

Direct Testimony

of

Rochelle Phipps

Finance Department

Financial Analysis Division

Illinois Commerce Commission

Illinois-American Water Company
Petition for Certificate of Public
Convenience and Necessity to operate a water supply
And wastewater collection system;
and for approval of water supply plant contribution,
Construction cost refund proposals for water and wastewater,
Accounting entries, depreciation rates,
And water and wastewater rates.

Docket No. 05-0253

July 26, 2005

1 **1. Q. Please state your name and business address.**

2 A. My name is Rochelle Phipps. My business address is 527 East Capitol
3 Avenue, Springfield, Illinois 62701.

4 **2. Q. By whom are you employed and in what capacity?**

5 A. I am employed by the Illinois Commerce Commission (“Commission”) as a
6 Senior Financial Analyst with the Finance Department of the Financial
7 Analysis Division.

8 **3. Q. Describe your qualifications and background.**

9 A. In May 1998, I received a Bachelor of Arts degree in Finance from Illinois
10 College, Jacksonville, Illinois. In May 2000, I received a Master of
11 Business Administration degree from the University of Illinois at
12 Springfield. I have been employed by the Commission since June 2000.

13 **4. Q. What is the purpose of your testimony in this proceeding?**

14 A. Pursuant to Section 8-406(b) of the Illinois Public Utilities Act (“Act”), for
15 the Commission to determine that proposed construction will promote the
16 public convenience and necessity, a utility must satisfy three criteria. I will
17 present my evaluation of Illinois-American Water Company’s
18 (“Illinois-American” or “Company”) financial ability to construct, operate
19 and maintain a water supply and distribution system (“Water System”) and

20 a wastewater collection system (“Sewer System”) for an area located
21 within the Village of South Barrington (the “Area”) pursuant to Section
22 8-406(b)(3) of the Act.

23 **5. Q. Please summarize your conclusions.**

24 A. The estimated cost of construction for the Company is diminutive in
25 relation to its financial resources. Thus, in my judgment, the Company has
26 the financial ability to construct, operate and maintain the Water and
27 Sewer Systems for the Area.

28 **6. Q. What are the requirements of Section 8-406(b)(3) of the Act?**

29 A. Section 8-406(b)(3) of the Act requires the Commission to determine that
30 the proposed construction will promote the public convenience and
31 necessity only if a utility demonstrates that it is capable of financing the
32 proposed construction without significant adverse financial consequences
33 for the utility or its customers.¹

34 **7. Q. Describe the proposed construction and estimated cost for the**
35 **Company.**

36 A. Pursuant to the Water Service Agreement (“Agreement”) between
37 Illinois-American and Toll IL WSB, L.P. (“Toll”), provided as Exhibit 1 to
38 the Company’s Amended Petition, Toll will construct the Water and Sewer

¹ 220 ILCS 5/8-406(b)(3).

39 Systems to serve the Area. Toll will then transfer the Water and Sewer
40 Systems to Illinois-American, who will then provide public water and
41 wastewater service to the Area, including but not limited to, a 392-unit
42 residential subdivision.² Illinois-American will not purchase the Water and
43 Sewer Systems. Rather, Illinois-American's investment in the Water and
44 Sewer Systems will be made as customers are added to the Systems over
45 the next ten years.³ Overall, the Company anticipates refunding to Toll
46 \$885,332 for the Water System and \$1,313 for the Sewer System.⁴ The
47 Company will also incur transaction-related expenses (i.e., legal expenses
48 and financial review and support) totaling \$70,000.⁵ The Company does
49 not anticipate any capital expenditures will be required for the Area during
50 years 2005 through 2009.⁶

51 **8. Q. How will the Company finance the payments associated with new**
52 **customers joining the Systems?**

53 A. According to Illinois-American, the source of funds will depend on the
54 Company's overall cash flow and capital expenditure requirements. The
55 source will be debt, equity or internally generated funds.⁷

56 **9. Q. How does the estimated cost of the proposed construction compare**
57 **to Illinois-American's water utility assets and revenue?**

² Company's Amended Petition, par. 2 and Exhibit 1, Recital E.

³ Company response to ICC Staff data request FD 1.04; Company's Amended Petition, par. 10, 13, 16 and 19; Company Exhibit 4.

⁴ Company response to ICC Staff data request FD 1.05.

⁵ Company response to ICC Staff data request FD 1.06.

⁶ Company response to ICC Staff data request FD 1.07.

⁷ Company response to ICC Staff data request FD 1.08.

58 A. As reported in Illinois-American's 2004 Form 22 ILCC annual report, at
59 December 31, 2004, Illinois-American's net plant totaled \$598,487,540.
60 Illinois-American's total utility revenue for the twelve months ended
61 December 31, 2004, totaled \$169,607,371. In comparison,
62 Illinois-American estimates its investment to serve the Area equals
63 \$956,645 (*i.e.*, refunds totaling \$886,645, plus transaction-related
64 expenses totaling \$70,000).⁸ Thus, Illinois-American's investment for
65 serving the Development would equal \$956,645, or 0.16% of its total utility
66 plant and 0.56% of its total utility revenue. Moreover, the Agreement limits
67 the amount of payments by Illinois-American to Toll to the construction
68 cost for the Development, which totals \$7,956,000, plus interest.⁹ Thus,
69 even if Illinois-American reimbursed Toll for the entire construction cost, in
70 addition to paying the transaction-related expenses, Illinois-American's
71 investment in the system would equal \$8,026,000, or 1.34% of its total
72 utility plant and 4.73% of its total utility revenue. In my judgment,
73 Illinois-American's estimated cost of construction is diminutive in relation
74 to its financial resources.

75 **10. Q. Illinois-American indicates that it will finance the payments in**
76 **connection with new customers joining the System with debt, equity**
77 **or internally generated funds. Does Illinois-American have access to**
78 **the capital markets on reasonable terms?**

⁸ Company responses to ICC Staff data requests FD 1.05 and 1.06.

⁹ Exhibit C, attached to Exhibit 1 of Company's Amended Petition. Company responses to ICC Staff data requests FD 2.01 and 2.02 indicate the interest rate contemplated by the Agreement is 6.30%, which is the Company's estimated cost of debt capital. In my judgment, the Company has overestimated its debt cost. Current market data suggests that the Company's current cost for 10-year debt would more likely fall between 5.08% and 5.63% (*i.e.*, current yields for 10-year, A-rated financial bonds and 25/30-year,

79 A. Yes. Illinois-American obtains equity capital through its parent company,
80 American Water, who, in turn, obtains equity capital through its parent
81 company, RWE AG. RWE AG also provides substantially all debt funding
82 to another of American Water's wholly-owned subsidiaries, American
83 Water Capital Corporation ("AWCC").¹⁰ AWCC provides Illinois-American
84 with debt capital, as authorized in Docket No. 00-0306.¹¹ Standard &
85 Poor's ("S&P") categorizes debt securities on the basis of the risk that a
86 company will default on its interest or principal payment obligations. The
87 resulting credit rating reflects both the operating and financial risks of a
88 utility.¹² S&P rates AWCC "A."¹³ According to S&P, an A-rated utility has a
89 strong capacity to meet its financial obligations.¹⁴ The ratings on AWCC
90 largely reflect the consolidated credit quality of its ultimate parent, RWE
91 AG.¹⁵ AWCC has a Baa1 senior unsecured rating from Moody's Investor's
92 Service ("Moody's").¹⁶ According to Moody's, Baa-rated issuers offer
93 adequate financial security.¹⁷ Given Illinois-American's parent company,
94 American Water and indirect parent company, RWE AG, are financially
95 strong, in my judgment, Illinois-American has access to the capital
96 markets on reasonable terms.

97 **11. Q. What is your recommendation regarding Illinois-American?**

Baa/BBB-rated utility bonds, respectively). (Value Line, "Selection & Opinion," July 22, 2005, p. 1623) That range could be even lower given that a portion of the principle would be repaid before the end of the ten-year term. Thus, Staff does not endorse the Company's estimated debt cost in this case for ratemaking purposes.

¹⁰ Standard & Poor's, "Summary: American Water Capital Corp.," June 22, 2005.

¹¹ Order, Docket No. 00-0306, May 16, 2000.

¹² Standard & Poor's Utilities Rating Service, "Utilities Rating Criteria," May 20, 1996, p. 1.

¹³ Standard & Poor's, "Summary: American Water Capital Corp.," June 22, 2005.

¹⁴ Standard & Poor's Ratings Definitions, December 10, 2002, pp. 1-2.

¹⁵ Standard & Poor's, "Summary: American Water Capital Corp.," June 22, 2005.

¹⁶ Moody's Investor's Service, "Rating Action: American Water Capital Corporation," June 7, 2004, provided in response to ICC Staff data request FD 1.09.

¹⁷ Moody's Investor's Service, "Ratings Definitions," www.moody.com.

98 A. In my judgment, the proposed transaction meets the requirements of
99 Section 8-406(b)(3) of the Act. Therefore, I recommend the Commission
100 find that the Company is capable of financing the proposed construction
101 without significant adverse financial consequences for the utility or its
102 customers.

103 **12. Q. Does this conclude your direct testimony?**

104 A. Yes.