

**Direct Testimony**

**of**

**Mike Luth**

Rates Department

Financial Analysis Division

Illinois Commerce Commission

Aqua Illinois, Inc.

Petition for the Issuance of a Certificate of Public  
Convenience and Necessity to Operate a Water Supply and Distribution  
System in Champaign County, Illinois; and  
For the Issuance of an Order Approving  
Rates, Accounting Entries, and Tariff Language

Docket No. 04-0362

December 10, 2004

## INTRODUCTION TO TESTIMONY

1 Q. Please state your name and business address.

2 A. Mike Luth, 527 East Capitol Avenue, Springfield, Illinois 62701.

3 Q. Please state your professional qualifications and work experience.

4 A. I received a B.S. in Accounting from Illinois State University. I have earned the  
5 C.P.A and C.M.A professional designations. Since graduating, I have worked as  
6 an Assistant Property Manager with a real estate company and as a Field Auditor  
7 with the Wisconsin Department of Revenue. In October 1990, I joined the  
8 Accounting Department of the Illinois Commerce Commission ("Commission").  
9 In June 1998, I transferred from the Accounting Department of the Commission  
10 to the Rates Department.

11 Q. Have you testified in any previous Commission dockets?

12 A. Yes. I have testified on numerous occasions before the Commission.

## PURPOSE OF TESTIMONY

13 Q. What is the purpose of this proceeding?

14 A. Aqua Illinois, Inc. ("Aqua or Company") has filed a petition for a Certificate of  
15 Public Convenience and Necessity ("Certificate") to operate a water supply and  
16 distribution system in Champaign County, Illinois, specifically in the Village of  
17 Philo ("Village" or "Philo"). Aqua is also asking for approval of accounting entries

18 to record the net original cost of water facilities to be used to provide service in  
19 the area, and approval of rates for water service in the area.

20 Q. What is the purpose of your testimony?

21 A. I will address rate implications that should be considered for the Village of Philo  
22 system under Aqua ownership compared to possible Illinois-American Water  
23 Company ("IAWC") ownership as an alternative. Based upon a letter filed in this  
24 docket, from IAWC, to the Chief Clerk at the Commission, which states that  
25 IAWC is the least cost provider for Philo, as discussed by Staff witness Marr (ICC  
26 Staff Exhibit 1.0, page 6, line 119 through page 7, line 138), IAWC bid for the  
27 Philo system, but the Village government decided to sell the system to Aqua.  
28 Aqua is proposing that its Vermilion Water Division rates for water apply to Philo  
29 (Aqua Illinois Ex. 1.0 Second Revised, page 7, lines 157-167). Under  
30 hypothetical IAWC ownership, IAWC Champaign District rates would apply.

31  
32 I am also commenting on the municipal tax additions to customer bills that are  
33 part of the agreement between Philo and Aqua. Philo Ordinance No. 519,  
34 passed by the Village Trustees on March 17<sup>th</sup>, 2004, would have the Company,  
35 on behalf of the village and after approval by the Commission, charge Philo  
36 customers a 6 percent franchise fee and another 3 percent fire district fee.

37

38 **COMPARISON OF AQUA AND IAWC RATES APPLICABLE TO PHILO**

39 Q. Would Philo customers pay less if the Village sells the system to IAWC?

40 A. Assuming no increases in other Village taxes or fees if IAWC was to purchase  
41 the Village water system, Philo customers would pay approximately \$96,000 less  
42 annually for water service under IAWC ownership at IAWC Champaign District  
43 rates as compared to Aqua ownership. Aqua has indicated that its rates will  
44 recover approximately \$227,902 from Philo customers (1<sup>st</sup> Revised Response to  
45 ICC Staff data request ML-8). I calculate IAWC revenues from Philo customers  
46 at its Champaign District rates totaling \$131,953,<sup>1</sup> although IAWC has indicated  
47 that it will recover \$153,306 (IAWC Response to ICC Staff data request MHE  
48 1.01). The difference between \$227,902 Aqua revenues and \$131,953 IAWC  
49 revenues is approximately \$96,000.

50

51 Q. Is it a possibility that other taxes or fees in Philo would be higher if the water  
52 system were sold to IAWC rather than Aqua?

53 A. Staff witness Marr indicates in his direct testimony that Aqua is offering  
54 approximately \$217,500 more for the purchase and transaction costs compared  
55 to IAWC (ICC Staff Exhibit 1.0, page 6, line 133 through page 7, line 138). If the  
56 Village received \$217,500 less for its water system, it seems possible that the  
57 Village would need to raise the difference in revenue through increased taxes or  
58 fees.

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60 Q. Would Aqua recover its revenue requirement using the Aqua Vermilion rates?

61 A. If Aqua's Vermilion rate base were increased by the amount Staff has forecasted  
62 as a result of the addition of Philo, Aqua would recover a return of approximately

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<sup>1</sup> 547 customer charges at \$15.20 every 2 months + 43,068 CCF usage x \$1.9055 per CCF.

63 25.85 percent on Staff's Philo rate base of \$267,118 (ICC Staff Exhibit 2.0,  
64 Schedule 2.6, column (c)). A return of 25.85 percent is considerably above  
65 Staff's recommended return on Vermilion rate base in Docket No. 04-0442 of  
66 8.66 percent. Conversely, if Aqua's stated Philo rate base of \$1,124,879 (1<sup>st</sup>  
67 Revised Response to Staff data request ML-8) were used to determine return,  
68 rather than Staff's forecasted Philo rate base, then the return would be  
69 approximately 6.11 percent, which is less than Staff's recommended return on  
70 Vermilion rate base of 8.66 percent. In order to recover Staff's return on rate  
71 base of 8.66 percent on Aqua's stated Philo rate base, Aqua would need to  
72 recover approximately \$47,773 from Philo customers. In order to recover an  
73 additional \$47,773 from Philo customers, the Company would need to recover an  
74 additional \$87.34 per year from 547 Philo customers, or approximately \$7.28 per  
75 month, which is considerably more than Staff's proposed Danville public fire  
76 protection charge of \$4.05 per month in Docket No. 04-0442. I have not included  
77 a public fire protection charge, the revenues from which would be retained by  
78 Aqua rather than remitted to the Village, in my evaluation of Aqua's estimate of  
79 revenues from Philo. Revenues from a public fire protection charge were not  
80 included because the Company did not propose a fire protection charge, in the  
81 form of \$/hydrant charge, for Philo. Without such a Company proposal, there are  
82 no fire protection revenues to include in the analysis. However, if I had included  
83 the public fire protection charge from the Danville tariffs, for example, in the  
84 evaluation of Aqua's estimate of revenues from Philo, revenues from Philo would

85 have been increased by approximately \$26,584 and would have reduced the  
86 revenue deficiency at Philo assuming Aqua's stated rate base.

87

88 Q. Were you able to evaluate whether IAWC would recover its revenue requirement  
89 for Philo if IAWC was able to purchase the Philo system?

90 A. As discussed previously, IAWC's forecast of operating income at Philo appears  
91 to be flawed in that it overstates revenues. Assuming the IAWC combined  
92 income tax rate of 37.58 percent from Docket No. 02-0690 applicable to the  
93 Champaign District, and assuming the \$21,353 (\$153,306 minus \$131,953)  
94 reduction in revenues from Philo customers discussed previously, IAWC would  
95 have approximately \$38,230 in net operating income (ICC Staff Exhibit 2.0,  
96 Schedule 2.14, adjusted to \$131,953 in Total Revenue and a reduction of \$8,105  
97 in uncollectible accounts expense and combined income taxes, for a net  
98 reduction in net operating income of \$13,248), resulting in a 14.54 percent return  
99 on Staff's forecasted rate base of \$262,936 (ICC Staff Exhibit 2.0, Schedule  
100 2.15, column (c)). For the year ending December 31<sup>st</sup>, 2004, IAWC indicated that  
101 it would state rate base as \$361,504 (IAWC response to ICC Staff data request  
102 MHE 1.01). At IAWC's stated rate base, \$38,230 in net operating income would  
103 yield a return of 10.58 percent, which would be considerably more than the 7.39  
104 percent rate of return in the Commission's Order in Docket No. 02-0690. Under  
105 either the IAWC or Staff forecasted rate base, the IAWC Champaign District  
106 rates would recover more than its revenue requirement on the purchase of the  
107 Philo system, but there would be other considerations.

108

109 Q. What other considerations should be made in evaluating the sale of the Philo  
110 system to Aqua or IAWC?

111 A.

112 The comparisons of return on rate base vary widely, in large part because of  
113 significant differences in rate base. Staff has estimated a Philo rate base of  
114 \$241,360 under Aqua ownership and \$262,936 under IAWC ownership.<sup>2</sup> Staff's  
115 forecasted statement of rate base compares to Aqua's stated Philo rate base of  
116 \$1,124,879 and IAWC's stated Philo rate base of \$361,504. The reasons for the  
117 difference in the Aqua and the IAWC stated rate bases should be explained in  
118 order to compare returns on rate base using common assumptions. It is possible  
119 that Aqua's rate base includes the elevated storage tank that is to be built for the  
120 Philo system, while IAWC's rate base may not include the elevated storage tank.  
121 If that is the case, based upon Staff witness Marr's explanation of the storage  
122 tank alternatives for Philo (ICC Staff Exhibit 1.0, page 12, line 234 through page  
123 13, line 260), IAWC's rate base and depreciation expense would be increased by  
124 approximately \$500,000 and \$8,100 respectively, and would reduce the IAWC  
125 return on rate base.

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127 One other major item to be considered would be the significant difference in  
128 estimated operating and maintenance costs ("O&M") at Philo. Aqua's forecast  
129 that Philo O&M would be approximately \$119,885 as compared to IAWC's

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<sup>2</sup> The difference between the two rate bases as forecasted by Staff, is a cash working capital adjustment as explained in the testimony of Staff witness Mary H. Everson, ICC Staff Exhibit 2.0.

130 forecast of Philo O&M of \$75,172. Aqua's forecast is approximately \$44,713  
131 more per year, or 59.48 percent more than IAWC's forecast. A 59.48 percent  
132 difference is quite significant, and should be explained to determine if there is a  
133 difference in assumptions.

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135 Q. What is the importance of return on Philo rate base?

136 A. In evaluating whether Aqua should include Philo in its Vermilion service area, the  
137 effect of the potential Philo acquisition upon existing Vermilion customers should  
138 be considered as part of the Section 8-406(d) analysis of cost or cost savings to  
139 utility customers. Thus, if the Commission was to find that Aqua's statement of  
140 Philo rate base is appropriate, it appears that Philo would need to be subsidized  
141 by other Vermilion ratepayers in the next Vermilion rate proceeding because  
142 Aqua would not recover its cost of capital on the acquired Philo rate base at  
143 Vermilion rates at issue in the current Vermilion rate proceeding, Docket No. 04-  
144 0442. If Philo customers were to be charged Staff's proposed public fire  
145 protection rate of \$4.05 per month for the City of Danville in Docket No. 04-0442,  
146 Philo would still be underrecovered by approximately \$21,188 per year. \$21,188  
147 would represent a subsidy to be recovered from other Vermilion ratepayers in the  
148 next Vermilion rate docket of approximately 2/10<sup>ths</sup> of one percent of the Staff  
149 Vermilion revenue requirement in Docket No. 04-0442. I do not consider that a  
150 significant increase to other Vermilion customer bills, but nonetheless, it would be  
151 an increase to current Vermilion ratepayers not directly related to current  
152 Vermilion operations.

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On the other hand, if the Commission found that Staff’s forecasted statement of Philo rate base is appropriate, Aqua would overrecover its cost of capital on the acquired Philo rate base at Vermilion rates at issue in the current Vermilion rate proceeding, Docket No. 04-0442. If Aqua was to overrecover its cost of capital for the acquired Philo rate base, , then Philo rates should be reduced in comparison to Vermilion rates. In the situation where Philo customers would pay lower rates than Vermilion customers, it seems reasonable to expect that the Village government would not object to their residents paying rates lower than those paid by current Vermilion customers. The inclusion of Philo in the overall customer base for revenue recovery from the Vermilion service area could be addressed in the next Vermilion rate docket.

The same considerations should be applied to forecasted return on rate base resulting from IAWC ownership. In order to make a valid comparison between the rate base under Aqua ownership and the rate base under IAWC ownership, it would be important that the respective rate bases would include some common assumptions, such as the inclusion of the elevated water storage tank in rate base.

**MUNICIPAL TAXES**

Q. As part of the Assets Purchase Agreement entered into by Aqua and the Village, did Aqua and the Village agree to terms of a Franchise Agreement and agree to

176 execute that Franchise Agreement contemporaneously with the execution of the  
177 Assets Purchase Agreement?

178 A. Yes. (Petition, Exhibit A, Section 6f). In fact, the Village passed the Franchise  
179 Agreement as Ordinance No. 519. (Petition, Exhibit D)

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181 Q. What is Aqua's responsibility under the Ordinance?

182 A. Aqua, on behalf of the Village and after approval by the Commission, is to charge  
183 Philo customers a 6 percent franchise fee and another 3 percent fire district fee.  
184 (Petition, Exhibit D, Section 8 and Section 12)

185

186 Q. Does the Public Utilities Act ("Act") allow municipalities to impose a tax upon  
187 utilities serving the municipality and recover the municipal franchise taxes from  
188 customers?

189 A. Yes, Section 9-221 of the Act allows utilities to recover through an additional  
190 charge the amount of tax imposed upon the utility by the municipality. In order to  
191 charge the additional amount to customers, the utility must provide certain  
192 documentation of the municipal tax, as described in Section 9-221 of the Act.  
193 Section 9-221 of the Act references the Illinois Municipal Code, Section 8-11-2,  
194 as the authority for the municipal tax on the public utility.

195 Q. Should the Commission approve the municipal tax additions contemplated in the  
196 village ordinance?

197 A. At this time, the Commission should not approve the municipal tax additions  
198 described in the village ordinance. The municipal taxes total at least 9 percent of

199 a Philo customer's bill. According to the Illinois Municipal Code, the maximum in  
200 municipal taxes that can be added to a customer's water bill is 5.15 percent,  
201 which includes an additional 3 percent of the total taxes collected by the  
202 Company to revert back to the Company as an administrative fee for collecting  
203 the taxes, for a net maximum amount of municipal taxes of 5 percent ( $.05 \times .03 =$   
204  $.0515$ ) (65 ILCS 5/8-11-2, 4). The add-on charges (6 percent franchise fee plus  
205 3 percent fire district fee) to be collected by the Company on behalf of the  
206 Village, as contemplated in the ordinance, represent taxes that exceed the  
207 maximum amount allowable under Section 8-11-2 of the Illinois Municipal Code.  
208 In ICC Staff data request ML-11, I asked Aqua to explain why the limitations on  
209 municipal utility taxes under Section 8-11-2 of the Illinois Municipal Code would  
210 not apply to the proposed franchise and fire district fees, but the Company has  
211 not responded. As a result, I cannot recommend that the Commission approve  
212 the proposed add-on charges.

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214 Q. Does the Act allow a separate charge for fire protection?

215 A. Yes, Section 9-223 of the Act allows the Commission to authorize a water utility  
216 to charge an amount sufficient to cover a reasonable portion of the cost of  
217 providing the capacity, facilities and the water necessary to meet the fire  
218 protection needs of any municipality or public fire protection district.

219

220 Q. Does the proposed fire district fee meet the requirements and intent of Section 9-  
221 223 of the Act?

222 A. No, the proposed fire district fee fails Section 9-223 of the Act in 2 respects.  
223 First, the fire protection charge must be fixed in amount. The proposed fire  
224 district fee is 3 percent of the basic monthly-billed cost of water to the customer,  
225 and will therefore vary as the customer's billed usage varies. Second, the fire  
226 protection charge recovers the utility's cost of providing the capacity, facilities  
227 and the water necessary to meet the fire protection needs of the municipality.  
228 Since the proposed fire district fee will be remitted to the Village, it represents an  
229 additional charge from the Village to the Company, and does not represent part  
230 of the utility's costs to provide the capacity, facilities and the water necessary to  
231 meet the fire protection needs of the Village.

232  
233 Having failed Section 9-223 of the Act, the proposed fire district fee is therefore  
234 another municipal tax, recovered by the Company and remitted to the village,  
235 regardless of whether the money collected through the proposed fire district fee  
236 would be used to install fire hydrants or if the money is to be used for some other  
237 purpose. In combination with the franchise fee, the fire district fee would result in  
238 the Company remitting at least 9 percent more than its costs to provide utility  
239 service in the Village. Municipal utility taxes exceeding 5 percent of the  
240 customer's bill fail Section 8-11-2 of the Illinois Municipal Code and must be  
241 rejected by the Commission.

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

243 A. Yes, it does.