

DIRECT TESTIMONY

OF

ROCHELLE PHIPPS

FINANCIAL ANALYSIS DIVISION
FINANCE DEPARTMENT
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 PUBLIC UTILITIES ACT

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

DECEMBER 2, 2008

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INTRODUCTION

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

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

2. Q. What is your current position with the Illinois Commerce Commission (“Commission”)?

A. I am currently employed as a Senior Financial Analyst in the Finance Department of the Financial Analysis Division.

3. Q. Please describe your qualifications and background.

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

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

A. RME Illinois, L.L.C. (“RME” or the “Company”) requests Certificates of Public Convenience and Necessity (“CPCNs”) so that it may operate as an Illinois public utility and provide wastewater services to two parcels in Lake

18 Villa and Long Grove, Lake County, Illinois (“Lake County areas”). I will
19 evaluate the Company’s financial ability to construct, operate and maintain
20 onsite wastewater, collection and dispersal services to the Lake County
21 areas without significant adverse financial consequences for the utility or
22 its customers pursuant to Sections 8-406(a) and 8-406(b)(3) of the Illinois
23 Public Utilities Act (“Act”).¹ I also recommend a rate of return on rate base
24 for the Company.

25 **5. Q. Please summarize your findings and recommendations.**

26 A. I recommend that RME demonstrate it is capable of funding Staff’s
27 recommended level of investment, *i.e.*, \$637,896, without significant
28 adverse financial consequences for the utility or its customers, as required
29 by Section 8-406(b)(3) of the Act. Moreover, RME does not currently have
30 access to external funds. Thus, to ensure that RME has funds available
31 for unanticipated expenditures, I recommend the Company obtain a line of
32 credit from an external lender. I also recommend a 10.82% rate of return
33 on rate base for the Company.

34 **INVESTMENT IN THE UTILITY**

35 **6. Q. Please describe RME’s proposal.**

¹ 220 ILCS 5/8-406(a) and 5/8-406(b)(3).

36 A. Pursuant to the Company's proposed Wastewater Service Agreement,
37 developers would construct the wastewater systems that would serve the
38 Lake County areas at an estimated cost of \$1,086,000. Upon completion
39 of construction, the developers would transfer ownership of the
40 wastewater systems to RME in exchange for reimbursement of a portion
41 of the cost of the wastewater facilities as customers attach over a ten year
42 period.² Assuming all 53 lots in the Lake County areas are occupied
43 within ten years, RME's investment would equal \$49,763.³

44 **7. Q. How would RME fund the cost of the proposed construction?**

45 A. The Company asserts that the capital it needs would be internally
46 generated; no other sources of borrowed funds would be required. The
47 Company also asserts that it would not borrow any funds for investment in
48 the purchasing, operating or maintenance of the wastewater systems that
49 would serve the Lake County areas.⁴

50 **8. Q. Company witness Mr. Olson asserts that RME satisfies the**
51 **requirements of Section 8-406(b)(3) of the Act because the Company**

² Company Exs. 1.0 FC, lines 379-423 and 1.0 EG, lines 378-419.

³ Company Ex. 1.03 Response Revised, provided in Company's response to ICC Staff data request RP 3.02. RME's investment would equal \$41,069 for Falcon Crest (*i.e.*, \$934 x 44) and \$8,667 for Eastgate Estates (*i.e.*, \$963 x 9).

⁴ Company responses to ICC Staff data requests RP 1.01, RP 1.02 and RP 3.02 (including Co. Ex. RP 1.03 Response Revised).

52 **will not borrow any funds for investment in the proposed**
53 **construction.⁵ Do you agree?**

54 A. No. The Company has not shown that it can raise sufficient capital to fund
55 construction at Staff's recommended level of investment.

56 **9. Q. What level of investment does Staff propose for RME?**

57 A. Staff's total recommended level of investment equals \$637,896. Staff
58 witness Smith recommends that the Company invest \$465,388 in the
59 wastewater system for the Falcon Crest Subdivision and \$172,508 in the
60 wastewater system for Eastgate Estates.⁶

61 **SIGNIFICANT ADVERSE FINANCIAL CONSEQUENCES**

62 **10. Q. Do you know whether the Company is capable of funding Staff's**
63 **recommended level of investment without significant adverse**
64 **financial consequences for the utility or its customers?**

65 A. No. RME has not demonstrated it is capable of funding Staff's level of
66 investment in the wastewater systems that would serve the Lake County
67 areas. Thus, to ensure the Company is capable of financing the proposed
68 construction without significant adverse financial consequences for the

⁵ Company responses to ICC Staff data requests RP 1.01 and RP 2.02.

⁶ ICC Staff Ex. 1.0.

69 utility or its customers, RME should provide documentation showing it has
70 established an escrow account that includes contributed capital totaling
71 \$465,388 for Falcon Crest and \$172,508 for Eastgate Estates. The
72 escrow account should be designated solely for investment in the
73 wastewater systems that will serve the Lake County areas. Submitting
74 this documentation prior to or in rebuttal testimony would provide Staff an
75 opportunity to evaluate its provisions, including the amount in the escrow
76 account and its terms and conditions.

77 In the event the Company is not able to provide a copy of the escrow
78 agreement prior to or in rebuttal testimony, then at minimum, the
79 Company should provide the following information in testimony: (1) the
80 reason it is unable to provide a copy of the escrow account agreement; (2)
81 the name of each person and entity that will contribute capital to the
82 escrow account; (3) the amount (in dollars) each person and entity will
83 contribute to the escrow account; (4) a description of each and every
84 condition attached to the funds held in the escrow account; and (5) the
85 expected date the Company will establish the escrow account.

86 **11. Q. If RME does not establish an escrow account for its investment in**
87 **the wastewater systems, should the Commission reject the**
88 **Company's request for CPCNs to serve the Lake County areas?**

89 A. Yes.

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LINE OF CREDIT FOR THE COMPANY

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12. Q. Do you have any other recommendation related to the Company's requests for CPCNs pursuant to Section 8-406(a) of the Act?

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A. Yes. In order to avoid a cash shortfall, which could prevent RME from fulfilling its obligations as a utility under the Act, the Company should have a source of funds to cover unanticipated expenditures.

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Despite the Company's intention to fund all expenditures internally, borrowing funds may be necessary if the Company incurs higher costs or lower revenues than the Company's financial projections assume.

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Furthermore, the Company may need a source of funds to cover unanticipated expenditures. Absent a backup source of liquidity, higher costs or lower revenues than projected could result in significant adverse financial consequences for the utility or its customers. However, access to external funds could reduce the impact of any significant adverse financial consequences for the utility or its customers under those circumstances.

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Thus, I recommend the Company obtain access to a line of credit from an external lender.

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13. Q. Do you recommend a certain amount for the line of credit?

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A. Yes. I recommend a line of credit of at least \$35,000, which equals approximately one year of operating expenses (excluding depreciation and amortization) for the wastewater systems that would serve the Lake

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111 County areas.⁷ The Company should provide Staff a copy of the \$35,000
112 credit agreement in rebuttal testimony, which would provide Staff a
113 meaningful opportunity to evaluate the terms and conditions of the credit
114 agreement.

115 In the event the Company is not able to provide a copy of the credit
116 agreement prior to or in rebuttal testimony, then at minimum, the
117 Company should explain why it is unable to provide a copy of the
118 agreement for a line of credit agreement and provide a letter of intent from
119 an external lender for the line of credit that includes the following
120 information: (1) the name of the lender; (2) each and every borrower under
121 the line of credit; (3) the amount (in dollars) of the line of credit; (4) a
122 description of each and every condition to be attached to borrowings
123 under the line of credit; and (5) the anticipated date the Company will
124 establish the line of credit.

125 **14. Q. If RME does not obtain a line of credit for at least \$35,000, should the**
126 **Commission reject the Company's request for CPCNs to serve the**
127 **Lake County areas?**

128 A. Yes.

⁷ Staff's proposed revenue requirement is based on annual operating expenses (including income taxes and excluding depreciation) of \$28,615 and \$7,285 for Falcon Crest and Eastgate Estates, respectively (or \$35,900 for the combined Lake County areas). ICC Staff Ex. 2.0, Schedules 2.1 (FC) and 2.1 (EG).

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ALTERNATIVE RECOMMENDATIONS

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15. Q. Do you offer alternative recommendations?

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A. Yes. In the event the Commission grants RME two CPCNs despite it

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currently having neither an escrow account for investment in the

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wastewater systems nor a line of credit for meeting unanticipated

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expenditures, I recommend that, as a condition to granting the CPCNs,

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the Commission require RME to establish an escrow account and a line of

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credit.

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Escrow Account

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16. Q. Please explain your recommendation that the Commission require

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that the Company establish an escrow account.

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A. If the Commission grants the requested CPCNs in the absence of RME

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having established the escrow account I discuss above, I recommend that,

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as a condition to granting the CPCNs, the Commission require RME to

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establish an escrow account prospectively. To assure that the condition is

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met, I recommend the Commission's Order require the Company to file a

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compliance report with the Chief Clerk and Manager of the Finance

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Department within 10 business days of establishing the escrow account.

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The report would include the following information: (1) a copy of the

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escrow account agreement; (2) the name of each person and entity that

149 contributed capital to the escrow account; (3) the amount (in dollars) each
150 person or entity contributed to the escrow account; and (4) a description of
151 each and every condition attached to the funds held in the escrow
152 account. The escrow account compliance report should be filed in
153 connection with Docket Nos. 08-0490/08-0491 (Cons.) and include
154 verification from Mr. Olson.

155 Furthermore, under this alternative, until the Company files the
156 compliance report, I recommend that RME file status reports on March 31,
157 June 30, September 30 and December 31 of each year until the Company
158 establishes the escrow account. Those quarterly status reports should
159 include verification from Mr. Olson that indicates the Company has not
160 established the escrow account and the utility is not yet in operation.

161 **17. Q. In your judgment, would the alternative recommendation provide the**
162 **same level of protection against significant adverse financial**
163 **consequences for the utility and its customers as would the primary**
164 **recommendation to establish an escrow account for RME's**
165 **investment?**

166 A. No. Although compliance reports would inform the Commission of the
167 status of the escrow account and allow the Commission to review the final
168 terms of the escrow account once it is established, such compliance
169 reports would not provide any meaningful opportunity for the Commission

170 to review, and if necessary modify, the terms attached to the escrow
171 account in order to safeguard RME's financial condition.

172 ***Line of Credit***

173 **18. Q. Please explain your recommendation that the Commission require**
174 **RME to obtain a line of credit.**

175 A. If the Commission grants the requested CPCNs in the absence of the
176 Company having established a line of credit as I discuss above, I
177 recommend that, as a condition to granting the CPCNs, the Commission
178 require RME to establish a line of credit prospectively. To assure that the
179 condition is met, I recommend the Commission's Order require RME to file
180 a compliance report with the Chief Clerk and Manager of the Finance
181 Department within 10 business days of establishing a line of credit, which
182 should include a copy of the agreement establishing the line of credit, the
183 dollar amount of the line of credit and a description of each and every
184 condition attached to borrowings under the line of credit. The compliance
185 report should be filed in connection with Docket Nos. 08-0490/0491
186 (Cons.) and include verification from Mr. Olson.

187 Until the Company files the compliance report, I recommend the Company
188 file reports on March 31, June 30, September 30 and December 31 of
189 each year until the Company establishes the line of credit. Each quarterly

190 status report should include verification from Mr. Olson that indicates the
191 Company has not established a line of credit and the utility is not yet in
192 operation.

193 **19. Q. In your judgment, would the alternative recommendation provide the**
194 **same level of assurance that the Company would be able to carry out**
195 **its responsibilities under the Act as would your primary**
196 **recommendation that RME establish a line of credit and provide a**
197 **copy of the credit agreement in rebuttal testimony?**

198 A. No. As discussed above in relation to the escrow account, this alternative
199 proposal would not provide the Commission a meaningful opportunity to
200 review, and if necessary modify, the Company's credit agreement to
201 ensure it sufficiently protects RME's financial condition.

202 **RATE OF RETURN ON RATE BASE**

203 **20. Q. If the Commission were to grant the Company's request for**
204 **Certificates, what rate of return on rate base do you recommend the**
205 **Commission authorize for the Company?**

206 A. I recommend a 10.82% rate of return on rate base for the Company. The
207 Company's proposed capital structure is 100% equity, which is
208 inappropriate for ratemaking purposes. Thus, my cost of capital
209 recommendation for the Company is based on the cost of capital for a

210 hypothetical water utility with limited access to capital. Specifically, my
211 cost of capital recommendation for the Company comprises: (1) a capital
212 structure for a hypothetical water utility that is financed equally with debt
213 and equity, which approximates the average capital structure for the water
214 utility industry as a whole; (2) a 12.94% rate of return on common equity,
215 which is based on a cost of equity analysis for publicly-traded water
216 utilities on October 28, 2008, which includes a liquidity premium of 189
217 basis points;⁸ and (3) an 8.69% cost of debt, which equals the implied
218 interest rate for 5-year, BBB-rated utility bonds, plus a liquidity premium.⁹

219 **21. Q. Does this conclude your direct testimony?**

220 **A.** Yes, it does.

⁸ 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. The sample used to estimate the cost of equity comprises market-traded companies whose security prices do not reflect substantial liquidity costs. However, the security prices of small standalone companies such as RME typically reflect significant liquidity costs, which are largely due to the lack of a liquid market for their securities. The liquidity premium for RME equals the average liquidity premium for the four most recent cost of equity analyses Staff performed for small standalone water and wastewater utilities.

⁹ 8.69% equals the 5-year U.S. Treasury bond interest rate (i.e., 2.75%), plus the 405 basis points spread for BBB-rated 5-year utility bond rates, plus 189 basis points for liquidity costs. Federal Reserve Statistical Release H.15, November 3, 2008; Reuters Corporate Spreads for Utilities, October 29, 2008.