STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

CEDAR BLUFF UTILITIES, INC.	)	Docket No. 03-0398
	)	
APPLE CANYON UTILITY COMPANY	)	Docket No. 03-0399
	)	
CHARMAR WATER COMPANY	)	Docket No. 03-0400
	)	
CHERRY HILL WATER COMPANY	)	Docket No. 03-0401
	)	
NORTHERN HILLS WATER & SEWER COMPANY	)	Docket No. 03-0402
	)	
	)	
Proposed General Increase in Rates	)	*Consolidated*
	)	

DRAFT ORDER

By the Commission:

I. PROCEDURAL HISTORY

On May 2, 2003 and on May 20, 2003, five subsidiaries of Utilities, Inc. ("UI"), Cedar Bluff Utilities, Inc. ("Cedar Bluff"), Apple Canyon Utility Company ("Apple Canyon"), Charmar Water Company ("Charmar"), Cherry Hill Water Company ("Cherry Hill"), and Northern Hills Water & Sewer Company ("Northern Hills," collectively, the "Companies") filed revised tariff sheets and accompanying testimony with the Chief Clerk of the Illinois Commerce Commission (the "Commission") seeking a general increase in water and/or sewer rates.

Pursuant to proper notice, a Prehearing Conference was held in this matter before a duly authorized Administrative Law Judge of the Commission in Chicago, Illinois on July 14, 2003. At the Prehearing Conference, the Judge set a schedule which provided for the filing of Staff direct testimony, the Companies' rebuttal testimony, Staff rebuttal and the Companies' surrebuttal testimonies as well as hearings and Initial and Reply Briefs. On October 9, 2003, the Judge granted Staff's motion to consolidate the rate cases, as all the Companies are owned by UI and the proceedings primarily presented issues that were common to all the Companies. Evidentiary hearings were held at the Commission's Chicago offices on November 18, 2003. Appearances were entered on behalf of UI and Staff. Kristen Weeks and Steve Lubertozzi provided testimony on behalf of UI. Leslie Pugh, Dianna Hathhorn, Michael McNally, Cheri L. Harden, William Johnson, Peter Lazare, and William Marr provided testimony on behalf of Staff. At the conclusion of the November 18, 2003 hearing, the record was marked "Heard and Taken."

II. SERVICE AREA AND NATURE OF OPERATIONS

The Companies are wholly owned subsidiaries of UI, and together provide water and/or sewer service to approximately 1,500 customers in various Illinois counties. Apple Canyon also provides water availability to another approximately 1,500 users. UI owns and operates approximately 81 water and/or wastewater systems in 17 different States. Water Service Corporation ("WSC") manages the operations for all of UI's water and sewer systems, including the Companies' water and sewer systems. WSC provides management, administration, engineering, accounting, billing, data processing, and regulatory services for the utility systems. WSC's expenses are assigned directly to an operating utility or allocated to one or more of the various operating utilities pursuant to a formula that has been approved by this Commission.

III. SUMMARY OF PROPOSED RATE INCREASE

The Companies assert that the proposed rate increases are necessary to permit them to recover their operating expenses and to permit them to earn a fair rate of return on their capital investments. The following is a summary of the proposed rate base and operating incomes for each of the five Companies.

[FINAL SCHEDULES FOR RATE BASE AND OPERATING REVENUE, EXPENSES AND INCOME WILL DEPEND ON THE JUDGE'S FINAL RULING. THESE SCHEDULES WILL BE INCLUDED AS APPENDIX A]

A. Cedar Bluff

Rate Base: [DEPENDENT ON JUDGE'S FINAL RULING]
Operating Revenue: [DEPENDENT ON JUDGE'S FINAL RULING]
Operating Expense: [DEPENDENT ON JUDGE'S FINAL RULING]
Net Operating Income: [DEPENDENT ON JUDGE'S FINAL RULING]
Revenue Change: [DEPENDENT ON JUDGE'S FINAL RULING] (__%)

B. Apple Canyon

Rate Base: [DEPENDENT ON JUDGE'S FINAL RULING]
Operating Revenue: [DEPENDENT ON JUDGE'S FINAL RULING]
Operating Expense: [DEPENDENT ON JUDGE'S FINAL RULING]
Net Operating Income: [DEPENDENT ON JUDGE'S FINAL RULING]
Revenue Change: [DEPENDENT ON JUDGE'S FINAL RULING] (__%)

C. Charmar

Rate Base: [DEPENDENT ON JUDGE'S FINAL RULING]
Operating Revenue: [DEPENDENT ON JUDGE'S FINAL RULING]
Operating Expense: [DEPENDENT ON JUDGE'S FINAL RULING]
Net Operating Income: [DEPENDENT ON JUDGE'S FINAL RULING]
Revenue Change: [DEPENDENT ON JUDGE'S FINAL RULING] (__%)

D. Cherry Hill

Rate Base: [DEPENDENT ON JUDGE'S FINAL RULING]
Operating Revenue: [DEPENDENT ON JUDGE'S FINAL RULING]
Operating Expense: [DEPENDENT ON JUDGE'S FINAL RULING]
Net Operating Income: [DEPENDENT ON JUDGE'S FINAL RULING]
Revenue Change: [DEPENDENT ON JUDGE'S FINAL RULING] (__%)

E. Northern Hills - Sewer

Rate Base: [DEPENDENT ON JUDGE'S FINAL RULING]
Operating Revenue: [DEPENDENT ON JUDGE'S FINAL RULING]
Operating Expense: [DEPENDENT ON JUDGE'S FINAL RULING]
Net Operating Income: [DEPENDENT ON JUDGE'S FINAL RULING]
Revenue Change: [DEPENDENT ON JUDGE'S FINAL RULING] (__%)

F. Northern Hills - Water

Rate Base: [DEPENDENT ON JUDGE'S FINAL RULING]
Operating Revenue: [DEPENDENT ON JUDGE'S FINAL RULING]
Operating Expense: [DEPENDENT ON JUDGE'S FINAL RULING]
Net Operating Income: [DEPENDENT ON JUDGE'S FINAL RULING]
Revenue Change: [DEPENDENT ON JUDGE'S FINAL RULING] (__%)

IV. RATE BASE

In their testimony, the Companies presented evidence showing their original cost rate base after pro forma adjustments for the test year ending December 31, 2002. Staff proposed various adjustments to the Companies' pro forma rate base. Staff's adjustments are summarized in the sections below.

A. Adjustment for Pre-1971 Investment Tax Credits

Staff proposed an adjustment to rate base to disallow the unamortized balance from pre-1971 investment tax credits (“ITCs”). (Staff Group Ex. 1.0). This adjustment decreased rate base for Apple Canyon. The pre-1971 ITCs were removed from rate base because these amounts represent funds not provided by investors, and are a source of cost-free capital to the Companies. UI did not contest the adjustment.

B. Adjustment to Accumulated Deferred Income Taxes

Staff proposed adjustments to rate base to correct the presentation of deferred state income taxes. (Staff Group Ex. 1.0). These adjustments decreased rate base for Northern Hills. UI did not contest the adjustment.

C. Adjustment to Cash Working Capital

Staff proposed adjustments to cash working capital for the removal of real estate taxes and to incorporate the effects of other Staff-proposed adjustments. (Staff Group Ex. 2.0). These adjustments decrease Cash Working Capital for all the operating companies. UI did not contest, for the purposes of this proceeding, the cash working capital methodology or the adjustments. Cash Working Capital has been updated in Appendix A to the Order, based on the final Commission approved revenue requirements.

D. Adjustment to Plant for Unsubstantiated Additions and Retirements

Staff proposed adjustments to reduce the test year plant amount by additions and retirements that could not be verified. (Staff Group Ex. 2.0). These adjustments decrease plant for Cedar Bluff, Apple Canyon and Charmar. Cedar Bluff's test year plant was reduced by the amount of additions and retirements for which it could not provide any supporting documentation. Both Apple Canyon's and Charmar's test year plant were reduced by the amounts of additions for which the Companies could not provide any supporting documentation. Corresponding adjustments to accumulated depreciation, depreciation expense, and accumulated deferred income taxes were made. UI did not contest the adjustments.

E. Adjustment to Contributions in Aid of Construction

Staff proposed adjustments to Contributions in Aid of Construction ("CIAC") to comply with Accounting Instruction 39 in the Uniform System of Accounts for Water Utilities Operating in Illinois. (Staff Group Ex. 2.0). These adjustments increased Accumulated Depreciation and Accumulated Amortization of CIAC for Cedar Bluff, Apple Canyon, and Charmar. A one-time "transition," adjustment to implement Accounting Instruction 39 should be recorded for any depreciation on contributed plant not recorded in prior years, and for any impairment of CIAC not previously recognized. UI began recording amortization of CIAC in 1994. The Cedar Bluff adjustment records the proper accumulated amortization of CIAC for the period of 1976-1994. The Apple Canyon adjustment records the proper accumulated amortization of CIAC for the period of 1992-1994. The Charmar adjustment records the proper accumulated amortization of CIAC for the period 1990-1994. UI did not contest the adjustments.

F. Adjustment to Include Customer Advances

Staff proposed adjustments to include Customer Advances to reflect the amount on Cedar Bluff's trial balance and Apple Canyon's general ledger. (Staff Group Ex. 2.0). These adjustments reduce rate base for Cedar Bluff and Apple Canyon. Because the utility plant constructed with these funds is not financed by debt or equity, ratepayers should not be obligated to pay a return on these plant investments. The Customer Advances balance still has a refund obligation. UI did not contest the adjustments.

G. Adjustment to WSC for Correction of Error

Staff proposed an adjustment to correct an error on Schedule C of the Companies's initial filing. (Staff Group Ex. 2.0). This adjustment increases Cedar Bluff's rate base by the amount of the error. UI did not contest the adjustment.

H. Adjustment to Plant for Plant Held for Future Use

Staff proposed an adjustment to plant for plant held for future use. (Staff Group Ex. 2.0). This adjustment reduces rate base for Apple Canyon. Apple Canyon has no imminent use or plans for use of this particular property. This property has already been included in Apple Canyon's rate base for more than ten years and Apple Canyon has already earned a return on it for that period of time. UI did not contest the adjustment.

I. Adjustment to Incorporate Previous Order Adjustments

Staff proposed adjustments to incorporate previous order adjustments. (Staff Group Ex. 2.0). These adjustments reduce rate base for Apple Canyon and Charmar. The adjustments incorporate adjustments that UI never made from Apple Canyon's prior order Docket No. 90-0475/92-0401 and Charmar's short form filing with a test year ending December 31, 1989. UI did not contest the adjustments.

J. Adjustment to Plant for Pro Forma Plant Adjustment

Staff proposed an adjustment to reduce pro forma plant to reflect the actual cost to complete the project. (Staff Group Ex. 2.0). This adjustment reduces rate base for Apple Canyon. The adjustment reduces rate base to reflect the actual cost of the project that was completed under budget. UI did not contest the adjustment.

K. Adjustment to Deferred Charges – Tank Maintenance

Staff proposed adjustments to include deferred tank maintenance charges. (Staff Group Ex. 2.0). These adjustments increase rate base for Apple Canyon and Cherry Hill. UI did not contest the adjustments.

L. Adjustment to Plant Acquisition Adjustment

Staff witness Pugh proposed adjustments to remove acquisition adjustments from rate base. (Staff Group Ex. 2.0). These adjustments decrease rate base for both water and sewer operations for Northern Hills. UI did not contest the adjustments.

V. OPERATING REVENUES, EXPENSES AND OPERATING INCOME

In their testimony, the Companies presented evidence showing their pro forma operating revenues, expenses and income for the test year ending December 31, 2002. Staff proposed various adjustments to the Companies' pro forma operating statements. Staff's adjustments are summarized in the sections below.

A. Adjustment for Add-On Taxes

Staff proposed adjustments to disallow public utility taxes at present rates. (Staff Group Ex. 1.0). These adjustments decreased taxes other than income for all of the Companies. The gross revenues taxes were removed because they are an add-on charge to customers' bills, are not an actual operating expense of the utility, and therefore, should not be a part of tariffed rates. UI did not contest the adjustments.

B. Adjustment to Non-Health Insurance Expense

Staff proposed adjustments to disallow amounts from the Companies' pro forma increase to insurance expense for amounts that are not known and measurable. (Staff Group Ex. 1.0). These adjustments decreased general expenses for all of the Companies. Staff's adjustment used actual 2003 rates for auto, property, and worker's compensation premiums to determine the proper increase to the test-period, rather than the Companies' estimated 2004 rates. UI accepted the adjustments.

C. Adjustment to Income Taxes

Staff proposed adjustments to state and federal income tax expense in the test year based on the use of a unitary state income tax rate. (Staff Group Ex. 1.0). These adjustments decreased state and federal income taxes for Apple Canyon, Cherry Hill, and Northern Hills' sewer operations. Adjustments to state and federal income taxes for Cedar Bluff, Charmar, and Northern Hills' water operations included both increases and decreases. Use of a unitary tax rate is appropriate since the Companies pays its Illinois state income tax as a member of a unitary business group. UI did not contest the adjustments.

D. Adjustment to Health Insurance Expense

Staff proposed adjustments to operating expense to calculate pro forma health insurance expense using June 30, 2003 data. (Staff Group Ex. 1.0). The Companies updated their pro forma health insurance expense adjustment through August 31, 2003 data in rebuttal testimony. (UI Ex. 1-R & 2-R). These adjustments decreased general expenses for all of the operating companies. Staff accepted the Companies' updated adjustments.

E. Adjustment to Monthly Billing Expense/ Adjustment to Remove Monthly Billing Expense

Staff proposed adjustments to operating expense to reflect updated costs for the Companies' change to monthly billing. (Staff Group Ex. 1.0). In rebuttal testimony, the Companies stated they no longer intended to change to monthly billing. (UI Ex. 1-R and 2-R). Therefore, Staff removed all the expenses the Companies included for monthly billing. (Staff Ex. 7.0, Schedules 7-9). These adjustments decreased general and maintenance expenses for Cedar Bluff, Apple Canyon, Charmar, and Cherry Hill.

F. Adjustment for New IEPA Fee

Staff proposed adjustments to increase taxes other than income taxes for a new Illinois Environmental Protection Agency fee for sewer companies. (ICC Staff Exhibit 7.0, p. 8). These adjustments increased taxes other than income taxes for Cedar Bluff and Northern Hills' sewer operations. The new National Pollution Discharge Elimination System Permit Fee was effective as of July 1, 2003 and will be assessed annually. UI did not contest the adjustments.

G. Adjustment to Normalize Maintenance Expense

Staff proposed an adjustment to operating expense to normalize the test year amount of certain maintenance expenses. (Staff Group Ex. 1.0). This adjustment decreased maintenance expense for Apple Canyon. UI did not contest the adjustment.

H. Adjustment to Deferred State Income Taxes

Staff proposed an adjustment to operating expense to correct the presentation of deferred state income taxes. (Staff Group Ex. 1.0). This adjustment decreased deferred state income tax expense for Cherry Hill. UI did not contest the adjustment.

I. Adjustment to Rate Case Expense

[THIS IS A CONTESTED ISSUE. THE PARTIES WILL INDIVIDUALLY SUBMIT PROPOSED ORDER LANGUAGE WITH THEIR REPLY BRIEFS.]

THE FOLLOWING IS UI'S RECOMMENDED LANGUAGE:

Staff proposed to amortize the Companies' rate case expenses over a five-year period, rather than three years as proposed by UI. Staff argued that its practice is to base rate case amortization on the time elapsed since a company's previous rate case filing, and the time elapsed since the Companies last applied for a rate increase, although varying substantially between the five, was too long to justify a three-year amortization period. (Staff Br. at 12).

UI pointed out however, that the Commission recently approved a three-year amortization period for UI subsidiary Del Mar Water Company in Docket No. 02-0592, despite the fact that Del Mar's last rate increase had been approved in Docket 98-0046, a period between filings of more than three years. The Commission also approved a three-year amortization of rate case expense for UI subsidiary Lake Wildwood Utilities in Docket No. 01-0663.

The Companies further argued that there is no requirement that the Commission reject a three-year amortization period just because a company's previous rate case was filed more than three years ago. The Companies also pointed out that, given the rapid recent increase in certain expenses, such as health insurance expense, UI

expects to be filing for a rate increase prior to the completion of a five-year amortization period.

Staff argued its position was not inconsistent with prior Commission decisions, and that the Commission has not pre-determined a three-year amortization period for all UI rate cases. Staff further stated that since it considers historical records are a better gauge of future filings than company expectations, the Commission's practice should be to determine the amortization period based upon the length of time between prior rate case filings for each utility

Staff also pointed out that the Commission's current practice of allowing a utility to include any unamortized rate case expense from its prior rate case as a component of rate case expense to be amortized in the next rate case. However, UI pointed out that in such a case it could be eight years or more before the full amount of the rate case expense for the Companies' current rate case is recovered.

The Commission determined that given its practice of granting a three-year amortization period for rate case expense for other UI subsidiaries, and UI's expressed desire to file rate cases for the Companies on a three to four year cycle, it is reasonable for rate case expense to be amortized over a three-year period.

J. Adjustment to Amortize Insurance Claim Expense

[THIS IS A CONTESTED ISSUE. THE PARTIES WILL INDIVIDUALLY SUBMIT PROPOSED ORDER LANGUAGE WITH THEIR REPLY BRIEFS.]

THE FOLLOWING IS UI'S RECOMMENDED LANGUAGE:

For Cedar Bluff only, Staff disallowed $4,478 in operating expenses to amortize Cedar Bluff's insurance claim expense over a five year period. (Staff Ex. 7.0, p. 7). The claim was the result of a sewer back-up that caused damage to the property of three people. (Staff Group Ex. 1.0; Tr. pp. 69-70). Staff reviewed insurance claim expense for Cedar Bluff for the period 1998 to 2001. Staff argued that this was a unique expense not present in the previous five years and was not representative of the Companies' normal, expected, recurring level of expenditures for the period in which rates will be in effect. (Staff Ex. 7.0, p. 7). Therefore, Staff reasoned, the expense should be amortized.

UI argued that Staff failed to consider operations and maintenance ("0 & M") expenses as a whole over the five year period from 1998 through 2002, and instead only looks at the individual insurance claim expense in isolation. The 2002 annual report 0 & M expenses for Cedar Bluffs, $36,571, are comparable to the five-year average of 0 & M expenses, $36,261. (UI Ex. 2-SR at KEW Ex. 1). Thus UI asserts that Cedar Bluff's total 0 & M expense for the test year is consistent with past years and failure to include the entire insurance claim would result in an underrecovery of expenses in the test year.

Staff points out that it performed a detailed variance analysis of the test year O & M, and inquired about significant changes. Staff also states that it investigated and proposed increases as well as decreases to test year O & M in this case. However, UI argues that Staff did not apply the backward looking analysis of insurance claim expense consistently to other components of Cedar Bluff's 0 & M expense. For example, Staff conceded that they did not make any positive adjustment to rate base for a significant decrease in another individual 0 & M expense account. (Tr. at 62-64).

The Commission determined that Staff cannot evaluate and amortize a single component of 0 & M expense without applying that same type of analysis to all the other individual components of 0 & M expense. Staff must either provide a historical analysis of each component of Cedar Bluff's 0 & M expense, and make the resulting adjustments, or Staff must include the entire amount of the insurance claim in the 0 & M expense for the test year.]

VI. COST OF CAPITAL/RATE OF RETURN

Two witnesses submitted testimony regarding the Companies' cost of capital. Ms. Kirsten E. Weeks presented the Companies' proposed capital structures and weighted average costs of capital ("WACC"). (UI Ex. 2). Mr. Michael McNally presented Staff's analysis of the Companies' capital structures and WACC. (Staff Group Ex. 4.0). Each of the Companies is a 100% equity financed, wholly-owned subsidiary of UI. Therefore, both parties used UI's capital structure and WACC to represent the capital structure and WACC of each of the Companies. UI accepted Staff's analysis regarding the overall cost of capital for the Companies.

A. Capital Structure

The Companies proposed using a December 31, 2002 capital structure, comprising 59.76% long-term debt and 40.24% common equity. (UI Ex. 2). Staff's capital structure proposal incorporates the same equity balance as the capital structure proposed by the Companies. However, Staff made two adjustments to UI's long-term debt balance. First, Staff included current maturities in the calculation of the face amount outstanding. Second, they used the "carrying value" of UI's outstanding long-term debt for the long-term debt balance. Those adjustments produced a capital structure comprising 59.79% long-term debt and 40.21% common equity. (Staff Group Ex. 4.0, pp. 3-8).

B. Cost of Long-Term Debt

The Companies proposed a 7.24% cost of long-term debt in its initial filing. (UI Ex. 2). Staff made two adjustments to the Companies' proposed cost of long-term debt. First, the coupon interest expense for the four outstanding promissory notes was adjusted to reflect their interest rates multiplied by their respective face amounts outstanding. Second, the annual amortization of debt expense was adjusted to reflect straight-line amortization of each issue's December 31, 2002 unamortized debt expense

balance over its remaining life. Those adjustments resulted in a 7.50% cost of long-term debt. (Staff Group Ex. 4.0, p. 9).

C. Cost of Common Equity

The Companies proposed that the 10.02% cost of equity authorized in UI's last case, ICC Docket No. 02-0592, provides a reasonable risk premium relative to their estimate of the Companies' embedded cost of debt and to the April 15, 2003 yield on 30-year U.S. Treasury Bonds. Thus, the Companies' testimony adopted a 10.02% cost of equity. (UI Ex. 2.0).

Staff witness Michael McNally estimated the cost of common equity for UI with DCF and risk premium models. DCF and risk premium models cannot be applied directly to UI because its common stock is not market-traded. Therefore, Mr. McNally applied those models to two samples. (Staff Group Ex. 4.0, pp. 9-10). The first sample comprises nine domestic electric and natural gas distribution utilities selected from the *Standard & Poor's Utility Compustat II* database that had S&P credit ratings of BBB to A ("Utility Sample"). The second sample consists of seven domestic water companies for which sufficient data was available to conduct DCF and risk premium analysis and that were not being acquired by another company ("Water Sample").

DCF analysis assumes that the market value of common stock equals the present value of the expected stream of future dividend payments. The companies in both of Mr. McNally's proxy samples pay dividends quarterly. Therefore, Mr. McNally applied a constant-growth quarterly DCF model. Mr. McNally measured the market-consensus expected growth rates with projections published by IBES and Zacks. The growth rate estimates were combined with the closing stock prices and dividend data as of August 20, 2003. Based on this growth, stock price, and dividend data, Mr. McNally's DCF estimates of the cost of common equity were 9.68% for the Utility Sample and 10.02% for the Water Sample. (Staff Group Ex. 4.0, p. 14).

In a risk premium analysis, the required rate of return for a given security equals the risk-free rate of return plus a risk premium associated with that security. The risk premium methodology is consistent with the theory that investors are risk-averse. Mr. McNally used a one-factor risk premium model, the Capital Asset Pricing Model ("CAPM"), to estimate the cost of common equity. In the CAPM, the risk factor is market risk, which cannot be eliminated through portfolio diversification. (Staff Group Ex. 4.0, pp. 15-25). The CAPM requires the estimation of three parameters: beta, the risk-free rate, and the required rate of return on the market. First, Mr. McNally developed two distinct sample average betas for each of his samples, one based on the Value Line methodology and the other based on the Merrill Lynch methodology, with the following substitutions made to the latter: (1) total excess return data was substituted for the total price change data that the Merrill Lynch methodology uses and (2) the NYSE Composite Index was substituted for the S&P500 Index as a proxy for the market return. The average beta estimate for the Utility Sample was 0.57, while the average beta estimate for the Water Sample was 0.50. (Staff Group Ex. 4.0, pp. 21-24). Second, Mr. McNally considered two current estimates of the risk-free rate of return: the 0.96% yield

on three-month U.S. Treasury bills and the 5.48% yield on thirty-year U.S. Treasury bonds. Both estimates were measured as of August 20, 2003. Forecasts of long-term inflation and the real risk-free rate suggest that the long-term risk-free rate is between 5.7% and 6.2%. Thus, Mr. McNally concluded that the U.S. T-bond yield is currently the superior proxy for the long-term risk-free rate. (Staff Group Ex. 4.0, pp. 19-20). Finally, to measure the expected rate of return on the market, Mr. McNally conducted a DCF analysis on the firms composing the S&P 500 Index. That analysis estimated that the expected rate of return on the market equals 13.66%. (Staff Group Ex. 4.0, p. 21). Inputting those three parameters into the CAPM, Mr. McNally calculated cost of common equity estimates of 10.14% for the Utility Sample and 9.57% for the Water Sample. (Staff Group Ex. 4.0, p. 25).

The average of Mr. McNally's DCF and risk premium estimates for the Utility Sample and the Water Sample produced a preliminary cost of equity estimate of 9.85%. To determine the suitability of that cost of equity estimate for UI, Mr. McNally compared the financial ratios that S&P uses in its analysis of investor-owned utilities (collectively, the "S&P Benchmark Ratios") for his two samples to those of UI to assess their relative risk levels. The S&P Benchmark Ratios indicate that UI is slightly riskier than the proxy samples. Thus, Mr. McNally adjusted the 9.85% cost of equity estimate for the two samples upward by 12 basis points to reflect the difference in risk between UI and the proxy samples, which produced a final cost of equity estimate of 9.97% for UI. (Staff Group Ex. 4.0, pp. 26-27).

Mr. McNally testified that a thorough cost of common equity analysis requires both the application of financial models and the analyst's informed judgment. Therefore, Mr. McNally compared the 9.97% cost of equity estimate to the concurrent 6.69% yield on BBB-rated long-term utility bonds. In addition, Mr. McNally determined that the pre-tax interest coverage ratio of 2.38x resulting from his cost of capital recommendation is within the S&P pre-tax interest coverage ratio target range of 1.8x to 2.8x for a BBB credit rating for a utility with a business profile score of 3. Based on those analyses, Mr. McNally concluded that the required rate of return on common equity for UI equals 9.97%. (Staff Group Ex. 4.0, p. 25).

D. Recommendation

Staff's capital structure and capital component cost recommendations produce an overall cost of capital of 8.49%. The Companies did not contest Mr. McNally's cost of capital recommendations. The agreed upon capital structure and WACC is presented below:

Capital Component	Amount	Percent of Total Capital	Cost	Weighted Cost
Long Term Debt	$115,472,241	59.79%	7.5%	4.49%
Common Equity	$77,650,144	40.21%	9.97%	4.01%
Total Capital	$193,122,385	100.00%		
Total Weighted Average Cost of Capital				**8.49%**

VII. RATE DESIGN

The Companies have presented their proposed rates and Staff has accepted some proposals but proposed changes in other areas. The Companies have accepted Staff's revisions on rate design matters. Staff's proposals include across-the-board increases for base rates as well as selected increases for miscellaneous charges. (Staff Group Ex. 13 p. 9 (Cherry Hill); p. 10 (Northern Hills); Staff Group Ex. 12.0 pp. 5 & 10 (Apple Canyon); Staff Group Ex. 5.0 pp. 10-11 (Charmar); Staff Group Ex. 5.0 pp. 6-7 (Cedar Bluff)). Detailed rate design analyses and bill comparisons are set forth in Appendix C.

A. Base Rates

Staff advocates across-the-board increases as the only reasonable approach for base rates, even though the across-the-board approach diverges from the standard Commission policy of basing rates on costs. Staff did not recommend a cost-based approach because Staff believed the information provided by the Companies was not sufficient to run its cost-of-service study. Thus, Staff argued, it was necessary to diverge from cost-based rates in favor of across-the-board increases on individual rate elements. The Companies argued that their cost data was adequate but agreed that across-the-board increases were appropriate.

B. Miscellaneous Charges

Each of the Companies developed a set of proposals for miscellaneous charges. Staff reviewed the proposed charges and developed a reasonable set of miscellaneous charges. A summary of these charges is presented below.

1. Late Payment Fees

Staff made an adjustment to Late Payment Fees for Apple Canyon, Charmar, and Cedar Bluff. (Staff Group Ex. 12.0, p. 5; Staff Group Ex. 5.0, p. 6; Staff Ex. 9.0, p. 4). Staff's position was that Late Payment Fees are 1 ½% of a customer's bill, therefore if the Companies' rates increase, Late Payment Charge revenues should also increase. Staff adjusted the Late Payment Fees to reflect approximately the same number of customers paying their bills after the due date, but at Staff's proposed rates. (Staff Group Ex. 12.0, p. 5). UI did not object to this change.

2. Outside Meter Reader Charge

Apple Canyon proposed a new $40 Outside Meter Reader Charge for any current or new customer who requests that an outside meter reader be installed. (ILL.C.C. No. 1, Fourth Revised Sheet No. 1.1). Staff agreed with the proposed $40 Outside Meter Reader Charge. Staff recognized that there must be a cost involved with the outside meter reader, and currently a $40 charge for outside meter reading is used by Northern Hills. The $40 cost for an outside meter reader for Northern Hills was approved by the Commission in Docket No. 98-0045.

3. Non-sufficient Funds Check Charge

Staff proposed increasing the NSF Check Charge to $10 from current levels for Cedar Bluff, Apple Canyon, Charmar, and Cherry Hill in order to provide consistency with other UI companies and because Staff and the Companies recognize that there has been inflation since previous NSF Check Charges were put into effect. (Staff Group Ex. 12.0, p. 16). Staff's proposed charge is consistent with the $10 NSF Check Charge currently in effect for Northern Hills, which was approved by the Commission in Docket No. 98-0045. The Companies did not object to Staff's proposal.

4. New Customer Charge

Staff proposed increasing the New Customer Charge for Cedar Bluff and Charmar up to $15, from the current $12, for consistency with other UI companies and because Staff and the Companies recognize that there has been inflation since the $12 New Customer Charge was put into effect. (Staff Group Ex. 5.0, p. 12). The Companies did not object to Staff's proposal.

5. "Redistribution": Apple Canyon Utility Company

Apple Canyon proposed adding what it terms a "Redistribution" section on its tariffs (ILL.C.C. No. 1, Fourth Revised Sheet No. 1.1). Staff did not agree with the proposed language (Staff Group Ex. 12.0, (Apple Canyon) p. 14 Staff Ex. 9.0, p. 5). Staff argued that the language implied that water service is provided through a single meter, and that one bill is sent to the owner and therefore one customer charge is applied. Staff questioned why the customer charge should be multiplied by the number of dwelling units if one bill is sent. The Company incurs no additional costs since only one bill is sent, one meter is installed, and only one service line is installed. (Staff Group Ex. 12.0, (Apple Canyon) p. 14). The Company accepted Staff's position.

VIII. MISCELLANEOUS ISSUES

In the course of these proceedings, Staff and the Companies raised several additional miscellaneous issues.

A. Continuing Property Records

[THIS IS A CONTESTED ISSUE. THE PARTIES WILL INDIVIDUALLY SUBMIT PROPOSED ORDER LANGUAGE WITH THEIR REPLY BRIEFS.]

THE FOLLOWING IS UI'S RECOMMENDED LANGUAGE:

Staff asserted that UI is not maintaining proper Continuing Property Records ("CPRs") as required by section 605 of the Commission's rules, 83 Ill. Admin Code 605.10, and recommended that UI change its recordkeeping procedures. (Tr. p 79). UI, however, argued that its current records systems, consisting of a general ledger and supporting invoices, is sufficient to meet section 605's requirements. Furthermore, UI asserted that there is no additional information another form of CPR could provide that is required by the rule but is not already present in UI's existing ledger and invoice system. (UI Ex. 1-SR, p. 3). Beyond general references to section 605, and National Association of Regulatory Utility Commissioners ("NARUC") ratemaking principles, UI believes Staff has not specifically identified those areas where UI's general ledger and invoice system do not meet Commission requirements. (Tr. at 79–82; Staff Ex. 6.0 (Pugh Rebuttal) at8-10). UI asserted that Staff fails to describe any specific area where UI's existing records do not meet the requirements of Instruction 28 of the Uniform System of Accounts for Water Utilities, as adopted by section 605. 83 IAC 605.10.

Staff also argued that the Commission's Order in Apple Canyon Utility Company, et. al., Docket No. 94–0157, required UI to maintain CPRs using the "Will County Continuing Property Records" as a model. (Staff Ex. 6.0, p. 10). Staff therefore stated that UI must change its current records system to comply with this Order. However, UI pointed out that there is no Commission finding in the 94-0157 Order that it was necessary for UI to maintain CPRs in the format sought by Staff and no finding in the Order that the benefits of such a CPR system would outweigh the costs to UI. Rather, UI states that the 94-0157 Order merely accepts an agreement made between UI and Staff regarding CPRs. The 94-0157 Order's Findings Paragraph No. 7 finds only that "agreement has been reached by Staff and Petitioners on the various accounting, bookkeeping and other procedural issues [including continuing property records] . . . and the resolution of those issues . . . should be accepted by the Commission." The subsequent ordering language only states "that the resolution of the issues referred to in Finding (7) is hereby accepted by the Commission." UI believes that this language indicates that the 94-0157 Order simply accepts an arrangement between UI and Staff without making any findings with regards to the necessity or benefit of CPRs for UI. Because the 94-0157 Order has no actual and specific findings with regards to UI's recordkeeping, the Order does not supercede prior Commission findings that the burdens on UI of installing a CPR system would outweigh any benefits.

The Companies further argued that changing their records systems as Staff recommends would require the hiring of two additional staff members and would be a burdensome and expensive task. The Companies stated that given their small size, the benefits of adopting Staff's recommendations regarding CPRs would not outweigh these

additional costs. The Companies pointed out that in several past proceeding involving UI subsidiaries, the Commission found that the Staff's recommendation for a more complex and costly CPR system was impractical for companies of such small size. See Apple Canyon Utility Company, et al., Consolidated Docket Nos. 90-0475/92-0401; Camelot Utilities, Docket No. 92–0345.

Staff admitted that it would be a "large project" for UI to come into compliance with their view of the CPR requirements. (Tr. at 85). However, Staff disagreed with the Company's assessment that the cost of maintaining CPRs clearly outweighs the benefits. The cost of maintaining CPRs can be distributed among the 25 Utilities, Inc. water companies in Illinois. Adequate records will instill the Commission's confidence in the financial reports by the Company.

As Staff acknowledged in this proceeding, it is the Commission's responsibility, not Staff's, to determine whether the benefits of a new CPR system for these five utilities exceed the costs. (Tr. at 91). In the case of UI and its subsidiaries, the Commission has determined in the past that instituting a complex new CPR system would be unduly burdensome. Staff cannot point to any changes in the regulatory environment since the Commission made those determinations which would require a different outcome now. Staff has also not shown how any benefits of its recommended CPR system would outweigh the substantial costs to UI. Since Staff's proposed CPR system will require UI to expend significant resources, while producing information that will be little different from UI's existing system, the costs of maintaining CPRs clearly outweigh the benefits. For that reason, the Commission rejects Staff's recommendation on the CPRs.]

B. Rules, Regulations, and Conditions of Service

In its direct testimony, UI proposed to update the Rules, Regulations, and Conditions of Service tariffs for all five of the Companies, since they have not been updated in at least eight years. Staff reviewed the tariffs and agreed with their content. Staff recommended that the Commission approve the proposed Rules, Regulations, and Conditions of Service tariffs for Cedar Bluff, Apple Canyon, Charmar, Cherry Hill, and Northern Hills. Staff stated that these tariffs were compiled previously by Staff, provided to other Illinois regulated utilities, and approved by the Commission in several different docketed proceedings. *See Westlake Utilities, Inc.*, Docket No. 01-0050; *Del Mar Water Company*, Docket No. 02-0592. (Staff Group Ex. 3.0, p. 5; Staff Group Ex. 12.0, pp. 3 & 12). Staff also recommended that the Companies indicate the applicable billing period when it files its final tariffs. (Staff Group Ex. 3.0, p. 5, Staff Group Ex. 12.0, p. 12; Staff Ex. 9.0, p. 2). Staff further recommended that the Commission Order the Companies to file the Rules, Regulations, and Conditions of Service tariffs (as attached to Companies' direct testimony), within ten (10) days of the Commission Order, with an effective date of not less than ten (10) working days after the date of filing, for service rendered on and after their effective date, with individual tariff sheets to be corrected within that time period, if necessary. (Staff Group Ex. 3.0, pp. 5-6; Staff Group Ex. 12.0, pp. 4 & 16; Staff Ex. 9.0, p. 6).

C. Original Cost Determination

Staff requested the Commission include in this proceeding's order the original cost of plant at December 31, 2002 (Staff Group Ex. 2.0). The following table reflects the original cost of plant as of December 31, 2002 for the Companies in this proceeding:

Company	Plant as of 12/31/2002	Source
Cedar Bluff	$425,122	Staff Group Ex. 2.0, Sched. 1.12
Apple Canyon	$1,896,723	Staff Group Ex. 2.0, Sched. 2.9
Charmar	$101,441	Staff Group Ex. 2.0, Sched. 1.11
Cherry Hill	$189,927	Staff Group Ex. 1.0, Sched. 1.3
Northern Hills	Sewer - $452,561 Water -$383,429	Staff Group Ex. 1.0, Sched. 1.3

D. Billing Cycles

In its direct testimony, UI proposed converting to a monthly billing cycle for Cedar Bluff, Apple Canyon, Charmar, and Cherry Hill. UI stated that the Companies believed that a monthly billing cycle would enable the Companies to provide better service to the customers of Cedar Bluff, Apple Canyon, Charmar, and Cherry Hill. UI initially stated that no additional employees would be required to handle the increased number of billings for Cedar Bluff, Apple Canyon, Charmar, and Cherry Hill.

In direct testimony, Staff stated that this change to a monthly billing cycle would be beneficial to the customers and the quality of their service. Staff agreed that benefits resulting from the proposed change to the monthly billing cycle justified the minimal additional cost (Staff Group Ex. 3.0, p. 4; Staff Group Ex. 12.0, p. 13).

In rebuttal testimony, UI stated that Cedar Bluff, Apple Canyon, Charmar, and Cherry Hill no longer desired to convert to a monthly billing cycle. UI stated that after further review, the Companies found that additional expenses would have to be incurred that they did not foresee in direct testimony. For example, they did not take into account the additional staffing costs associated with administration and meter reading.

Staff did not object to the Companies' decision to forego monthly billing. Staff had no objection to the Companies continuing its current billing practices if the Companies would rather not spend the extra money on monthly billing and customers will not be adversely affected. Staff recommended that all additional costs related to converting to monthly billing be removed from Staff's recommended revenue requirement (Staff Ex. 9.0, p. 2).

IX. FINDINGS AND ORDERING PARAGRAPHS

The Commission, having considered the entire record herein and being fully advised in the premises, is of the opinion and finds that:

(1) The Companies provide water and/or sewer service to the public within the State of Illinois, and, as such, are public utilities within the meaning of the Public Utilities Act;

(2) the Commission has jurisdiction over the Companies and the subject matter herein;

(3) the recital of facts and conclusions reached in the prefatory portion of this Order are supported by the evidence, and are hereby adopted as findings of fact;

(4) a test year ending December 31, 2002, should be adopted for the purpose of this rate proceeding;

(5) for the test year ending December 31, 2002, and for the purposes of this proceeding, the Companies' rate base is as follows

Cedar Bluff: [DEPENDENT ON JUDGE'S FINAL RULING];
Apple Canyon: [DEPENDENT ON JUDGE'S FINAL RULING];
Charmar: [DEPENDENT ON JUDGE'S FINAL RULING];
Cherry Hill: [DEPENDENT ON JUDGE'S FINAL RULING];
Northern Hills - Sewer: [DEPENDENT ON JUDGE'S FINAL RULING];
Northern Hills - Water: [DEPENDENT ON JUDGE'S FINAL RULING]

(6) a fair and reasonable rate of return on the Companies' rate base is 8.49%; rates should be set to allow the Companies an opportunity to earn that rate of return on its rate base, as determined herein;

(7) the Companies' rates presently in effect are insufficient to generate the operating income necessary to permit the Companies to earn a fair and reasonable rate of return; those rates should be permanently canceled and annulled as of the effective date of the new tariffs allowed by this Order;

(8) the Companies should be permitted to file new tariff sheets setting forth the rates designed to produce annual operating revenues and an increase in net operating income as follows:

Cedar Bluff: [DEPENDENT ON JUDGE'S FINAL RULING];
Apple Canyon: [DEPENDENT ON JUDGE'S FINAL RULING];
Charmar:[DEPENDENT ON JUDGE'S FINAL RULING];
Cherry Hill: [DEPENDENT ON JUDGE'S FINAL RULING];
Northern Hills - Sewer: [DEPENDENT ON JUDGE'S FINAL RULING];
Northern Hills - Water: [DEPENDENT ON JUDGE'S FINAL RULING];

such revenues are necessary to provide the Companies a rate of return of 8.49% on their rate base, consistent with the findings herein;

(9) the Companies' proposed Rules, Regulations, and Conditions of Service tariffs are approved;

(10) the original cost of the Companies' plant at December 31, 2002 for the purposes of this proceeding, is reflected in Section VIII, Miscellaneous Issues, C. Original Cost Determination of this Order.

(11) [CONTESTED ISSUE - UI PROPOSED LANGUAGE] *the Commission finds that Staff's recommendation for a more complex and costly Continuing Property Record system is impractical given the Companies' small size and rejects Staff's recommendation that the Companies implement a new Continuing Property Records system.*

(12) all remaining motions, petitions, objections, or other matters in this proceeding should be disposed of in a manner consistent with the conclusions reached herein.

IT IS THEREFORE ORDERED by the Illinois Commerce Commission that the tariff sheets proposing a general increase in water and/or sewer rates filed by the Companies on May 2, 2003 and May 20, 2003, are hereby permanently canceled and annulled.

IT IS FURTHER ORDERED that the Companies be authorized to place into effect tariff sheets which will produce the annual operating revenues and operating incomes set forth in Finding (8) above, and consistent with Appendix A to this Order, to be effective on the date of filing for water and/or sewer service furnished on and after such effective date.

IT IS FURTHER ORDERED that the Companies file their Rates, Rules, Regulations, and Conditions of Service tariffs, within ten (10) days of the Order, with an effective date of not less than ten (10) working days after the date of filing, for service rendered on and after their effective date, with individual tariff sheets to be corrected within that time period, if necessary.

IT IS FURTHER ORDERED that upon the effective date of the tariff sheets filed pursuant to this Order, the presently effective tariff sheets of the Companies which are replaced thereby are permanently cancelled and annulled.

IT IS FURTHER ORDERED that any petitions, objections or motions made in this proceeding and not otherwise specifically disposed of herein are hereby disposed of in a manner consistent with the conclusions contained herein.

IT IS FURTHER ORDERED that, subject to the provisions of Section 10-113 of the Public Utilities Act and 83 Ill. Adm. Code 200.800, this Order is final; it is not subject to the Administrative Review Law.

By Order of the Commission this ____ day of ____, 2004.

(SIGNED) EDWARD C. HURLEY

Chairman