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DIRECT TESTIMONY  
(PUBLIC VERSION)

of

MICHAEL McNALLY

Finance Department  
Financial Analysis Division  
Illinois Commerce Commission

The Southern Company, AGL Resources Inc., and Northern Illinois Gas Company d/b/a  
Nicor Gas Company

Joint Application for Approval of a Reorganization  
Pursuant to Section 7-204 of the Public Utilities Act

Docket No. 15-0558

February 3, 2016

1

**WITNESS IDENTIFICATION**

2 **Q1. Please state your name and business address.**

3 A1. My name is Michael McNally. My business address is 527 East Capitol Avenue,  
4 Springfield, IL 62701.

5 **Q2. By whom are you employed and in what capacity?**

6 A2. I am employed by the Illinois Commerce Commission (“ICC” or “Commission”) as  
7 a Senior Financial Analyst in the Finance Department of the Financial Analysis  
8 Division.

9 **Q3. Please describe your qualifications and background.**

10 A3. I received both a Bachelor of Arts degree in Economics and a Master of Business  
11 Administration degree with a concentration in Finance from the University of Illinois  
12 at Urbana-Champaign. I earned the Chartered Financial Analyst designation from  
13 the organization now known as the CFA Institute in 2003. I have been employed  
14 by the Commission since 1999 and have previously testified before the  
15 Commission on a variety of financial issues.

16 **Q4. Please state the purpose of your testimony in this proceeding.**

17 A4. The Southern Company (“Southern Company”), AGL Resources Inc. (“AGL  
18 Resources”), and Northern Illinois Gas Company d/b/a Nicor Gas Company (“Nicor  
19 Gas”) (collectively, the “Joint Applicants”) request approval of a reorganization  
20 under which Nicor Gas’s parent, AGL Resources, would become a wholly-owned  
21 subsidiary of Southern Company.

22 The purpose of my direct testimony is to present my evaluation of the financial  
23 implications of the proposed reorganization under Section 7-204(b)(4) of the Public  
24 Utilities Act (“Act”), which states that in reviewing any proposed reorganization, the  
25 Commission must find that “the proposed reorganization will not significantly impair  
26 the utility’s ability to raise necessary capital on reasonable terms or to maintain a  
27 reasonable capital structure.” 220 ILCS 5/7-204(b)(4).

28 I will also present my evaluation and recommendation regarding Nicor Gas’s post-  
29 merger capital structure as it relates to Section 6-103 of the Act. Section 6-103  
30 requires that in any reorganization of a public utility the Commission shall authorize  
31 the amount of capitalization, which shall not exceed the fair value of the property  
32 involved. 220 ILCS 5/6-103.

33 **Q5. Please describe the proposed reorganization.**

34 A5. Pursuant to the Agreement and Plan of Merger dated August 23, 2015, provided  
35 as Joint Applicants (“JA”) Ex. 1.1, Southern Company will acquire AGL Resources  
36 by purchasing its common stock for \$66 per share. (JA Ex. 1.0, 11.) Following the  
37 proposed reorganization, AGL Resources will become a wholly-owned, first-tier  
38 corporate subsidiary of Southern Company, and Nicor Gas a second-tier corporate  
39 subsidiary of Southern Company.

40 The estimated cost of the transaction is \$8 billion, which Southern Company plans  
41 to ultimately finance with a combination of approximately \$5 billion of new debt and  
42 \$3 billion of new equity. However, Southern Company plans to issue the equity  
43 gradually between the fourth quarter of 2015 and the end of 2019 through a  
44 combination of a continuous equity offer, or “dribble” program, and internal equity  
45 plans, including employee savings plans, a dividend reinvestment program, and

46 the exercise of employee stock options. Thus, Southern Company expects to have  
47 issued only approximately \$1 billion of new equity prior to the transaction closing.  
48 The remaining \$7 billion required to execute the transaction will be funded initially  
49 with new debt at the corporate level, which will weaken Southern Company's  
50 capital structure from 43% common equity and 57% debt and preferred securities  
51 as of September 30, 2015, to approximately \*\*\* BEGIN CONFIDENTIAL \*\*\* XXX  
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55 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX \*\*\* END CONFIDENTIAL \*\*\*. (JA Ex. 1.0,  
56 12; JA Resp. to Staff Data Requests ("DR") MGM 1.04, MGM 2.02, MGM 2.06.)

57 **Q6. Please summarize your findings and recommendations.**

58 A6. In my judgment, the Joint Applicants' proposal will satisfy Section 7-204(b)(4) of  
59 the Act. I also recommend a reporting requirement that would address the  
60 requirements of Section 6-103 the Act.

61 **SECTION 7-204(b)(4)**

62 **Q7. How does Nicor Gas currently obtain external equity and debt capital?**

63 A7. Currently, Nicor Gas obtains external equity capital through contributions from its  
64 parent company, AGL Resources. For debt capital, Nicor Gas issues its own long-  
65 term debt, historically as first mortgage bonds, and raises short-term debt through  
66 its commercial paper program, which is backed by a \$700 million revolving credit  
67 facility. (JA Resp. to Staff DR MGM 2.03.)

68 **Q8. How would Nicor Gas obtain external equity and debt capital following the**  
69 **proposed reorganization?**

70 A8. The Joint Applicants state that, at this time, they “do not anticipate any changes to  
71 the methods used by Nicor Gas to raise capital” as a result of the proposed  
72 transaction. (JA Resp. to Staff DR MGM 2.04.)

73 **Q9. Does Nicor Gas currently have access to the capital markets on reasonable**  
74 **terms?**

75 A9. Yes. Standard & Poor’s (“S&P”) has assigned Nicor Gas a corporate credit rating  
76 of BBB+. According to S&P, “an obligor rated ‘BBB’ has adequate capacity to meet  
77 its financial commitments. However, adverse economic conditions or changing  
78 circumstances are more likely to lead to a weakened capacity of the obligor to meet  
79 its financial commitments.” (Standard & Poor’s, “Standard & Poor’s Rating  
80 Definitions,” November 20, 2014.) Moody’s Investors Service (“Moody’s”) has  
81 assigned Nicor Gas an A2 issuer rating, which Moody’s considers upper-medium  
82 grade and subject to low credit risk. (Moody’s Investors Service, “Rating Symbols  
83 and Definitions,” February 2013.) In my opinion, a utility with a sound credit profile,  
84 such as indicated by Nicor Gas’s credit ratings, has access to the capital markets  
85 on reasonable terms.

86 **Q10. Does Southern Company have access to the capital markets on reasonable**  
87 **terms?**

88 A10. Yes. Like AGL Resources and Nicor Gas, Southern Company has reasonably  
89 strong corporate credit ratings – currently A– from S&P and Baa1 from Moody’s.  
90 According to S&P, “an obligor rated ‘A’ has strong capacity to meet its financial  
91 commitments but is somewhat more susceptible to the adverse effects of changes  
92 in circumstances and economic conditions than obligors in higher-rated

93 categories.” (Standard & Poor’s, “Standard & Poor’s Rating Definitions,”  
94 November 20, 2014.) According to Moody’s, “obligations rated Baa are judged to  
95 be medium-grade and subject to moderate credit risk and as such may possess  
96 certain speculative characteristics.” (Moody’s Investors Service, “Rating Symbols  
97 and Definitions,” February 2013.) As with Nicor Gas, it is my opinion that the sound  
98 credit profile indicated by Southern Company’s credit ratings indicates it has  
99 access to the capital markets on reasonable terms.

100 **Q11. How is the proposed reorganization expected to affect Nicor Gas’s credit**  
101 **ratings?**

102 A11. The Joint Applicants state that the “transaction will be seamless for Nicor Gas’s  
103 customers, as Nicor Gas will continue to serve its customers and will retain its own  
104 leadership and operating structure.” Further, the Joint Applicants do not expect  
105 the transaction to cause any material change in Nicor Gas’s debt-to-equity ratio or  
106 in how Nicor Gas uses debt and equity to support its investments and fund its  
107 operations. In fact, the Joint Applicants expect no changes to the forecasted  
108 financial statements for Nicor Gas as a result of the transaction. (JA Ex. 1.0, 3,  
109 12, 26; JA Resp. to Staff DR MGM 1.03.) Thus, any potential effect of the proposed  
110 reorganization on Nicor Gas’s credit ratings will likely be the result of Nicor Gas’s  
111 new affiliation with Southern Company rather than any changes at Nicor Gas, itself.

112 Nicor Gas’s affiliation with Southern Company is expected to have a slightly  
113 positive effect, if any, on Nicor Gas’s corporate credit ratings. Following the merger  
114 announcement in August 2015, S&P revised Nicor Gas’s credit outlook from stable  
115 to positive. Specifically, S&P, whose ratings generally reflect a group credit

116 profile,<sup>1</sup> states that its revised outlook reflects the potential for higher ratings by up  
117 to one notch as a result of AGL Resources's plan to merge with Southern Co.  
118 Further, S&P's discussion of the "downside scenario" for AGL Resources and its  
119 subsidiaries is limited to the possibility of reaffirming their current ratings.  
120 (Standard & Poor's, "Research Update: AGL Resources Inc. Ratings Affirmed,  
121 Outlook Revised To Positive On Merger With Southern Co.," August 24, 2015.)  
122 Moody's, whose ratings generally reflect a stand-alone credit profile, maintained  
123 Nicor Gas's stable outlook, which indicates a low likelihood of a rating change over  
124 the medium term. (Moody's Investors Service, "Rating Action: Moody's affirms  
125 AGL Capital and Nicor Gas; outlooks stable," August 24, 2015; Moody's Investors  
126 Service, "Rating Symbols and Definitions," February 2013.) Thus, neither S&P nor  
127 Moody's expects the proposed reorganization to have a deleterious effect on Nicor  
128 Gas's credit ratings.

129 **Q12. In your judgment, will the proposed reorganization significantly impair Nicor**  
130 **Gas's ability to raise necessary capital on reasonable terms?**

131 A12. No. As noted above, following the proposed reorganization, Nicor Gas is expected  
132 to maintain, or perhaps improve, its current credit ratings. In my opinion, utilities  
133 rated BBB+ or higher, as Nicor Gas is, have access to the capital markets on  
134 reasonable terms. As such, it is my judgment that the effect of the proposed  
135 reorganization on Nicor Gas's credit ratings will not significantly impair its ability to  
136 raise necessary capital on reasonable terms.

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<sup>1</sup> An S&P issuer credit rating reflects the influence a company's relationship with affiliates, such as a parent company, has on its stand-alone credit profile. Typically a company will be assigned the same issuer credit rating as its parent company, unless there are significant barriers limiting the rights and responsibilities of the parent and subsidiary for each other's resources and obligations.

137

**SECTION 6-103**

138 **Q13. What are the requirements of Section 6-103 of the Act?**

139 A13. Section 6-103 of the Act requires that in any reorganization, the Commission shall  
140 authorize the amount of capitalization of a public utility formed by a reorganization,  
141 which shall not exceed the fair value of the property involved. 220 ILCS 5/6-103.

142 **Q14. What effect would the proposed reorganization have on the capitalization of**  
143 **Nicor Gas?**

144 A14. As noted above, the Joint Applicants do not expect the transaction to cause any  
145 material change in Nicor Gas's debt-to-equity ratio, Nicor Gas's use of debt and  
146 equity to support its investments and fund its operations, or the forecasted financial  
147 statements for Nicor Gas. (JA Ex. 1.0, 12, 26; JA Resp. to Staff DR MGM 1.03.)  
148 However, following the proposed reorganization, the U.S. Securities and  
149 Exchange Commission ("SEC") may require fair value adjustments (also referred  
150 to as "purchase accounting" and "push down accounting" adjustments) to Nicor  
151 Gas's balance sheet. Thus, although the Joint Applicants do not expect push down  
152 accounting adjustments will be required, they will not know until after Nicor Gas  
153 files its first post-merger financial statements with the SEC. (JA Ex. 1.0, 27-28.)

154 **Q15. If there are purchase accounting adjustments to Nicor Gas's balance sheet**  
155 **following the proposed reorganization, would the proposed reorganization**  
156 **satisfy the requirement set forth in Section 6-103 of the Act?**

157 A15. If Nicor Gas's post-merger balance sheet reflects "push down" accounting  
158 adjustments, then Nicor Gas's capitalization would not equal original cost and the  
159 Commission would have to determine whether the post-merger capitalization of

160 Nicor Gas satisfies the requirements of Section 6-103 of the Act following the  
161 proposed reorganization.

162 **Q16. If there are no purchase accounting adjustments to Nicor Gas's balance**  
163 **sheet following the proposed reorganization, would the proposed**  
164 **reorganization satisfy the requirement set forth in Section 6-103 of the Act?**

165 A16. Yes. Absent purchase accounting adjustments, Nicor Gas's capitalization would  
166 equal original cost and, consequently, would satisfy the requirements set forth in  
167 Section 6-103 of the Act.

168 **Q17. How do you recommend the Joint Applicants notify the Commission of Nicor**  
169 **Gas's post-merger capitalization?**

170 A17. I recommend the Commission require the Joint Applicants to make the filings  
171 described on page six of Staff witness Tolsdorf's direct testimony (Staff Ex. 4.0).  
172 No further action would be required with regard to this recommendation if Nicor  
173 Gas's post-merger capital structure does not involve any push down accounting  
174 adjustments. On the other hand, if there are push down accounting adjustments  
175 to Nicor Gas's balance sheet, then the Commission should also require Nicor Gas  
176 to file a petition seeking Commission approval of the fair value studies and  
177 resulting capital structure for Nicor Gas pursuant to Section 6-103 of the Act.

178 **CONCLUSION**

179 **Q18. Please summarize your conclusions.**

180 A18. In my judgment, the proposed reorganization will satisfy the requirements set forth  
181 in Section 7-204(b)(4) of the Act.

182 Further, for compliance with Section 6-103 of the Act, I recommend the  
183 Commission condition its approval of the proposed reorganization on Staff witness  
184 Tolsdorf's proposed reporting requirement regarding Nicor Gas's post-merger  
185 capitalization, as discussed above.

186 **Q19. Do you have any further recommendations?**

187 A19. Yes. I recommend that the Joint Applicants provide a list of all conditions to which  
188 they agree, similar to the list presented in Joint Applicants Ex. 1.2, which the Joint  
189 Applicants should update at each stage of the proceeding.

190 **Q20. Does this conclude your direct testimony?**

191 A20. Yes, it does.