

Direct Testimony

of

Janis Freetly

Finance Department
Financial Analysis Division
Illinois Commerce Commission

Joint Application for Approval of Proposed Reorganization

Pursuant to Section 7-204 of the Public Utilities Act

Corix Utilities (Illinois) LLC
Hydro Star, LLC
Utilities, Inc.
Each of the 23 Illinois Operating
Subsidiaries of Utilities, Inc.

Docket No. 12-0279

September 13, 2012

PUBLIC VERSION
Confidential Information Identified As
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Introduction

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

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

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

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

8 **Q. Please describe your qualifications and background.**

9 A. In May of 1995, I earned a Bachelor of Business from Western Illinois University.
10 I received a Master of Business Administration degree, with a concentration in
11 Finance, from Western Illinois University in May of 1998. I have been employed
12 by the Commission in my present position since September of 1998. I was
13 promoted to Senior Financial Analyst on August 31, 2001.

14 **Q. What is the purpose of your direct testimony?**

15 A. On February 17, 2012, Highstar Capital Fund II, L.P. and certain of its affiliates
16 and co-investors (“Highstar”) and Corix Utilities (Illinois) LLC (“CUI” or
17 “Company”) entered into a Purchase and Sale Agreement (“Agreement”) that will
18 result in CUI acquiring control of Hydro Star, LLC (“HS”). The purpose of my
19 testimony is to assess the financial implications and to evaluate and make a

20 recommendation with respect to the proposed reorganization pursuant to
21 Sections 7-204(b)(4) and 6-103 of the Public Utilities Act ("Act").

22 First, I will present my evaluation of the financial implications of the proposed
23 reorganization under Section 7-204(b)(4) of the Act. Before the Commission may
24 approve a reorganization, Section 7-204(b)(4) requires that the Commission find
25 that "the proposed reorganization will not significantly impair the utility's ability to
26 raise necessary capital on reasonable terms or to maintain a reasonable capital
27 structure."

28 Second, I will present my evaluation and recommendation concerning Section 6-
29 103 of the Act, which requires that in any reorganization of a public utility, the
30 Commission shall determine the amount of capitalization, which shall not exceed
31 the fair value of the property involved.

32 **Q. Please describe the proposed reorganization.**

33 A. Utilities Inc. ("UI") is a wholly-owned subsidiary of Hydro Star Holdings
34 Corporation, which, in turn, is a wholly-owned subsidiary of HS. Utilities Inc. has
35 23 operating subsidiaries in Illinois. The Agreement provides for the acquisition
36 of all of the membership interests in HS by CUI. Utilities Inc. will remain the
37 owner of the 23 operating subsidiaries in Illinois.¹

Section 7-204(b)(4)

38 **Q. How have the Illinois operating subsidiaries obtained capital?**

¹ Joint Application, pp. 1-3.

39 A. The Illinois operating subsidiaries are 100% equity-financed. They obtained their
40 equity from UI.²

41 **Q. Would the proposed reorganization change the method of raising capital**
42 **for the Illinois operating subsidiaries?**

43 A. No. The Joint Applicants have stated that no changes to the process for
44 obtaining funding for the Illinois operating subsidiaries are planned at this time.³

45 **Q. How does UI currently obtain debt and equity capital?**

46 A. UI obtains debt financing through short-term credit facilities from large lending
47 institutions based solely on UI's financial position. Paid-in capital has been
48 obtained only through equity infusions from HS, which is 100% equity financed.⁴

49 **Q. Does UI currently have access to the capital markets on reasonable terms?**

50 A. To determine whether UI has access to the capital market on reasonable terms,
51 the creditworthiness of UI must be examined. The credit rating agencies do not
52 rate the creditworthiness of UI. Therefore, I used Moody's Investors Service's
53 ("Moody's") rating methodology for water utilities to estimate the credit rating UI's
54 financial ratios imply. Specifically, I calculated the four ratios that Moody's
55 focuses on to assess the financial strength for the regulated water utility industry:
56 (1) funds from operations ("FFO") interest coverage; (2) debt to capitalization; (3)
57 FFO to net debt; and (4) retained cash flow ("RCF") to capital expenditures

² Joint Applicants' Response to AG Data Requests AG-1.12 and AG-1.13.

³ Joint Applicants' Response to AG Data Request AG- 1.16.

⁴ Joint Applicants' Response to Staff Data Requests JF-1.07 and JF-1.08.

58 (“CapEx”).⁵ For UI, the three-year average FFO interest coverage ratio is 3.02x,
59 which falls within the bottom third of the benchmark range of a Baa credit rating
60 (i.e., Baa3). The three-year average debt to capitalization ratio for UI is 54.90%,
61 which falls within the bottom third of the benchmark range of an A credit rating
62 (i.e., A3). The three-year average FFO to net debt ratio for UI is 13.84%, which
63 falls within the middle third of the benchmark range of a Baa credit rating (i.e.,
64 Baa2). The three-year average RCF to capital expenditures ratio for UI is 0.86X,
65 which falls within the top third of the benchmark range of a Ba credit rating (i.e.,
66 Ba1). Together, the four ratios that I calculated for UI are consistent with a Baa2
67 rating, when weighted in accordance with the Moody’s rating methodology for
68 regulated water utilities.⁶ Issuers of debt with Moody’s credit ratings in the Baa
69 range are subject to moderate credit risk but are considered to have adequate
70 capacity to meet its financial commitments.⁷ Hence, UI currently has access to
71 capital markets on reasonable terms.

72 **Q. The Joint Applicants have stated that UI will continue to be responsible for**
73 **raising capital for the Illinois operating subsidiaries. Is this sufficient for**
74 **the Commission to conclude that the proposed reorganization will not**
75 **significantly impair the utility’s ability to raise necessary capital on**
76 **reasonable terms?**

⁵ Moody’s Investors Service, Rating Methodology: Global Regulated Water Utilities, December 2009, pp. 19-22.

⁶ Moody’s assigns 15% weighting to FFO interest coverage and Debt to capitalization and 5% weighting to FFO to Debt and RCF to CapEx. Moody’s Investors Service, Rating Methodology: Global Regulated Water Utilities, December 2009, p 7. Moody’s assigns the financial ratios a weight of 40% in determining the overall credit rating for regulated water utilities. Id.

⁷ Moody’s Investors Service, Rating Symbols and Definitions, June 2012, p. 5.

77 A. No. Because UI raises capital for its Illinois operating utilities, the Commission
78 should evaluate the effect of the proposed reorganization on UI's ability to raise
79 necessary capital on reasonable terms.

80 **Q. How would UI obtain capital following the proposed reorganization?**

81 A. Following the proposed organization, the Joint Applicants anticipate that UI's
82 capital structure and the debt financing currently in place will be maintained.⁸
83 However, since the ultimate parent company of UI will change, UI would obtain
84 paid-in capital through CUI instead of HS following the proposed reorganization.⁹

85 **Q. Does CUI have any debt outstanding?**

86 A. No.¹⁰

87 **Q. Is the lack of debt on CUI's balance sheet sufficient to conclude that CUI
88 would be able to raise necessary capital on reasonable terms?**

89 A. No. As the parent company of UI, CUI would provide equity capital for the Illinois
90 operating companies if UI's internal sources were insufficient to meet its needs.
91 CUI is an indirect subsidiary of Corix Infrastructure ("Corix").¹¹ Corix is a
92 privately held holding company, which means that it finances its equity needs
93 without directly accessing the capital markets. ***BEGIN CONF***XXXXXXXXXX

⁸ Joint Applicants' Response to Staff Data Request JF-2.05.

⁹ Id.

¹⁰ Joint Applicants' Response to Staff Data Request JF-1.05.

¹¹ Direct Testimony of Steven M. Lubertozi, p. 3.

94 [REDACTED]

95 [REDACTED] ***END CONF***¹²

96 **Q. Why is Corix’s indebtedness relevant to UI’s ability to raise capital on**
97 **reasonable terms?**

98 A. Under Standard & Poor’s consolidated rating methodology, the rating of wholly-
99 owned or substantially-controlled utility subsidiaries is constrained to the level of
100 its parent company’s credit quality. Without structural barriers in place, a parent
101 company can move cash around to meet its obligations. Hence, there is a risk
102 the parent will weaken the utility’s financial profile to some degree, if its own
103 financial condition begins to deteriorate.¹³ Evidence that the parent has taken
104 affirmative steps to distance utility subsidiaries from non-utility subsidiaries is
105 required for S&P to justify a stand-alone credit rating for the utility subsidiaries.

106 According to Moody’s Investors Service, for the rating of a regulated water utility
107 to reflect exclusively its own credit quality, structural features designed to insulate
108 the credit quality of the water utility from that of its wider corporate family are
109 crucial.¹⁴

110 ***BEGIN CONF*** [REDACTED]

111 [REDACTED]

¹² Joint Application, Exhibit E (confidential) (Consolidated Financial Statements of Corix Infrastructure Inc. for the year ended 2011).

¹³ S&P Ratings Direct, *Methodology: Differentiating The Issuer Credit Ratings of A Regulated Utility Subsidiary And Its Parent*, March 11, 2010, pp.1-3.

¹⁴ Moody’s Rating Methodology: Global Regulated Water Utilities, December 2009, pp. 23-24.

112 [REDACTED] ***END

113 CONF***¹⁵

114 **Q. Given that Corix is not rated by any of the credit rating agencies,¹⁶ why is**
115 **the rating methodologies of S&P and Moody's relevant?**

116 A. The consolidated rating methodologies of S&P and Moody's are a proxy for the
117 expectations of lenders when evaluating the creditworthiness of a company.
118 Potential investors would also evaluate affiliated companies when assessing the
119 risk of the investment.

120 **Q. Have you evaluated Corix's ability to raise capital on reasonable terms?**

121 A. Yes. Because the credit rating agencies do not rate the creditworthiness of
122 Corix, I used Moody's rating methodology for water utilities discussed above to
123 estimate the credit rating Corix's financial ratios imply.¹⁷ For Corix, the three-
124 year average FFO interest coverage ratio is ***BEGIN CONF*** [REDACTED]

125 [REDACTED]

126 ***END CONF*** The three-year average debt to capitalization ratio for Corix is

127 ***BEGIN CONF*** [REDACTED]

128 [REDACTED] ***END CONF*** The three-year average

129 FFO to net debt ratio for Corix is ***BEGIN CONF*** [REDACTED]

¹⁵ ***BEGIN CONF*** [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED] ***END CONF***

¹⁶ Joint Applicants' Response to Staff Data Requests JF-1.01 & JF-1.02.
¹⁷ Moody's Investors Service, Rating Methodology: Global Regulated Water Utilities, December 2009, pp. 19-22.

130 [REDACTED] ***END
131 CONF*** The three-year average RCF to capital expenditures ratio for Corix is
132 ***BEGIN CONF*** [REDACTED]
133 [REDACTED].***END CONF*** Together, the four ratios
134 that I calculated for Corix are consistent with ***BEGIN CONF*** [REDACTED]
135 [REDACTED]. ***END CONF***, when weighted in accordance with the Moody's rating
136 methodology for regulated water utilities.¹⁸ Issuers of debt with Moody's credit
137 ratings in the ***BEGIN CONF*** [REDACTED]
138 [REDACTED].***END CONF***¹⁹ Because the implied credit
139 ***BEGIN CONF*** [REDACTED]***END CONF*** ,
140 Corix's ability to raise capital on reasonable terms is ***BEGIN CONF***
141 XXXXX.²⁰ [REDACTED]
142 [REDACTED]
143 [REDACTED].²¹ [REDACTED].²² [REDACTED]
144 [REDACTED]
145 [REDACTED].²³ ***END
146 CONF***

¹⁸ See footnote 6, supra.
¹⁹ Moody's Investors Service, Rating Symbols and Definitions, June 2012, p.5.
²⁰ "Investment grade" refers to the four highest credit ratings (i.e., Moody's Aaa, Aa, A and Baa ratings).
²¹ ***BEGIN CONF*** [REDACTED]
END CONF
²² ***BEGIN CONF*** [REDACTED]
END CONF
²³ ***BEGIN CONF*** [REDACTED]
[REDACTED]
[REDACTED]

156 **Q. What additional information should the Joint Applicants provide in rebuttal**
157 **to help you to reach a firmer conclusion?**

158 A. As noted above, the financial ratios I examined compose 40% of a credit rating
159 score under Moody's rating methodology for regulated water utilities. It is
160 possible that Corix has sufficiently low operating risk ***BEGIN CONF***XXXXX
161 XXXXXXXXXXXXXXXX***END CONF*** If this is the case, then the Joint
162 Applicants should be able to show that Corix has recently issued indebtedness
163 with costs that are in line with investment grade utility debt with similar terms to
164 maturity.

165 Further, the Joint Applicants should demonstrate that UI will be sufficiently
166 separated from the parent group, through ring fencing or other provisions,
167 ***BEGIN CONF***XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX. ***END
168 CONF*** Specifically, the Joint Applicants should inhibit the flow of financing
169 funds from UI to Corix through restrictions on dividends, common stock
170 repurchases, and advances and loans.

Section 6-103

171 **Q. Why is it necessary to review the capitalization of a public utility in a**
172 **reorganization?**

173 A. Under Section 6-103 of the Act, "[t]he capitalization of a public utility formed by a
174 merger or consolidation of two or more corporations shall be subject to the
175 approval of the Commission." Additionally, "[i]n any reorganization of a public

176 utility, resulting from forced sale, or in any other manner, the amount of
177 capitalization . . . shall be as authorized by the Commission which in making its
178 determination, shall not exceed the fair value of the property involved.”²⁵

179 **Q. In your judgment, does the proposed reorganization come within the ambit**
180 **of Section 6-103?**

181 **A.** Yes. The proposed reorganization involves the sale of the Illinois operating
182 companies, which are public utilities.

183 **Q. Does the Commission need to determine the amount of capitalization of the**
184 **Illinois operating companies in this proceeding?**

185 **A.** No. The balance sheet and capitalization of the UI Illinois operating companies
186 will not change as a result of the reorganization.²⁶ Thus, the capitalization of the
187 public utilities will remain as authorized by the Commission.

188 **Q. Does this conclude your direct testimony?**

189 **A.** Yes, it does.

²⁵ 220 ILCS 5/6-103.

²⁶ Direct Testimony of Steven M. Lubertozi, pp. 10-11.

ILL. C. C. DOCKET NO. 12-0279

**Joint Applicant s Responses to
Staff Data Requests JF 1.01 through 1.15**

JF-1.01 Is Corix Utilities (Illinois) LLC, Hydro Star LLC, or Utilities, Inc., or any of its affiliates, rated by Standard & Poor's, Moody's or Fitch Ratings? If so, please provide the most recent rating report issued by each of the rating agencies and any other reports from each of the rating agencies that discusses Corix Utilities (Illinois) LLC, Hydro Star LLC, or Utilities, Inc. or any of its affiliates issued in 2010 or 2011.

Response: No.

Prepared by: Steven M. Lubertozi
(847) 897-6510

ILL. C. C. DOCKET NO. 12-0279

**Joint Applicant s Responses to
Staff Data Requests JF 1.01 through 1.15**

JF-1.02 Please provide copies of all calculations of financial ratios that S&P, Moody's or Fitch Ratings provided any of the Joint Applicants in connection with the proposed reorganization.

Response: Not applicable.

Prepared by: Steven M. Lubertozi
(847) 897-6510

ILL. C. C. DOCKET NO. 12-0279

**Joint Applicant s Responses to
Staff Data Requests JF 1.01 through 1.15**

JF-1.05 Please describe Corix Utilities (Illinois) LLC's current capital structure (i.e., proportions of short-term debt, long-term debt, preferred stock, and common equity).

Response: Corix Utilities (Illinois) LLC was formed on February 16, 2012 to hold the membership interests that will be acquired from Hydro Star LLC and its capital structure will not be relevant to finance the transaction or future rate cases. Corix Utilities (Illinois) LLC has access to sufficient capital to pay the purchase price required to acquire Hydro Star through a combination of available cash and committed financing sources and, if necessary, equity contributions from Corix Infrastructure, Inc. Corix Utilities (Illinois) LLC has no debt.

Prepared by: Steven M. Lubertozzi
(847) 897-6510

ILL. C. C. DOCKET NO. 12-0279

**Joint Applicant s Responses to
Staff Data Requests JF 1.01 through 1.15**

JF-1.07 Please describe Hydro Star, LLC's current capital structure (i.e., proportions of short-term debt, long-term debt, preferred stock, and common equity).

Response: The ownership of Hydro Star LLC is as follows:

Name	Company Interests
Highstar Capital II Prism Fund, L.P.	29.87%
Highstar Capital Fund II, L.P.	43.87%
Hydro Star Interco LLC	8.40%
American General Life Insurance Company	17.86%

Prepared by: Steven M. Lubertozzi
(847) 897-6510

ILL. C. C. DOCKET NO. 12-0279

**Joint Applicant s Responses to
Staff Data Requests JF 1.01 through 1.15**

JF-1.08 Please describe Utilities, Inc.'s current capital structure and how Utilities, Inc. currently raises debt and equity.

Response: UI's current capital structure is comprised of approximately 50% equity and 50% long-term debt. Since Hydro Star acquired ownership of Utilities, Inc. ("UI"), UI has obtained debt financing only through short-term credit facilities from large lending institutions based solely on UI's financial statements and financial performance. Additionally, since Hydro Star acquired ownership of UI, UI has obtained additional paid-in capital only through equity infusions from Hydro Star.

Prepared by: Steven M. Lubertozi
(847) 897-6510

ILL. C. C. DOCKET NO. 12-0279

**Joint Applicants' Responses to
Staff Data Requests JF-2.01 through JF-2.15**

JF-2.05 Please provide the expected capital structure ratios (i.e., proportions of long-term debt, preferred stock, and common equity) after the acquisition of Utilities, Inc for Corix Utilities (Illinois), LLC, Corix Infrastructure, Inc.

Response: The capital structure ratio for UI as of the period ending March 31, 2012 is 51.2% debt and 48.8% equity and it is expected that it will be approximately the same after the acquisition. Corix Infrastructure Inc. is the parent company for a group of companies involved in a variety of businesses, both regulated and non-regulated. These businesses can be grouped into three categories: utility services, which includes metering and measurement; utility products, which includes distribution of pipes, valves and the manufacture and distribution of small water and wastewater treatment plants; and utilities, which involves the operation of water, wastewater and energy utilities.

The Corix group of companies is structured along the lines of these distinct business areas both for operational reasons and to ensure the appropriate financial arrangements are in place for each of the business units, some of which are regulated and many of which are non-regulated entities. In acquiring Utilities, Inc. Corix will be maintaining the capital structure and the debt financing currently in place, and future capital requirements of Utilities, Inc. will be financed by Utilities, Inc. As discussed in the response to JF-2.06 below, the levels of debt and equity at the parent company Corix Infrastructure Inc. are appropriate for the various lines of business in which the company is involved. The specific capital structure or cost of debt at Corix Infrastructure Inc. or Corix Utilities (Illinois) LLC is not relevant to the transaction or to the future operations of Utilities Inc.

Prepared by: Steven M. Lubertozzi
(847) 897-6510

ILL. C. C. DOCKET NO. 12-0279

**Joint Applicant s Responses to Attorney General
First Set Of Data Requests - AG 1.1 through AG 1.26**

AG 1.12. Over the last 10 years, have the Illinois UI operating companies obtained equity capital from sources other than Hydro Star LLC and the four entities identified on page 1 of Exhibit C to the Joint Application? If yes, please identify those sources.

Response: The Illinois operating companies obtain equity from Utilities, Inc.

Prepared by: Steven M. Lubertozzi
(847) 897-6510

ILL. C. C. DOCKET NO. 12-0279

**Joint Applicant s Responses to Attorney General
First Set Of Data Requests - AG 1.1 through AG 1.26**

AG 1.13. Over the last 10 years have the Illinois UI operating companies obtained debt financing from sources other than Hydro Star LLC and the four entities identified on page 1 of Exhibit C to the Joint Application? If yes, please identify those sources.

Response: The Illinois operating companies are 100% equity financed.

Prepared by: Steven M. Lubertozzi
(847) 897-6510

ILL. C. C. DOCKET NO. 12-0279

**Joint Applicant s Responses to Attorney General
First Set Of Data Requests - AG 1.1 through AG 1.26**

AG 1.16. Please describe all changes to the process for obtaining funding for Illinois operating companies that will or are expected to result from the reorganization described in this docket, including any and all changes to the capital projects planning review committee or other committee or group responsible for determining which Illinois operating companies projects will be funded and the identity of the affiliate, committee, group, or individual that will be responsible for funding Illinois projects and operations if the reorganization is approved.

Response: No changes to the process for obtaining funding for Illinois operating companies are planned at this time and it is anticipated that after closing the same capital budgeting process currently in effect will remain in effect.

Prepared by: Steven M. Lubertozzi
(847) 897-6510