecasted cost of long-term debt respectively?

A. Staff has proposed a downward adjustment from 4.58% to 4.32% for Peoples Gas and from 4.95% to 4.01% for North Shore. AG witness Mr. Brosch has proposed a downward adjustment from 4.58% to 4.46% for Peoples Gas and from 4.95% to 4.60% for North Shore.

Staff's and the AG's proposed downward adjustments result mainly from downward adjustments to the forecasted rates for Peoples Gas' and North Shore's 2013 long-term debt issuances. Staff also eliminated interest costs related to an interest rate swap on Peoples Gas' Series NN-2 and North Shore's N-2 bonds.

Q. Are Staff's and the AG's adjustments to the Utilities' forecasted long-term debt rates in 2013 appropriate?

A. No, they are not appropriate. Staff has assumed that the Utilities will issue long-term debt with a 10-year term at current 10-year rates. Given the forecasted continuation of the current low interest rate environment, the Utilities are planning to issue long-term debt in 2013 with a 30-year term. This will ensure that the Utilities' customers will receive the benefits of the current and forecasted low interest environment for a longer period of time and it will reduce the interest rate risk of the Utilities' debt portfolio. Current forecasts indicate that Peoples Gas and North Shore could issue 30-year long-term debt in 2013 at 4.45% and 4.20%, respectively. These rates are included in the Utilities' updated costs of long-term debt (Schedules D-3) and overall costs of capital (Schedules D-1).

Staff and the AG also propose to use historical yields on long-term debt issues rather than forecasted rates as proposed by the Utilities. I will address this issue separately below.

Q. Are Mr. McNally's adjustments to the Utilities' long-term debt expenses related to the interest rate swap appropriate?

A. No, they are not appropriate. To support his adjustment, Mr. McNally simply claims that the Utilities have not demonstrated that it was reasonable to enter into the interest rate swap. However, as shown in the Interest Rate Hedge Plan documentation (NS-PGL Ex. 23.4), the Utilities, in accordance with their financing plan, issued a total of $115 million in long-term debt in May 2003. The Utilities considered the potential for volatility in the benchmark 10-year U.S. Treasury market and made a decision to hedge the interest rate exposure of both the Utilities and ratepayers resulting from the May 2003 long-term debt issuance. Given the historically low interest rate environment at the time, the Utilities decided to lock in rates at the then-current market prices in order to provide price security for the ratepayer as well as cost security for the Utilities. The Utilities also recognized that even though interest rates were at historic lows, there was a possibility for rates to decrease even further. Therefore, the Utilities did not hedge the entire portion of the long-term debt issue at one time. Instead, they entered into three separate hedge transactions of approximately equal amounts at three different time periods to capture the benefit of decreasing rates. It is important to note that a hedge is not intended to be a prediction of price movement one way or another, but is rather a risk mitigation strategy. In other words, the Utilities were not predicting that interest rates would be higher when the bonds were issued. They were simply recognizing that interest rates were at historic lows and made a strategic decision to lock in the rate of eventual long-term debt issuance at these low rates.

The Utilities' decision to lock in rates in May 2003 was entirely prudent. Indeed, if interest rates had risen above the average rate resulting from the hedge, the Utilities would have recognized a gain that would have served to reduce the overall cost of long-term debt. The modest cost of this particular hedge was the price of the risk mitigation achieved. If a hedge was prudent when made, then its cost or gain should be included in the Utilities' revenue requirement.

Q. Are your proposed adjustments to the Utilities' long-term debt costs reflected in the Utilities' updated revenue requirement estimates provided by Utilities witness Ms. Moy?

A. Yes they are. Our proposed adjustments to Staff's adjusted figures result in a long-term debt cost for Peoples Gas and North Shore of 4.52% and 4.66%, respectively. This calculation is provided in my revised D-3 schedules, NS-PGL Exs. 23.3P and 23.3N. Short-term debt costs for Peoples Gas and North Shore have been adjusted to 1.47% and

2.00%, respectively. This calculation is provided in my revised D-2 schedules, NS-PGL Exs. 23.2P and 23.2N. The adjusted long-term and short-term debt costs are reflected in the rate of return shown in Ms. Moy's revised C-1 Schedules, NS-PGL Exs. 26.1P and 26.1N.

III. <u>HISTORICAL VERSUS FORECASTED INTEREST RATES</u>

Q. What method has Mr. McNally used to determine the cost of short-term debt and new fixed rate debt included in Staff Ex. 5.0, Schedule 5.01?

A. Mr. McNally has used historical rates to predict rates for the test year in this case. He has used a November 9, 2012 spot rate for A2/P2 rated commercial paper as published by the Federal Reserve Board to derive the rate to be applied to short-term debt in his capital structure. He has similarly used historical spot-day utility bond yields on new 10-year issuances to estimate the rates on the Utilities' respective 2013 long-term debt issuances.

Q. Why are historical rates a poor predictor of the Utilities' costs for the forecast period?

A. Historical rates reflect the historical economic environment. Worse, historical spot-day rates reflect only the economic conditions that prevailed on a single day in the past. Using historical rates to set rates for a future test year assumes that the historical interest rate environment will continue through the test year. By contrast, interest rates forecasts take into account the economic conditions that are expected to prevail during the test year. The Commission should not base the Utilities' rates on inferior information when better information is available.

Q. Does Moody's DataBuffet.com provide the assumptions supporting its interest rate forecasts?

A. Yes. In fact, Moody's forecast anticipates that current economic and fiscal conditions will continue to persist into 2013 even though their forecast of U.S. Treasury yields is increasing. This directly conflicts with Mr. Brosch's assertion that rates will remain as they are currently since the Federal Reserve intends on maintaining its accommodative monetary policy. While Mr. Brosch bases his rate conclusion on monetary policy only, Moody's DataBuffet.com bases its forecast on its assessment of not only monetary policy but also fiscal policy, the U.S. dollar, and energy prices. Moody's DataBuffet.com's forecast assumptions are provided in NS-PGL Ex. 23.5.

Q. But isn't it true that forecasts can be wrong, sometimes significantly so?

A. Yes, that is true. But forecasts are the best information we have, whereas there is no reason whatsoever to believe that interest rates on a single day in the past will approximate the rates that will prevail during a future period.

Q. Does Mr. McNally rely on forecasts in his cost estimates of other components of the capital structure?

A. Yes. In fact, Mr. McNally uses forecasts of inflation rates and real GDP growth expectations from Global Insight and EIA to support his assertion that U.S. Treasury yields should be used to approximate the long-term risk-free rate used in his ROE estimate using the Capital Asset Pricing Model. He also uses growth rates for the companies in the Delivery Group to formulate his cost of equity estimate in his DCF model. These growth rates are based on the companies' forecasted earnings.

Q. Do Global Insight and EIA also provide forecasts for U.S. Treasury rates that can be used as the benchmark for estimating the rates on the Utilities' respective bond issuances in 2013?

A. Yes. Global Insight and EIA provide forecasts of 10-year U.S. Treasury yields. These yields closely approximate the forecasted 10-year U.S. Treasury yields from Moody's DataBuffet.com.

Q. What do these forecasts from Global Insight and EIA suggest?

A. Global Insight and EIA forecast yields of 2.16% and 2.76% for 10-year U.S. Treasury securities. This is a marked increase from the December 10, 2012 U.S. Treasury rate of 1.62%. If, as Global Insight and EIA predict, U.S. Treasury yields increase in 2013 from their current levels, this also means that rates on the Utilities' respective 2013 bond issuances will increase from the current rates as well.

Q. But aren't the Utilities currently intending to issue 30-year bonds in 2013?

A. Yes, but Global Insight and EIA do not provide a forecast of 30-year U.S. Treasury yields. However, the fact that the Moody's DataBuffet.com forecast of 10-year U.S. Treasury yields approximates the forecasts from sources relied upon by Staff supports the reasonableness of the forecasted rates of 30-year U.S. Treasury yields from Moody's DataBuffet.com.

Q. What method have you used to determine the cost of short-term debt and new fixed rate debt included in your updated Schedules D-1, D-2, and D-3?

A. Peoples Gas has updated the forecasted rate on its proposed 2013 debt issue to 4.45%. North Shore has updated the forecasted rate on its proposed 2013 debt issue to 4.20%.

This rate is based on an underlying 30-year Treasury rate of 3.20% and 3.45% and an issue spread of 100 basis points. The Utilities used the forecasted 30-year Treasury rate from Moody's DataBuffet.com (as of November 5, 2012) and added 100 basis points which is the spread on Peoples Gas' most recent issuance.

The Utilities have also updated the forecasted rates on forecasted monthly short-term debt balances. The monthly short-term interest rates are based on forecasted 1-month commercial paper rates from Moody's DataBuffet.com as of November 5, 2012. The Utilities have determined that the rates forecasted by Moody's DataBuffet.com closely represent rates on AA rated commercial paper; therefore, Peoples Gas has added 31 basis points to the interest rate forecast from Moody's DataBuffet.com to approximate the spread between AA and A2/P2 rated commercial paper**.**

Q. How did you determine the 31 basis point spread between AA and A2/P2 rated commercial paper?

A. The 31 basis point spread is the difference between 30-Day AA and A2/P2 commercial paper rates from December 5, 2012, as published by the Federal Reserve Board. This is the same approach presented in my direct testimony.

IV. <u>COST OF COMMON EQUITY</u>

Q. What positions have the Staff and the AG taken on the Utilities' cost of common equity?

A. Compared to the Utilities' originally proposed return on equity of 10.75%, Staff recommends 9.06% for North Shore and Peoples Gas. The AG indicates that the current ROE of 9.45% is consistent with recent ROE findings for gas distribution utilities.[1]

Q. Has the testimony by Staff witness Mr. McNally or AG witness Mr. Brosch caused the Utilities to change their proposed cost of equity?

A. No. However, Mr. Moul's rebuttal testimony provides further support for the recommended cost of equity of 10.75% and demonstrates that methods used by Mr. McNally are unsupported and result in an unrealistically low ROE. Furthermore, the 9.06% ROE recommended by Mr. McNally would be equal to the lowest ROE authorized during 2012.

Mr. Brosch claims that the currently authorized 9.45% ROE is consistent with recent ROE findings for other gas distribution utilities. This is only true if you consider the third lowest ROE authorized in 2012 to be consistent. During 2012, authorized ROEs ranged from 9.06% to 10.5% with an average and median ROE of 9.87% and 9.83%, respectively. If Mr. Brosch is recommending that the Commission authorize an ROE consistent with recent findings, a 9.87% ROE is even more consistent with that recommendation.

V. SUMMARY

Q. In summary, what are your conclusions regarding the proposals by Staff and AG concerning the Utilities' overall rate of return on rate base in this case?

A. My conclusions are as follows:

[1] CUB-City also used the currently authorized ROE of 9.45% to derive their proposed Rate of Return

- Based on (a) the Utilities' revised capital structure, (b) their cost of equity, (c) their updated cost of short-term debt, and (d) their updated cost of long-term debt, the allowed overall rate of return on rate base should be 7.48% for Peoples Gas and 7.53% for North Shore. The rates compare to the current authorized return for Peoples Gas of 6.94% and 7.43% for North Shore.
- Staff's adjustments to the forecasted rates on Peoples Gas' forecasted long-term debt in 2013 should be updated to reflect the Utilities' current plan to issue 30-year debt vs. 10-year debt. The Utilities' respective updated D-3 Schedules reflect this change.
- Using historical interest rates is not consistent with forecasting the Utilities' costs in a forecasted test year. Historical interest rates reflect only the current economic environment. They are inconsistent with a forecasted test year and assume that interest rates in the past will continue to be available through the 2013 test year. Forecasted interest rates allow for forecasted changes in the economic environment. The Commission should not base the Utilities' rates on inferior information when better information is available.
- As discussed in the rebuttal testimony of the Utilities' witness Mr. Moul, the cost of equity proposals made by Staff and the AG are inadequate and inconsistent with market expectations as measured by the proxy group of companies used in Mr. Moul's return on equity study. An ROE that is out of line with current market expectations would have a harmful effect on the Utilities' ability to raise sufficient capital at a reasonable cost.

Q. Does this complete your rebuttal testimony?

A. Yes.