

DIRECT TESTIMONY

OF

THOMAS Q. SMITH

WATER DEPARTMENT
FINANCIAL ANALYSIS DIVISION
ILLINOIS COMMERCE COMMISSION

RME ILLINOIS, L.L.C.

PETITIONS FOR ISSUANCE OF CERTIFICATES OF PUBLIC CONVENIENCE AND
NECESSITY TO PROVIDE ONSITE WASTEWATER, COLLECTION AND DISPERSAL
SERVICES TO PARCELS IN LAKE COUNTY, ILLINOIS, PURSUANT TO SECTION
8-406 OF THE ILLINOIS PUBLIC UTILITIES ACT

DOCKET NOS. 08-0490/08-0491 (CONSOLIDATED)

DECEMBER 2, 2008

1 WITNESS IDENTIFICATION

2 Q. Please state your name and business address.

3 A. My name is Thomas Q. Smith. My business address is 527 East Capitol Avenue,
4 Springfield, Illinois 62701.

5

6 Q. Please describe your present position and related responsibilities.

7 A. I am presently employed as an Economic Analyst in the Water Department of the
8 Financial Analysis Division of the Illinois Commerce Commission (“ICC” or the
9 “Commission”). My responsibilities include reviewing and analyzing tariff filings
10 related to rates, rules, regulations, and conditions of service for water and sewer
11 service; reviewing applications for certificates of public convenience and
12 necessity; reviewing information regarding the prudence of Qualifying
13 Infrastructure Plant investment costs; conducting inspections of water and sewer
14 public utilities; reviewing requests for general increases in rates for water and
15 sewer service; reviewing tariff filings related to purchased water surcharge riders
16 and information sheets; reviewing applications for approval of proposed
17 reorganizations; and presenting expert witness testimony in docketed
18 proceedings before the Commission. Prior to my transfer to the Water
19 Department, I served as an auditor in the Commission’s Accounting Department.

20

21 Q. Please describe your background and professional qualifications.

22 A. I received a Bachelor of Arts Degree in Accounting from Michigan State
23 University. I am a Certified Public Accountant licensed to practice in Illinois,

24 Michigan, and Wisconsin. My prior experience includes seven years as an
25 auditor with the Michigan Public Service Commission. Subsequently, I was
26 employed for three years by Wisconsin Southern Gas Company in the initial
27 capacity of Senior Accountant - Rate Specialist and later as Controller. I am a
28 member of the American Institute of Certified Public Accountants and the
29 American Water Works Association.

30

31 Q. Have you previously testified before regulatory bodies?

32 A. Yes, I have testified on many occasions before the Illinois Commerce
33 Commission, the Michigan Public Service Commission, and the Public Service
34 Commission of Wisconsin. During the course of various rate proceedings, I have
35 testified to accounting, rates, cost of service, finance, and operational issues.

36

37 INTRODUCTION

38 Q. What is the purpose of your testimony in this proceeding?

39 A. The purpose of my testimony is to review: (i) under Section 8-406 of the Illinois
40 Public Utilities Act ("Act"), RME Illinois, L.L.C.'s ("RME" or the "Company") need
41 for Certificates of Public Convenience and Necessity ("Certificates") to provide
42 sewer service to the Falcon Crest Subdivision in the Village of Lake Villa and
43 Eastgate Estates in the Village of Long Grove, both in Lake County, Illinois; (ii)
44 the Company's proposed certificated service areas; (iii) the Company's proposed
45 Rules, Regulations, and Conditions of Service tariffs for sewer service; and (iv)
46 the Company's proposed level of investment in the wastewater systems.

47

48 Q. Are you including any attachments with this testimony?

49 A. Yes. I am including the following attachments with this testimony:

50 Attachment 1.1 Alternative Wastewater Systems in Illinois; and

51 Attachment 1.2 Voluntary National Guidelines for Management of

52 Onsite and Clustered (Decentralized) Wastewater

53 Treatment Systems.

54

55 PUBLIC CONVENIENCE AND NECESSITY

56 Q. Why is the Company presently seeking Certificates to serve these areas?

57 A. The Company has been requested by the developer and the Lake County Health

58 Department to provide sewer service to 44 single-family residential customers of
59 the Falcon Crest Subdivision in the Village of Lake Villa in Lake County, Illinois.

60 The Company has also been requested by the developer and the Lake County

61 Health Department to provide sewer service to 9 single-family residential

62 customers of Eastgate Estates in the Village of Long Grove in Lake County,

63 Illinois.

64

65 Q. What criteria did you use to review public convenience and necessity?

66 A. I addressed requirements (1) and (2) in Section 8-406(b) of the Act, which states,

67 in part:

68 ...The Commission shall determine that proposed construction will
69 promote the public convenience and necessity only if the utility
70 demonstrates: (1) that the proposed construction is necessary to provide
71 adequate, reliable, and efficient service to its customers and is the least-

72 cost means of satisfying the service needs of its customers; (2) that the
73 utility is capable of efficiently managing and supervising the construction
74 process and has taken sufficient action to ensure adequate and efficient
75 construction and supervision thereof; and (3) that the utility is capable of
76 financing the proposed construction without significant adverse financial
77 consequences for the utility or its customers.
78

79 Q. Is the proposed construction necessary to provide adequate, reliable, and
80 efficient service to customers within the proposed areas?

81 A. Yes. The Company's proposed construction of the wastewater systems is
82 necessary to provide adequate, reliable, and efficient sewer service to the
83 customers within the proposed certificated service areas. The need for sewer
84 service in these areas is reflected in letters from the developers of the
85 subdivisions in question and the Lake County Health Department. These
86 documents are provided by the Company and identified as RME EXHIBIT 1.01
87 FC, RME EXHIBIT 1.02 FC, RME EXHIBIT1.01 EG, and RME EXHIBIT 1.02 EG.

88
89 Q. Do the Company's proposed wastewater systems have sufficient capacity to
90 meet the estimated demand from the customers within the proposed areas
91 without constructing additional wastewater facilities?

92 A. Yes. According to information provided by the Company, in RME EXHIBIT NO.
93 1.0 FC, line 137, capacity of the Company's proposed wastewater system for the
94 Falcon Crest Subdivision is rated at 17,720 gallons per day ("gpd"). The
95 estimated demand for sewer service from the customers within the Falcon Crest
96 Subdivision is 8,800 gpd as shown on line 133 of RME EXHIBIT NO. 1.0 FC.
97 The capacity of the Company's proposed wastewater system for Eastgate

98 Estates is rated at 4,320 gpd as shown on line 133 of RME EXHIBIT NO. 1.0 EG.
99 The estimated demand for sewer service from the customers within Eastgate
100 Estates is 1,800 gpd as shown on line 130 of RME EXHIBIT NO. 1.0 EG.
101 Therefore, the Company's proposed wastewater systems will have sufficient
102 capacity to meet the estimated demand from the customers within the proposed
103 areas without the need to construct additional wastewater facilities.

104

105 Q. Is the proposed construction the least-cost means of satisfying the service needs
106 of the customers within the proposed areas?

107 A. Yes. The Company's proposed construction of the wastewater systems
108 constitutes the least-cost means of satisfying the sewer service needs of the
109 customers within the proposed areas. The Company has indicated that no other
110 public sewer utility is willing or able to provide sewer service to the proposed
111 areas and that no municipal corporation is willing or able to provide sewer service
112 to the proposed areas.

113

114 Mr. Olson testified that a lagoon wastewater treatment system for these
115 properties is impractical. He further stated that the sites are very hilly and
116 placing a lagoon on the sites would be difficult, if not impossible. In addition, he
117 testified that there is not enough land outside of the wetland boundaries for the
118 dispersal of the wastewater by spray irrigation. (RME EXHIBIT No. 1.0 FC, Lines
119 183-192 and RME EXHIBIT No. 1.0 EG, Lines 179-188) Typically, lagoon
120 wastewater treatment systems are the least expensive type of wastewater

121 treatment system to construct, but in this case, a lagoon is not a feasible
122 alternative.

123
124 A report written and published by the Illinois Community Action Association titled
125 “Alternative Wastewater Systems in Illinois”, ICC Staff Exhibit 1.0, Attachment
126 1.1, indicates that a Septic Tank Effluent Pump (“STEP”) system has lower
127 capital, operation, maintenance, and construction costs than a similar sized
128 conventional wastewater system, is advantageous when there is limited available
129 space and environmental conditions, and is generally preferred because of
130 aesthetics compared to a lagoon.

131
132 According to a manual published in March 2003 by the United States
133 Environmental Protection Agency (“EPA”) titled “Voluntary National Guidelines
134 for Management of Onsite and Clustered (Decentralized) Wastewater Treatment
135 Systems”, ICC Staff Exhibit 1.0, Attachment 1.2, page 12, decentralized
136 wastewater treatment systems are a cost-effective and long-term option for
137 meeting public health and water quality goals, particularly in less densely
138 populated areas. Attachment 1.2, page 12, indicates that the EPA found that
139 decentralized systems can protect public health and the environment, typically
140 have lower capital and maintenance costs for low-density communities, are
141 appropriate for varying site conditions, and are suitable for ecologically sensitive
142 areas.

143

144 Q. Is the Company capable of efficiently managing and supervising the construction
145 process and has it taken sufficient action to ensure adequate and efficient
146 construction and supervision thereof?

147 A. No. The Company is not capable of efficiently managing and supervising the
148 construction necessary to provide sewer service to the proposed areas and it has
149 not taken sufficient action to ensure adequate and efficient construction and
150 supervision thereof.

151
152 On May 23, 2007, the Company previously requested a Certificate in Docket
153 Nos. 07-0331/07-0332 (Consolidated). On November 7, 2007, the Water
154 Department inspected the Company's proposed certificated service areas and, at
155 that time, construction of the wastewater system in Eastgate Estates had not
156 begun. The Certificate was denied on July 16, 2008 in the previous proceeding.

157
158 On September 29, 2008, I inspected the Company's proposed certificated
159 service areas and found that the developer had begun construction of the
160 wastewater system in Eastgate Estates even though the Commission has not
161 issued a Certificate to RME. Thus, the Company has been a participant in the
162 certification process with the Commission prior to the commencement of
163 construction and should have been well aware that ICC approval was needed
164 prior to construction. It was not reasonable for RME to enter into a working
165 relationship with an entity that began construction of a wastewater system prior
166 to ensuring that proper regulatory approvals had been obtained. It was

167 managerially imprudent for RME to agree to own and operate the wastewater
168 systems as a public utility without first obtaining approval from the ICC.

169

170 While the wastewater system in Eastgate Estates was constructed by the
171 developer, RME is nevertheless required to supervise construction under Section
172 8-406(b)(2) of the Act. Section 8-406(b) of the Act requires that a Certificate be
173 granted prior to the commencement of construction of a wastewater system.

174 RME has agreed to take ownership of the wastewater system from the developer
175 and has thus in fact, if not according to law, participated in the construction of the
176 wastewater system without approval of the Commission. It is my opinion that
177 RME has engaged in an activity that is contrary to the requirements of the Act,
178 and that by doing so, RME has acted irresponsibly. It is my opinion that the
179 developers and RME should have been aware of the need for ICC approval prior
180 to embarking on construction of the subdivisions and wastewater systems.

181

182 Q. In your opinion, has the Company met the requirements set forth in Section 8-
183 406(b)(1) and (2) of the Act?

184 A. No. The Company's proposal does not meet the requirements of Section 8-
185 406(b)(2) of the Act for the reasons stated above. Staff witness Rochelle Phipps
186 addresses the requirement set forth in Section 8-406(b)(3) of the Act in her
187 testimony. (ICC Staff Exhibit 3.0)

188

189

190 PROPOSED CERTIFICATED SERVICE AREAS

191 Q. Please describe the Company's proposed certificated service areas.

192 A. The Company has requested a Certificate to provide sewer service to the Falcon
193 Crest Subdivision in the Village of Lake Villa in Lake County, Illinois. The Falcon
194 Crest Subdivision proposed certificated service area is shown on the map
195 identified as RME Exhibit FC-A of the Petition and legally described in RME
196 Exhibit FC-B of the Petition. Mr. Olson testified that the total acreage for this
197 proposed certificated service area is approximately 35.1 acres. (RME Ex. 1.0 FC,
198 line 96)

199
200 The Company has requested a Certificate to provide sewer service to Eastgate
201 Estates in the Village of Long Grove, Vernon Township, Lake County, Illinois.
202 The Eastgate Estates proposed certificated service area is shown on the map
203 identified as RME Exhibit EG-A of the Petition and legally described in RME
204 Exhibit EG-B of the Petition. Mr. Olson testified that the total acreage for this
205 proposed certificated service area is approximately 22.5 acres. (RME Ex. 1.0 EG,
206 line 96)

207
208 Q. In your opinion, should the Company's proposed certificated service areas be
209 approved?

210 A. In the event the Commission grants the Certificates, I recommend that the
211 Commission approve the Company's proposed certificated service areas. I
212 reviewed the Company's proposed certificated service areas and they appear to

213 be properly defined.

214

215 PROPOSED RULES, REGULATIONS, AND CONDITIONS OF SERVICE TARIFFS

216 Q. Has the Company provided proposed Rules, Regulations, and Conditions of
217 Service tariffs for sewer service?

218 A. Yes. The Company has provided proposed Rules, Regulations, and Conditions
219 of Service tariffs for sewer service as Attachments FC-3 and EG-3 to the Petition.
220 The documents that contain the Company's proposed Rules, Regulations, and
221 Conditions of Service tariffs for sewer service for each of the proposed
222 certificated service areas, Falcon Crest Subdivision and Eastgate Estates,
223 appear to be identical except for exhibit numbers. It is my understanding that the
224 Company intends to have only one set of tariff sheets for Rules, Regulations, and
225 Conditions of Service for sewer service that applies to both Falcon Crest
226 Subdivision and Eastgate Estates.

227

228 Q. Have you reviewed the Company's proposed Rules, Regulations, and Conditions
229 of Service tariffs for sewer service?

230 A. Yes. I have reviewed the Company's proposed Rules, Regulations, and
231 Conditions of Service tariffs for sewer service.

232

233 Q. In your opinion, should the Company's proposed Rules, Regulations, and
234 Conditions of Service tariffs for sewer service be approved?

235 A. If the Commission grants the Certificates, I recommend that the Commission also
236 approve the Company's proposed Rules, Regulations, and Conditions of Service
237 tariffs for sewer service. The Company's proposal is consistent with standard
238 tariffs that have been developed by Staff, provided to other Illinois regulated
239 utilities, and approved by the Commission in numerous Docketed proceedings,
240 most recently in Docket No. 06-0522 for Rockwell Utilities, LLC.

241

242 If the Commission grants the Certificates, I recommend that the Commission
243 Order the Company to file these Rules, Regulations, and Conditions of Service
244 tariffs for sewer service, within ten (10) days of the final Order, with an effective
245 date of not less than five (5) working days after the date of filing, for service
246 rendered on and after their effective date, with individual tariff sheets to be
247 corrected within that time period, if necessary.

248

249 Q. Has the Company provided a justification for installing proposed sewer mains
250 that are two inches (2") in diameter in size?

251 A. Yes. Standard Rules, Regulations, and Conditions of Service tariffs for sewer
252 service developed by Staff require sewer mains to be at least 6-inches in
253 diameter to meet service requirements. Exceptions to the size of the sewer main
254 can be made by the Commission to comply with good engineering principles. Mr.
255 Olson testified in RME EXHIBIT NO. 1.0 FC, beginning on line 158, that the
256 sewer mains are sized to comply with good engineering principles to meet each
257 proposed subdivision's service requirements. He asserted that 2" in diameter

258 sewer mains are adequate for up to 100 equivalent dwelling units. He further
259 claimed that the peak flow rate for each proposed subdivision will be 19.5 gallons
260 per minute (“gpm”), which is well within the acceptable flow parameters for a 2” in
261 diameter sewer main. The Company’s proposed Rules, Regulations, and
262 Conditions of Service tariffs for sewer service included the 2” in diameter sewer
263 main size.

264

265 INVESTMENT

266 Q. Why is it necessary that an entity have an adequate amount of investment in a
267 wastewater system?

268 A. As discussed in “Accounting for Public Utilities”, Hahne and Aliff, Matthew
269 Bender & Co., §1.01, a utility “... is allowed to earn (but not guaranteed) a
270 “reasonable profit” and a utility “...is obligated to provide adequate service to its
271 customers, on demand.” In essence, a utility would not be able to fulfill its
272 service obligations without an adequate amount of investment. If a utility were
273 inadequately funded, there would be no basis upon which to earn a profit and the
274 utility would be unable to support its duty to “provide adequate service” on
275 demand.

276

277 Q. Can you address more specific concerns in addition to the general theory that
278 you have cited?

279 A. Yes, I can. In this case, RME is proposing that more than 95% of the cost of
280 wastewater system construction be contributed by the developer, rather than

281 acquired through investment by RME. The problem with this sort of arrangement
282 is that the profits and recovery of capital cost will be limited. At best, less than
283 5% of the cost of construction will be recovered through sewer rates charged to
284 customers. Even without consideration for inflation, the Company will not
285 recover enough investment to replace the wastewater systems as they
286 deteriorate and begin to fail. The customers will eventually fail to receive
287 adequate sewer service because the infrastructure cannot be replaced.

288

289 More difficult to see, but of equal concern, is that the lack of profit resulting from
290 inadequate investment is a disincentive to efficient operations. Risk associated
291 with low profits results in difficulty obtaining lines of operating credit. Also, a lack
292 of profit reduces the incentive for a utility to protect its investment in the utility.
293 As a result, proper maintenance of the system can suffer at the expense of what
294 little profit does exist. In many instances, facilities are allowed to deteriorate,
295 forcing replacement of plant items at an earlier date, and at a greater cost to
296 customers and investors, than if they were maintained properly. While
297 substantial contributions can result in lower short-term rates to customers, the
298 customers of those utilities with inadequately funded rate bases often receive
299 less than acceptable service at an excessive long-term cost.

300

301 Q. What criteria do you propose be used to serve as a basis for calculating the
302 amount of investment to be included in the Company's rate bases in these
303 Dockets if the Commission grants the Certificates?

304 A. Because no wastewater systems similar to Falcon Crest Subdivision and
305 Eastgate Estates exist in Illinois, and because no Commission rules apply to
306 sewer utilities, I am relying upon 83 Ill. Adm. Code 600.370 (Service to New
307 Customers) of the Commission's regulations as investment policy. 83 Ill. Adm.
308 Code 600.370(a) requires the utility to provide all backbone plant (treatment –
309 central plant costs) at its cost and expense without requiring contributions from
310 developers.

311

312 Q. What has the Company proposed as the level of investment in the Falcon Crest
313 Subdivision wastewater system?

314 A. Mr. Olson's RME Exhibit 1.06 FC, Schedule 1.06-2, revised September 5, 2008,
315 and his response to ICC Staff Data Request TQS 2.23, indicate that the
316 Company intends to invest \$41,096 in ownership of the Falcon Crest Subdivision
317 wastewater system. The investment on a per lot basis would be \$934. The
318 Company is proposing that the investment be accrued through refund of the
319 developer's contribution of plant investment as customers attach to the
320 wastewater system.

321

322 Q. Do you know the actual cost of the Falcon Crest Subdivision wastewater system?

323 A. Yes, I do. RME Exhibit 1.04 FC shows that the total cost of wastewater
324 treatment plant is \$465,388 and that total cost of wastewater collection plant is
325 \$363,612, or \$829,000 total for the entire wastewater system.

326

327 Q. What has the Company proposed as the level of investment in the Eastgate
328 Estates wastewater system?

329 A. Mr. Olson's RME Exhibit 1.06 EG, Schedule 1.06-2, Revised September 5, 2008,
330 and his response to ICC Staff Data Request TQS 2.24, indicate that the
331 Company intends to invest \$8,667 in ownership of the Eastgate Estates
332 wastewater system. The investment on a per lot basis would be \$963. The
333 Company is proposing that the investment be accrued through refund of the
334 developer's contribution of plant investment as customers attach to the
335 wastewater system.

336

337 Q. Do you know the actual cost of the Eastgate Estates wastewater system?

338 A. Yes, I do. RME Exhibit 1.04 EG shows that the total cost of wastewater
339 treatment plant is \$172,508 and that total cost of wastewater collection plant is
340 \$84,492, or \$257,000 total for the entire wastewater system.

341

342 Q. Has the Company proposed an adequate level of investment in the wastewater
343 systems?

344 A. No. The Company has proposed that it invest an amount equal to 5.0% of the
345 total cost to construct the Falcon Crest Subdivision wastewater system: \$41,096
346 investment divided by \$829,000 total cost. The Company has proposed that it
347 invest an amount equal to 3.4% of the total cost to construct the Eastgate
348 Estates wastewater system: \$8,667 investment divided by \$257,000 total cost.

349 The investment that RME is proposing is negligible when compared with the total
350 cost of the wastewater systems.

351
352 Because the Company is obligated to make an investment in the wastewater
353 systems as discussed above, refunds by RME to the developers are
354 inappropriate and the refund mechanism as identified by the Company (See
355 RME Ex. 1.0 FC, line 346 *et seq.* and RME Ex. 1.0 EG, line 342 *et seq.*) should
356 be rejected.

357
358 Q. What do you recommend as an adequate level of investment in the wastewater
359 systems by the Company?

360 A. If the Commission grants the Certificates, I recommend that the Company be
361 required to invest \$465,388 in the wastewater system for the Falcon Crest
362 Subdivision and \$172,508 in the wastewater system for Eastgate Estates. The
363 recommended level of investment above is the amount that the Company has
364 described as central plant costs, which is what Staff has determined is backbone
365 plant for the proposed wastewater systems.

366

367 CONCLUSION

368 Q. Please summarize your conclusions.

369 A. In my opinion, the Company has not met the requirements set forth in Section 8-
370 406(b)(2) of the Act. Based on the foregoing, I recommend that the requested
371 Certificates be denied.

372

373 If the Commission grants the Certificates, however, I recommend the following:

374

375 1) the Commission approve the Company's proposed certificated service areas,
376 which are shown on the maps identified as RME Exhibits FC-A and EG-A of the
377 Petition and legally described in RME Exhibits FC-B and EG-B of the Petition;

378

379 2) the Commission approve the Company's proposed Rules, Regulations, and
380 Conditions of Service tariffs for sewer service;

381

382 3) the Commission Order the Company to file the Rules, Regulations, and
383 Conditions of Service tariffs for sewer service, within ten (10) days of the final
384 Order, with an effective date of not less than five (5) working days after the date
385 of filing, for service rendered on and after their effective date, with individual tariff
386 sheets to be corrected within that time period, if necessary; and

387

388 4) the Company be required to invest \$465,388 in the wastewater system for the
389 Falcon Crest Subdivision and \$172,508 in the wastewater system for Eastgate
390 Estates.

391

392 Q. Does this conclude your prepared direct testimony?

393 A. Yes.