

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

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

**REPLY BRIEF ON EXCEPTIONS
OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION**

Staff of the Illinois Commerce Commission (“Staff”), by and through its counsel, pursuant to Section 200.830 of the Rules of Practice (83 Ill. Adm. Code 200.830) of the Illinois Commerce Commission’s (“Commission”), respectfully submits its reply to the Brief on Exceptions filed by the Office of the Attorney General of behalf of the People of the State of Illinois (“AG BOE”) in response to the Proposed Order (“PO”) issued by the Administrative Law Judge (“ALJ”) on June 14, 2005 in the above-captioned matter.

I. INTRODUCTION

The AG BOE argues that the PO should reject Staff’s proposed liquidity premium because it is “unnecessary, not supported by record evidence, and inappropriate for a company that has NLU’s service quality and operational problems”. (AG BOE, p. 9) To the contrary, Staff has provided record evidence that supports allowing NLU a rate of return on common equity that reflects, in part, a liquidity premium. While Staff concurs that the Commission has the discretion to consider NLU’s service quality and operational problems when determining a reasonable rate of return that is a separate issue from the determination of whether to allow a liquidity premium.

II. ARGUMENT

In testimony, Staff described the methodology used to estimate NLU’s liquidity premium (Staff IB, pp. 25-26, citing Staff Ex. 3.0, p. 22, ll. 415-423) Staff also referenced several prior rate cases in which the Commission adopted liquidity premiums

for small utilities like NLU. (Staff RB, p. 16) Certain cases in which the Commission adopted a liquidity premium involved small, standalone companies with service quality and operational problems similar to NLU. (Staff RB, p. 16, citing Order, Docket No. 97-0605, Crystal Clear Water Co. (June 16, 1999), pp. 7-14; Order, Docket No. 97-0606, Highland Shores Water Co. (June 16, 1999), pp. 7-14; Order, Docket No. 97-0607, McHenry Shores Water Co. (June 16, 1999), pp. 7-15; Order, Docket No. 97-0608, Northern Illinois Utilities, Inc. (June 16, 1999), pp. 7-15; Order, Docket No. 97-0609, Wonder Lake Water Co. (June 16, 1999), pp. 7-14) Those cases in which the Commission adopted liquidity premiums for small utilities with problems similar to NLU support the fact that a liquidity premium is unrelated to service quality or operational problems. Rather, a liquidity premium is necessary because 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 RB, p. 15 and Staff IB, p. 25, citing Staff Ex. 3.0, p. 21, ll. 405-412)

According to the AG BOE, the PO adopts “an inflated rate of return because the utility is owned by one person, who, by the way, has failed to operate it in a just and reasonable way”. (AG BOE, p. 9) The AG BOE incorrectly asserts that by including the liquidity premium in the allowed return on common equity the PO “unreasonably and excessively increases [the] rate of return notwithstanding the poor service quality and lack of maintenance and investment demonstrated by the record.” (AG BOE, p. 11) Again, referring to the liquidity premium, the AG BOE states, “[a] poorer incentive to good service could hardly be imagined than to increase the return above a fair market value for such proven poor performance.” (AG BOE, p. 11) That is, the AG BOE mischaracterizes Staff’s proposed liquidity premium as a reward to NLU’s owner. In contrast, the liquidity premium is intended to compensate investors for the additional risk inherent in a small utility such as NLU. That is not to say that the Commission could not penalize NLU for its history of service quality and operational problems. (See Staff

BOE, pp. 5-8) Should the Commission conclude NLU has not been providing adequate service, the Commission could reduce NLU's authorized rate of return to reflect the value of service the Commission concludes NLU has been providing ratepayers. (Staff RB, p. 29)

The PO recognizes that NLU has not been providing adequate service. However, the PO also recognizes that reducing NLU's allowed rate of return may discourage potential lenders from offering access to capital (p. 13). That is, the PO did not reduce NLU's rate of return because doing so might not provide NLU sufficient capital to comply with applicable laws, service quality standards and other regulations. Staff agrees that is a valid concern which must be weighed against the likelihood that a qualified receiver will be appointed to operate NLU. Absent appointment of a qualified receiver, some penalty would be proper despite NLU's need to raise capital given NLU ownership's history of subordinating the interests of its customers to those of affiliates.

However, penalizing NLU's owner by reducing the authorized rate of return is a distinct adjustment from adopting a rate of return on common equity for NLU that includes a liquidity premium because NLU incurs liquidity costs due to its small size relative to publicly traded water utilities.

Despite the AG BOE's mischaracterization of the liquidity premium as a reward to NLU's owner and sole shareholder, the AG BOE recognizes that the premium is based on the lack of a liquid market for NLU's common stock. Specifically, the AG BOE states:

Staff and the Proposed Order seek to increase the rates paid by consumers because Gene Armstrong, who owns all of the stock of NLU's parent, may not be able to sell his stock "at the desired time, at a predictable price." Proposed Order at 13. ... (AG BOE, p. 10)

The AG BOE continues by asserting that liquidity costs are a "false concern". This conclusion is based on the following inaccurate descriptions of cost of equity analyses:

There are many things that influence the ability to sell common stock of a privately or a publicly held company. All investors face uncertainty in connection with stock prices and the DCF and CAPM models are intended to capture these risks faced by investors. The Proposed Order would

effectively double count the risk faced by NLU's one investor and inflate the rates paid by consumers by accepting a "liquidity premium." (AG BOE, p. 10)

The AG BOE incorrectly suggests that the factors that influence the ability to sell common stock of a privately held company vis-à-vis a publicly held company are identical. To the contrary, liquidity premiums are intended to compensate investors for the additional risk that exists when a company is not market-traded. (Staff RB, p. 18, citing Tr. p. 493) Similarly, the AG BOE asserts that the DCF and CAPM models are intended to capture risks faced by investors. Although the DCF and CAPM models capture investment risk, those models require market data, and were consequently applied to proxy groups comprising market-traded companies whose security prices do not reflect substantial liquidity costs. (Staff IB, pp. 22-23 and 25) Moreover, since Staff's DCF and CAPM analyses could not capture liquidity costs, then it necessarily follows that those models did not double count the liquidity cost inherent in NLU's stock. Thus, Staff's analysis does not inflate the cost of equity estimate for NLU.

The AG BOE criticizes Staff's methodology for calculating NLU's liquidity premium. Staff calculated NLU's liquidity premium using Rural Telephone Finance Cooperative ("RTFC") loan rates, which the AG BOE argues are irrelevant to the water and sewer industry. (AG BOE, p. 10) Staff witness Phipps used RTFC loan rates because they are the best available proxy for estimating the liquidity costs associated with an illiquid company such as NLU. (Staff RB, p. 18, citing Tr., pp. 495 and 498)

The AG BOE argues that using debt rates to estimate a common equity liquidity premium is an "apples to oranges" comparison. (AG BOE, pp. 10-11) Staff witness 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 firms is not directly observable. (Staff RB, p. 18, citing Staff Ex. 3.0, p. 22, ll. 415-417) She explained that it would be impossible to estimate a liquidity premium using data for market-traded companies because the liquidity premium is intended to compensate

investors for the additional risk that exists when a company is not market-traded. Thus, Staff witness Phipps necessarily used a proxy to estimate a liquidity premium for NLU's cost of equity. (Staff RB, p. 18, citing Tr., p. 493) Proxies are a necessary part of cost of equity analysis. (Staff Ex. 3.0, p. 20, ll. 382-385) While debt rates are imperfect estimators, a declaration that they are "oranges" to common equity "apples" ignores their commonalities such as their incorporation of the risk-free rate, inflation expectations, and a risk premium that is proportional to risk. (Staff Ex. 3.0, pp. 11-12, ll. 212-230)

The AG BOE also criticizes Staff's use of judgment in determining NLU's cost of equity. The AG BOE argues that although an analyst's judgment is relevant, "if judgment is used to radically change the return on common equity, that judgment must be fully justified or it will undermine and effectively replace [DCF and CAPM analyses]." (AG BOE, p. 9) Contrary to the AG BOE, Staff did not use judgment to "radically" modify the results of its DCF and CAPM analyses. Rather, Staff used the DCF- and CAPM-derived cost of equity estimates as a starting point for estimating NLU's cost of equity. Staff then added to the DCF- and CAPM-derived cost of equity estimate a liquidity premium based on the best available proxies. Clearly, Staff did not undermine or replace DCF and CAPM analyses by recommending a cost of equity for NLU that reflects, in part, a liquidity premium. .

III. CONCLUSION

WHEREFORE, for all the reasons set forth herein, the Staff of the Illinois Commerce Commission respectfully requests that the AG BOE modifications concerning rate of return should be rejected and Staff's recommendations be adopted in this proceeding.

June 27, 2005

Respectfully submitted,



JANIS E. VON QUALEN
Staff Attorney

Counsel for the Staff of the
Illinois Commerce Commission

Carla Scarsella
Office of General Counsel
Illinois Commerce Commission
160 North LaSalle Street
Suite C-800
Chicago, Illinois 60601
Phone: (312) 793-3305
Fax: (312) 793-1556
mail to: cscarsel@icc.state.il.us

Janis E. Von Qualen
Office of General Counsel
Illinois Commerce Commission
527 East Capitol Avenue
Springfield, IL 62701
Phone: 217-785-3402
Fax: 217-524-8928
[mail to: jvonqual@icc.state.il.us](mailto:jvonqual@icc.state.il.us)