STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

New Landing Utility, Inc.	:	
	:	04-0610
Proposed general increase in water and Sewer rates.	:	

INITIAL BRIEF OF THE STAFF OF

THE ILLINOIS COMMERCE COMMISSION

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Staff of the Illinois Commerce Commission ("Staff"), by and through its counsel, pursuant to Section 200.800 of the Rules of Practice (83 Ill. Adm. Code 200.800) of the Illinois Commerce Commission's ("Commission"), respectfully submits its Initial Brief in the above-captioned matter.

I. INTRODUCTION

A. Background

In this proceeding, the Commission is investigating the tariffs filed by New Landing Utility, Inc. (the "Company" or "NLU" or "New Landing") on September 3, 2004, seeking a general increase in gas rates pursuant to Article IX of the Illinois Public Utilities Act ("Act"), (220 ILCS 5/9).

In setting rates a "utility is entitled to ask a fair return upon the value of that which it employs for public convenience, but, on the other hand, the public is entitled to demand that no more be exacted from it than the services rendered are reasonably worth." *State Public Utilities Commission vs. Springfield Gas and Electric Co.*, 291 Ill. 209, 217 (1919) The Commission is empowered to set utility rates in order to maintain the balance between the service provided and the rates charged.

Rates are designed to provide a utility the opportunity to recover its cost of providing service on a going-forward basis. The traditional formula, and the one employed in Illinois, determines the overall level of rates through the calculation of a revenue requirement. The revenue requirement is the sum of a utility's operation and maintenance expenses, depreciation and amortization expenses, income taxes, and return on rate base investment (operating income equals the return on rate base). In order to determine a utility's cost of providing service, one must first determine a representative level of service and then match together the cost components of the revenue requirement formula that correspond to that level of service. To accomplish the appropriate matching of service level with cost amounts, a specific period of time, i.e., a test year, is chosen and it is the operating expenses, rate base, capitalization and cost of money of the utility during that test year that are used in the revenue requirement formula.

Once a test year is chosen, revenues, expenses and rate base investment from that test year are scrutinized by the Commission and adjusted so that the test year revenue requirement will be representative of the utility's cost to provide service over time. Excessive or improper expenses are disallowed so as not to be considered in the rate formula. It is important to note that rates are not set with the intention of recovering the particular expenses of a utility. Rather, the rates are set to provide a utility with the opportunity to recover its overall level of reasonable costs, as reflected in the test year, over time on a forward-going basis.

In this docket, there are contested issues in the area of rate base, revenue requirement, operating revenues and expenses, cost of capital (i.e., rate of return), cost of service, conditions of service and other miscellaneous areas. This docket is remarkable for the dearth of support the Company has provided for its proposed increase in rates. Staff adjusted NLU's rate base in large part due to its failure to maintain continuing property records. Further, NLU's failure to obtain Commission approval for various transactions with affiliated interests caused Staff to remove those expenses from the NLU's operating expenses. Staff recommends alternatively an 8.38% rate of return on rate base, or that the Commission use its discretion to set rate of return on rate base at an appropriate level in consideration of the service rendered by New Landing.

The Company also failed to provide a cost of service study or sufficient information from which Staff could perform its own cost of service study. Therefore Staff proposes a rate design for water usage based upon customer and usages charges. NLU failed to support the requested increase in sewer or water service availability rates, therefore Staff recommends no increase. Staff recommends a flat charge for sewer service because the Company's proposal was not cost-based. In addition, Staff recommends changes to the Rules and Regulations proposed by the Company.

B. Procedural History

On September 3, 2004, New Landing filed tariffs for a proposed general increase in rates pursuant to Section 9-201 of the Public Utilities Act ("Act"). (220 ILCS 5/9-201) The Commission entered an order suspending the tariffs and initiating this proceeding, Docket No. 04-0610, on October 6, 2004.

New Landing had filed similar tariffs on March 11, 2004. The Commission entered an order suspending those tariffs and initiating Docket No. 04-0321 ("original rate proceeding") on April 7, 2004. At a status hearing on August 24, 2004, New Landing announced its intent to withdraw the original rate filing, stating that "... we feel that it's in our best interest and prudent for us to seek approval of those agreements..." in reference to affiliate agreements for which the Company had not received Commission approval. (Docket No. 04-0321, Tr., p. 42 (August 24, 2004)) On September 3, 2004, the Company filed a Motion to Withdraw the Tariff Schedules it filed on March 11, 2004.[1] On September 28, 2004, the Commission granted the Company's motion and the tariff sheets were permanently cancelled and annulled.

Pursuant to proper notice, a Prehearing Conference was held in this matter before duly authorized Administrative Law Judge of the Commission in Chicago, Illinois on October 20, 2004. At the Prehearing Conference, the Judge set a schedule which provided for the filing of Staff and Intervenor direct, Company rebuttal, Staff and Intervenor rebuttal and Company surrebuttal testimonies as well as hearings and Initial and Reply Briefs.

[1] Note that the tariff filing, which led to the initiation of the instant proceeding, was also made on September 3, 2004.

Petitions to Intervene were filed by the New Landing of the Delta Queen Property Owner's Association, Lost Nation Property Owner's Association (together the "POA") and People of the State of Illinois by the Office of the Attorney General ("AG"). All Petitions to Intervene were granted.

On November 9, 2004, New Landing filed a Petition for Approval of Agreements with Affiliated Interests, which was docketed as No. 04-0666. In Docket No. 04-0666, the Company seeks approval of affiliate agreements in connection with legal services and office space. (See Docket No. 04-0666, Verified Petition) On December 6, 2004, a motion to consolidate Docket No. 04-0666 with the instant rate case was denied based upon the delay in filing the former docket and difficulties in meeting procedural deadlines in the rate case. (See Docket No. 04-0666, Tr., pp. 7-8 (December 6, 2004))

Evidentiary hearings were held at the Commission's Chicago offices on April 4 and April 5, 2005. Appearances were entered on behalf of New Landing, the POA, the AG, and Staff. Gene Armstrong provided testimony on behalf of New Landing. Scott Struck, Thomas L. Griffin, Rochelle Phipps, Cheri L. Harden, and William D. Marr provided testimony on behalf of Staff. David J. Effron, Brett Hanson, Dennis Connor, and Scott J. Rubin provided testimony on behalf of the AG. At the conclusion of the April 5, 2005 hearing, the record was marked "Heard and Taken."

C. Nature of Operations

New Landing owns and operates water and sewer systems in Illinois.

D. Test Year

The Company proposed a historical test year of 2003 with known and measurable changes. There were no objections to the Company's proposal.

II. RATE BASE

A. Utility Plant

Staff recommends a water rate base for New Landing of $319,175 and a sewer rate base of $260,492.

Calculating a proper level of Utility Plant for ratemaking purposes is challenging for two reasons. First, the Company does not maintain proper continuing property records as required by 83 Ill. Adm. Code 605, Uniform System of Accounts for Water Utilities and 83 Ill. Adm. Code 650, Uniform System of Accounts for Sewer Utilities (See Accounting instruction 28). Second, the Company has not filed a rate case in 25 years.

Staff witness Thomas L. Griffin calculated utility plant by beginning with the last Commission Order, which found an allowed level of Utility Plant for ratemaking purposes (Order, Docket Nos. 79-0673/79-0675 Cons., pp. 11 and 15 (January 14, 1981)). He then asked Mr. Armstrong, Company President, to provide documentation that justifies any additions to plant since that Order. Mr. Armstrong provided some documentation, which Mr. Griffin reviewed. Mr. Griffin then added those plant items, which were supported by documentation, to the water and sewer rate bases. (Staff Exhibit 2.0-R, p. 5, ll. 84-89). This method has been used in the past by the Commission when a utility had inadequate continuing property records to support its utility plant. (Docket Nos. 97-0605, 97-0606, 97-0607, 97-0608 and 97-0609). Mr. Griffin adjusted utility plant using this method. (Staff Exhibit 2.0-R, Schedules 2.01-W and 2.01-S)

He also made corresponding adjustments to Accumulated Depreciation (Staff Exhibit 2.0-R, Schedules 2.02-W-rev and 2.02-S-rev) and Contribution in Aid of Construction. (Staff Exhibit 2.0-R, Schedules 2.03-W-rev and 2.03-S). In addition, Mr. Griffin reclassified old Construction Work in Progress balances to Contribution in Aid of Construction. (Staff Exhibit 2.0-R. Schedules 2.04-W and 2.04-S.)

B. Land and Land Rights

In the Order in Docket Nos. 79-0673/79-0675 Cons., the Commission allocated all of the Land and Land Rights to the water plant. However, it is reasonable to split Land and Land Rights between water and sewer. Staff witness Griffin made an allocation of 52% to water and 48% to sewer based on relative proportions of total Utility Plant. (Staff Exhibit 2.0-R, p. 6, ll. 102-106 and Schedules 2.01-W and 2.01-S).

C. Materials and Supplies Inventory

The Company has $7,274 of Materials and Supplies inventory, which it has divided evenly between water and sewer on its books. Mr. Griffin discussed this with Mr. Armstrong and Mr. Armstrong confirmed that this inventory consists of non-used and useful scrap. Since this inventory is not used to provide service to the ratepayers, it should not be included in rate base. Mr. Griffin removed the

Materials and Supplies Inventory from the water and sewer rate bases. (Staff Exhibit 2.0-R, p. 8, 150-156 and Schedules 2.05-W and 2.05-S)

D. Cash Working Capital

The Company needs to keep a supply of working cash available to pay for its current obligations. For large utilities, this can be calculated with a sophisticated lead lag study, but for small utilities the Commission has routinely applied a formula approach, which assumes 45 lag days. Mr. Griffin used this approach to determine the Company's cash working capital requirement. (Staff Exhibit 2.0-R, p. 9, ll. 159-164 and Staff Exhibit 11.0, Schedules 11.02-W and 11.02-S)

III. Operating Revenues and Expenses

A. Material and Supply Expense

Staff witness Griffin proposed an adjustment to reclassify repair costs, which had been charged to material and supplies. This appears to have been a simple coding error by the Company. (Staff Exhibit 2.0-R, p. 9, ll. 166-169 and Schedules 2.07-W and 2.07-S)

B. Chemical Expense

The Company does not maintain an inventory of chemicals; instead it buys chemicals as needed. Mr. Armstrong has said that this is preferable because he can obtain the chemicals quickly and he prefers not to have chemicals lying around. Normally, when a company acquires chemicals, it treats those chemicals as an investment in inventory and then recognizes the cost of the chemicals as an expense as the chemicals are used. This is known as accrual accounting. However, the Company does not use this method to recognize the cost of its chemicals. Instead, the Company recognizes the full cost of the chemicals when they are acquired. Since the chemicals are not always paid for within a short time after being acquired, the Company books show lumpiness for its chemicals expense. This results in the Company's books reflecting no cost for chemicals during most periods and disproportionately large costs in other periods. These costs do not reflect the period in which chemicals were used. Also, for years 2002 and 2003, all of the chemical expense was charged to water. In 2001, the chemical expense was split 50-50 between water and sewer. The Company has provided no analysis showing a proper split. (Staff Exhibit 2.0-R, pp. 9-10, ll. 171-186)

For the years 2002 and 2003, Staff Witness Griffin allocated 50% of the chemical expense to sewer. He then took an average of the chemical expense for the last three years and used that result for a level of chemical expense for ratemaking purposes. (Staff Exhibit 2.0-R, p. 10, ll. 189-192 and Schedules 2.08-W and 2.08-S)

C. Contract Services

1. Accounting

Accounting expenses in the test year include billings from an accounting firm, which cover services performed over several years. Also, included in the accounting firm billings were fees for the preparation of tax returns for prior years, which were submitted to the Company but never filed with the Internal Revenue Service or Illinois Department of Revenue. In fact, Mr. Armstrong stated to Staff Witness Griffin, during Mr. Griffin's visit to New Landing's offices in July of 2004, that New Landing has never filed a tax return. During cross-examination, Mr. Armstrong stated that New Landing did file tax returns in November of 2004. (Tr., April 4, 2005, p. 402, ll. 6-12) Nevertheless, no tax returns have been put into the record nor have they been reviewed by Staff. According to Mr. Armstrong, he believes the tax returns have been filed for the years 1985 through 2003. (Tr., April 4, 2005, p. 402, ll. 13-18) Although, there is no evidence that any taxes were due as the Company books show losses in every year, the filing of state and federal income tax returns is required, even if no taxes are due. Staff has disallowed the accounting firm's costs. However, Staff did allow a total of $400 for accounting services for ratemaking purposes ($200 each for water and sewer). Based on prior billings, this should be sufficient for the preparation of tax returns and miscellaneous services in the future. (Staff Exhibit 2.0-R, p. 11, ll. 202-213 and Schedules 2.09-W and 2.09-S)

2. Legal Services

In his Second Supplemental Testimony, Mr. Griffin adopted the adjustment to legal expenses set forth in AG witness Effron's direct testimony. (Staff Exhibit 11.0, p. 2-3, ll. 30-42, citing AG Exhibit 1, p. 8) Staff believes that Mr. Effron's adjustment is reasonable because he used legal expenses projected by Mr. Armstrong for 2008. Further, Mr. Effron noted that Mr. Armstrong's description of this level of legal expense as being "more typical of the legal expenses other small, independent water and sewer utilities would incur." (AG Exhibit 1, p. 8) This amount of legal expenses includes no extraordinary costs such as defense against the current IEPA lawsuits. The calculation of Staff's adjustment is found on Schedules 11.01-W and 11.01-S.

3. Affiliated Interests

For rate making purposes, Staff recommends the elimination of various costs which were for transactions between affiliated interests for which affiliated interest agreements have not been approved pursuant to Sec. 7-101(3) of the Act. Regarding such affiliated transactions, Sec. 7-101(3) states in part "... Every contract or arrangement not consented to or excepted by the Commission as provided for in this Section is void." (emphasis added).

Staff eliminated the costs incurred in transactions with the following affiliated interests:

- Gene L. Armstrong and Associates, P.C. – Legal Services. (Staff Exhibit 2.0-R, pg. 12, ll. 216-226)
- Dame Co. – Management Services. (Staff Exhibit 2.0-R, pp. 12-13, ll. 234-239)
- CAM Properties – Rent. (Staff Exhibit 2.0-R, pp. 13-14, ll. 253-259)
- Matthew Armstrong – Billing services (Staff Exhibit 11.0, pp. 3, ll. 44-52).
- Water Tank Repair

D. Repair and Maintenance

1. Overview

Staff witness Griffin has averaged Repair and Maintenance Expense for water over the last four years for ratemaking purposes. This is done so that rates will recover expected Repair and Maintenance costs for a normal year as opposed to actual costs in the test year. Repair and Maintenance costs will fluctuate from year to year due to a number of factors. By including an average amount of Repair and Maintenance costs over a number of years, the Company is more likely to recover the appropriate amount of costs over the life of the rates. Although unusual to Staff, New Landing, as verified by Mr. Armstrong, does not have Repair and Maintenance costs for sewer. (Staff Exhibit 2.0-R, pg. 13, ll. 242-250) Thus, none were included for rate making purposes.

2. Tank Repair

a) Background

The Company has proposed to renovate the water storage tank. (NLU Exhibit 1, pp. 4 & 6; NLU Ex. 2, p. 1; NLU Exhibit WTC-F, pp. 1-3) On May 24, 2004, members of the Commission Water Department, including Staff witness William D. Marr, conducted an inspection of the Company's water and sewer facilities. During the inspection, the Water Department observed that the exterior of the 150,000 gallon elevated water storage tank was in poor condition and deteriorated because NLU failed to perform preventative maintenance (such as tank painting) and properly maintain the tank. The exterior surface of the water storage tank was rusted. Further, since the water storage tank was not protected from unauthorized access by a fence, trespassers had painted graffiti on it. (Staff Exhibit 9.0, pp. 1-2, ll. 20-31) In addition, the inspection revealed that the existing elevated water storage tank overflow pipe did not extend to an elevation between 12 and 24 inches above the ground surface level, which is a violation of Illinois Environmental Protection Agency regulations. The overflow pipe did not discharge over a drainage inlet structure or splash plate. (Staff Exhibit 9.0, pp. 2-3, ll. 40-46)

As a result of the inspection, the Commission Water Department issued a letter dated June 15, 2004 to the Company and made many recommendations, including repairs and maintenance to the water storage tank. (Staff Exhibit 9.0, p. 2 & 3, ll. 33-38 & 46-49) The Company never acknowledged receipt or responded to the June 15, 2004 letter. A second letter dated August 5, 2004 was sent to the Company. Once again, the Company did not acknowledge receipt or respond to the letter. (Staff Exhibit 9.0, p. 3, ll. 51-64, Attachment A and Attachment B)

The Company has entered into a Water Tank Maintenance Contract with Utility Service Company, Inc. dated February 10, 2005. (NLU Exhibit 2, p. 1, NLU Exhibit WTC-F, pp. 1-3) While the water storage tank needs extensive work as noted in the Water Department's letters to the Company, Mr. Marr stated that it appears reasonable to renovate the water storage tank instead of replacing the tank with a new tank. (Staff Exhibit 9.0, pp. 4-5, ll. 79-92)

b) Cost Recovery

Initially, Staff recommended that the Company should not be allowed to recover any costs for the repair of the water tank. This recommendation was based on Mr. Armstrong's failure to produce any evidence that costs that were known and measurable. (Staff Exhibit 2.0-R, pp. 6-7, ll. 109-118)

With its supplemental direct testimony, the Company submitted a copy of a signed Water Tank Maintenance Contract ("Contract") with Utility Service Company, Inc. (NLU Exhibit WTC-F) Any change to the revenue requirement based upon this Contract must be considered in light of the Commission's rules for allowing pro forma adjustments to a historical test year found in 83 Ill. Adm. Code 287.40 which states:

> *A utility may propose pro forma adjustments (estimated or calculated adjustments made in the same context and format in which the affected information was provided) to the selected historical test year for all known and measurable changes in the operating results of the test year. These adjustments shall reflect changes affecting the ratepayers in plant investment, operating revenues, expenses, and cost of capital where such changes occurred during the selected historical test year or are reasonably certain to occur subsequent to the historical test year within 12 months after the filing date of the tariffs and where the amounts of the changes are determinable. Attrition or inflation factors shall not be substituted for a specific study of individual capital, revenue, and expense components. Any proposed known and measurable adjustment to the test year shall be individually identified and supported in the direct testimony of the utility. Each adjustment*

> *shall be submitted according to the standard information requirement schedules prescribed in 83 Ill. Adm. Code 285*

The Contract with Utility Service Company qualifies as a pro forma adjustment under 83 Ill. Adm. Code 287.40 because the costs are known and measurable. The Contract has specific costs and time frames for work to be done. However, only some of the costs and work are to be done within 12 months after the filing date of this case. The Contract stipulates payments of $88,946 in 2005, $88,946 in 2006, $88,946 in 2007 and $11,555 annually beginning in 2008. Thus, only the first payment of $88,946 would qualify as a pro forma adjustment in this case. Staff recommends that the first payment due under the Contract be considered in this case. In addition, for ratemaking purposes, Staff recommends that the costs be amortized over 10 years so the pro forma adjustment to maintenance expense would be $8,895. (Staff Exhibit 7.0, pg. 3, ll. 62-66) Amortization is appropriate because, if the entire $88,946 were to be allowed as maintenance expense in the test year, the Company would recover that amount from customers every year while the new rates are in effect. As a result, the Company would over recover the cost of the Contract by a large amount. The appropriate rate making treatment is to amortize the cost over a number of years that represents the life of the maintenance work that is done. It has been the Commission's practice to allow a 10-year amortization period for maintenance work done to water tanks. (Staff Exhibit 7.0, pg. 4, ll. 68-74)

E. Regulatory Expense

Staff has proposed an adjustment that recognizes rate case expenses for the current proceeding. Staff witness Griffin included the cost of the Company's attorney in this rate case and amortized the cost over five years. As of the time of Mr. Griffin's review of the Company's records, the Company only recorded billing through July 8, 2004. Mr. Griffin offered to review any additional billing the Company produced for rate case expense prior to submittal of Staff Rebuttal Testimony in this docket. However, the Company submitted no additional billings. (Staff Exhibit 2.0-R, p. 14, ll. 262-268 and Schedules 2.13-W and 2.13-S)

F. Late Fees

For sewer, Staff recommends the elimination of a $93 late fee paid to the EPA. Rate payers should not be responsible for fees associated with the Company's failure to pay bills when due. (Staff Exhibit 2.0-R, pg. 14, ll. 269-271)

G. Other Staff Recommendations

1. Main Replacement Charge

The Commission should deny the Company's request for a $75 per month charge to Lost Nation Lake Subdivision customers for water main replacement. (Staff Exhibit 2.0-R, pp. 7-8, ll. 119-139) There are two problems with the Company's proposed water main replacement charge. First, the Company failed to show that the cost for the main replacement is known and measurable. Second, the Company's monthly charge proposal would recover the cost of the water main replacement more quickly than it would be recovered if the cost of the water main replacement were included in rate base. Plant in the Company's rate base is depreciated, and therefore recovered, over 50 years. The Company has offered no justification as to why NLU should be allowed to recover the cost of the water main replacement on an expedited basis. Staff does not disagree with the concept of having the customers that are to be served by the water mains, paying for them as opposed to adding the cost to the entire rate base. Although the proposed charge would accomplish this goal, the two problems Staff has identified should be resolved before the Commission considers such an approach. In addition, the types of investments for the escrow fund, estimated rate of return, and conditions for withdrawal proposed by the Company with respect to the proposed charge would all have to be considered and approved by the Commission. The Company has not provided information in regards to any of these issues. Thus at this time, no analysis of them can be performed and the Commission should reject the proposal accordingly.

2. Continuing Property Records System

The Company should institute a continuing property records system within three months of an Order in this case. (Staff Exhibit 2.0-R, p. 8, ll. 140-147) The proposed system should be submitted to the Commission's Manager of Accounting for approval. Such a system is required under Commission rules (Accounting Instruction 28, Uniform System of Accounts), and is necessary as it helps to assure that the Company has an opportunity to earn a fair return of and on the investment that is made on behalf of customers. This in turn will help assure that the Company has sufficient funds to provide safe and reliable service to its customers.

3. Chemical Expense

Staff has two recommendations regarding accounting for chemical expense. (Staff Exhibit 2.0-R, pg 11, ll. 195-199) First, the Company should employ accrual accounting with regards to chemical expense in order to smooth out the cost and to accurately reflect cost of chemicals in the period when chemicals are being used. Second, the Company should properly allocate chemical costs between water and sewer.

4. Management Issues and Concerns

As a result of Staff's review of additional information supplied by the AG (Notice of the People of the State of Illinois of Additional Evidence, filed on e-Docket March 11, 2005), Staff has great concern as to whether or not the current management of New Landing can be relied upon to use the financial resources available to it to provide safe and reliable service to its customers. A review of the information has revealed that prior to and subsequent to the test year, New Landing has made significant payments to affiliated contractors, including other corporations for which Gene Armstrong is the majority shareholder and family members, neither of which have been approved by the Commission.

As a result, Staff witness Griffin proposed significant reductions in the Company's revenue requirement to exclude unapproved payments to affiliated interests. However, while the Company's cash resources are being used to make these unapproved payments, the Company is neglecting to pay the certified water operator, Mr. Willard Cox, and the Company that does the repair and maintenance work necessary to operate the system, Pfoutz Electric Service, Inc. ("Pfoutz"). Mr. Cox has threatened to resign and it cannot be assumed that Pfoutz will continue to provide service if they are not paid. An example of this problem is that, at the time they submitted their affidavits in February 2005 (AG Cross Exhibits 4 and 7), both Mr. Cox and Pfoutz had not been paid since September 2004. However, during that same time New Landing was making payments to unapproved affiliates. For example, on October 24, 2004 New Landing paid Gene L. Armstrong & Associates, P.C. $4,300 on account for legal services. (AG Cross Ex. 5)

The documents demonstrate that inappropriate payments have occurred in past years as well. Billing clerk duties are being performed by Matthew Armstrong, Gene Armstrong's son. (Staff Cross Exhibit 10; Transcript, April 4, 2005, p. 321, ll. 13-14) In past years, this work was performed by Ann Armstrong, Gene Armstrong's wife. (AG Cross Exhibit 6; Transcript, April 4, 2005, pp. 316-317) Neither of these people were hired as employees, but they were paid as independent contractors. (Transcript, April 4, 2005, p. 317, ll. 5-8 and p. 320, ll. 21-22 through p. 321, ll. 1-2) They were, therefore, affiliated interests under Sec. 7-101(h) of the Act. But no affiliated interest agreement was approved by the Commission. The records Staff witness Griffin reviewed showed that they were the only outside contractors to receive a holiday bonus. In addition, a $3,000 payment was made to Matthew Armstrong on January 30, 1994. That payment was described as interest on a demand note of $15,000.00. The lender was Violet Armstrong, now deceased, mother of Gene Armstrong and therefore also an affiliated interest under Sec. 7-101(h) of the Act. There was no Commission Approval for the note. (Staff Exhibit 11.0, pp. 5-6, ll. 91-98)

In addition, Mr. Griffin reviewed a stipulation from and copies of checks to Tri-Star Alarms, Ltd. Tri-Star stipulates that they provide no service to New Landing. But they do provide service to Mr. Gene Armstrong's private residence. Payments for that service were made by New Landing. (Staff Exhibit 11.0, p. 6, ll. 99-102)

As a result of the foregoing, Staff makes the following recommendations:

1) Staff recommends that the Commission, at its earliest convenience, issue an interim order in this proceeding requiring New Landing to cease and desist making any payments to any affiliated interests that have not been approved by the Commission.[2] (Staff Exhibit 11.0, p. 6, ll. 105-114) Such affiliated interests include, but are not limited to:

- Gene L. Armstrong & Associates, P.C.
- DAME Co.
- CAM Properties
- Matthew P. Armstrong
- Ann H. Armstrong

[2] A motion requesting that the Commission authorize the filing of a petition in Circuit Court for the appointment of a receiver and that the Commission order NLU to desist from making unauthorized payments to affiliates was filed by Staff on March 30, 2005 and supplemented on April 1, 2005.

2) Staff recommends that the Commission grant Staff's motion to petition the appropriate court to appoint a receiver to be responsible for the operation of the utility. Staff believes this to be important, not only because of the problems Staff has described relating to new information provided by the Office of the Attorney General, but also because of problems previously identified in this case (i.e. failure to file timely rate cases, failure to keep continuing property records and failure to file tax returns). (Staff Exhibit 11.0, p. 7, ll. 115-121)

IV. COST OF CAPITAL/RATE OF RETURN

A. Overview

In Direct Testimony, NLU President Gene L. Armstrong requested a 10.30% rate of return for the Company. (NLU Exhibit 1, p. 17) On behalf of the AG, Mr. David J. Effron proposed a 7.60% rate of return for NLU. (AG Exhibit 1, Schedule DJE-5) Staff witness Rochelle Phipps recommended an 8.38% overall cost of capital for NLU. (Staff Exhibit 3.0, Schedule 3.01) The AG disagrees with Staff witness Phipps' proposed debt and equity costs. Both NLU and the AG disagree with Ms. Phipps' hypothetical capital structure. (Docket 04-0610, Response to Staff's Request for Stipulation of Facts)

B. Staff's Analysis

1. Cost of Common Equity

NLU did not provide a cost of equity estimate. AG witness Effron proposes a 10.00% cost of equity for NLU. (AG Exhibit 1, Schedule DJE-5) Staff witness

Phipps estimates the investor-required rate of return of common equity for NLU is 12.36%. (Staff Exhibit 3.0, Schedule 3.01; Staff Pre-Trial Memorandum, p. 13)

Ms. Phipps estimated NLU's cost of common equity with the discounted cash flow ("DCF") and risk premium models. Since current market data is not available for NLU, DCF and risk premium models cannot be applied directly to NLU. Therefore, Ms. Phipps applied both models to two samples, one comprising water utilities and another comprising public utilities. (Staff Exhibit 3.0, p. 3, ll. 47-52) The first sample comprises six market-traded water utilities within the *Standard & Poor's Utility Compustat* database for which Zacks Investment Research ("Zacks") growth forecasts were available ("water sample"). (Staff Exhibit 3.0, pp. 3-4, ll. 55-62) The second sample consists of seven public utilities selected from the *Standard & Poor's Utility Compustat* database that have been assigned a Standard & Poor's ("S&P") credit rating of AA, AA-, A+, A, or A- and a business profile score of 1, 2 or 3 for which Zacks growth forecasts were available, and were not in the process of being acquired by another company ("utility sample"). (Staff Exhibit 3.0, p. 5, ll. 86-95)

a) DCF Analysis

According to DCF analysis, the market value of common stock equals the present value of the expected stream of future dividend payments. (Staff Exhibit 3.0, pp. 5-6, ll. 105-108) Ms. Phipps applied a constant-growth quarterly DCF model, which properly accounts for the quarterly payment of dividends by the companies comprising her samples. (Staff Exhibit 3.0, pp. 6-7, ll. 119-125)

DCF analysis requires a growth rate that reflects the expectations of investors. Ms. Phipps measured the market-consensus expected growth rates with projections published by Zacks. The growth rate estimates were combined with the closing stock prices and dividend data as of January 4, 2005. (Staff Exhibit 3.0, pp. 7-8, ll. 127-142) Based on this growth, stock price, and dividend data, Ms. Phipps' DCF-derived cost of equity estimate is 10.53% for the water sample and 8.78% for the utility sample. (Staff Exhibit 3.0, p. 9, ll. 172-177)

b) Risk Premium Analysis

According to financial theory, the required rate of return for a risky security equals the risk-free rate of return plus a risk premium associated with that security. The risk premium methodology is consistent with investors' risk-aversion. Ms. Phipps 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 Exhibit 3.0, p. 10, ll. 189-202)

The CAPM requires the estimation of three parameters: beta, the risk-free rate, and the required rate of return on the market. First, using Value Line beta estimates and regression analysis, Ms. Phipps estimated forward-looking betas of 0.54 for the water sample and 0.66 for the utility sample. (Staff Exhibit 3.0, p. 19, ll. 367-370) Second, Ms. Phipps considered two current estimates of the risk-free rate of return as of January 4, 2005: the 2.40% yield on U.S. Treasury bills and the 4.97% yield on long-term U.S. Treasury bonds. (Staff Exhibit 3.0, pp.

13-14, ll. 264-267) Forecasts of long-term inflation and the real GDP growth rate suggest that the long-term risk-free rate is between 5.6% and 6.0%. Thus, Ms. Phipps concluded that the U.S. Treasury bond yield is currently the superior proxy for the long-term risk-free rate. (Staff Exhibit 3.0, pp. 14-15, ll. 282-286) Finally, to measure the expected rate of return on the market, Ms. Phipps conducted a DCF analysis on the firms composing the Standard & Poor's 500 Index. That analysis estimated that the expected rate of return on the market equals 13.59%. (Staff Exhibit 3.0, p. 16, ll. 312-315) Using those three parameters in her risk premium model, Ms. Phipps estimated the cost of common equity is 9.62% for the water sample and 10.66% for the utility sample. (Staff Exhibit 3.0, p. 20, ll. 373-375)

c) Cost of Equity Recommendation

Ms. Phipps testified that a thorough cost of common equity analysis requires both the application of financial models and the analyst's informed judgment. A cost of common equity recommendation based solely upon judgment is inappropriate. However, because cost of common equity measurement techniques necessarily employ proxies for investor expectations, judgment is necessary to evaluate the results of such analyses. Along with DCF and CAPM analyses, Ms. Phipps considered the observable 5.57% rate of return the market currently requires on A-rated utility long-term debt. (Staff Exhibit 3.0, p. 20, ll. 379-387)

Ms. Phipps estimates the investor-required rate of return on common equity for NLU is 12.36%. Ms. Phipps estimated the investor-required rate of return on common equity by: 1) averaging the DCF-derived estimates of the required rate of return on equity, or 9.66%, 2) averaging the risk premium-derived estimates of the required rate of return on equity, or 10.14%, 3) taking the midpoint of the DCF- and risk premium-derived estimates, or 9.90%, and 4) adding 246 basis points for liquidity costs. (Staff Exhibit 3.0, pp. 20-21, ll. 387-397)

Ms. Phipps testified that liquidity costs arise from the probability and financial consequences of an investor's inability to sell an asset at the desired time, at a predictable price. Both samples Ms. Phipps used to estimate NLU's cost of equity comprise market-traded companies whose security prices do not reflect substantial liquidity costs. However, the security prices of small standalone companies such as NLU typically reflect significant liquidity costs, which are largely due to the lack of a liquid market for their securities. (Staff Exhibit 3.0, p. 21, ll. 405-412)

Ms. Phipps testified that a direct assessment of the liquidity premium in the cost of NLU's common equity could not be performed since the cost of common equity to small water companies is not directly observable. Ms. Phipps estimated NLU's liquidity premium by subtracting the current, observable 4.89% rate of return on 10-year, A-rated corporate utility bonds from the 7.35% interest rate the Rural Telephone Finance Cooperative ("RTFC") charges for a 10-year loan. (The RTFC provides lending and financial services to eligible cooperative and commercial telephone companies serving rural areas.) Ms. Phipps then added the resulting liquidity premium, totaling 246 basis points, to her 9.90% cost of equity estimate to derive a 12.36% cost of equity estimate for NLU. (Staff Ex. 3.0, p. 22, ll. 415-423)

2. Long-Term Debt Cost

NLU's proposed debt cost is 11.35%, which reflects historical prime interest rates during the 1981-2002 measurement period, plus two percentage points. (Staff Exhibit 3.0, p. 25, ll. 492-494) AGO witness Effron proposed a 6.0% cost of debt for NLU. (AG Exhibit 1, Schedule DJE-5) Staff witness Phipps recommended a 5.25% debt cost for NLU, which is the current prime interest rate. (Staff Exhibit 3.0, p. 26, ll. 520-521; Staff Pre-Trial Memorandum, p. 12)

Ms. Phipps testified that the Commission should reject NLU's proposed debt cost for two reasons. First, it is based on a 21-year historical average of the prime interest rate even though the variable interest rate for the mortgage note is adjusted monthly. Ms. Phipps testified that the current prime rate should be used to estimate NLU's cost of debt because current interest rates are better predictors of future interest rates than historical averages. (Staff Exhibit 3.0, pp. 25-26, ll. 497–502) Second, NLU's proposed debt cost includes a default penalty. Prior to NLU defaulting on its mortgage note, the interest rate on the mortgage note was set equal to the prime rate. (Staff Cross Exhibit 6) Ms. Phipps testified that NLU's debt cost should not reflect a default penalty because it is inconsistent with her proposed capital structure, which reflects a financially strong utility. (Staff Exhibit 3.0, p. 26, ll. 502-514) Moreover, NLU provided no reason why ratepayers should be charged a 2% default penalty for indebtedness that is currently held by NLU's affiliate and owner, DAME Co. (Staff Exhibit 3.0, p. 26, footnote 28) Finally, NLU's indebtedness was transferred from Associated Mortgage Investors to DAME Co. without Commission approval (Order, Docket Nos. 79-0673/0675 Consolidated, January 14, 1981, pp. 4-5 and 16-17; Staff Group Cross Exhibit 1, p. 1); hence, that transfer is void under Section 6-104 of the Act, which states:

> "… all stock and every stock certificate, and every bond, note or other evidence of indebtedness of a public utility not payable within 12 months, issued with the authorization of the Commission, but not conforming in its provisions to the provisions, if any, which it is required by the order of authorization of the Commission to contain, shall be void;…". (220 ILCS5/6-104, formerly Ill. Rev. Stat. 1983, ch. 111 2/3, par. 23)

3. Capital Structure

NLU did not propose a capital structure in conjunction with its requested rate of return. Mr. Effron used a hypothetical capital structure comprising 60% debt and 40% equity to estimate NLU's cost of capital. (AG Exhibit 1, Schedule DJE-5) Ms. Phipps estimated NLU's cost of capital using a capital structure for a hypothetical water utility comprising 56% debt and 44% equity. (Staff Exhibit 3.0, Schedule 3.01; Staff Pre-Trial Memorandum, p. 12)

On December 31, 2003, NLU's capital structure included a negative common equity balance. Ms. Phipps testified NLU's negative equity balance is problematic because when multiplied by the cost of common equity, it produces a negative return requirement, which is nonsensical given investors require positive returns to compensate them for the risk of their investment. (Staff Exhibit 3.0, p. 24, ll. 457-463) Thus, Ms. Phipps estimated NLU's cost of capital using a capital structure for a hypothetical water utility, which is based on the mean debt and equity ratios of the two proxy groups she used to estimate NLU's cost of equity, and, thus, is consistent with her proposed cost of equity for NLU. (Staff Exhibit 3.0, p. 24, ll. 468-470)

4. Recommendation

Ms. Phipps' overall cost of capital recommendation, incorporating her recommended capital structure, cost of long-term debt, cost of common equity and assuming NLU is providing adequate service, is 8.38%. (Staff Exhibit 3.0, Schedule 3.01) The record demonstrates Ms. Phipps' recommendations are based upon the valid application of sound financial theory. Thus, Staff recommends that the Commission adopt Ms. Phipps' recommendations as a starting point for setting rates in this proceeding.

Staff Proposal: New Landing Utility, Inc.'s

Weighted-Average Cost of Capital

Class of Capital	**Percent of Total Capitalization**	**Cost**	**Weighted Cost**
Long-Term Debt	56%	5.25%	2.94%
Common Equity	44%	12.36%	5.44%
Total	100%		**8.38%**

Although Ms. Phipps recommended an overall rate of return on rate base of 8.38%, her analysis assumes that a utility is providing adequate utility service. (Staff Exhibit 3.0, p. 2, ll. 34-39) If the Commission concludes that NLU has not been providing adequate service, the Commission could reduce NLU's authorized rate of return to better reflect the value of service the Commission concludes that NLU has been providing ratepayers. Staff will discuss this option in more detail later in this brief.

C. Staff's Criticisms of Mr. Armstrong's Proposed Rate of Return

Ms. Phipps testified that Mr. Armstrong's proposed 10.3% rate of return estimate for NLU should not be given any weight in this proceeding because it is based on historical returns of stocks, corporate bonds and U.S. Treasury bills during the 1980-1999 measurement period. She asserted that historical data is improper for estimating the investor-required rate of return. Ms. Phipps also noted that the Commission has previously rejected the use of historical data in determining a company's cost of capital. (See Staff Exhibit 3.0, pp. 27-29, ll. 536-566, citing Order, Docket No. 92-0357 (July 21, 1993), p. 66; Order, Docket No. 95-0076 (December 20, 1995), p. 69; Order, Docket Nos. 99-0121/01330 Consol. (August 25, 1999), p. 10; Order, Docket Nos. 01-0528/0628/0629 Consol. (March 28, 2002), p. 12; Order, Docket No. 02-0837 (October 17, 2003), p. 37; and Order, Docket No. 03-0403 (April 13, 2004), p. 42)

D. Staff's Criticisms of AGO Witness Effron's Proposed Rate of Return

Each of Mr. Effron's estimates for capital structure, cost of debt and cost of equity are based on his experience and lack any supporting analysis or other documentation. (Staff Group Cross Exhibit 2, p. 3) Mr. Effron has stated that he is not presenting himself as a cost of capital or rate of return expert and, therefore, does not have an opinion on Ms. Phipps' proposed weighted average cost of capital recommendation for New Landing, as presented on Staff Exhibit 3.0, Schedule 3.01. (Staff Group Cross Exhibit 2, p. 2) Thus, Mr. Effron's cost of capital recommendation should not be given any weight in this proceeding.

E. Consideration of Service Quality

The recommendation of an 8.38% overall rate of return on rate base assumes that the utility is providing adequate utility service. (Staff Exhibit 3.0, p. 2, ll. 34-39) In the case at hand, evidence has been presented that the water and sewer facilities have not been adequately maintained on a long-term basis and that New Landing is not in compliance with numerous regulations promulgated by the Commission and by the Illinois Environmental Protection Agency ("IEPA"). (See Staff's Motion for Receiver, filed on e-docket March 30, 2005, paragraphs 7 through 15) Staff filed a Motion for Receiver requesting the Commission to authorize the filing of a petition in Circuit Court seeing the appointment of a receiver and also requesting the Commission to order NLU to desist from making payments to affiliated interests, for which no Commission approved affiliated interest agreement exists. Staff detailed the reasons for

Staff's conclusion that New Landing is unable or unwilling to provide safe, adequate, or reliable service and no longer possesses sufficient technical, financial or managerial resources and abilities to provide safe, adequate, or reliable service. Staff continues to advocate, as its primary position, that a receiver should be appointed to manage New Landing. A receiver with the technical and managerial resources to operate a water and sewer utility would eliminate NLU's pervasive service quality issues.

However, if the Commission declines to proceed to Circuit Court for the appointment of a receiver and concludes that NLU has not been providing adequate service, the Commission could reduce NLU's authorized rate of return to better reflect the value of service and to establish just and reasonable rates.

The Commission exists for the function of balancing the rates charged by the utilities and the services performed by the utilities. (*Village of Apple River et al., v. Illinois Commerce Commission*, 18 Ill. 2d 518, 523 (S Ct 1960)) In that regard, it determines whether a utility's rates are just and reasonable and services are adequate. (*Id*.) The rate making process under the Act, i.e., the fixing of 'just and reasonable' rates, involves a balancing of the investor and the consumer interests. (*Citizens Utility Board v. Illinois Commerce Com'n*, 276 Ill. App. 3d 730, 736, 658 N.E. 2d 1194, 1200, (1995) citing *Illinois Bell Telephone Co. v. Illinois Commerce Comm'n*, (1953), 414 Ill. 275, 287, 111 N.E.2d 329, quoting *Federal Power Comm'n v. Hope Natural Gas Co.*, (1944), 320 U.S. 591, 603, 88 L. Ed. 333, 345, 64 S. Ct. 281, 288)) In determining whether a proposed rate schedule is fair and reasonable, the Commission can consider quality of service. (*Citizens Utility Company of Illinois v. Phillip R. O'Connor et al.*, 121 Ill. App. 3d 533, 540; 459 N.E.2d 682, 687 (1984)) Quality of service may be a relevant consideration in determining where a proposed rate schedule is fair and reasonable. (*Id.)* However, when a utility satisfies its burden of proof and establishes a revenue deficiency of a given amount, it is the Commission's duty to move forward and implement rates to recover the deficiency. (*Id.*, at 688, citing *General Telephone Company of the Southwest v. Corporation Commission and Lea County, et al*., 98 N.M. 749, 757; 652 P.2d 1200, 1208 (1982)) To do otherwise, would be a violation of due process and result in an unconstitutional confiscation of a utility's property without due process. (*Id.)* A rate found to be insufficient to pay the proper operating expenses and to return a reasonable profit on investment deprives a utility of property without due process of law. (*Citizens Utility Board v. Phelps*, 121 Ill. App. 3d 533, 538, 459 N.E. 2d 682, 686 (1984))

For instance in *General Telephone Company of the Southwest v. Corporation Commission, et al.*, the Court held that the State regulatory commission had no authority to deny a utility's increase in rates in an amount which it first found to be just, fair and reasonable, by means of imposing a subsequent penalty for poor or inadequate service. (*General Telephone Company of the Southwest v. Corporation Commission and Lea County, et al*., 98 N.M. 749, 758; 652 P.2d 1200, 1209 (1982)) The State regulatory commission, after having found that the utility was due an increase in rates, discussed the utility's poor quality of service and lowered the rate of return from

11.91%, which it had determined to be appropriate in absent of service inadequacies, to 11.5%. (*Id.* at 752, 1203) Once the commission arrived at a fair and reasonable rate of return, it had no authority to penalize the utility for reasons relating to quality of service. (*Id*. at 758, 1209) The Court noted that its ruling did not preclude the State regulatory commission "from properly considering in a rate proceeding, quality or inadequacy of service in determining, under the facts and circumstances in each particular case, what is a fair, just and reasonable rate of return to the utility. (*Id.)*

Further, in *Citizens Utilities Company of Illinois v. Phillip R. O'Connor et al*., the Court held that it was proper for the Commission to consider the factor of quality of service as a basis for denying a rate increase. (*Citizens*, 121 Ill. App. 3d 533, 541; 459 N.E.2d 682, 688) The Commission had determined that the utility failed to improve service and failed to comply with repeated directions in the recording of deferred income taxes and thus, "should not be rewarded with an increase in its authorized rate of return and an increase in rates." (*Id.* at 539, 687) The Company argued that the Commission order penalized the Company for noncompliance with prior Commission orders and was unauthorized by law. (*Id*.) The Court found that "[q]uality of service may be a relevant consideration in determining whether a proposed rate schedule is fair and reasonable, although it is not relevant to whether a confiscatory rate has been established." (*Id.,* at 540, 687)

In the case at hand, evidence has been presented that the water and sewer facilities have not been adequately maintained on a long-term basis and that New Landing is not in compliance with numerous regulations promulgated by the Commission and by the Illinois Environmental Protection Agency ("IEPA"). (AG Exhibit 2, pp. 7-8, and Schedules 1, 2 and 3; AG Exhibit 3, pp. 4-5 and Schedules 2 and 3; AG Exhibit 4.0, pp. 9-11 and Schedule SJR-2; AG Ex. 4.1, pp. 4-5 and 9-12; AG Cross Exhibits 4 and 7; and Staff Exhibit 9.0, Attachments A and B and see Staff's Motion for Receiver, filed on e-docket March 30, 2005, paragraphs 7 through 15) It would be well within the Commission's authority to consider the Company's inadequate quality of service when determining what is a fair rate of return. Staff has provided schedules illustrating the effect of both a 8.38% and a 0% rate of return on revenue requirement. Should the Commission in its discretion determine that a rate of return between 8.38% and 0% is appropriate; Staff could supplement the record with an appropriate schedule.

V. Revenue Requirement

Staff has calculated Staff's recommended revenue requirement after incorporating all of the recommendations of Staff witnesses in this docket. (Staff Exhibit 10.0, Schedules 10.01-W and 10.01-S). These calculations show two options which Staff witness Griffin describes in his second supplemental testimony (Staff Exhibit 11.0, pg. 8, ll. 139-151)

The first option would be to approve a rate increase that would give New Landing an opportunity to pay approved expenses and earn an 8.38% return on rate base. In the alternative, based upon the evidence in this record regarding the quality of service provided by New Landing, the Commission could determine that the evidence in this case demonstrates an abuse of discretion by the Company's current management that has resulted in an inability to provide safe and reliable service to their customers. In that event, the Commission may determine that an 8.38% return on rate base would result in ratepayers being required to pay more than the services rendered by New Landing are reasonably worth. A second option would be for the Commission to approve rates that would include a return on rate base in the range between 8.38% and 0% as the Commission deems appropriate, to restore the balance between the rates charged by the utility and the services performed.

Staff's revenue requirement calculations present the range between the 0% and the 8.38% options. Staff's proposed revenue requirements of $129,219 for water and $114,091 for sewer, reflecting an 8.38% return on rate base, are presented on ICC Staff Exhibit 10.0, Schedules 10.01-W and 10.01-S, column (h). The alternative revenue requirements of $97,800 for water and $88,448 for sewer, reflecting a 0% return on rate base, are presented on ICC Staff Exhibit 10.0, Schedules 10.01-W and 10.01-S, column (j).

VI. RATE DESIGN

The Staff proposes rate design changes for New Landing Utilities, Inc. based on the traditional components of customer and usage charges. (Staff Exhibit 4.0-R, p. 4) The Company did not provide a cost of service study. Neither did the Company provide sufficient data to enable Staff develop its own cost of service study. In the absence of a cost of service study, Staff designed rates with customer and usage charges to link rates with usage. (*Id.*, p. 6) Staff's proposals represent the most reasonable approach to rate design given the amount and quality of information provided by the Company in this proceeding. Staff recommends that the Commission adopt its changes in this proceeding.

A. Water Rates

With respect to water rates, the Company proposed tripling the minimum bill, doubling the usage charge per 1,000 gallons and tripling the availability charge (NLU Exhibit 1, p. 9). The Company also proposed: (1) establishing a new rate for the availability of service to a side yard lot (NLU Exhibit 1, p. 11); and (2) imposing a surcharge on certain customers of $7.50 per month for additional costs to serve these customers (NLU Exhibit 1, pp. 9-10). A second surcharge of $75.00 per month for main replacement (NLU Exhibit 1, p. 10) was addressed by Staff witness Griffin (Staff Ex. 2.0-R).

Staff does not agree with the Company's proposals noted above and advocates establishing a monthly customer charge of $10.00. The monthly customer charge would replace the minimum bill that is currently in the tariffs. Under Staff's proposal, if a customer does not use any water during a billing cycle, a rate schedule should provide some means of recovering those costs to have the water connected for use that are independent of the actual usage of water (i.e., the costs of meter reading, billing and fixed costs on plant and equipment). Also, the monthly charge recovers the current minimum bill that customers have been paying the Company under the current tariffs. Finally, any other revenue should be generated through the usage charge. (Staff Exhibit 4.0-R, p. 8, ll. 168-178)

With respect to the Company's proposal to maintain its block usage charge, but changing the range and increasing the price of each block, Staff witness Harden recommends a flat charge per 1,000 gallons used by the water customers. Ms. Harden recommends against a blocked structure for usage charges in this case because all of the NLU customers are residential customers. (Staff Exhibit 4.0-R, p. 11, ll. 234-256)

In its last rate case, the Commission authorized NLU to charge lot owners an availability charge as long as water service is available for use, whether or not a tap is made into the system and whether or not there is an actual taking of water. The company proposes increasing the availability charge from $4.50 to 13.50 per month. (*Id.*, pp. 7-8, ll. 169-170) Ms. Harden recommends maintaining the current availability charge for water customers. At the time of the Company's last rate case, the Commission found that the availability charges were necessary and in the public interest. (See Staff Exhibit 4.0-R, p. 8, ll. 159-166, quoting Order, Docket 79-0195, pp. 6-7) The Company has failed to provide any information that the cost of providing this service has increased since the rate was set 25 years ago. (Staff Exhibit 4.0-R, p. 8, ll. 140-178)

In this proceeding the Company has proposed to establish a second availability charge. Rate 3 would apply to customers with side lots, defined as a lot adjacent to a lot improved with a residence. (See Co. Tariffs, Sect. No. 2, Orig. Sheet No. 6-7) The Rate 3 Side Yard Lot Charge would currently apply to 88 customers. (NLU Exhibit 1, p. 11) This proposal should be rejected because Rate 3 would be in violation of Section 9-241 of the Act. Section 9-241 of the Act states, in part:

> "No public utility shall, as to rates or other charges, services, facilities or in other respect, make or grant any preference or advantage to any corporation or person or subject any corporation or person to any prejudice or disadvantage. No public utility shall establish or maintain any unreasonable difference as to rates or other charges, services, facilities, or in any other respect, either as between localities or as between classes of service."

NLU's proposal is clearly inconsistent with Section 9-241 of the Act, which prohibits unreasonable differentiation between classes of service. NLU has failed to provide any reasonable foundation to account for the differentiation of rates between the side yard lots and the availability customers. By isolating 88 of 690 availability customers into a different payment category, NLU would be granting a preference or advantage to those 88 customers simply by the location of their adjoining lots. (Staff Exhibit 4.0-R, pp. 8-10, ll. 181-232)

Further, from a rate design perspective, the Company's proposed Rate 3 is inappropriate. The proposed Rate 3 is simply a variation of an availability charge, which have fallen out of favor with the Commission and is no longer recommended for approval. If an availability charge exists, it may continue to exist. However, the proposed Rate 3 is a new availability charge and Staff cannot recommend the Commission allow it. (Staff Exhibit 4.0-R, p. 10, ll. 217-232)

The Company has proposed a new surcharge of $7.50 a month for additional costs of serving certain water customers. (NLU Exhibit 1, pp. 9-10) This surcharge should be disallowed because the repair costs for these, and all, customers of NLU are already included in the Company's expenses. If the Company implemented such a surcharge, it would be collecting money twice from these 88 customers, first through the established rates for all customers and second through the added surcharge for these customers (Staff Exhibit 4.0-R, p. 13, ll. 278-303).

Depending upon the rate of return set by the Commission, Staff recommends the adoption of the proposed water rates set forth on Staff Exhibit 12.0, Schedule 12.01 or Schedule 12.02.

B. Sewer Rates

With respect to sewer rates, the Company proposed tripling the sewer rate and the availability charge. (NLU Exhibit 1, p. 5). The Company proposed leaving the sewer rate at 120% of the cost of water service. The Company also proposed establishing a new rate for the availability of service to a side yard lot (NLU Exhibit 1, p. 11).

The Company's proposal to leave the sewer rate at 120% of the water bill should be rejected because it is not a cost-base charge. Instead, Ms. Harden recommends a flat charge for sewer service. (Staff Exhibit 4.0-R, p. 19, ll. 438-446) The Company's proposal simply captures the water revenue requirement and increases it by 20%. Staff's proposal utilizes the Staff's proposed revenue requirement for the sewer portion of the Company and divides it equally among the sewer customers after subtracting the availability revenue.

The Company's proposals regarding the availability charge and Rate 3 should be rejected for the same reasons set forth above in regards to water service.

Staff's proposed sewer rates are set forth on Staff Exhibit 12.0, Schedules 12.01 or Schedule 12.02, depending upon the Commission decision in regards to rate of return.

C. MISCELLANEOUS TARIFF ISSUES

Staff does not object to the following Company proposals: (1) eliminating the installation charge; (2) eliminating the outside meter reading device charge (NLU Exhibit 1, p. 5); (3) changing the reconnection charge and (4) establishing a NSF Check Charge (NLU Exhibit 1, pp. 11-12). (Staff Exhibit 4.0-R, pp. 19-21, ll. 448-484)

VII. TARIFF TERMS AND CONDITIONS

The Company's current tariffs for water and sewer service are the original Rules, Regulations, and Conditions of Service for NLU and became effective on February 15, 1980. (NLU Exhibit 1, pp. 1 & 4) In the current proceeding, the Company has proposed changes to its Rules, Regulations, and Conditions of Service tariffs for water and sewer service. (NLU Exhibit 1, pp. 4, 9, 12, & 19; List of NLU Exhibits; NLU Exhibit PN; NLU Exhibit PR) The Rules, Regulations, and Conditions of Service tariffs for water and sewer service proposed by the

Company were based on those developed and suggested by the Commission Staff, with a few differences that the Company asserts "would fall into the category of wording preferences". (NLU Exhibit 1, p. 12) These tariffs that were developed previously by the Commission Staff were provided to other Illinois regulated utilities and approved by the Commission in several different docketed proceedings, most recently in Docket No. 03-0402 for Northern Hills Water and Sewer Company. (Staff Exhibit 5.0, pp. 7 & 14, ll. 128-132 & 281-284)

Staff witness William D. Marr reviewed the Company's proposed Rules, Regulations, and Conditions of Service tariffs for water and sewer service. (Staff Exhibit 5.0, pp. 4-5, ll. 84-87) Since the Company's proposed changes are more than mere "wording preferences", Mr. Marr recommended various changes to the Company's proposed Rules, Regulations, and Conditions of Service tariffs for water and sewer service. (Staff Exhibit 5.0, pp. 5-17, ll. 93-348) Mr. Marr also recommended that the Commission order the Company to file revised Rules, Regulations, and Conditions of Service tariffs for water and sewer service, within ten (10) days of the final 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 Exhibit 5.0, p. 17, ll. 350-356)

VIII. CONCLUSION

WHEREFORE, for all the reasons set forth herein, the Staff of the Illinois Commerce Commission respectfully requests that its recommendations be adopted in this proceeding.

April 26, 2005

Respectfully submitted,

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