IAWC EXHIBIT NO. 7.0

DIRECT TESTIMONY

OF

MARY KANE

STIFEL, NICOLAUS & COMPANY INCORPORATED

DOCKET NO. 02-0352

TABLE OF CONTENTS

	Page
WITNESS IDENTIFICATION AND BACKGROUND	1
PURPOSE OF TESTIMONY	2
CITY'S PURCHASE PLAN	2
RESERVES	4
SEWER FUND	11
CREDIT WORTHINESS ANALYSIS	13
GRANTS AND LOANS	16
UNAVAILABILITY OF NON-WATER SOURCES OF FUNDS	21
RATE FORECAST	22

TABLE OF EXHIBITS

Exhibit No.	Description
7.1	Water Study Task Force Summary Report dated August 9, 1999, Considerations page.
7.2	Stifel Nicolaus chart entitled "City of Pekin, Illinois General Fund Revenues by Primary Source"
7.3	Stifel Nicolaus chart entitled "City of Pekin, Illinois General Fund Revenues, Expenses and Fund Balance"
7.4	Stifel Nicolaus charts entitled "General Fund Revenues Received per Capita" and "General Fund Expenses by Service Category per Capita"
7.5	City of Pekin Five Year Capital Plan dated May 9, 2002 and Stifel Nicolaus chart entitled "City of Pekin Illinois Capital Plan Expenditures by Fund"
7.6	2001 Comprehensive Plan Update, pages 23 and 54
7.7	Stifel Nicolaus chart entitled "City of Pekin, Illinois Internal Services Fund Revenues, Expenses and Retained Earnings"
7.8	FY 2001 and 2002 Annual Financial Reports, Multi Purpose Long Form for Pekin, Illinois
7.9	Stifel Nicolaus chart entitled "City of Pekin, Illinois General Fund Expenditures by Category"
7.10	City of Pekin Wastewater Facility Plan by Farnsworth Group, Inc. dated August 2001, page 2
7.11	City of Pekin, Illinois Financial Statements dated April 30, 1996, page 48
7.12	City of Pekin, Illinois Sewerage Fund Financial Statements dated April 30, 2000, page 6, and City of Pekin, Illinois Sewerage Fund Financial Statements dated April 30, 2001, page 6
7.13	Stifel Nicolaus chart entitled "City of Pekin, Illinois Sewer Fund Revenues, Expenses and Retained Earnings"
7.14	Illinois First printout from http://illinoisgis.ito.state.il.us/ilfirst/creport.asp?prj=all&county=Tazewell
7.15	Stifel Nicolaus chart entitled "Bond Buyer 20-Bond Index 1970 to Present
7.16	Stifel Nicolaus chart entitled "$3,340,000.00 City of Pekin Sources & Uses"
7.17	Stifel Nicolaus Table - Pekin District Acquisition Analysis - $17,700,000; Stifel Nicolaus Table - Pekin District Acquisition Analysis - $64,565,000 $17,700,000 Debt Service Schedule and Sources & Uses; $64,565,000 Debt Service Schedule and Sources & Uses

DIRECT TESTIMONY OF MARY KANE

Docket 02-0352

WITNESS IDENTIFICATION AND BACKGROUND

Q 1. Please state your name and business address.

A. My name is Mary Kane. My business address is Stifel, Nicolaus & Company, Incorporated ("Stifel Nicolaus"), One Financial Plaza, 501 North Broadway, St. Louis, Missouri, 63102.

Q 2. Ms. Kane, what is your present position?

A. I am a First Vice President of Stifel Nicolaus and a member of the Firm's Capital Market's Group.

Q 3. As First Vice President, what are your responsibilities?

A. I am a senior staff member within the Public Finance Department and responsible for Illinois Investment Banking activities. In this capacity, I have gained expertise in municipal finance and related issues. I and my firm analyze municipal finances and assist in arranging the capital required to fund the municipal projects. Under my direction, Stifel Nicolaus has underwritten as Senior Manager or Co-manager over $3.1 billion in bonds since 1998.

Q 4. Please discuss your educational and business background.

A. I obtained a Bachelor of Arts from Newcomb College, Tulane University and a Master of Science from the University of Arizona. I served as staff for an engineering and planning firm before joining Madison County, Illinois, first as the County's Community Development Program Director and then as Director of Administration for the County. I have served as the Executive Director of the Leadership Council

Southwestern Illinois and the Southwestern Illinois Development Authority, the latter an economic development and financing entity, and have been with Stifel Nicolaus for the past ten years.

PURPOSE OF TESTIMONY

Q 5. What is the purpose of your testimony in this proceeding?

A. I was engaged to testify in this proceeding by counsel for Illinois-American Water Company (the "Company", "Illinois-American" or "IAWC"). The purpose of my testimony is to discuss my analysis of various assumptions and issues related to municipal finance relied upon and raised by Pekin's proposal and by Pekin witnesses Leta Hals and Richard Hierstein in their direct testimony. In the course of my analysis, I have reviewed the Direct Testimony of the City of Pekin ("City" or "Pekin") as it relates to issues regarding municipal finance practices. In addition, I have reviewed data requests and responses related to these same topics. The documents I have reviewed included detailed information regarding the City's financial condition and its planning process.

CITY'S PURCHASE PLAN

Q 6. How does the City propose that it will fund the purchase of the water system and future capital improvements?

A. Ms. Hals' testimony (Q20) states that the City is to issue General Obligation ("G.O.") debt for both the purchase of the water system and the funding of future capital improvements. Ms. Hals' analysis (Schedule A-4) and the terms of previous Pekin bonds issued in 1992 and 1993 suggest that such G.O. debt would first be paid from revenues received from the water system and then, in the event of a shortfall in those revenues, from its existing General Fund reserves or from a property tax levy. G.O. debt is defined as debt which is guaranteed to be paid from the full faith and credit of the City, including if necessary, the levy of a property tax.

Q 7. Is this plan workable?

A. Whether it is workable or not would depend upon several factors. As the City's Water Study Task Force stated in its Summary Report, the purchase price should not exceed $20 million. The page of the report showing this statement is marked as IAWC Exhibit 7.1. Above that amount, the Task Force itself questions the benefit to the City or the public good of an acquisition. Second, no matter what the acquisition cost, even if it is comparable to the amount that Ms. Hals' projected in her testimony, the City will have to raise rates immediately unless it wishes to impose a tax increase on residents or further drain moneys from its General Fund reserves. Although the City has stated that it hopes to use bonds and grants for activities associated with the water system acquisition, as set forth more fully below, this will not be feasible in the immediate future. The issuance of G.O. bonds will be required, and certain tests will have to be met relative to debt service coverage that will immediately require significant water rate (or tax) increases. This will be all the more true if the acquisition cost of the system exceeds Hals' estimate.

Q 8. What did your review of the City's financial statements reveal in regard to its tax structure?

A. As in the case of all municipalities, the most stable source of revenue to support the general operations of the City is a property tax. During the period from 1994 to 2001, the City aggressively decreased its property tax rate from $2.9315 in 1994 to $1.1173 in 2001. It appears from the City's financial records that it made a conscious decision to shift from property taxes to sales and other use taxes, which consist of Replacement

Taxes, State Sales and Use Taxes, Local Sales Use Taxes, and State Income Tax. In order to achieve a decrease in the property tax rate, the City has levied taxes specifically for police and fire protection, police and fireman's pension, library and occasionally, garbage service. To secure additional revenue, the City has also enacted numerous local tax measures, such as local sales taxes, local motel taxes, and local motor fuel taxes. This conscious shift from property taxes to Sales and Other Use Taxes has put more reliance on often fluctuating and volatile Sales and Other Use Taxes that can decrease in a declining economic cycle or with the announcement of the closure of a major retailer or car dealership in the area. As shown on the City's 2002 financial audit, only 18.7% percent of the City's General Fund revenues were derived from property taxes. A chart illustrating the General Fund revenues by primary sources is marked as IAWC Exhibit 7.2.

Because the City historically only levies for specific City purposes and funds, the property tax revenues currently collected by the City for the General Fund would not be utilized to fund water operations because of the specific use for which the taxes are levied.

RESERVES

Q 9. Does the City currently have revenue resources from non-water sources to fund the acquisition of the water system and to then make capital improvements to the water system?

A. No. With its current General Fund revenues and/or fund balance (reserves), the City is ill-equipped to fund the acquisition and capital needs of the water system in the face of declining revenues, declining reserves and the other imminent needs of the community. Moreover, the substantial or long-term use of General Fund revenues to subsidize a water enterprise system may negatively impact the availability of revenues for other City services thus having a greater adverse impact on the public. The City's increased reliance on volatile tax sources is discussed above.

A review of the City's General Fund financials indicates that in 2002 the City had an overall decrease in revenues of 13%, approximately a 16% decrease in Sales and Other Use Taxes, as defined previously, and a 19.6% decrease in its fund balance. A chart illustrating the changes in the total revenues and expenditures and the corresponding effect on the General Fund balance is marked as IAWC Exhibit 7.3. This is an indicator of a downturn in the City's economic condition. If there is such a trend, it will be important to understand what measures the City will undertake to correct this decline and balance its budget as required by Illinois law. There is no discussion in the financial records Stifel Nicolaus reviewed of any such measures.

Similarly, in 2002, for the first time in five years, the amount the City spent on a per capita basis for services to citizens was greater than (by $140 per person) the amount of revenues it received on a per capita basis. The five-year history of these items is shown in IAWC Exhibit 7.4.

As of April 30, 2002, the City had $11,860,122 in its General Fund undesignated reserves, which was a 19.59% decline from 2001. The General Fund further decreased from $14,749,630 in 2001 to $11,860,122 in 2002. This decline can be attributed to an overall decline of 13% in City revenues, increases in expenditures and the increased capital outlay costs associated with the construction of the new City Hall.

From our review of the City's 2001 Comprehensive Plan and its 2002 Five Year

Capital Plan, marked as Exhibit 7.5, the City has a very ambitious list of capital projects. These include:

- $7.7 million for Veterans Drive Ring Road to be funded by grants, Capital Projects fund (local motor fuel tax) and the Motor Fuel Tax fund. Significantly, while $2.6 million in improvements has been budgeted for Veteran's Drive, the City has yet to significantly begin the project. This may indicate the City does not have the funding to make the appropriations it budgeted. As stated in the Comprehensive Plan, this project will primarily be funded with local City revenues. This need for local funding would require additional revenues, which may put an additional burden on the City if the water system is acquired;

- $1.2 million Downtown to be funded through Tax Increment Financing ("TIF"); and

- $5.0 Riverfront Improvements to be funded through General Fund and primarily through TIF.

By classification, the City anticipates spending the following:

- Street Construction $7.9;
- Sewage Treatment Plan Improvements $7.8[1];
- Sewer Construction $3.4;
- Vehicle Replacement $4.9;
- Buildings and Improvements $4.2;
- Land and Improvements $3.6; and
- General Public Improvements $1.5.

In addition, the City plans on purchasing approximately $20,941,500 in capital items solely using the General Fund over the next five years. These purchases include many routine City items such as vehicle replacement and computers. One of the largest projects the City intends to undertake with General Fund Revenues is the construction of a $1,000,000 fire station in 2007. The relevant pages of the 2001 Comprehensive Plan

[1] Note that the City's Plan does not call for spending on sewer facilities in the amount required by the City's own Farnsworth study.

are marked as IAWC Exhibit 7.6. (See IAWC Ex. 7.6, page 23.) According to the Comprehensive Plan, this is a safety concern for the community because expansion of the City's boundaries has increased response time to certain areas to an unacceptable level.

Noticeably absent from either plan is any discussion of the proposed acquisition and improvement of the water system. It does not appear that the City has done any analysis to determine the financial impact of the acquisition and improvement of the water system on its general fund or fund balance.

Without an additional revenue source, such as an increase in property taxes and/or imposing other user taxes, to supplement the maintenance and capital needs of the water system when water revenues are not sufficient, the City will need to redirect already committed resources to subsidize the system. This would also limit the City's ability to handle emergency or other situations affecting the City.

Q 10. What level of reserves should a municipality such as Pekin maintain?

A. To operate in accordance with recognized governmental standards, each municipality should establish an unrestricted fund balance or operating reserve policy for contingency and emergency purposes or unanticipated cash flow needs. An absolute minimum reserve balance is generally viewed to be 20% of the next year's anticipated expenditures. Using the FY 2003 budget as a base for Pekin, 20% of the General Fund budgeted expenditures would amount to retaining $2,326,929. This amount can be considered to be a minimum operating reserve for Pekin.

The standard operating reserve more commonly used by most practitioners is that a city should have available in the event of emergency or disaster within a community three to six months of its operating budget. Based upon the 2002 Audit this would require a reserve of $2,570,532 to $5,141,065 for the General Fund. While the amount of reserves required varies with each community, the City Finance Director for Pekin has recommended that the City should maintain at least a 6-month operating budget reserve. Using this criteria, the City would retain, based on the 2002 Audit, $10,282,131 in reserves and only have $1,577,991 available as excess to subsidize water or special city funds, such as the Sewer Fund.

Q 11. Absent increased property taxes, do you believe the outlook for funding the acquisition and planned activities of the water system will improve in the future?

A. No, the City's General Fund will only face greater pressure in the future. As stated above, in 1995, the City shifted its primary base of revenue from property tax to volatile Sales and Other Use Taxes. Today, approximately 62% of the City's total General Fund revenues are derived from volatile, fluctuating sources driven by the economy or based upon computations set at the State level and subject to redistribution at the General Assembly's discretion. Further, the City has already obligated itself to certain personnel costs and/or benefits, which will place increasing demands on future City General Fund moneys. As an example,

- the City has a medical self-insurance program, which pays medical insurance claims of City employees and their covered dependents. Annual claims are paid from the accumulated premium payments and claims exceeding a fixed amount per employee are paid by an umbrella insurance carrier. As shown by the chart marked as IAWC Exhibit 7.7, based upon the City's most recent two audited fiscal years, the Net Income for the Internal Services Fund has been in a negative position for both 2001 and 2002. The Ending Fund Balance has declined by 42% from $1,369,160 in 2000 to $794,233 in 2002.

- according to the 2001 and 2002 City of Pekin Annual Financial Reports filed with Illinois Comptroller's Office, which are based upon the City's audited statements, the City had an increase in employee salaries of 14% from 2001 to 2002, from

$7,800,432 in 2001 to $8,896,988 in 2002. The relevant material from the reports is marked as IAWC Exhibit 7.8.

- according to Schedule H of the 2001 Audit, the City has 282 employees of which 76.5% are union employees. The language of the contracts that Stifel Nicolaus reviewed for the General Employees Bargaining Group and the Street Department, specify annual increases in salary. These contracts are with Teamsters, Chauffers & Helpers Local 627 ("Teamsters Local 627"). Such contracts make it difficult for the City to quickly or easily address rising personnel costs and benefits in the event of a decline in revenues.

- as illustrated by the chart marked as IAWC Exhibit 7.9, the overwhelming expenditures of the City are those associated with the category of Public Safety, which includes both police and fire. Cost escalations associated with enhanced police and fire protection will impact the City significantly. In addition, should the City acquire the water facility, it would incur increased responsibility for preserving and protecting the facility operation, particularly in light of the increased liability resulting from the threat of terrorism following 9/11. According to the information provided in the City's year to date expenditure report, the City spent in excess of $164,700 for contractual overtime, much of which was paid by Illinois-American for increased facility safety and protection activities. If the City's acquisition plan is approved, these responsibilities would not disappear; rather they would become a direct cost of Pekin.

- Also, Stifel Nicolaus noted in the City's audited financials that Pekin is insured through the Illinois Municipal League ("IML") for various risks of loss including destruction of assets and natural disasters. Claims in excess of the pooled/self-insured retention amounts are covered through third party limited coverage insurance policies. Current and prior year claims are paid from the City's General Fund. General liability had a $100,000 retention and a $900,000 limit on coverage in FY 2002. Including the cost of the water facilities in the insurance program will have an impact on the City's IML and umbrella coverage costs. Additionally, a disaster of any type, such as a tornado, which would be covered by the General Fund as is the current practice, could negatively affect the City's ability to perform/provide other City services.

Q 12. Despite the circumstances you discuss, are the remaining reserves of the City available or sufficient to fund the proposed acquisition of the water system or for capital needs following acquisition?

A. No. The City's reserves are limited in light of its decreasing revenues, increasing expenses and numerous capital projects the City anticipates completing. As discussed above, the City would like to maintain a 6-month reserve which leaves little available to a substantial long-term maintenance commitment such as the acquisition of the water system. The City has set out in its Comprehensive Plan and in its 5-Year Capital Plan its projects and capital expenditures needed over the next 20-years to adequately provide services to the community. As stated in these plans, the substantial financial resources needed to meet these basic improvements will meet and likely exceed the City's financial resources. In addition, the City did not identify in either plan the acquisition, financing or long-term maintenance needs of the water system. Thus, the City has not given consideration to acquisition of the water system in connection with its comprehensive planning process, and there is no indication that the City has any realistic notion of how funding would be arranged.

Q 13. Please comment on the suggestion that the City could use its General Fund to cover water-related costs.

A. The notion that the City would use General Fund revenues (as opposed to reserves) if necessary for the water system implies that the water system would not be operated or managed as a true enterprise fund by the City. This would have a negative impact on the City's bond rating and/or cost of bond insurance, and could also be challenged by the City's auditor as not being in conformance with Governmental Accounting Standards Board ("GASB") standards. If the water system were operated as an enterprise fund, it would be funded solely by funds coming in from the enterprise (the water system). The practice of transferring moneys to and from the General Fund from enterprise funds is neither recommended nor endorsed by the GASB. The use of General Fund revenues to fund the water system would negatively affect the overall operations of the City if the City does not adjust revenues and expenditures. For example, moneys moved from the General Fund to enterprise funds divert tax dollars away from City services, such as police, fire and streets, to support City ventures that should be managed as self-sustaining operations through user charges and other fees.

SEWER FUND

Q 14. Does the financial history of the City's wastewater facilities tell you anything about its proposed future management of the water system?

A. Yes. In order to analyze the City's future financial management of the water system should it be acquired, I analyzed the City's financial record in the operation of the wastewater system by reviewing the City's Sewer Fund information as provided in the City's Audits from FY 1996 to FY 2002. From this review, there are numerous examples from the City's past performance with the wastewater system that indicates that the City has not raised rates as needed to adequately fund the operation and improvement of the system.

As illustrated in the Water Study Task Force Report, the City has had a stable to declining fee structure for its Sewer Fund since 1982. In 1982, the City had a rate of $10.78 per 6,000 gallons per month per user, which declined in 1998 to a rate of $8.25 per 6,000 gallons per month per user. This decline is in spite of the annual increasing costs of personnel, repairs and other general costs of operations. The Water Study Task Force Report also shows that Pekin's sewer rate has been held to a level significantly lower than the average sewer rates in Tazewell County (without Pekin).

Examples of these increasing costs are set forth in the City's audited statements for the sewer system. The statements include a line item of other services and charges, which includes the contract amount the City pays to United Water to operate its sewer treatment plant. These expenses have increased and decreased over the six years, but the average annual increase is approximately 5.97% and the aggregate increase is 35.86% over the six years from 1996 to 2002. The most substantial changes in the sewer system accounts have occurred in the personnel services line. From 1996 to 2002, this line item expenditure increased 103%, from $82,036 in 1996 to $166,654 in 2002, or an average of 17.2% annually.

In the years FY 1999, 2000, 2001 and 2002, the City showed an operating loss in the Sewer Fund with expenses exceeding revenues. The Sewer Fund, as of December 2002 based on Year to Date information had a net income of negative $595,641. Without a rate increase or dramatic change in revenues or expenses, this fund can be expected to have a negative retained earnings balance at the end of FY 2003. Using the minimum twenty percent of operating expenses as reserve standard, the FY 2003 Sewer Fund should have at least $428,242 (excluding a one-time capital construction line item). The City is, therefore, grossly under funded in the Sewer Fund.

According to the City of Pekin Wastewater Facility Plan prepared by Farnsworth Group, Inc. in 2001, the City has an estimated $9,259,155 in capital improvements that must be completed. The Farnsworth Group stated that the upgrade of Sewage Treatment Plant No. 1 constitutes $8,963,125 of this cost and that "based on the evaluation of the existing treatment facility and the current wastewater loadings, the process of improving and expanding the treatment plant should be initiated in the immediate future." The relevant page from the Farnsworth Group Plan is marked as IAWC Exhibit 7.10. As stated in the 2001 Comprehensive Plan, the existing wastewater treatment system within the City of Pekin planning area is “inadequate to meet the projected wastewater needs throughout the 20-year planning period." (IAWC Ex. 7.6 at p. 54.) According to the City's Five Year Capital Plan for fiscal years 2004-2008, the City is planning to spend $7,800,000 for "required improvements in the sewer treatment plant." (IAWC Ex. 7.5 at p. 1.) The City budgeted improvement costs are less than the Farnsworth Study recommended, thus, the City may not plan on completing the projects identified as critical to service by the Study.

CREDIT WORTHINESS ANALYSIS

Q 15. Did your analysis of the City's operation and management of the wastewater facility reveal information about the City's management of the Sewer Fund?

A. Yes. While many factors will influence the overall credit standing of a municipality, rating agencies and investors will look at the historical management and past practices of Pekin as indicators to assess risk and its ability to adequately maintain, operate and ultimately pay back its debt. Some of the City's past practices with its wastewater system, which include significant and continuous transfers of revenues from the General Fund to and from the Sewer Fund and the City's unwillingness to raise or maintain rates, would be viewed by rating agencies and investors as indicative of future practices which would negatively impact the City's ability to pay off its debt. From a rating agency and investor perspective, it is important for the City to maintain the integrity and operations of the water system and its cash flow. Because of this concern, an issue to the rating agencies and investors is the ability of the City to transfer moneys out of the enterprise system funds to subsidize other City purposes. Such transfers drain the Sewer Fund cash position and constrain the City's ability to complete capital improvement projects.

As documented in the 1996 Audit, marked as IAWC Exhibit 7.11, the City Council in June 1993 transferred $1,000,000 out of the Sewer Fund to loan to the General Fund. On March 13, 1995, the City Council passed a resolution that forgave the loan to the General Fund thus leaving a 1995 fiscal year ending balance of negative $1,258,382 in the Sewer Fund. In June 1995, the City Council rescinded the resolution and transferred $1,000,000 from the General Fund to the Sewer Fund providing a 1996 ending fund balance of positive $268,532 in the Sewer Fund. This activity was to the detriment of the fund and may have diverted resources needed to make improvements to the system. In addition, since 1999, the City has transferred a total of $590,070 out of the Sewer Fund to the other municipal funds. Between FY 2000 and 2001, the City increased the amount it was transferring to the General Fund from $12,500 per month to $18,750 per month - $6,250 monthly, $75,000 annually or 40%. This is shown in IAWC Exhibit 7.12, the Pekin Sewerage Fund Financial Statements dated April 30, 2000 and April 30, 2001. The fact that the City has previously depleted the reserves to the detriment of the Sewer Fund and continues to make significant annual transfers would raise concerns with regard to the revenue stream for management and operations of the enterprise system.

Secondly, even though the City has made the commitment to freeze water rates if it were to acquire the water system, certain legal and binding covenants may be imposed by the rating agencies and investors that may impact the City's ability to maintain the rate freeze or issue additional debt to make necessary capital improvements. From necessity therefore, rates would either have to be increased or service would deteriorate as the City would be unable to pay for the capital improvements necessary to maintain and improve the water system. Rating agencies and investors would be likely to mandate an annual debt service and rate covenant, which would be legally binding upon the City, to maintain a rate structure that provides adequate annual revenues for operations and maintenance in addition to coverage on any outstanding debt service. This annual test generally would require the City to maintain a revenue over expenses coverage of 1.25x. In the event the City would not meet the annual rate covenant, it would be required to either raise rates or risk a default on the issued debt.

As stated above, the Water Study Task Force Summary Report indicates the City has maintained the same or a declining rate structure in its Sewer Fund between 1982 and 1998. The City has had a negative net income balance and a declining Sewer Fund balance each year since 1999. The chart marked as IAWC Exhibit 7.13 illustrates this decline. As of April 2002, the Sewer Fund had an ending fund balance of $340,868, which is a 67% decline since 1999. From a credit rating perspective, this shows an unwillingness of the City to properly charge residents the necessary fees to adequately operate, maintain and improve the enterprise system and plan for known capital improvement needs or emergency capital needs on an on-going basis. Ratings agencies and investors would be concerned about the risk which such practices create for the water system operation.

Furthermore, as Pekin proposes to do multiple bond issues, rating agencies and investors would require Pekin to meet an Additional Bond Test ("ABT") to maintain a minimum level of revenue coverage before issuing additional debt. A conservative and common ABT requires that net revenues for a prior fiscal period equal at least 125% of the maximum annual debt service requirement, taking into account the issuance of the proposed bonds. Using the Sewer Fund as an example, the City would have little flexibility to issue additional debt without a major rate increase due to the inability of revenues to cover expenses. This reflects a lack of planning by Pekin for future capital improvement projects.

Q 16. Are there any other factors that will affect the City's credit review?

A. Yes. As shown in the 2001 Comprehensive Plan, the City is projecting a .5 % annual increase in population for Pekin. This is an indicator of relatively stagnant population growth. Stagnant population growth will have a negative effect on both future water consumption needs and the ability of the City to issue debt, as large and frequently occurring bond issues will significantly increase the per capita debt load of Pekin residents.

GRANTS AND LOANS

Q 17. On pages 17 and 18 of Mr. Hierstein's Direct Testimony, he asserts that municipal ownership of the water system would allow the City "to tap into a variety of funding sources that are unavailable to private enterprise, and therefore to Illinois-American." In addition, on page 12, Ms. Hals also assumes that the City could fund capital improvements through reserves or grants. Do you agree with Mr. Hierstein's and Ms. Hals' statements?

A. No. Public water suppliers no longer have unlimited state and federal loan and grant programs available to them. Grants are very difficult to secure from any source, and loans, while available for water infrastructure purposes, are very competitive and require an application processing period of 18 months to two years. Further, Pekin, in particular as a home-rule City in a metropolitan region, with a population exceeding

30,000, has fewer options than certain small, rural communities.

Under certain conditions, Illinois-American is actually eligible for many of the same funding sources as Pekin and has accessed those moneys in recent years in Illinois. The IEPA, for example, provides funds through a State Revolving Loan Program. Initial funds are received from the federal government and loaned to water suppliers through a loan application process administered by the IEPA. The current interest rate on this Program is 2.65%, and the money may be repaid over a period of 20 years.[2] The application process is very competitive. The average time required to complete an application and receive funds is from 12 to 18 months. Initial applications must be submitted by March 31 of each year. This program is not restricted only to public entities, but is also available to private entities such as Illinois-American. As Mr. Ruckman testifies, Illinois-American has applied for and received revolving loan funds from Illinois.

The following is a further discussion of potential funding sources:

(1) **RDS**-The Rural Development Service, USDA provides loans for public entities such as water districts and small communities in rural areas of the State. Pekin is <u>not</u> eligible due to its population and inclusion in the Greater Peoria Metropolitan Statistical Area ("MSA").

(2) **EDA**-The Economic Development Administration of the United States Department of Commerce provides moneys for public infrastructure, but requires that the infrastructure be related to economic development efforts, such as the extension of a main to a business park or new industrial facility. It is my understanding that Pekin accessed these funds to assist in the location of a steel industry within the community; and that Illinois-American obtained a variance from the ICC's regular rules to allow these funds to be used. The money is in the

[2] At this time, IEPA has proposed but is not enforcing the inclusion of a covenant in its loan documents that would require the loan be senior to all other debt. Even if Pekin borrowed these funds for its Sewer System, which according to its engineering report it needs to do immediately, the enforcement of such a covenant could cause significant problems for any future Pekin water bonds. Bondholders almost universally require a senior lien as collateral for any bonded debt.

form of grants and loans, but it is not available for maintenance or upgrade of facilities and receipt of the grants is very competitive. As Mr. Ruckman indicates, if Pekin can obtain funds from this source, it can use the funds to facilitate development in cooperation with Illinois-American as was done in connection with the steel industry project.

(3) **HUD/CDBG**-The Department of Housing and Urban Development provides funds through the Community Development Block Grant Program ("CDBG"). Pekin receives these funds on an annual basis. Funds must be used to benefit low and moderate-income areas. CDBG funds thus cannot be used for citywide maintenance and improvement projects. The use of such funds in replacing mains and hydrants in parts of the City would require an analysis of census tract information to determine that greater than 51% of the population of the area where the improvement is to be made is low income. If a specific water project is to benefit low and moderate income portions of the City, it would be possible for Pekin and Illinois-American to enter into an agreement that would enable CDBG funds to be used in these areas even today, under Illinois-American ownership. As in the case of EDA Funds, Pekin's condemnation proposal does not affect the availability of these grants.

(4) **Bond Bank**-The Illinois Rural Bond Bank provides public entities the opportunity to issue bonds for infrastructure projects through a pooled program. Such a service is of no benefit to Pekin due to its ability to issue stand alone bonds at the same or better interest rates without the restrictions of the pooled program.

(5) **IDFA**-Similarly, the Illinois Development Finance Authority ("IDFA") is an issuing authority for municipal bonds and provides loans for specific economic development projects such as water line extensions to industrial locations when jobs are created. Cities can apply for such loans on behalf of private enterprises and Pekin could do so in cooperation with Illinois-American. Tax-exempt bonds issued through IDFA for municipal governments, such as Pekin, carry the double tax exemption (no federal or state income taxes paid by purchasers of the bonds which lowers the interest rate by five or ten basis points). However, a cost benefit analysis is required for each proposed project to ensure the cost of the IDFA application fee, issuer counsel fee and issuer fee do not offset the reduced interest rate advantage of the double exemption as Illinois income taxes are lower than those of many states.

It is important to note that Illinois-American is also eligible to access the same tax-exempt bond market that Pekin intends to use to finance the acquisition of the water system. Unlike Pekin, Illinois-American must secure "volume cap[3]" for the issuance of

[3] Within each state, the IRS has established a ceiling on the amount of tax-exempt bonds that can be issued on an annual basis for certain activities. This aggregate amount is the "volume cap" and is based on $75 per capita.

its tax-exempt debt, but in the last two years this has been easier to accomplish. This is due to the significant increase in volume cap available within the State because of a change in the federal formula dispensing volume cap to the states. Illinois-American is in a better position to access lower rates through the tax-exempt bond market because, due to its size and strong financial position, it may issue some or all of its bonds as variable rate debt, enabling it to take advantage of daily, weekly, or monthly rates which today are in the vicinity of 1.6%. This is less possible for Pekin as it does not have the size, financial flexibility or risk management capabilities of Illinois-American. Pekin would, more likely, be required to use fixed tax-exempt rate debt at a higher interest level.

Q 18. Are Illinois First funds still available to municipalities such as Pekin?

A. No. Under the previous administration (1999-2002), the State of Illinois launched Illinois FIRST, which was an aggressive capital funding program open to all units of local government and others throughout the State. Grants were made primarily in the categories of environment, which included water treatment, public safety, quality of life, education facility construction and improvement, and transportation improvements. These grants are no longer available or have been severely restricted due to the State's current and severe fiscal crisis. It is interesting to note, however, in reviewing the list of Illinois First funds disbursed in Tazewell County, marked as IAWC Exhibit 7.14, that of the reported $44,012,157 in total Illincis FIRST projects received in the County, it appears Pekin only received $200,000 for environmental quality related issues. Of this amount, $50,000 was to enforce an erosion control ordinance and $150,000 was to construct a dam to retain water in Pekin Lake. Pekin obtained some Illinois First moneys for road improvements, but did <u>not</u> obtain funding for the critical wastewater system. In comparison, East Peoria received $3,261,065 in environment and public safety categories alone, including $1.454 million for a wastewater plant upgrade. And, South Pekin received $2.595 million for its wastewater treatment plant and collection system.

Q 19. What does Pekin's approach regarding use of Illinois First funds to fund capital improvements to its wastewater system tell you?

A. First, it raises questions about the City's priorities when the 2001 Comprehensive Plan and the Wastewater Treatment Plan cite an immediate need for capital improvements of over $9 million to the wastewater system. Second, although Mr. Hierstein states on page 18 of his Direct Testimony that "government financing can lead to much more rapid and aggressive improvements in the aging [water] system," Pekin's failure to capitalize on the availability of funds from Illinois First to finance capital improvements to the wastewater system belies his statement. Finally, as discussed above, Pekin now has an imminent need to undertake deferred capital improvements in excess of $9.2 million. This immediate need for cash to upgrade the wastewater system, that will also need to be financed, leads to the inevitable conclusion that the City has been unable to implement Mr. Hierstein's proposed strategy of rapid capital spending with respect to its inadequate sewer system. My detailed review of Pekin's financial status suggests no basis to believe that Pekin would implement such a strategy for the water operation.

<u>UNAVAILABILITY OF NON-WATER SOURCES OF FUNDS</u>

Q 20. What does your analysis show with regard to the City's ability to acquire the water system and finance its capital needs?

A. Public water supply systems, including the Pekin System, are capital-intensive enterprises, which require significant ongoing capital investment and maintenance programs. Water services are the most capital-intensive of all utilities largely because of the high cost of building and repairing water pipelines. In a report prepared in 2002, the U.S. Environmental Protection Agency (the "EPA") indicated that capital needs for drinking water over a twenty-year period from 2000 to 2019 range from $154 billion to $446 billion dollars. The EPA Report is sponsored by Mr. Gloriod and marked as IAWC Exhibit 1.1. And as Mr. Gloriod's testimony demonstrates, the water industry is facing huge challenges stemming from the virtually nation-wide need to replace and upgrade existing aged water structures. [See T. Gloriod Testimony (Ex. 1.0) at 11.] This is occurring at a time when more and more stringent environmental rules are being promulgated.

Quite simply, as detailed above, Pekin does not have the ability to subsidize the water system. And, as Mr. Ruckman's rate schedules show, based on the minimum valuation determined by Mr. Reilly, it will take a cumulative 106.87% increase in water rates over 10 years to cover the costs for acquisition of the water system and capital additions. Cities often do not have the political will to raise rates to cover costs, and Pekin has already promised a 5-year rate freeze and has failed to raise sewer rates to make needed improvements. As Mr. Gloriod indicates, if there is a condemnation and Pekin proceeds to acquire the water system, Pekin's rates would be seriously deficient. This would represent the same pattern of underfunding that plagues the sewer operation.

Q 21. Could the City raise taxes instead of raising rates?

A. Yes, the use of G.O. debt implies the City could levy a property tax on City residents to pay the bonds. However, there does come a point at which the citizens can be overburdened, and the City may have difficulty securing credit enhancement or an investment grade rating for its bonds which will subsequently result in it having to pay much higher interest rates. The transition to such a position is dependent upon total outstanding debt of the City, economic development and demographic factors within the area, including levels of property values, population, tax rates and the overlapping debt of other local government districts. And, the current Pekin administration has demonstrated an unwillingness to use property taxes as a funding source.

RATE FORECAST

Q 22. Do you have any comments regarding the assumptions Ms. Hals used in developing Pekin's rate forecast as set forth in her testimony?

A. Yes. Several of the assumptions Ms. Hals makes are misleading or inaccurate:

- Interest Rates- Interest rates are not anticipated to remain at the 40-year historical lows of today. A graph illustrating the dramatic changes in interest rates over the last thirty years is marked as IAWC Exhibit 7.15. Therefore, Ms. Hals' assumption that the City will maintain a 4.2% average interest rate for bonds projected to be issued in 2006, 2009 and 2012 is misleading. Interest costs have achieved historically low levels, and there is no basis to assume that the present low rates will exist in the future if Pekin were to someday acquire and operate the water system. Mr. Ruckman addresses this point further.

- Cost of Issuance Fees- As discussed below, Ms. Hals' projected amounts for both the total Costs of Issuance and the Bond Insurance (<u>see</u> Schedule A-3 and A-5 to Ms. Hals' testimony) are too low.

- Additional Bonds Test- As set forth above, as defined by Standard & Poor's, a conservative additional bonds test requires that net revenues for a prior fiscal period equal at least 125% of the maximum annual debt service taking into account the issuance of proposed debts. The debt service coverage presented in Ms. Hals' analysis in Schedule A-4 of her Direct Testimony does not always meet the 125% coverage test, and would not if interest rates or the amount borrowed increased. Because the test is not always met, the City's cost of debt would increase to a level above that assumed by Ms. Hals.

- Continued bond issuance without accompanying economic growth or an adequate diverse economic base increases the per capita debt burden and would inevitably result in a downgrade of the City's credit rating. This would result in a higher cost of debt than that assumed by Ms. Hals.

Q 23. Please discuss Ms. Hals' assumptions with respect to Costs of Issuance and Bond Insurance.

A. The formula used by Ms. Hals to project insurance costs for bonds is incorrect and results in a gross understatement of the costs of bond insurance. However, as the total costs of insurance is amortized over 20 years, the impact of the error is not significant. Similarly, the estimated level of issuance costs for the several small issues that Ms. Hals contemplates are also much too low; $41,185 for Hals' schedule as compared to a more accurate forecast of $115,000 for the 2006 issuance. As shown on IAWC Exhibit 7.16, it is Stifel Nicolaus' estimate that such costs would be approximately $65,000 to $75,000 higher for each issue than Ms. Hals originally estimated. Again, these costs would be amortized over the maturity of the issue, so they are not significant on an annual basis. Ms. Hals, however, does create the misleading impression that the costs of borrowing and bond debt is much lower than it actually is.

Q 24. Please discuss Ms. Hals' calculation of debt service coverage.

A. As discussed earlier, there are standards used to evaluate water and sewer funds provided by Standard and Poor's and the other municipal bond rating agencies including Moody's and Fitch. The preference of Standard and Poor's and the other rating agencies is to secure 1.25 times debt service coverage for any revenue bond issue. Although Pekin has stated it will issue G.O. debt, it will not rely on its property taxes to repay the costs of acquiring and improving the water system. Thus, if Pekin attempts to secure an investment grade rating to achieve the lowest possible interest rates, it would have to raise rates to ensure that it has such projected coverage prior to the initial bond issue, and commit in legal documents to maintain that coverage through the life of the issue.

Ms. Hals has calculated a debt service coverage ratio by first subtracting adjusted operating expenses (not including revenue funded repairs) from total revenues and then dividing these adjusted operating expenses by the annual debt service to achieve a coverage ratio. Calculating debt service coverage in this manner, however, is deceiving and fails to represent both the factor of time and the need for essential maintenance as an ongoing and required expense of the system. Debt service coverage is calculated at a set point in time typically at the end of the fiscal year when all other numbers including total revenues and expenses are calculated. Ms. Hals' formula recognizes total revenues, but then does not recognize revenue financed capital costs until after debt service coverage is calculated. This results in a faulty coverage number, as if debt service coverage was calculated in mid-year while all other revenues and expenses were derived at year-end.

As an illustration, in Schedule A-4, Ms. Hals identified annual expenditures for renewal and replacement (the revenue financed capital projects) and in her testimony stated that she assumed that the City would make this level of investment annually. In Schedule A-4, however, she calculated coverage before those expenditures are subtracted suggesting that either the revenue financed capital expenditures would not be made at all or would not be made on a priority basis. According to the Governmental Accounting Standards Board ("GASB") and as required under the Local Government Debt Reform Act of the State of Illinois, debt service coverage is a calculation of net revenues (all revenues less expenses excluding depreciation) plus debt service divided by annual debt service. Using the correct formula in Ms. Hals' Schedule A-4, the debt service coverage ratio falls from 1.78x to 1.07x in 2004. Similar decreases exist for all subsequent years.

This lower coverage makes a significant difference to the rating agencies and they would require that rate increases be imposed immediately if Pekin wishes to issue its bonds with an investment grade rating which would not be reliant on the levy of property taxes. In completing my comparative table, included as IAWC Exhibit 7.17, I assumed that moneys budgeted for renewal and replacement from operations, i.e., maintenance and repair or revenue financed capital projects, would be spent annually as shown, and the debt service coverage would be calculated properly at the end of the year. These modified assumptions lead to a substantially greater need for rate increases than Ms. Hals' analysis demonstrates.

Comparing Stifel Nicolaus' analysis to Hals' analysis, assuming an approximate $14,000,000 acquisition price, the bond issue amount would be $17,700,000.[4] If bonds were issued in 2003, rate increases would begin in year 2004 and would be required each year thereafter through 2006.[5] Rate increases will be greater and more frequent as the bond amount increases due to a larger acquisition cost.

Q 25. Does this conclude your Direct Testimony?

A. Yes it does.

[4] Bonds are issued in increments of $5,000.00.

[5] As demonstrated by Mr. Reilly, the number is significantly lower than the value a court would apply in condemnation.