Direct Testimony

of

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Northern Illinois Gas Company d/b/a Nicor Gas Company

Proposal to Establish Rider PORCB

(Purchase of Receivables with Consolidated Billing)

Docket No. 12-0569

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Introduction

Q. Please state your name and business address.

A. My name is Rochelle M. Phipps. 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 a Senior Financial Analyst in the Finance Department of the Financial Analysis Division.

Q. Please describe your qualifications and background.

A. I received a Bachelor of Arts degree in Finance from Illinois College, Jacksonville, Illinois. I received a Master of Business Administration degree from the University of Illinois at Springfield. I have been employed by the Commission since June 2000.

Q. Please state the purpose of your testimony in this proceeding.

A. Northern Illinois Gas Company d/b/a Nicor Gas Company ("Nicor Gas" or "Company") proposes to implement a Rider 17 Purchase of Receivables with Consolidated Billing ("Rider 17" or "PORCB program") pursuant to a Settlement Agreement in Docket No. 11-0046, between AGL Resources Inc., Nicor Inc., Nicor Gas, the Retail Energy Supply Association ("RESA") and Interstate Gas

Supply of Illinois ("IGS").[1] The Company proposes to recover prudently incurred capital costs associated with implementing a PORCB program and to apply a carrying charge that equals the Commission-authorized rate of return on rate base to the unrecovered PORCB costs (*i.e.*, the PORCB assets).[2] Staff witness Dr. David Rearden presents Staff's primary position to reject the Company's Rider 17 proposal. Nevertheless, I will present my evaluation of the Company's rate of return proposal, as well as my rate of return recommendation for the PORCB assets and related tariff language recommendations for the Company's proposed Rider 17, should the Commission approve the Company's proposal to implement a PORCB program.

Q. Please summarize your conclusions and recommendations.

A. The Company's proposed rate of return equals the cost of capital for gas delivery services, which implies that the risk inherent in the recovery of PORCB assets equals the risk of the Company's gas delivery services assets. In my judgment, the PORCB assets warrant a lower rate of return than gas delivery services. Specifically, I recommend applying a 4.45% rate of return on common equity to PORCB assets, which results in an overall rate of return of 5.17%. My cost of equity estimate equals the midpoint of the five-year yield on AAA-rated debt and the Company's rate of return on rate base, as adjusted to reflect a five-year maturity instead of perpetuity. I recommend the Commission use the same

[1] Nicor Gas Ex. 1.0, pp. 3-4.

[2] Nicor Gas Ex. 1.1, "Rider 17 Purchase of Receivables with Consolidated Billing (PORCB)".

weighted costs of debt and preferred stock it applies to rate base as a matter of convenience.

Rate of Return for PORCB Assets

Q. What is the Company's proposed rate of return for PORCB assets and cost recovery mechanism?

A. The Company states:

> As defined in Rider PORCB, CRCs [Capital Recovery Costs] are the revenue requirement necessary to recover the Company's investment in information technology systems necessary for the PORCB Program… Annually, CRCs will equal the five-year levelized revenue requirement sufficient to recover the return of and on the Company's investments…at an 8.09% rate of return as approved by the Commission in Nicor Gas' last rate case, Docket No. 08-0363.
>
> …Nicor Gas will apply a Capital Recovery Adjustment ("CRA") charge or credit to applicable Q-AGSs' monthly Supplier Aggregation Service bills to recover or refund any anticipated under-collected or over-collected CRCs received through application of the 0.5% portion of the Discount Factor.[3]

Q. Please describe the key characteristics that distinguish the risks inherent in the recovery of PORCB assets from the risks inherent in the investment in traditionally rate-based assets.

A. The Company's gas delivery services rates are based on a Commission-authorized revenue requirement, which includes a targeted, fair return on unrecovered investment. Nevertheless, the return on unrecovered investment is not guaranteed. The utility could earn more or less than the targeted, fair return

[3] Nicor Gas Ex. 1.0, pp. 9-11.

on investment depending upon the degree to which its actual revenues, expenses and investment differ from the levels composing its revenue requirement.

In contrast, the Company's proposed Rider 17 "provides the methodology and terms under which the Company is provided with full recovery of the costs it incurs to provide service under this Rider, including the costs of any uncollected receivables that may arise as a result of the purchase of Qualifying Receivables."[4] Towards that end, the Company proposes recovering the PORCB assets through a Capital Recovery Adjustment ("CRA") to the extent it does not initially recover those costs through the discount rate. The CRA includes a reconciliation component that would capture differences (either positive or negative) between the actual capital recovery cost revenue requirement for the reconciliation period and the amounts collected through the application of the 0.5% CRC component of the Discount Factor, plus amounts collected or refunded to Q-AGSs through the CRA during the prior reconciliation period.[5] That reconciliation, or "true-up," reduces risks associated with the PORCB assets relative to cost recovery through traditional rates. The rate of return investors require varies with risk; therefore, the PORCB assets require a lower rate of return than rate base assets.

[4] Nicor Gas Ex. 1.1, Ill. C. C. No. 16 – Gas, Original Sheet No. 75.9.3.

[5] Nicor Gas Ex. 1.0, p. 11.

Q. Does the Company's proposal include a prudence review of CRCs by the Commission?

A. Yes.[6] This risk factor is reflected in my rate of return recommendation.

Q. What cost of equity do you recommend for the Company's PORCB assets?

A. I recommend a 4.45% rate of return on common equity for PORCB assets, which represents a 321 basis point adjustment from the time horizon-adjusted rate of return on common equity the Commission authorized in the Company's last rate case, as shown in Schedule 3.01. The table below presents my rate of return recommendation for the Company's PORCB assets.

Company's Weighted Average Cost of Capital

for PORCB Assets[7]

Capital Component	Ratio	Cost	Weighted Cost
Short-Term Debt	10.02%	2.50%	0.25%
Long-Term Debt	38.80%	6.80%	2.64%
Preferred Stock	0.11%	4.77%	0.01%
Common Equity	51.07%	**4.45%**	2.27%
Total	100.00%		**5.17%**

Based on my calculation, the Company's estimated Capital Recovery Costs of $3.88 million,[8] and a 5.17% rate of return, would produce an annual levelized five-year revenue requirement of $841,849, as shown on Schedule 3.02.

[6] Company Response to ICC Staff Data Request RMP 1.07.

[7] Order on Rehearing, Docket No. 08-0363, October 7, 2009, Appendix A, p. 8 of 12, except for the cost of common equity, which was determined using the methodology shown on Schedule 3.01.

Q. How did you estimate the investor-required rate of return for PORCB assets?

A. The Company's authorized rate of return on rate base reflects the investor-required rate of return on equity into perpetuity. In contrast, the Company's proposal would amortize PORCB assets over five years. All else equal, assets with different lives have different required rates of return. Currently, the yields for five- and 30-year, A-rated corporate bonds are 2.01% and 4.52% respectively, which is a difference of 251 basis points.[9] This differential is a consequence of differences between five-year and 30-year expectations regarding the nominal risk-free rate and the risk premium, both of which are components of the required rate of return on common equity. Therefore, the common equity component of the interest rate should take the investment time horizon into account. Using the 251 basis point yield spread between five and 30-year A-rated corporate bonds as an estimate of the investment time horizon premium in common equity reduces the Company's proposed cost of equity from 10.17% to 7.66%.[10] This cost recovery period adjustment does not take into account any risk adjustment, such as that associated with the cost recovery rider's true-up mechanism.

Next, I adjusted the Company's authorized rate of return on rate base to reflect a 321 basis point adjustment that equals one-half the spread between the current

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[8] Nicor Gas Ex. 1.0, p. 13.

[9] Vanguard bond yields, http://personal.vanguard.com/us/FundsBondsMarketSummaryTable, February 13, 2013.

[10] Before it was acquired by AGL Resources, Nicor Gas was rated AA/A2 by Standard & Poor's/Moody's Investors Service.

interest rate for AAA-rated, five-year bonds (1.24%) and the Company's time horizon-adjusted, Commission-authorized cost of common equity (7.66%). I chose the midpoint between the 1.24% rate of return on AAA-rated, five-year bonds and the Company's authorized rate of return on common equity, adjusted for a five-year amortization period, because while it is clear that the risk of PORCB cost recovery falls between those two limits, determining the precise proportion of the difference between the AAA bond yield and the full, time horizon-adjusted cost of common equity that can be attributable to the risk of non-recovery of imprudent or unreasonably incurred costs is not possible. That is, rider recovery of PORCB assets effectively eliminates both regulatory lag and the risk of non-recovery of prudent and reasonable costs incurred in implementing the PORCB program; however, the prudency and reasonableness of PORCB assets is still subject to Commission review. Thus, there remains some degree of risk of non-recovery of costs.

Q. Please explain why you did not adjust the Company's cost of debt and preferred stock.

A. Estimating the Company's marginal cost of debt would be theoretically superior to using the embedded cost of long-term debt, but would necessitate removing from the Company's ratemaking capital structure the long-term debt used to fund PORCB assets. The estimated $3.88 million cost to implement the PORCB program is diminutive relative to the size of the Company's rate base assets, which total approximately $1.3 billion.[11] As such, removing the debt and preferred stock costs assigned to the PORCB assets would not materially affect the Company's rate of return on rate base. Therefore, I used the Company's capital structure, embedded costs of long-term debt, short-term debt and preferred stock, as approved in the Company's last rate case, Docket No. 08-0363, to calculate the weighted- average cost of capital for PORCB assets, which does not materially affect my recommendation.[12]

Q. What would be the effect of applying a carrying charge to unrecovered PORCB assets that equals the Company's rate of return on rate base?

A. Authorizing a rate of return for PORCB assets that exceeds the investor-required rate of return on PORCB assets would benefit the Company shareholders at the expense of Q-AGS (and ultimately their customers) because the portion of return that exceeds the investor-required rate of return would be collected from Q-AGS and passed through to Company investors.

Proposed Changes to Company's Rider 17

Q. Do you propose any revisions to the Company's proposed Rider 17 tariff language?

[11] Order on Rehearing, Docket No. 08-0363, October 7, 2009, Appendix A, page 1 of 12.

[12] *Id.*, page 8 of 12.

A. Yes. I propose the following revisions to Rider 17 PORCB (Nicor Gas Ex. 1.1), Ill. C. C. No. 16 – Gas, Original Sheet Nos. 75.9.3, 75.9.11 and 75.9.12, in order to reflect my rate of return recommendation for PORCB assets:

> …at a~~n~~ 5.17~~8.09~~% rate of return as approved in Docket No. 12-0569~~08-0363~~.

I also recommend the following revisions to Rider 17 PORCB (Nicor Gas Ex. 1.1) Ill. C. C. No. 16 – Gas, Original Sheet Nos. 75.9.3:

> **Discount Factor (DF)**
>
> A ~~Q-AGS~~ Discount Factor (DF) of 1.5% shall be applied to Qualifying Receivables (QR) purchased by the Company from the Q-AGS. The Discount Factor shall include~~s~~ .5% for Capital Recovery Costs until the end of the five-year recovery period. Thereafter, a Discount Factor of 1.0% shall be applied to Qualifying Receivables purchased by the Company from the Q-AGS.

The above revision recognizes that 0.5 percentage points of the 1.5% Q-AGS Discount Factor (DF) is designed to recover capital costs over a five-year period. After that recovery period ends, the 0.5 percentage points for Capital Recovery Costs should cease to be collected.

Conclusion

Q. Does this question conclude your direct testimony?

A. Yes, it does.

Northern Illinois Gas Company d/b/a Nicor Gas Company
Rate of Return on Common Equity (ROE) Summary

30-Year, A-Rated Corporate Bond Yield	4.52%
5-Year, A-Rated Corporate Bond Yield	2.01%
Time Horizon Adjustment =	2.51%
Return on Equity authorized in Docket No. 08-0363	10.17%
Less: Time-Horizon Adjustment	2.51%
Time-Horizon Adjusted ROE on Rate Base =	7.66%
5-Year, AAA-Rated Corporate Bond Yield =	1.24%
Midpoint of Time-Horizon Adjusted ROE for Rate Base Assets and 5-Yr., AAA-Rated Corporate Bond Yield =	4.45%
ROE Recommendation for PORCB Assets	**4.45%**

Sources:
Vanguard bond yields, http://personal.vanguard.com/us/FundsBondsMarket SummaryTable, 2/13/13.
Order on Rehearing, Docket No. 08-0363, 10/7/09, Appendix A, p. 8 of 12

Northern Illinois Gas Company d/b/a Nicor Gas Company
Five-Year Levelized Rate of Return Methodology

Year	Investment	Book Depreciation	Tax Depreciation	Accumulated Depreciation	Accumulated Deferred Income Tax	Year End Rate Base	Before Tax Return on Rate Base	Capital Revenue Requirement
1	$ 3,880,000	$ 776,000	$ 3,880,000	$ 776,000	$ 1,278,072	$ 1,825,928	$ 123,615	$ 899,615
2	3,880,000	776,000	-	1,552,000	958,554	1,369,446	92,711	868,711
3	3,880,000	776,000	-	2,328,000	639,036	912,964	61,808	837,808
4	3,880,000	776,000	-	3,104,000	319,518	456,482	30,904	806,904
5	3,880,000	776,000	-	3,880,000	-	-	-	776,000

Capital Component	Ratio	Cost	Weighted Cost	GRCF	Before Tax Cost of Capital
Short-Term Debt	10.02%	2.50%	0.25%	1.00	0.25%
Long-Term Debt	38.80%	6.80%	2.64%	1.00	2.64%
Preferred Stock	0.11%	4.77%	0.01%	1.70	0.02%
Common Equity	51.07%	**4.45%**	2.27%	1.70	3.86%
Total	100.00%		**5.17%**		**6.77%**

Year	Capital Revenue Requirement	Present Value Factor	Present Value of Cash Flow
1	$ 899,615	0.9366	$ 842,573
2	$ 868,711	0.8772	$ 762,038
3	$ 837,808	0.8216	$ 688,330
4	$ 806,904	0.7695	$ 620,905
5	$ 776,000	0.7207	$ 559,262
			$ 3,473,108

$ 841,849 = Annual Amount of Levelized Five-Year Revenue Requirement