STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Aqua Illinois, Inc.	:	
	:	
	:	04-0442
Proposed general increase in water rates. (Tariffs filed on May 28, 2004.)	:	

PRETRIAL MEMORANDUM OF STAFF OF THE ILLINOIS COMMERCE COMMISSION

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**PRETRIAL MEMORANDUM OF STAFF
OF THE ILLINOIS COMMERCE COMMISSION**

Pursuant to the July 19, 2004 Administrative Law Judge's Notice, Staff of the Illinois Commerce Commission ("Staff"), by and through its attorneys, hereby submits its Pretrial Memorandum in this investigation of Aqua Illinois, Inc.'s ("Aqua" or the "Company") proposed general increase in water rates.

I. STATEMENT OF CONTESTED AND UNCONTESTED FACTS

In this docket the Illinois Commerce Commission ("Commission") is investigating Aqua's request for a general rate increase for its Vermilion service area. Because this is a general rate case, there is no concise list of facts or assertions at issue as there would be in a complaint case. Indeed, every number or amount contained in the Company's 83 Ill. Adm. Code 285 filing is potentially a contested fact. Staff's primary role is to review the Company's filing and advise the Commission with respect to those issues it is able to identify. Although Staff conducts a thorough and complete review, Staff is not -- as a practical matter -- able to review each and every fact or identify each and every possible issue. Further, Staff's testimony is typically, if not exclusively, expert testimony. Although Staff relies on discovery responses, field audits and other information to identify factual inaccuracies in a utility's filing and presents facts obtained through discovery or other means to support necessary adjustments, Staff does not typically present fact witnesses and typically does not possess knowledge that would allow it to state or form an opinion on whether a fact identified by a utility is correct or not. Given that discovery through depositions is not typically utilized in Commission proceedings, Staff is often unable to test or explore factual assertions until cross-examination at hearings. Thus, contested facts sometimes develop or are discovered at hearings, and Staff fully reserves its right to raise disputed facts in that manner. Even if Staff does not contest a particular fact, that does not prevent other parties or the Commission from either contesting such fact or asserting or finding that the utility has not met its burden of proof with respect to such fact. Accordingly, subject to the qualifications and limitations stated above, Staff submits that the contested and uncontested facts are those reflected below in Staff's statement of contested and uncontested issues.

II. STATEMENT AS TO STIPULATIONS TO BE PRESENTED AT TRIAL

There are no stipulations at this time between Staff and the Company that will be presented at the evidentiary hearing in this proceeding.

III. RATE BASE

A. Uncontested Issues

1. Cash Working Capital

Staff witness Mary H. Everson proposed an adjustment to cash working capital based on Staff's changes to the Company's operating expenses. (ICC Staff Exhibit 1.0,

p. 5, lines 98-103.) The amount will change based on the final amounts of operating expense ordered in this proceeding.

Company witness Schreyer agreed not to contest this issue. (Aqua Ex. R-2.0, p. 4, lines 74 and 76; Aqua Ex. S-2.0, p. 3, lines 67-75.)

2. Accumulated Depreciation

Staff witness Everson proposed an increase to Accumulated Depreciation related to the Indianola water system acquisition. The adjustment is necessary to update the amount of accumulated depreciation for the intervening time period between the original cost study valuation date and the acquisition closing date. The assets continued to depreciate in the intervening time period and must be recorded on Aqua's books. (ICC Staff Exhibit 1.0, pp. 6-8, lines 104-170.)

Company witness Schreyer agreed not to contest this issue. (Aqua Ex. R-2.0, p. 4, lines 65 and 66.)

3. Deferred Tank Painting

Staff witness Everson proposed an adjustment to reduce deferred tank painting costs of $69,604 due to an overestimate of one of the projects. The projection in rate base was more than double the amount of the bid obtained for the project. (ICC Staff Exhibit 1.0, pp. 9-10, lines 171-213.)

Company witness Schreyer agreed not to contest the issue. (Aqua Ex. R-2.0, p. 4, lines 65 and 67.)

4. Capitalized Payroll

Staff witness Ebrey proposed an adjustment to Capitalized Payroll, which she withdrew in rebuttal testimony. (ICC Staff Exhibit 6.0, p. 7, lines 132-137.)

5. Capitalized Payroll Tax

Staff witness Ebrey proposed adjustments to Plant Additions and Capitalized Benefits, which result from her proposed adjustments to FICA, SUTA and FUTA Taxes. Staff's adjustments are based on the capitalized payroll percentage based on total payroll per Staff. (ICC Staff Exhibit 6.0, pp. 11-12, lines 227-237.) The Company's surrebuttal testimony Capitalized Payroll percentage is 21.89%. (Aqua Ex. S-2.0, p. 4, lines 94-95.) Final capitalized Payroll Tax will need to be calculated based on the final Capitalized Payroll percentage the Commission adopts in this proceeding. (Aqua Ex. S-2.0, p. 4, lines 95-97.)

6. Materials and Supplies

Staff witness Theresa Ebrey proposed an adjustment to reduce the Company's Materials and Supplies Inventory balance for the amount of average materials and supplies included in accounts payable. (ICC Staff Exhibit 2.0, p. 24, lines 465-467.)

Company witness Schreyer agreed not to contest this adjustment. (Aqua Ex. R-2.0, p. 4, lines 65 and 69.)

7. Pension Reserve

Staff witness Ebrey proposed an adjustment to decrease the Company's FAS 87 Pension Reserve based on updated actuarial reports provided by the Company for 2004 and 2005. (ICC Staff Exhibit 6.0, p. 26, lines 526-537.)

Company witness Schreyer accepted this adjustment. (Aqua Ex. S-2.0, p. 7, lines 170-171.)

8. Deferred Taxes

Staff witness Ebrey proposed adjustments to both State and Federal Deferred

Income Taxes resulting from the adjustment to FAS 87 Pension Reserve. (ICC Staff Exhibit 6.0, p. 26, lines 539-542.)

Company witness Schreyer accepted this adjustment. (Aqua Ex. S-2.0, p. 7, lines 170-171.)

B. Contested Issues

There are no contested rate base issues, except those conditioned upon the Commission's final determination of other contested issues and discussed above for Cash Working Capital and Capitalized Payroll Tax.

IV. OPERATING REVENUES, EXPENSES AND INCOME

A. Uncontested Issues

1. Interest Synchronization

Staff witness Mary H. Everson proposed an adjustment to interest synchronization in order to ensure that the revenue requirement reflects the tax savings generated by the interest component of revenue requirement. (ICC Staff Exhibit 1.0, pp. 4-5, lines 81-90.)

Company witness Schreyer agreed not to contest this issue. (Aqua Ex. R-2.0, p. 4, lines 74 and 75.) He also agreed with Staff witness Everson that the final amount for this item should be based upon the Commission's final determinations in this proceeding. (Aqua Ex. S-2.0, p. 3, lines 67-75.)

2. QIPS Revenues

Staff witness Everson proposed an adjustment to reclassify $517,063 of revenues from the Qualified Infrastructure Plant Surcharge ("QIPS") rider to base rates. Under the terms of the surcharge rider, the Company is entitled to collect QIPS revenues prior to the time the related plant items are placed into rate base. Once the plant items are in rate base, the surcharge revenues should no longer be collected since the return on rate base and return of depreciation expense they simulate will be recovered through base rates. (ICC Staff Exhibit 1.0, p. 11, lines 215-224.)

Company witness Schreyer agreed not to contest this issue. (Aqua Ex. R-2.0, p. 4, lines 74 and 77.)

3. Amortization Expense

Staff witness Everson proposed an adjustment to reduce the Company's amortization expense due to her adjustment to deferred tank painting. (ICC Staff Exhibit 1.0, p. 14, lines 286-299.)

Aqua witness Jack Schreyer agreed not to contest this issue. (Aqua Ex. R-2.0, p. 4, lines 65 and 68.)

4. Payroll Tax Expense-FICA

Staff witness Ebrey proposed an adjustment to Taxes Other than Income based on Staff's proposed total payroll multiplied by the FICA rate of 7.65%. (ICC Staff Exhibit 6.0, p. 8, lines 149-152, and Schedule 6.2.) The Company accepts Staff's methodology (Aqua Ex. R-2.0, p. 19, lines 425-428) but disputes the amount of total payroll used in the calculation (Aqua Ex. S-2.0, p. 3, lines 78-86). Final FICA tax will need to be calculated based on the final total payroll costs approved by the Commission.

5. Payroll Tax Expense-SUTA and FUTA

Staff witness Ebrey proposed an adjustment to Taxes Other than Income based on 36.5 employees times the $9,800 wage limit and 1.04% rate for SUTA and the $7,000 wage limit and 0.80% rate for FUTA. (ICC Staff Exhibit 6.0, pp. 9-11, and

Schedules 6.3 and 6.4.)

Company witness Schreyer does not contest this adjustment. (Aqua Ex. S-2.0, p. 4, lines 100-104.)

6. Capitalized Payroll Tax Expense

Capitalized Payroll Tax Expense is discussed under Rate Base, Uncontested Issues, *supra*, page 4.

7. Workers Compensation Insurance Expense

Staff witness Ebrey proposed an adjustment to Workers Compensation Insurance Expense, which she withdrew in rebuttal testimony. (ICC Staff Exhibit 6.0, p. 3, lines 50-53.)

8. Other Expenses-Membership Dues

Staff witness Ebrey proposed an adjustment to remove dues to certain community organizations from the Company's recoverable miscellaneous general expenses since participation in such groups is a promotional and goodwill practice and not necessary in providing utility service. (ICC Staff Exhibit 2.0, p. 25, lines 491-496.)

Company witness Scheyer agreed not to contest the adjustment. (Aqua Ex. R-2.0, p. 4, lines 65 and 70.)

9. Other Expenses-Lobbying Fees

Staff witness Ebrey proposed an adjustment to remove the portion of membership dues related to lobbying efforts. (ICC Staff Exhibit 2.0, p. 26, lines 506-507.)

Company witness Scheyer agreed not to contest the adjustment. (Aqua Ex. R-2.0, p. 4, lines 65 and 71.)

10. Collections Expense

Staff witness Ebrey proposed an adjustment to Miscellaneous General Expense to reverse the $13,407 adjustment proposed by the Company in its Rebuttal testimony since the Company has not provided an explanation for the derivation of the amount. Staff also proposed an adjustment to decrease payroll expense by $26,907 for the wages related to the Remittance Center which were inadvertently not removed by the Company per its response to Staff data request MHE 6.03. (ICC Staff Exhibit 6.0, pp. 23-24, lines 472-485.)

Company witness Schreyer accepted these adjustments. (Aqua Ex. S-2.0, p. 6, lines 134-139.)

11. Lime Expense

In his rebuttal testimony, Aqua witness Schreyer proposed an increase to lime expense to reflect a new contract the Company entered into in September. (Aqua Ex. R-2.0, p. 39.) The Company included this increase in its rebuttal revenue requirement.

In her rebuttal testimony, Staff witness Everson indicated that she received information from the Company verifying the amount of the increase. (ICC Staff Exhibit 5.0, p. 8.) Staff did not propose an adjustment to remove the effect of the increase from the Company's rebuttal revenue requirement.

B. Contested Issues

1. Payroll Expense

a. Staff's Proposed Adjustment

Staff witness Ebrey proposed an adjustment decreasing payroll expense by $90,129 to reflect the Company's historic practice of over budgeting total payroll costs.

(ICC Staff Exhibit 6.0, p. 7, lines 128-130.)

b. Staff's Recommended Disposition

Staff recommends that the Commission approve its adjustment to decrease payroll expense by $90,129.

c. Revenue Requirement Impact

Staff's adjustment decreases the revenue requirement by $90,129.

2. Incentive Compensation Expense

a. Staff's Proposed Adjustment

Staff proposed adjustments disallowing incentive compensation expense included in Salaries and Wages Expense ($21,468) and in other O&M Expenses ($12,322), for reasons outlined in ICC Staff Exhibit 2.0, pp. 10-15, lines 175-300. The Company opposes Staff's adjustments, stating the costs are a legitimate cost of business for a utility. (Aqua Ex. R-2.0, p. 21, lines 457-458.)

b. Staff's Recommended Disposition

Staff recommends that the Commission approve its adjustments reducing Operating Expenses by a total of $33,790.

c. Revenue Requirement Impact

Staff's proposed adjustments to disallow Incentive Compensation Expense decrease operating expenses by a total of $33,790.

3. Advertising Expense

a. Staff's Proposed Adjustment

Staff witness Ebrey proposed an adjustment to disallow certain costs from Advertising Expense because they are promotional or goodwill in nature or remain unsupported by the Company. (ICC Staff Exhibit 6.0, p. 20, lines 404-405.)

b. Staff's Recommended Disposition

Staff recommends that the Commission approve its adjustment to reduce Advertising Expense by $9,540.

c. Revenue Requirement Impact

Staff's proposed adjustment to Advertising Expense decreases operating expenses by $9,540.

4. Charitable Contributions Expense

a. Staff's Proposed Adjustment

Staff witness Ebrey proposed an adjustment to disallow costs from Charitable Contributions that are in reality membership dues, promotional advertising, and educational subsidies. (ICC Staff Exhibit 6.0, p. 22, lines 454-456.) The Company opposes Staff's adjustment because the amounts Staff disallows are "for the welfare of the public". (Aqua Ex. R-2.0, p. 32, lines 730-731.)

b. Staff's Recommended Disposition

Staff recommends that the Commission approve its adjustment to reduce Charitable Contributions Expense by $27,675.

c. Revenue Requirement Impact

Staff's proposed adjustment to Charitable Contributions Expense decreases operating expenses by $27,675.

5. Management Fees

a. Staff's Proposed Adjustment

Staff witness Ebrey proposed an adjustment to decrease Management Fees by the $19,246 Company-estimated costs related to the Remittance Center. The Company does not rebut Staff's premise that the $223,521 increase in Management Fees would include the Remittance Center costs. (ICC Staff Exhibit 2.0, p. 27, lines 539-542.) While the Company accepts Staff's adjustment disallowing the Company's increase to Miscellaneous Expense for $19,246, it does so for a different reason than proposed by Staff. Since Staff witness Everson is withdrawing her adjustment to include non-utility revenues in the operating statement, the costs related to those revenues ($19,246 Remittance Center Costs) must also be removed for a proper matching of revenues and expenses. (ICC Staff Exhibit 6.0, p. 24, lines 488-504.)

b. Staff's Recommended Disposition

Staff recommends that the Commission approve its adjustment reducing Management Fees by $19,246.

c. Revenue Requirement Impact

Staff's proposed adjustment to Management Fees decrease operating expenses by $19,246.

6. Wastewater Billing Revenues

a. Staff's Proposed Adjustment

Staff witness Everson proposed an adjustment to the amount of revenues related to the Company's wastewater billing in the revenue requirement due to the inclusion of the related expenses for the Vermilion Remittance Center in the revenue requirement. (ICC Staff Exhibit 1.0, pp. 11-12, lines 225-240.)

b. Staff's Recommended Disposition

Staff recommends that these revenues not be included in the revenue requirement if the Commission approves Staff witness Ebrey's adjustments to Payroll and Collections Expense (ICC Staff Exhibit 6.0, Schedule 6.8) and Management Fees (ICC Staff Exhibit 6.0, Schedule 6.9), since those adjustments remove operating expenses related to the Remittance Center where these revenues are generated. In surrebuttal testimony, Aqua accepted Staff witness Ebrey's adjustment to payroll expense and collections expense (Aqua Ex. S-2.0, p. 6, lines 134-139) but took issue with her adjustment to Management Fees (Aqua Ex. S-2.0, pp. 29-30, lines 657-673). Staff witness Everson's adjustment to revenues was proposed since the expenses were still included in the Company's revenue requirement. (*See* also Collections Expense and Management Fees issues.) If the Commission finds that Staff's adjustments to Payroll Expense, Collections Expense, and Management Fees are inappropriate, the revenue adjustment should be included to present a matching of expenses and revenues.

c. Revenue Requirement Impact

Staff's proposed adjustment to wastewater billing revenues decreases the revenue requirement by $116,483.

7. Lab Testing Services Revenues

a. Staff's Proposed Adjustment

Staff witness Everson proposed an adjustment to the amount of revenues related to the Company's lab testing services in the revenue requirement due to the inclusion of the related expenses for the Vermilion Remittance Center in the revenue requirement. (ICC Staff Exhibit 1.0, p. 12, lines 241-255.)

b. Staff's Recommended Disposition

Staff recommends that these revenues not be included in the revenue requirement if the Commission approves Staff witness Ebrey's adjustments to Payroll and Collections Expense (ICC Staff Exhibit 6.0, Schedule 6.8) and Management Fees (ICC Staff Exhibit 6.0, Schedule 6.9), since those adjustments remove operating expenses related to the Remittance Center where these revenues are generated. In surrebuttal testimony, Aqua accepted Staff witness Ebrey's adjustment to payroll expense and collections expense (Aqua Ex. S-2.0, p. 6, lines 134-139) but took issue with her adjustment to Management Fees (Aqua Ex. S-2.0, pp. 29-30, lines 657-673). Staff witness Everson's adjustment to revenues was proposed since the expenses were still included in the Company's revenue requirement. (*See* also Collections Expense and Management Fees issues.) If the Commission finds that Staff's adjustments to Payroll Expense, Collections Expense, and Management Fees are inappropriate, the revenue adjustment should be included to present a matching of expenses and revenues.

c. Revenue Requirement Impact

Staff's proposed adjustment to lab testing services revenues decreases the revenue requirement by $9,282.

8. Customer Data Sales Revenues

a. Staff's Proposed Adjustment

Staff witness Everson proposed an adjustment to the amount of revenues related to the Company's customer data sales in the revenue requirement due to the inclusion of the related expenses for the Vermilion Remittance Center in the revenue requirement. (ICC Staff Exhibit 1.0, pp. 13-14, lines 271-285.)

b. Staff's Recommended Disposition

Staff recommends that these revenues not be included in the revenue requirement if the Commission approves Staff witness Ebrey's adjustments to Payroll and Collections Expense (ICC Staff Exhibit 6.0, Schedule 6.8) and Management Fees (ICC Staff Exhibit 6.0, Schedule 6.9), since those adjustments remove operating expenses related to the Remittance Center where these revenues are generated. In surrebuttal testimony, Aqua accepted Staff witness Ebrey's adjustment to payroll expense and collections expense (Aqua Ex. S-2.0, p. 6, lines 134-139) but took issue with her adjustment to Management Fees (Aqua Ex. S-2.0, pp. 29-30, lines 657-673). Staff witness Everson's adjustment to revenues was proposed since the expenses were still included in the Company's revenue requirement. (*See* also Collections Expense and Management Fees issues.) If the Commission finds that Staff's adjustments to Payroll Expense, Collections Expense, and Management Fees are inappropriate, the revenue adjustment should be included to present a matching of expenses and revenues.

c. Revenue Requirement Impact

Staff's proposed adjustment to customer data sales revenues decreases the revenue requirement by $8,517.

9. Collection Revenues

a. Staff's Proposed Adjustment

Staff witness Everson proposed an adjustment to the amount of revenues related to the Company's collection revenues in the revenue requirement due to the inclusion of the related expenses for the Vermilion Remittance Center in the revenue requirement. (ICC Staff Exhibit 1.0, pp. 12-13, lines 256-270.)

b. Staff's Recommended Disposition

Staff recommends that these revenues not be included in the revenue requirement if the Commission approves Staff witness Ebrey's adjustments to Payroll and Collections Expense (ICC Staff Exhibit 6.0, Schedule 6.8) and Management Fees (ICC Staff Exhibit 6.0, Schedule 6.9), since those adjustments remove operating expenses related to the Remittance Center where these revenues are generated. In surrebuttal testimony, Aqua accepted Staff witness Ebrey's adjustment to payroll expense and collections expense (Aqua Ex. S-2.0, p. 6, lines 134-139) but took issue with her adjustment to Management Fees (Aqua Ex. S-2.0, pp. 29-30, lines 657-673). Staff witness Everson's adjustment to revenues was proposed since the expenses were still included in the Company's revenue requirement. (*See* also Collections Expense and Management Fees issues.) If the Commission finds that Staff's adjustments to Payroll Expense, Collections Expense, and Management Fees are inappropriate, the revenue adjustment should be included to present a matching of expenses and revenues.

c. Revenue Requirement Impact

Staff's proposed adjustment to collection revenues decreases the revenue requirement by $3,408.

10. Rate Case Expense

a. Staff's Proposed Adjustment

Staff witness Everson does not agree with Aqua witness Schreyer, who indicated in rebuttal testimony that, at the evidentiary hearings in this matter, the Company would like to present new and additional rate case costs for recovery. (Aqua Ex. R-2.0, pp. 39-40.)

b. Staff's Recommended Disposition

Staff witness Everson proposes that the Commission approve the amount of rate case expense the Company proposed and supported in its direct testimony. The Company has had adequate opportunity to present its updated information in prepared testimony but has chosen not to do so. Presenting such a revision at the evidentiary hearing precludes Staff from reviewing the expenses and eliminates the opportunity for discovery related to the additional costs. (ICC Staff Exhibit 5.0, pp. 9-10, lines 164-197.)

c. Revenue Requirement Impact

The revenue requirement impact is unknown since the Company is unwilling to provide the additional costs to the Commission until the evidentiary hearing in this matter.

V. CAPITAL STRUCTURE AND COST OF CAPITAL

A. Uncontested Issues

1. Capital Structure

In surrebuttal testimony, the Company accepted Staff witness Rochelle Phipps' proposed average 2005 capital structure comprising 51.64% common equity, 47.79% long-term debt, 0.32% preferred equity, and 0.25% short-term debt. (ICC Staff Exhibit 7.0, Schedule 7.1; Aqua Exhibit S-2.0, p. 2.)

2. Cost of Preferred Equity

The Company does not dispute Staff witness Phipps' proposed cost of preferred equity. (Aqua Ex. R-3.0, p. 2.)

B. Contested Issues

1. Cost of Capital

The Company requests a 9.18% overall cost of capital. (Aqua Schedule D-1, p. 1.) Staff witness Phipps estimates the Company's overall cost of capital is 8.66%. (ICC Staff Exhibit 7.0, Schedule 7.1.) Staff and the Company disagree on the costs for long-term debt, short-term debt and common equity.

2. Cost of Long-Term Debt

The Company estimates the cost of long-term debt is 7.57%, which reflects a 6.50% interest rate for the proposed December 2004 debt issuance that is expected to mature in 2016. (Aqua Schedule D-3, p. 1.) The Company's 6.50% interest rate estimate assumes a 5.0% U.S. Treasury bond yield, plus 150 basis points due to the Company's NAIC-2 designation. (ICC Staff Exhibit 3.0, pp. 11-12, citing Company response to Staff data request FD-21.)

Staff estimates the Company's cost of long-term debt is 7.18%, which reflects a 5.42% interest rate for the Company's proposed December 2004 debt issuance. Staff's 5.42% interest rate estimate equals the current yield for 10-year U.S. Treasury bonds, plus 112 basis points. (ICC Staff Exhibit 3.0, p. 12.) Staff's long-term debt schedule also reflects the Company's proposal to refund bonds that carry a 9.19% interest rate with the lower cost debt issue expected to occur during December 2004. (ICC Staff Exhibit 7.0, pp. 2-3.)

3. Cost of Short-Term Debt

The Company estimates the cost of short-term debt is 3.07%. (Aqua Schedule D-2, p. 1.) Staff estimates the Company's cost of short-term debt is 2.52%. (ICC Staff Exhibit 3.0, pp. 10-11.) The Company's estimate reflects a forecasted interest rate and alleged issuance expenses. (Aqua Schedule D-2; Aqua Exhibit R-3.0, p. 2.) Staff's estimate is based on the current LIBOR rate (rather than interest rate projections) and does not reflect undocumented issuance expense. (ICC Staff Exhibit 7.0, p. 5.)

4. Cost of Common Equity

Staff witness Phipps estimates the investor-required rate of return on common equity for Aqua is 10.07%. (ICC Staff Exhibit 7.0, Schedule 7.1.) She measured the investor-required rate of return on common equity for Aqua with DCF and CAPM analyses, which she applied to both a sample of water companies and a sample of public utilities. (ICC Staff Exhibit 3.0, p. 13.) Staff witness Phipps' quantitative risk analysis of Aqua indicates Aqua is as risky as the water sample and slightly riskier than the utility sample. Accordingly, Staff witness Phipps assigned the cost of equity estimates for the water sample twice the weight that she assigned the cost of equity estimates for the utility sample. Because Aqua is not riskier than at least one of the samples (i.e., water sample), adding an investment risk premium to Aqua's rate of return on common equity is unwarranted. (ICC Staff Exhibit 7.0, pp. 10-11.)

The Company estimates an 11.35% rate of return on common equity for Aqua, but reduced its requested rate of return to 10.75%. (Aqua Exhibit 2.0, p. 9.) The cost of common equity was estimated with the same forms of DCF, CAPM, ECAPM, RPM (including Beta RPM) and CEM analyses the Commission rejected in Docket No.

03-0403. The Company's cost of equity estimate includes an investment risk premium due to the Company's small size and the Company's NAIC-2 designation. (Aqua Exhibit 3.0, pp. 61-62.)

VI. COST OF SERVICE AND RATE DESIGN

A. Uncontested Issues

1. Cost of Service Study ("COSS")

Staff witness Mike Luth prepared a COSS (ICC Staff Exhibit 4.1) in response to the COSS presented by David R. Monie on behalf of the Company (Aqua Illinois Exhibit 4.0, Schedule 1).

Company witness Monie stated that he does not dispute the results of Staff's COSS as it affects the overall Customer Class Cost of Service. (Aqua Ex. R-4.0, p. 2, lines 27-28.)

2. Public Fire Protection Rates

In direct testimony, Staff witness Mike Luth proposed Public Fire Protection rates that vary according to fire protection district and are based upon the "Single-Tier" method for determining Public Fire Protection rates (ICC Staff Exhibit 4.1, pp. 13-14) in response to Company witness Monie's recommendation that public fire protection rates move toward uniform rates across the Vermilion service area (Aqua Illinois Exhibit 4.0, "COST OF SERVICE AND TARIFF DESIGN STUDIES", pp. 6-7).

In rebuttal testimony, Company witness Monie recommended Public Fire Protection rates based upon the "Two-Tier" method for determining public fire protection rates. (Aqua Ex. R-4.0, pp. 4-5.) In Staff rebuttal testimony, Mr. Luth accepted the use of the "Two-Tier" method for determining public fire protection rates. (ICC Staff Exhibit

8.0, pp. 7-8.)

B. Contested Issues

1. Fourth Usage Block

In direct testimony, Staff witness Mike Luth proposed the elimination of the fourth usage block because usage billed through the fourth usage block is slight, in terms of both the Vermilion service area as a whole, and the Industrial customer class in particular, which is the only Vermilion customer class with any usage billed through the fourth usage block. (ICC Staff Exhibit 4.0, p. 13, lines 249-255.)

In rebuttal testimony, Company witness Monie objected to the elimination of the fourth usage block, stating that the purpose of the trailing usage block is so it applies to the largest water users because it is cheaper to provide water in large quantities and provide a tool for the community to attract and maintain industry. (Aqua Ex. R-4.0, pp. 10-11.) Staff witness Luth maintained his position that the fourth usage block should be eliminated, and responded that his three usage blocks reflect lower costs for large quantities of water usage because the third usage block is considerably lower than the smaller first and second usage blocks, that the Company's proposed fourth usage block does not represent a significant reduction in an industrial customer's billing from Staff's proposed three-usage block billing even if a single hypothetical industrial customer accounted for all of the usage billed through the fourth usage block, and that consolidation of the fourth usage block consumption with third usage block consumption slightly reduces the third usage block. (ICC Staff Exhibit 8.0, pp. 8-10.)

2. Increase in Customer Charges

In direct testimony, the Company recommended an increase in all rates, including the customer charge that increases as the size of meter increases. (Schedule E-2, pp. 1, 4, and 5, Facilities Charge.) With the exception of the 6-inch turbine meter customer charge currently applicable only to TeePak, LLC, the largest Vermilion customer, Staff proposed no increases in customer charges. (ICC Staff Exhibit 4.1, p. 1 of 18.)

In rebuttal testimony, Company witness Monie stated that the Company proposes an increase in the Customer Charge at the same percentage as the overall increase in metered revenues. (Aqua Ex. R-4.0, p. 11, lines 263-265.) As a compromise position, Mr. Monie recommends an increase in the Customer Charge that is 50 percent of the overall percentage increase in metered revenues, other than the Customer Charge for a 6-inch turbine meter applicable only to TeePak. (Aqua Ex. R-4.0, p. 11, lines 278-282.) Staff witness Luth explained that an increase in the Customer Charge, other than an increase in the 6-inch turbine meter, is unnecessary because under current rates, Customer Charge revenues exceed customer costs recoverable under the Customer Charge. (ICC Staff Exhibit 8.0, p. 10, lines 196-210.)

In surrebuttal testimony, Company witness Monie pointed out that Staff's proposed 6-inch turbine meter Customer Charge applicable to TeePak is higher than the standard 6-inch turbine meter Customer Charge applicable to other customers. (Aqua Ex. S-4.0, p. 4, lines 78-81.)

3. Teepak (Large Industrial)

In direct testimony, Company witness Monie proposed an increase of only 1 percent over and above the current 5 percent QIPS roll-in to TeePak, LLC ("Teepak"), a large Aqua customer at Vermilion (Aqua Illinois Exhibit 4.0, p. 5, lines 22-24), compared to a revenue requirement increase of 14.28 percent, which when added to the QIPS roll-in of $517,063 (Aqua Schedule C-23, p. 2 of 2, line 4, column (E)), results in an overall percentage increase of 15 percent. Staff witness Luth proposed a larger increase to TeePak, which, similar to the Company's proposal, would still result in revenues less than the cost of service to TeePak at 60 percent of the TeePak cost of service (ICC Staff Exhibit 4.0, p. 13, lines 242-248), compared to Staff-proposed increases to other customer classes that would recover more than 100 percent of cost of service from those customer classes. (ICC Staff Exhibit 4.1, p. 2 of 18.)

In rebuttal testimony, Aqua offered the testimonies of Mr. Monie (Aqua Ex. R-4.0), and Mr. Douglas K. Cunningham, the Danville, Illinois, Plant Manager for TeePak (Aqua Ex. R-5.0). Both Mr. Monie and Mr. Cunningham recommend a lower than general increase applicable to TeePak, with Mr. Monie specifying the increase at the same 6 percent (Aqua Ex. R-4.0, p. 5, lines 111-113) and Mr. Cunningham stating that the increase should be limited to the "bare minimum" (Aqua Ex. R-5.0, p. 5, lines 109-111). Staff witness Luth maintained his recommendation that TeePak rates recover 60 percent of the cost to serve TeePak, with other Vermilion customers compensating for Staff's proposed below-cost of service TeePak rates in addition to paying their full cost of service. (ICC Staff Exhibit 8.0, p. 13, lines 255-264.) Staff's proposed TeePak rate would require a 40 percent increase in TeePak rates. (ICC Staff Exhibit 8.1, p. 2.)

VII. ACRONYMS AND TERMS

A. Rate Base

1. GRCF

Gross Revenue Conversion Factor is a calculation that is based on the Federal tax rate, state tax rate, and the Company's uncollectible rate. It is an amount that is applied to the income deficiency to derive the change in the Company's revenue requirement.

2. QIPS

Qualified Infrastructure Plant Surcharge is the surcharge that is authorized by 83 Ill. Adm. Code 656. The surcharge allows water and sewer utilities to earn a return on, and depreciation expense related to, the utility's investment in certain items of plant that qualify under the terms of 83 Ill. Adm. Code 656.40. Section 656.40 specifies certain eligible non-revenue producing plant accounts which were not reflected in the Company's most recent rate proceeding.

B. Operating Revenues, Expenses and Income

1. FICA

The Federal Insurance Contributions Act involves Social Security and Medicare taxes.

2. FUTA

Federal Unemployment Tax Act.

3. SUTA

State Unemployment Tax Act.

C. Capital Structure and Cost of Capital

1. Accounting earnings

Earnings calculated from accounting-based valuations rather than market-based valuations.

2. AFUDC

Allowance for Funds Used During Construction.

3. Benchmark Ratios

Benchmark ratios are financial targets published by Standard & Poor's for the following three ratios it uses in its analysis of investor-owned utilities: (1) funds from operations ("FFO") interest coverage; (2) FFO to total debt; and (3) total debt to total capital.

4. Beta RPM

Beta RPM is a risk premium model that the Company used to estimate the cost of common equity. Beta RPM is a modified Capital Asset Pricing Model, which improperly substitutes a corporate bond yield for the risk-free rate.

5. BPS

A basis point ("BPS") is 1/100 of a percentage point.

6. CAPM

The Capital Asset Pricing Model is a method both Staff and the Company used to estimate the cost of common equity.

7. CEM

The Comparable earnings model is a model the Company used to estimate its cost of common equity.

8. CWIP

Construction Work In Progress.

9. DCF

Discounted Cash Flow is a method both Staff and the Company used to estimate the cost of common equity.

10. ECAPM

Empirical CAPM is a modified CAPM, which the Company used to estimate its cost of common equity.

11. EMH

Efficient Market Hypothesis.

12. FFO

Funds From Operations.

13. LIBOR

London Interbank Offered Rate.

14. NAIC

National Association of Insurance Commissioners is an association of commissioners that regulate insurance companies, one function of which is to assign scores to debt that is purchased by insurance companies. Unlike Standard & Poor's and Moody's Investors Service, the NAIC is neither a credit rating agency nor one of the U.S. Securities and Exchange Commission's Nationally Recognized Statistic Rating Organizations.

15. Overall Cost of Capital

Overall cost of capital is the sum of the costs of the capital structure components (i.e., debt and equity) after weighting each component according to its proportion of total capitalization.

16. Regression beta

Regression beta refers to a beta that Staff calculated using the Merrill Lynch beta estimation methodology.

17. RPM

The Risk Premium Model is a method the Company used to estimate its cost of common equity.

18. S&P

Standard & Poor's is one of the rating agencies that rates credit risk. The U.S. Securities and Exchange Commission has designated S&P a Nationally Recognized Statistic Rating Organization.

19. Value Line beta

Value Line beta is a beta that either Value Line publishes or it calculated using the Value Line methodology.

D. Cost of Service and Rate Design

1. CCF

CCF is the acronym for one hundred cubic feet. It is the measure of water by which the Company bills usage charges.

2. COSS

A Cost Of Service Study is a study performed to functionalize a utility's revenue requirement into basic categories and to allocate those costs across rate classes to determine each class' cost of service. Rates can then be designed to recover the cost to serve each customer class. In the water industry, embedded cost studies are utilized as the main guide to designing rates unique to each utility.

3. Max Day

Max Day is the demand factor for the maximum day for each customer class, expressed as a multiple of the average day usage for each customer class.

4. Max Hour

Max Hour is the demand factor for the maximum hour for each customer class, expressed as a multiple of the average day usage for each customer class.

5. MGD

Million Gallons per Day.

6. O&M Expense

Operating and Maintenance Expense.

VIII. CONCLUSION

Staff respectfully requests that the Illinois Commerce Commission approve its recommended rate base of $42,003,186, as found on ICC Staff Exhibit 5.0, Schedule 5.3; cost of capital of 8.66%, as found on ICC Staff Exhibit 5.0, Schedule 5.1 and ICC Staff Exhibit 7.0, Schedule 7.1; revenue requirement of $11,827,417, as found on ICC Staff Exhibit 5.0, Schedule 5.1; and rate design as found on ICC Staff Exhibit 8.1, page 1 of 2.

Respectfully submitted,

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