STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Aqua Illinois, Inc.	:	
	:	
Proposed general increase in water rates. (Tariffs filed on May 28, 2004.)	:	**ICC Docket No. 04-0442**
	:	
	:	

INITIAL BRIEF OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION

PUBLIC VERSION

Confidential Information Identified As

*****BEGIN CONF _____ END CONF*****

LINDA M. BUELL
Office of General Counsel
Illinois Commerce Commission
527 East Capitol Avenue
Springfield, IL 62701
Phone: (217) 557-1142
Fax: (217) 524-8928
lbuell@icc.state.il.us

CARMEN L. FOSCO
Office of General Counsel
Illinois Commerce Commission
160 North LaSalle Street, Suite C-800
Chicago, IL 60601
Phone: (312) 814-2865
Fax: (312) 793-1556
cfosco@icc.state.il.us

Counsel for the Staff of the Illinois Commerce Commission

December 10, 2004

Table of Contents

Page

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Aqua Illinois, Inc. Proposed general increase in water rates. (Tariffs filed on May 28, 2004.)	: : : : :	**ICC Docket No. 04-0442**

INITIAL BRIEF OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION

Staff of the Illinois Commerce Commission ("Staff"), by and through its counsel, pursuant to Section 200.800 of the Illinois Commerce Commission's ("Commission") Rules of Practice (83 Ill. Adm. Code 200.800), respectfully submits its Initial Brief in the above-captioned matter.

I. Introduction

In this proceeding, the Commission is investigating Aqua Illinois, Inc.'s ("Aqua" or the "Company") May 28, 2004 request for a general increase in water rates for its Vermilion Division ("Vermilion") pursuant to Article IX of the Illinois Public Utilities Act ("Act"), (220 ILCS 5/9).

Aqua proposed the use of a future test year for the twelve years ending December 31, 2005. Staff did not object to the Company's proposed test year.

During the course of the proceeding, Staff proposed various adjustments and changes to the Company's May 24, 2004 request. The Company accepted certain of

Staff's modifications and Staff withdrew others. A summary of Staff's recommendation to the Commission in this proceeding is attached hereto as Appendix A.

II. RATE BASE

A. Uncontested Issues

1. Cash Working Capital

Staff witness Everson proposed an adjustment to cash working capital based on the operating expense adjustments proposed by Staff. (ICC Staff Exhibit 1.0 C, p. 5, lines 99-104.) The final amount of the adjustment will change based on the final amounts of operating expense ordered in this proceeding.

The Company agreed to this adjustment in the rebuttal testimony of Jack Schreyer. (Aqua Ex. R-2.0, p. 4, lines 74, 76, and 109-117; Aqua Ex. S-2.0, p. 3, lines 67-75.)

2. Accumulated Depreciation

Staff witness Everson proposed an adjustment to update Accumulated Depreciation related to the Indianola Water System acquisition. (ICC Staff Exhibit 1.0 C, p. 6, lines 107-108.) 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 continue to depreciate in that intervening time period and must be recorded on Aqua's records. (ICC Staff Exhibit 1.0 C, p. 6, lines 131-139.) The Commission has previously approved a similar adjustment in Docket No. 03-0403:

> The Commission concludes that, until the transaction actually closed, the acquired system was operated by its former owner, and it continued to depreciate due to its operation.

(*Consumers Illinois Water Company, Tariffs seeking general increase in water rates for the Kankakee Water Division (Tariffs filed on May 21, 2003)*, Ill. C.C. Docket No. 03-0403, Order, p. 6 (April 13, 2004) (hereafter, "03-0403 Order").)

Staff witness Everson also recommended that the Company update its accounting records for the accumulated depreciation and submit a report with the journal entries showing the update to the accounting records. (ICC Staff Exhibit 1.0 C, p. 8.)

The Company accepted Staff's proposed adjustment in the rebuttal testimony of Jack Schreyer. (Aqua Ex. R-2.0, p. 4, lines 65-66.)

3. Deferred Tank Painting

Staff witness Everson proposed an adjustment to deferred charges related to tank painting. Specifically, Staff witness Everson proposed an adjustment to correct for the Company's overestimate of cost to paint the Indianola 96,000 gallon standpipe. The bids received were considerably lower than the projected amount in the Company's filing. (ICC Staff Exhibit 1.0 C, p. 9, lines 175-179.)

The Company accepted this adjustment in the rebuttal testimony of Jack Schreyer. (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 Staff's proposed 23.80% capitalized payroll percentage, which is based on total payroll per Staff. (ICC Staff Exhibit 6.0, pp. 11-12, lines 227-237, Schedule 6.2, line 8.) The Company's surrebuttal testimony Capitalized Payroll percentage is 21.89%. (Aqua Ex. S-2.0, p. 4, lines 94-95.) Staff and the Company agree that final capitalized Payroll Tax should 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.

III. 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 C, pp. 4-5, lines 82-91.)

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 remove Qualified Infrastructure Plant Surcharge ("QIPS") revenues from the Company's calculation of operating revenues. (ICC Staff Exhibit 1.0 C, pp. 10-11, lines 215-225.) The adjustment was proposed to remove QIPS revenues from the operating revenues since QIPS revenues are collected under a surcharge rider, not base rates. (*Id.*) (ICC Staff Exhibit 1.0 C, p. 11, lines 218-225.)

The Company agreed not to contest this adjustment in the rebuttal testimony of Jack Schreyer. (Aqua Ex. R-2.0, p. 4, lines 74, 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 C, p. 14, lines 287-300.)

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 accepted 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). Staff and the Company agree that the final FICA tax should 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 Schreyer 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 Schreyer 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 2004. (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 C, p. 8, lines 157-164.) 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; lines 139-142.)

b) Argument

As illustrated by ICC Staff Exhibit 6.0, Schedule 6.1, page 2, the Company's over budgeting for Total Payroll Costs have ranged from a low of 3.82% in 2001 to a high of 8.82% projected for 2004. Since the Company has not claimed that its budgeting processes have changed since 2001 or 2004 from what the Company used to project its test year 2005 payroll (Tr., p. 245), it is reasonable to expect that this sustained pattern of over budgeting will continue into the 2005 projections.

The Company counters that Staff's adjustment only considers one line item and does not consider the underlying reasons for the variances applicable to that line item that are associated with other line items -- namely, Capitalized Payroll and Contractual Services-Other. (Aqua Ex. S-2.0, p. 8, lines 178-183.) The Company is incorrect in its assertion. Staff did, in fact, consider both Capitalized Payroll variances and Contractual Services-Other variances.

The record is clear that Staff considered Capitalized Payroll variances. Staff's adjustment as set forth on ICC Staff Exhibit 6.0, Schedule 6.1, clearly shows that Total Payroll Budget Variance is the basis of Staff's adjustment, not Payroll Expense Budget Variance as the Company continues to claim. (*Id.*)

The Company offers a comparison to Payroll Expense approved in the Vermilion Division's last rate case, Docket No. 00-0339, as evidence that Staff's adjustment to payroll expense is unreasonable. (Aqua Ex. S-2.0, p. 16, lines 353-362.) Under cross-examination, Company witness Schreyer agreed that while the total payroll cost for the test year 2001 approved in Docket No. 00-0339 was $1,376,958, the actual payroll incurred for the year ended 12/31/2001 was $1,241,555. (Tr., p. 127.) (Notable is that, as illustrated in ICC Staff Exhibit 6.0, Schedule 6.1, page 2, the budget for 2001 total payroll cost was $1,290,887, 6.25% less than the test year payroll approved in Docket No. 00-0339. The Commission cannot rely on the test year 2005 payroll costs when historic actual 2001 budgets compared to the Company's test year 2001 projection have that great a variance. In addition, Mr. Schreyer agreed that Staff's proposed total test year payroll is actually $65,858 higher than actual payroll for 2001. (*Id*.) While Mr. Schreyer claims that Staff's proposal results in a substantial decrease from the amount approved in Docket No. 00-0339 (Aqua Ex. S-2.0, p. 16, lines 359-362), Staff is actually proposing an increase over the Payroll Expense in fact incurred by the Company for the period used as the test year in Vermilion's last rate case.

The Company also offers its 20.4% increase in gross utility plant in service since Docket No. 00-0339 as evidence that increased payroll costs are reasonable. (Aqua Ex. S-2.0, p. 16, lines 365-369.) However, an increase in the value of plant in service does not correlate to an increase in payroll costs. When older plant in service is simply replaced with newer plant, the newer plant typically has a higher original cost. Conversely, the newer plant would typically require less maintenance than the older plant that was at the end of its useful life. Thus, in this regard, an increase in the value of plant more logically correlates to a decrease, rather than an increase, in labor costs. Mr. Schreyer, when asked about the relocation of water mains discussed in Aqua Ex. R-2.0, p. 16, lines 344-349, admitted that those relocations would increase gross utility plant in service but was unable to explain how a simple relocation of plant would have any impact on future labor costs. (Tr., p. 129.) Mr. Schreyer's contention that increases in gross utility plant have a direct correlation to increases in labor costs should be disregarded as it is unsupported by concrete evidence and, at best, is an exercise in faulty logic.

Staff also considered Contractual Services Budget Variance and found that the Company had increased its budget for this line item over what had been budgeted in prior years. (ICC Staff Exhibit 6.0, p. 5, lines 97-102.) In response to Staff data request TEE 5.10 (Aqua Cross Exhibit 2), the Company attempts to explain its inadequate budgeting for Contractual Services for 2004 and the test year, stating that "an examination of 2004 actual Contractual - Other costs clearly reveals the Company's budgets for 2004 and 2005 are not adequate". What the Company fails to reveal is that while Staff requested support for the 2004 actual year-to-date Contractual-Other Costs in Staff data request TEE 5.09 (ICC Staff Exhibit 2.0, p. 5, lines 88-90), its 119 page response did not included a single item related to 2004. Claims made by the Company regarding actual current costs and the inadequacy of its own budgeting remain completely unsupported.

The Company requests that the Commission, if it accepts Staff's payroll adjustment, also increase Contractual Service-Other based on historic budget variances. (Aqua R-2.0, p. 17, lines 384-387.) Staff does not agree that the contractual services and labor expense items are sufficiently similar so as to require or merit the same treatment. The information provided to Staff regarding capitalized payroll indicated a history of under budgeting. Staff does not have information indicating a similar history of under (or over) budgeting Contractual Services-Other. Had Staff observed a similar sustained pattern of budget variances in Contractual Services-Other, a similar adjustment might have been proposed. However, since the facts do not support such a conclusion, Staff cannot support the position that Contractual Services can be adjusted applying the same logic that Staff used for Labor expense. (Tr., pp. 272-273.) What Staff did observe is that there have been elements unrelated to payroll costs that have impacted the level of Contractual Services required, most notably sludge hauling expense. (Aqua Cross Exhibit 2.) Since these two expense items are not as directly related as the Company insinuates and each reflect a different fact pattern, the same theory of evaluation cannot be applied to both items to produce the same result for each item as the Company contends.

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

2. Incentive Compensation Expense

a) Staff's Proposed Adjustment

Staff witness Ebrey proposed adjustments disallowing incentive compensation expense included in Salaries and Wages Expense ($21,468) and in other O&M Expenses ($12,322).

b) Argument

Staff recommends that the Commission disallow the costs associated with Aqua's incentive compensation plan (the "plan") because:

1) The plan is dependent upon financial goals of the Company which benefit shareholders and not ratepayers;
2) The goals in the plan may not be met and thus no cost would be incurred by the Company yet ratepayers would have provided funding;

3) The plan is discretionary and may be discontinued at any time;

4) There is not sufficient comparable historical data on which to determine if the test year level is reflective of a "normal" level; and

5) The disallowance of incentive compensation is consistent with prior Commission Orders.

(ICC Staff Exhibit 2.0, p. 10, lines 175-185.)

Not until surrebuttal testimony did the Company respond in any way to Staff's five main objections to recovery of costs associated with its incentive compensation plan, and the Company's responses were inadequate.

<u>The plan is dependent upon financial goals which benefit shareholders and not ratepayers</u>

The plan descriptions for all Incentive Compensation programs as provided by the Company indicate that the ***BEGIN CONF xxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxx. END CONF*** The plan states:

> …***BEGIN CONF xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx. END CONF*** (Aqua Cross Exhibit 4, VER 024295 and 024302)

The plans are based on the financial performance goals of the Company. These types of goals are based upon circular reasoning; that is, the larger the rate increase granted, the more success Aqua will have in achieving its earnings goals. Thus, Aqua will further enhance its ability to award incentive compensation to the extent that incentive compensation is included in Aqua's new rates. These goals primarily benefit shareholders; therefore, shareholders should bear the cost. This process, while providing benefits to the shareholders, would provide little benefit to ratepayers, since the cost of the plan would be included in the revenue requirement regardless of whether the performance goals are met. (ICC Staff Exhibit 2.0, pp. 10-11, lines 190-205.)

The Commission has previously voiced concern regarding this very issue. In Docket No. 93-0183, concerning Illinois Power Company, the Commission concluded that since financial goals benefit shareholders, ratepayers should not have to bear the cost:

> Two of the goals, earnings per share and reduced O & M expenses are goals that benefit shareholders. If the shareholders are the ones to benefit, they should be the ones who foot the bill.

Illinois Power Company, Docket No. 93-0183, p. 52 (Order entered April 6, 1994).

When disallowing CILCO's incentive compensation plan, the Commission noted, "[T]here are financial performance goals on which the plan is dependent that benefit shareholders rather than ratepayers." (Docket Nos. 01-0465/01-0530/01-0637 (Cons.), p. 59.) When denying Illinois Power's request to recover the cost of its incentive compensation plan, the Commission stated, "IP's ability to meet certain of the goals depends, in part, on the magnitude of the rate relief granted in this proceeding." (Docket No. 91-0147, p. 96.)

The Company, in its attempt to divert attention away from Staff's objection, provides examples of payments made under the plan over the last two years, but fails even once to discuss the plan's dependency on financial goals of the Company that only benefit shareholders. (Aqua Ex. S-2.0, pp. 18-19, lines 412-441.)

<u>The goals in the plan may not be met and thus no cost would be incurred by the Company yet ratepayers would have provided funding</u>

The 2005 test year amount is based upon the goals established and performance to be achieved in 2005. There is no mechanism to protect ratepayers should Aqua not achieve its performance goals in 2005 or future years. If recovery is allowed through rates, ratepayers will pay the cost of incentive compensation whether or not Aqua incurs it. The Commission has been concerned about this issue repeatedly in the past:

> [T]he Commission is concerned that ratepayers are not protected if IP fails to achieve the financial goals and incentive compensation payments are not made. Under that scenario, ratepayers would still pay for the incentive compensation plan if IP's position were adopted. Illinois Power Company, Docket Nos. 99-0120/99-0134 Cons., p. 44 (Order entered August 25, 1999).
>
> [T]he Commission is not persuaded that ratepayers are protected in the event that the targeted return on capital investment is not achieved. Under CILCO's proposal, ratepayers would still fund the test year level of incentive payments even if that level is not achieved. While failure to achieve the efficiencies that would result in the projected level of incentive payments may penalize individual managers, ratepayers receive no benefit from this "penalty." Shareholders, on the other hand, would benefit. Central Illinois Light Company, Docket Nos. 99-0119/99-0131 Cons., p. 38 (Order entered August 25, 1999).
>
> The commission is not convinced that the ratepayers are protected in the event that the targeted return on capital investment is not achieved. Ratepayers would still fund the projected levels of incentive compensation even if that level is not achieved. MidAmerican Energy Company, Docket No. 99-0534, p. 9 (Order entered July 11, 2000).

In response to Staff data request TEE 2.01, the Company indicated that it met its budgeted incentive compensation in only one year. In the two most recent years of data provided, the Company's incentive compensation was only 75% or less of the budgeted amount. (ICC Staff Exhibit 2.0, p. 12, lines 233-238.) If the amounts of budgeted incentive compensation expense had been included in rates for those years, the 25% of budgeted incentive compensation expense not actually incurred would have gone directly to the shareholders, with no benefit to ratepayers. (*Id*.)

The Company, in response to this concern, points to its Schedule S-2.2 and claims that document "attests thoroughly to goals being met". (Aqua Ex. S-2.0, p. 20, line 445.) Yet under cross-examination, Company witness Schreyer was unable to identify a single goal listed on those pages or indicate whether or not a specific goal was met. (Tr., pp. 119-120.)

<u>The plan is discretionary and may be discontinued at any time</u>

The plan description for 2004 states:

> *** BEGIN CONF xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx. (Aqua Cross Exhibit 4, VER 024294 and 024301.)

Ixxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx. END CONF*** In fact, the plan was discontinued for Union employees of the Vermilion Division as of June 1, 2002. (ICC Staff Exhibit 2.0, p. 14, lines 266-267.)

As further evidence that the plan may be discontinued the plan indicates that *** BEGIN CONF xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxx. END CONF ***(Aqua Cross Exhibit 4, VER 024300 and 024307.)

The Company responded to this concern by stating that it is at the discretion of the Parent Company that the plan will continue. (Aqua Ex. S-2.0, p. 20, lines 452-453.) By its very definition, a discretionary plan may be discontinued at any time. Just because the Parent Company claims the plan will continue in 2005 has no bearing on whether it will continue beyond 2005. That decision, as described in the plan, is made on a year-to-year basis.

The Commission has previously expressed concern about the discretionary nature of incentive compensation plans. When denying recovery of CILCO's incentive compensation plan, the Commission stated:

> As asserted by Staff, payments under CILCO's plan are dependent upon goals established and performance achieved. Therefore, if incentive compensation expense is incorporated into rates, ratepayers would be required to pay for the projected costs of the plan whether or not such costs are actually incurred. Second, there are financial performance goals on which the plan is dependent that benefit shareholders rather than ratepayers. <u>Also, the plan is discretionary and may be discontinued at any time.</u>
>
> Accordingly, while the Commission believes that incentive compensation plans have the potential to provide benefits in terms of improving performance and reducing costs, and that the recovery of expenses associated with incentive compensation plans may be appropriate in some circumstances, <u>the Commission concludes, for the reasons set forth above, that CILCO should not be allowed to recover from ratepayers the expenses associated with its current incentive compensation plan as requested in this docket.</u> ((Docket Nos. 01-0465/01-0530/01-0637 (Cons.), p. 59) (emphasis added).)

Given the Company's failure to provide concrete evidence of benefits to ratepayers, the discretionary nature of Aqua's incentive compensation plan is a sufficient and reasonable basis to deny recovery of these costs.

<u>There is no comparable historical data on which to determine if the test year level is reflective of a "normal" level</u>

In its response to Staff data request TEE 5.06, the Company indicated that its incentive compensation plan has undergone significant changes from 2000 to 2003. (ICC Staff Exhibit 2.0, Attachment B.) Not only has the population eligible for the incentive compensation payout changed, but the mechanism used to derive the amount of the payout for the majority of the eligible employees has also changed. Therefore, since the structure for the payout historically is different from the test year, there is insufficient data to analyze, based upon historical data, what the payout would be in the future. (ICC Staff Exhibit 2.0, p. 14, lines 278-285.)

In response, the Company stated that there have been payouts for the prior three years under the incentive compensation plan and that a simple average of those amounts is sufficient evidence to support the expense level it is currently requesting. (Aqua Ex. S-2.0, p. 20, lines 459-463.) Under cross-examination, Staff witness Ebrey pointed out that the numbers of employees who actually received payments under the incentive compensation plan has changed from the inclusion of all union employees in 2002, to just six non-union employees in 2003 and only three non-union employees in 2004. (Tr., pp. 274-275.) Clearly, the Company missed the operative words in Staff's objection – "comparable" and "normal". With ever changing qualifications for eligibility under the incentive compensation plan, no comparable or normal level can be determined.

<u>The disallowance of the cost of incentive compensation programs is consistent with prior Commission Orders.</u>

The Commission rejected the costs for incentive compensation plans in the following cases:

- AmerenCIPS and AmerenUE: Docket No. 00-0802;
- MidAmerican Energy Company: Docket No. 99-0534;
- Illinois Power Company: Docket Nos. 99-0120/99-0134 (Cons.), 93-0183, and 91-0147;
- Central Illinois Light Company: Docket Nos. 99-0119/99-0131 (Cons.), and 94-0040;
- Consumers Illinois Water Company: Docket Nos. 95-0641, 95-0307/95-0342 (Cons.); and
- Citizens Utilities Company of Illinois, Docket No. 94-0481.

The Company replies that only the Order in Docket 03-0403 need be considered in this docket, since the plan under consideration is materially identical to that plan. (Aqua Ex. S-2.0, pp. 21 –22, lines 485-488.) The Company argues, "the plan that was fully litigated and approved by the Commission in Docket No. 03-0403 was the Company's 2003 plan, which is materially identical to the Company's plan that is currently subject to Staff's objections" (Aqua Exhibit S-2.0, p. 21, lines 470-472). The Company is incorrect that the issues before the Commission in this proceeding were fully litigated in Docket No. 03-0403. The concerns Staff has raised in this proceeding regarding the plan are different from the concerns the Commission considered in Docket No. 03-0403. Under cross-examination, Company witness Schreyer was unable to support his statement that the plan was "fully litigated". When asked to indicate where in the evidentiary record of Docket No. 03-0403 the plan was fully litigated, Mr. Schreyer was unable to do so. (Tr., p. 112.) When asked specifically if Staff's objections to the plan in Docket No. 03-0403 were the same objections Staff made in the current docket, Mr. Schreyer stated that he did not see the same objections in Ms. Ebrey's testimony. (*Id*., pp. 107-110.)

The Company contends that Staff's adjustment contradicts the Commission ruling on the same issue in Docket No. 03-0403. (Aqua Ex. R-2.0, p. 21, lines 460-461.) The Company is incorrect. The Company fails to acknowledge and consider that the Commission Order in Docket No. 03-0403 specifically charged the Company with demonstrating compliance with the requirements for recovery of incentive compensation costs in future cases:

> The Commission reiterates that, to recover incentive compensation, the plan must confer upon ratepayers specific dollar savings or other tangible benefits. Furthermore, the degree of benefit that accrues directly to ratepayers, rather than to other stakeholders, is a significant factor in determining whether incentive compensation should be recovered in rates.
>
> Under this rubric, the Commission concludes that the incentive compensation costs should be recovered by CIWC. The Commission notes that many of the objectives can be measured by tangible or quantifiable results, and <u>expects detailed evidence of the same to be presented in future cases if the issue arises</u>.

(03-0403 Order, p. 15 (emphasis added).)

Company witness Schreyer opines that the Commission Order was simply providing direction to "other Companies with respect to other incentive compensation plans". (Aqua Ex. S-2.0, p. 18, lines 402-404.) The Company took the Order as a blanket approval of the incentive compensation plan and recovery of its related costs in all future rate proceedings. Aqua's contention that a final Commission Order in an Aqua proceeding provides instruction to all utilities **except** Aqua, is nonsensical on its face and must be rejected. The Company's position is also contrary to the Commission's Order. The sentence of Commission's Order at issue (and quoted above) clearly is referring to the Company's incentive compensation plan when it states that "many of the objectives can by measured by tangible or quantifiable results". That the Commission is referring to Aqua's incentive compensation plan and program is made exceedingly clear by the very next sentence in the Commission's Order which states: "As a whole, the program appears to set targets for a broad range of objectives," (03-0403 Order, p. 15.) Further, as a matter of law, Commission decisions do not have a *res judicata* effect in later proceedings before it, *United Cities Gas Co. v. ICC*, 163 Ill.2d 1, 22-23 (1994); *Illinois American Water Co. v. ICC*, 772 N.E. 2d 390, 395 (2^{nd} Dist. 2002). This is not to suggest that the Commission should totally ignore its actions in prior dockets. However, the Commission is clearly free to consider each case on its own facts. As explained above and below, the facts of this case provide a more than sufficient basis to reach a different conclusion.

The Company has failed to provide the detailed evidence of objectives measured by tangible or quantifiable results and the specific dollar savings or other tangible benefits conferred upon ratepayers from its incentive compensation plan that the Commission explicitly required the Company to provide in order to support recovery of incentive compensation costs. In his Surrebuttal testimony, Company witness Schreyer claims that the Company has provided that detailed evidence as Schedule S-2.2. (Aqua Ex. S-2.0, p. 19, lines 436-441.) However, under cross-examination, Mr. Schreyer was unable to indicate the detailed objectives, quantifiable results of the objectives, specific dollar savings or the benefits to ratepayers he purported Schedule S-2.2 to present. (Tr., pp. 119-120.) When asked if Schedule S-2.2 provided convincing evidence that recovery of costs related to the incentive compensation plan should be allowed in the current docket, Staff witness Ebrey explained that the information contained in that

Schedule only supports Staff's position that there is insufficient comparable historical data on which to determine if the test year level is reflective of a normal level. She stated: "There has been a moving target as to who is eligible and who receives the award. It is impossible to determine a normal level when the employees who receive the award change dramatically from year to year." (Tr., pp. 274-275.)

At the pre-hearing conference in this matter, the ALJ expressed a concern regarding the testimony of witnesses regarding the Commission's Order in Docket No. 03-0403 for Aqua's Kankakee Division. Although Staff and the Company both indicated that none of their witness intended to offer legal opinion testimony (and thus was not objectionable on that basis), Staff believes the manner in which the Company's witnesses have relied upon the Commission's Order in Docket No. 03-0403 is one-sided and unbalanced – and in that regard it is improper and should be given little weight. To the extent that the Company was satisfied with the Order in Docket No. 03-0403, its witnesses appears to believe that an issue cannot be reconsidered; but for those issues that were not decided in the Company's favor, its witnesses readily support reconsideration if not re-litigation. (*See* e.g., Aqua Ex. R-2.0, p. 30, lines 675-682 and p. 37, lines 861-866 (Challenging Staff's adjustments for Charitable Contributions, which were approved in Docket No.03-0403.)) The Commission has historically considered each case on its own facts and each issue must be considered on its own merits. The facts of this case merit denial of Aqua's proposed incentive compensation expense.

Staff recommends that the Commission approve its adjustments disallowing incentive compensation expense reducing 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) Argument

Section 9-250 of the Act specifically states that goodwill advertising, which is advertising designed primarily to promote the image or name of the Company or promote controversial industry issues, should not be considered for the purpose of determining rates. Although Section 9-250 applies specifically to electric and gas utilities, the same ratemaking principle is valid for water utilities. It is not appropriate for captive customers to pay for advertising, the purpose of which is not to inform the customer, but, rather, to promote the Company. Captive customers should not pay rates that include amounts for promoting a product that they have little choice but to purchase.

The Company mischaracterizes Staff's adjustment to advertising expense by claiming, "Staff feels these advertisements are not informative to the customer." (Aqua Ex. S-2.0, p. 23, lines 515-516.) Under cross-examination, Company witness Schreyer admits that this is only his characterization of Staff's testimony. (Tr., p. 132.) Furthermore, Mr. Schreyer could not provide any citation to Staff's testimony to support his characterization. (*Id*., p. 131.) To the contrary, Staff never disputed the informative value of the advertisements; Staff's adjustment is based on the facts that certain of those advertisements are promotional or goodwill in nature and that other increases in advertisement expense have not been supported by the Company (ICC Staff Exhibit 2.0, p 17, lines 336-337), thus certain costs are not appropriately considered for recovery in rates.

Aqua's response is unconvincing. The Company merely discusses information provided in the radio spots for which it is seeking advertisement expense recovery, claiming that the information is "useful to consumers". (Aqua Ex. S-2.0, pp. 23-24, lines 524-542.)

Staff's analysis of the transcripts provided by the Company resulted in a vastly different conclusion. At first glance, the main focus of each advertisement is that Aqua Illinois, Inc. was formerly known as Consumers Illinois Water Company, a notification that will not be on-going in the test year and beyond. Upon further review, each transcript stresses a different point of information (ICC Staff Exhibit 6.0, p. 17, lines 342-346).

The first transcript states that the Company meets or exceeds standards set by the Illinois Environmental Protection Agency. This does not inform customers of anything except that the Company is following regulations, something customers should expect from their water provider. The second transcript gives a bit of trivia that a gallon of water costs less than one cent. Captive ratepayers have no choice from whom to acquire their water; thus, an advertisement promoting low prices only promotes the Company. The third transcript tells the ratepayers that the Company is upgrading and replacing old mains, once again something customers should expect from their water provider. (*Id*., lines 347-356.)

The next six transcripts do provide customers with useful information: 1) the times that the drive-up window is open, 2) the service the Company offers of collecting other utility company payments, 3) the opening of a new entrance to its office, 4) the direct debit program for paying water bills, 5) a reminder to insulate pipes in the winter to avoid costly repairs, and 6) suggestions to help prevent pipes from freezing. (*Id*., pp. 17-18, lines 357-362.)

The last three transcripts provided tell the customers that Aqua Illinois, Inc. employees are working through the winter months, that the Company provides free water to city parks, and that Danville does not experience water shortages. (*Id*., p. 18, lines 363-366.) The costs for these three radio advertisements were also disallowed by Staff because they are merely promotional.

As illustrated by the above analysis of these transcripts, only half of the ads provide information, as detailed in Section 9-225 of the Act and as discussed in ICC Staff Exhibit 2.0, pp. 18-19, lines 355-364, for which costs should be included in the revenue requirement. (*Id*., lines 367-370.)

In addition, the Company has not adequately supported certain of the increases in its test year advertising expense. The Company proposed test year costs for the Commercial Newspaper of $6,123. (Company response to Staff data request TEE 1.14.) This compares with actual costs for the Commercial Newspaper of $2,822.68 in 2002 and $3,120.32 in 2003. (Company response to Staff data request TEE 5.14.) Of those 2003 ads provided for Staff's review, Staff's adjustment does allow costs associated with the QIPS Notice Filing, an ad for "Fluoride Helps Healthy Teeth", and a help wanted ad. The advertisement in a visitor's guide for $1,305 and an ad in a summer arts program were not allowed since they are merely promotional and, thus, not recoverable in rates.

Finally, in explanation of the increased costs for newspaper ads, in rebuttal testimony, the Company provides examples of customer notifications the Company feels will be required for plant improvements currently under construction. (Aqua Exhibit R-2.0, p. 29, lines 659-662.) However, what the Company fails to explain is how these two specific current projects will increase customer notification required in 2005 and beyond. Additionally, no dollar estimates are given for those customer notifications. Using the QIPS notification cost of $401 as a guide, even if those costs were deemed recoverable, they fall short of the $3,000 increase proposed by the Company.

In addition, the Company shares a recommendation made by its own Community Advisory Panel to increase customer notifications. While the Company's Community Advisory Panel may recommend the Company increase customer notifications, that in itself does not support an increase in recoverable costs. (ICC Staff Exhibit 6.0, pp. 18-19, lines 373-397.)

The Company replies that its own advisory panel feels that prior levels of advertising have been inadequate and that some undefined level of "customer saturation" must be met. (Aqua Ex. S-2.0, p. 25, lines 570-576.)

The Company has once again, as it did in Docket Nos. 00-0339 and 03-0403, failed to sufficiently demonstrate the recoverability of its proposed advertising expenses. Staff recommends that the Commission accept its adjustment to reduce Advertising Expense 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.)

b) Argument

The Company opposes Staff's adjustment because, in its opinion, the amounts Staff disallows are "for the welfare of the public". (Aqua Ex. R-2.0, p. 32, lines 730-731.) This is a mischaracterization of Staff's adjustments. Staff proposes to disallow certain costs because they are:

1. Payments for Economic Council dues;
2. Payments that are promotional, goodwill or institutional in nature;
3. Payments made to non-charitable organizations. (ICC Staff Exhibit 6.0, pp. 20-21, lines 415-420.)

Staff removed payments to the Danville Area Economic Council since they represent membership dues to a community organization. The Company describes these costs as a "contribution…for the recruitment of future business to the Danville area". (Aqua Exhibit R-2.0, p. 33, lines 756-757.) The invoices reviewed by Staff for the payment to Danville Area Economic Council describe the payments as "Membership renewal – quarterly payment due". This is clearly membership dues in a community organization, which is no different from the Social and Service Club dues adjustment that was accepted by the Company in rebuttal testimony in this case. While the Economic Council may be a worthwhile organization, the ratepayers should not bear the expense of the Company taking part in this community organization. (ICC Staff Exhibit 6.0, p. 21, lines 422 – 431.)

The Company counters "Aqua's payments are used by the Council to further the Council's charter, which is the attraction of new businesses and retention of existing businesses in the community. (Aqua Ex. S-2.0, p. 27, lines 608-610.) This is no different than any other Social or Service Club organization and thus dues should be accorded the same treatment and should not be recovered in rates determined in this case.

Staff also removed the cost of sponsorships included by the Company as Charitable Contributions. Eleven of the fourteen items the Company included on Schedule 6.7 as charitable contributions are described as "sponsorships" for various events. By definition, a sponsor is a business enterprise that pays for a program in exchange for advertising. Therefore, although the Company chooses to include sponsorships in its accounting for charitable contributions, those costs result in goodwill advertising. (ICC Staff Exhibit 6.0, p. 21, lines 433-438.) The Commission has addressed this mixing of advertising and charitable contributions in the Company's last rate case as follows:

> Advertisements and charitable contributions are different types of transactions, and simply mixing their labels does not support their recovery in rates.

(03-0403 Order, p. 21.)

The Company argued that its contributions were made only to further the organizations' purposes and that it did not ask for any advertising in exchange for its payments. (Aqua Ex. S-2.0, p. 21, lines 625-633.) However, the fact remains that a sponsorship is by definition a form of advertisement.

Staff's final area for disallowance of costs requested as Charitable Contributions is the educational subsidies that benefit five individuals in the Company's service area. The Company argues that the Boys State and college scholarship awards benefit the general public by providing financial support to five individuals. Staff agrees that it is commendable that the Company provides these funds for students to continue their education through college and attendance at Boys State. However, these students are not considered charities. Neither does the Company provide any persuasive argument proving how the general public benefits from the continued education of these individuals. (ICC Staff Exhibit 6.0, p. 22, lines 445-452.)

Staff recommends that the Commission approve its adjustment to reduce Charitable Contributions Expense 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.

b) Argument

The Company proposed an adjustment to increase Miscellaneous General Expenses described as "Collections" for costs associated with its Remittance Center in its original filing. Part one of Staff's adjustment on ICC Staff Exhibit 2.0, Schedule 2.12 disallows the increase in Miscellaneous General Expenses since an increase has already been reflected in Management Fees which would cover the costs of the affiliate, Aqua Resources, providing the collections services. (ICC Staff Exhibit 2.0, p. 28, lines 557-560.) Expenses described as "Collections" are the same type of costs that would be included in Management Fees. The Company confirms this fact in its response to Staff data request TEE 7.06 wherein it states:

> The Illinois Commerce Commission has not yet approved an Affiliated Interest Agreement between Aqua Illinois and Aqua Resources. The Company intends to file a Petition for the Commission's approval of such an agreement prior to the conclusion of 2004.

Costs for Management fees are projected to increase $223,521 ($1,153,161 in 2003 to $1,376,682 in 2005 (Company Schedule C-13)). This increase over a two-year period would seem to be sufficient to cover the costs of collections as described by the Company. (ICC Staff Exhibit 2.0, p. 27, lines 531-542.)

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. (Aqua Ex. R-2.0, p. 26, lines 581-581.) The Company at no time explains the increased level of Management Fees included in its test year operating statement.

Since Staff witness Everson is withdrawing her adjustment to include non-utility revenues related to the Remittance Center 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.) As Staff indicated in its Direct Testimony, those costs can be reasonably deemed to be included in the increase in Management Fees. (ICC Staff Exhibit 2.0, p. 28, lines 557-560.) The Company offers Aqua Cross Exhibit 1 as support that the costs for the

Collections service at the Remittance Center are not included in Management Fees. However, during cross-examination, Staff witness Ebrey explained that the Company did not offer any support for the increase in Management Fees in response to her data request TEE 7.05. (Tr., pp. 233-234.) Since the burden of proof in a rate case lies with the Company (220 ILCS 5/9-201(c)) and the Company failed to support its claim that the costs associated with the Remittance Center are not included in the increase in Management Fees for the test year, Staff's adjustment is reasonable and should be approved.

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

6. Wastewater Billing Revenues

a) Staff's Proposed Adjustment

Staff witness Everson proposed an adjustment to include wastewater billing revenues in the Company's calculation of operating revenues if Staff's proposed adjustment to remove related Remittance Center expenses (i.e., management fee expenses -- Section III.B.5 above) is not accepted.[1]

b) Argument

Ms. Everson proposed the adjustment to wastewater billing revenues due to the inclusion in the revenue requirement of Company resources used to support this non-utility service. (ICC Staff Exhibit 1.0 C, p. 11, lines 230-231.)

[1] Staff's recommendation to remove wages related to the Remittance Center collection activities has been accepted by the Company. See Section III.A.10.

The Company's rebuttal testimony stated that it is improper to recognize expenses and revenues associated with non-utility services in setting rates for utility services, and contended that the expenses related to non-utility revenues had been removed from the Company's revenue requirement with the exception of $13,407 that had not been eliminated from its 2005 budget. (Aqua Ex. R-2.0, pp. 7-8, lines 148-152; p. 8, lines 159-163.)

Although Ms. Everson agreed that the most appropriate treatment for revenues and expenses related to wastewater billing revenues is to remove both from the Company's revenue requirement, she pointed out that the exact amount of expenses related to the Remittance Center was not known at the time Staff pre-filed its direct testimony and Ms. Everson's adjustment provided the necessary matching of related revenues and expenses. (*See* ICC Staff Exhibit 5.0 C, pp. 5-6, lines 98-112.) In other words, since unidentified amounts of expense associated with the wastewater billing revenues were included on Schedule C-1, but associated revenues were not included, Ms. Everson used the revenue amounts that were available for the adjustment in her direct testimony. (ICC Staff Exhibit 5.0 C, pp. 5-6, lines 100-106.)

The Company's rebuttal testimony admitted that certain expenses associated with non-utility operations were included in the revenue requirement, and proposed a new $13,407 adjustment that it contended would remove all expenses associated with non-utility operations. (Aqua Ex. R-2.0, p. 8, lines 160-164, 168-172.) However, the Company failed to demonstrate that all of the related expenses identified in response to Staff data request MHE 6.03 (Attachment 1).were actually removed from the revenue requirement; therefore, an adjustment to correct for the asymmetrical treatment of non-utility revenues and expenses must still be made. (ICC Staff Ex. 5.0 C, p. 6, lines 120-125.)

Ms. Everson testified in rebuttal that she was willing to withdraw her adjustment to wastewater billing revenues if the Commission accepts the Remittance Center expense adjustments proposed by Staff witness Theresa Ebrey in ICC Staff Exhibit 6.0. (ICC Staff Exhibit 5.0 C, p. 7, lines 128-135.) Similarly, Ms. Everson also testified that if the Commission were to decide that the related expense adjustments are not appropriate, then the revenue adjustments presented in her direct testimony (ICC Staff Exhibit 1.0 C, Schedule 1.11 C) should be reinstated to present a proper matching of revenues and expenses. (ICC Staff Exhibit 5.0 C, pp. 7-8, lines 143-147.)

For the reasons stated above, Staff recommends that the Commission include wastewater billing revenues in the Company's calculation of operating revenues if Staff's proposed adjustment to remove related Remittance Center expenses is not accepted.

7. Lab Testing Services Revenues

a) Staff's Proposed Adjustment

Staff witness Everson proposed an adjustment to include lab testing revenues in the Company's calculation of operating revenues. (ICC Staff Exhibit 1.0 C, p. 12, lines 242-247.)

b) Argument

Ms. Everson proposed the adjustment to lab testing revenues because Company resources were used to support the service.[2] (ICC Staff Exhibit 1.0 C, p. 12, lines 245-252.)

The Company's rebuttal testimony indicated that the expenses related to the lab testing revenues had been removed from the Company's revenue requirement with the exception of $13,407 that had not been eliminated. (Aqua Ex. R-2.0, p. 8, lines 159-163.)

In rebuttal testimony, Ms. Everson stated that the Company's revenue requirement included expenses associated with the lab testing revenues on Schedule C-1. Since unidentified amounts of expense were included, but associated revenues were not included, Ms. Everson used the revenue amounts that were available for the adjustment in her direct testimony. (ICC Staff Exhibit 5.0 C, p. 5, lines 100-105.) The Company admitted that certain of the related expenses were included in the revenue requirement in the rebuttal testimony of Jack Schreyer. (Aqua Ex. R-2.1, p. 8, lines 160-163.) However, the Company failed to demonstrate that all of the related expenses were removed from the revenue requirement, therefore an adjustment must be made to correct for the asymmetrical treatment of revenues and expenses. (ICC Staff Ex. 5.0 C, p. 6, lines 120-125.)

Since the appropriate treatment for revenues and expenses related to non-utility revenues is to remove both from the Company's revenue requirement and the amounts

[2] Staff's proposed lab testing revenue adjustment presents the same issue associated with the wastewater billing revenue adjustment discussed in Section III.B.6. Specifically, Staff proposes the inclusion of non-utility revenues to offset the inclusion of non-utility expenses unless Staff's adjustment to exclude non-utility expenses is accepted.

became available before Staff's rebuttal testimony, Ms. Everson stated that she was willing to withdraw her adjustment to lab testing revenues if the Commission accepts the Remittance Center expense adjustments proposed by Staff witness Theresa Ebrey, in ICC Staff Exhibit 6.0. (ICC Staff Exhibit 5.0 C, p. 7, lines 128-135.) Similarly, if the Commission were to decide that the related expense adjustments are not appropriate, then the revenue adjustments presented in Staff's direct testimony, ICC Staff Exhibit 1.0 C, Schedule 1.12 C should be reinstated to present a proper matching of revenues and expenses. (ICC Staff Exhibit 5.0 C, pp. 7-8, lines 143-147.)

8. Collection Revenues

a) Staff's Proposed Adjustment

Staff witness Everson proposed an adjustment to include collection revenues in the Company's calculation of operating revenues. (ICC Staff Exhibit 1.0 C, pp. 12-13, lines 257-260.)

b) Argument

Ms. Everson proposed the adjustment to collection revenues because Company resources were used to support the service.[3] (ICC Staff Exhibit 1.0 C, p. 13, lines 260-267.)

The Company's rebuttal testimony indicated that the expenses related to non-utility revenues had been removed from the Company's revenue requirement with the

[3] Staff's proposed collection revenue adjustment presents the same issue associated with the wastewater billing revenue adjustment discussed in Section III.B.6 and the lab testing revenue adjustment discussed in III.B.7. Specifically, Staff proposes the inclusion of non-utility revenues to offset the inclusion of non-utility expenses unless Staff's adjustment to exclude non-utility expenses is accepted.

exception of $13,407 that had not been eliminated. (Aqua Ex. R-2.0, p. 8, lines 159-163.)

In rebuttal testimony, Ms. Everson stated that the Company's revenue requirement included expenses associated with the collection revenues on Schedule C-1. Since unidentified amounts of expense were included, but associated revenues were not included, Ms. Everson used the revenue amounts that were available for the adjustment in her direct testimony. (ICC Staff Exhibit 5.0 C, p. 5, lines 100-105.) The Company admitted that certain of the related expenses were included in the revenue requirement in the rebuttal testimony of Jack C. Schreyer. (Aqua Ex. R-2.1, p. 8, lines 160-163.) However, the Company failed to demonstrate that all of the related expenses were removed from the revenue requirement, therefore an adjustment must be made to correct for the asymmetrical treatment of revenues and expenses. (ICC Staff Ex. 5.0 C, p. 6, lines 120-125.)

Since the appropriate treatment for revenues and expenses related to lab testing revenues is to remove both from the Company's revenue requirement and the amounts became available before Staff's rebuttal testimony, Ms. Everson stated that she was willing to withdraw her adjustment to collection revenues if the Commission accepts the Remittance Center expense adjustments proposed by Staff witness Theresa Ebrey, in ICC Staff Exhibit 6.0. (ICC Staff Exhibit 5.0 C, p. 7, lines 128-135.) Similarly, if the Commission were to decide that the related expense adjustments are not appropriate, then the revenue adjustments presented in Staff's direct testimony, ICC Staff Exhibit 1.0 C, Schedule 1.13 C should be reinstated to present a proper matching of revenues and expenses. (ICC Staff Exhibit 5.0 C, pp. 7-8, lines 143-147.)

9. Customer Data Sales Revenues

a) Staff's Proposed Adjustment

Staff witness Everson proposed an adjustment to include customer data revenues in the Company's calculation of operating revenues. (ICC Staff Exhibit 1.0 C, p. 13, lines 272-275.)

b) Argument

Ms. Everson proposed the adjustment to customer data revenues because Company resources were used to support the service.[4] (ICC Staff Exhibit 1.0 C, p. 13, lines 275-282.)

The Company's rebuttal testimony indicated that the expenses related to non-utility revenues had been removed from the Company's revenue requirement with the exception of $13,407 that had not been eliminated. (Aqua Ex. R-2.0, p. 8, lines 159-163.)

In rebuttal testimony, Ms. Everson stated that the Company's revenue requirement included expenses associated with the customer data revenues on Schedule C-1. Since unidentified amounts of expense were included, but associated revenues were not included, Ms. Everson used the revenue amounts that were available for the adjustment in her direct testimony. (ICC Staff Exhibit 5.0 C, p. 5, lines

[4] Staff's proposed customer data sales revenue presents the same issue associated with the wastewater billing revenue adjustment discussed in Section III.B.6, the lab testing revenue adjustment discussed in III.B.7, and the collection revenue adjustment discussed in III.B.8. Specifically, Staff proposes the inclusion of non-utility revenues to offset the inclusion of non-utility expenses unless Staff's adjustment to exclude non-utility expenses is accepted.

100-105.) The Company admitted that certain of the related expenses were included in the revenue requirement in the rebuttal testimony of Jack C. Schreyer. (Aqua Ex. R-2.1, p. 8, lines 160-163.) However, the Company failed to demonstrate that all of the related expenses were removed from the revenue requirement, therefore an adjustment must be made to correct for the asymmetrical treatment of revenues and expenses. (ICC Staff Exhibit 5.0 C, p. 6, lines 120-125.)

Since the appropriate treatment for revenues and expenses related to lab testing revenues is to remove both from the Company's revenue requirement and the amounts became available before Staff's rebuttal testimony, Ms. Everson stated that she was willing to withdraw her adjustment to lab testing revenues if the Commission accepts the Remittance Center expense adjustments proposed by Staff witness Theresa Ebrey, in ICC Staff Exhibit 6.0. (ICC Staff Exhibit 5.0 C, p. 7, lines 128-135.) Similarly, if the Commission were to decide that the related expense adjustments are not appropriate, then the revenue adjustments presented in Staff's direct testimony, ICC Staff Exhibit 1.0 C, Schedule 1.14 C should be reinstated to present a proper matching of revenues and expenses. (ICC Staff Exhibit 5.0 C, pp. 7-8, lines 143-147.)

10. Rate Case Expense

a) Staff's Position

Staff did not propose an adjustment to the Company's original estimate of its rate case expense. However, with respect to the Company's proposed increase of its original estimate, Staff's position is that the Company supported only its original estimate of rate case expense. (Tr., p. 210, lines 5-9.) The Company failed to provide any supporting documentation regarding a new estimate for rate case expense until the day before the evidentiary hearing (Tr., p. 218, lines 11-16), and Staff does not consider this last minute change to be properly supported or sufficient to justify the increased estimate.

b) Argument

Staff's position is that the Company supported only its original estimate of rate case expense. (Tr., p. 210, lines 5-9.) The Company failed to provide any supporting documentation regarding its new estimate for rate case expense until the day before the evidentiary hearing (Tr., p. 218, lines 11-16), and Staff does not consider this last minute change to be properly supported or sufficient to justify the increased estimate. Further, the Company's proposal in this docket is contrary to long-standing Commission policy.

In its rebuttal testimony, the Company indicated that it anticipated an increase in rate case expense in addition to the amount in its original filing. (Aqua Ex. R-2.1, pp. 39-40, lines 923-937.) However, the Company failed to provide supporting documentation regarding the new estimated amount for rate case expense until the day before the evidentiary hearing. (Tr., p. 218, lines 11-16.)

As a general matter, the Company's request to revise its rate case expense due to greater than anticipated discovery activity is contrary to long standing Commission policy. In *Lincoln Water Company, Proposed general increase in water rates,* Docket No. 84-0011, Order, 1984 Ill. PUC LEXIS 7, pp. 16-17, (October 17, 1984) the Commission was presented with a similar water utility request to revise and increase its estimated rate case expense due to greater than anticipated discovery and other activity. The Commission limited the utility to its originally filed estimate pursuant to its policy of restricting such expense to initial estimates unless extraordinary or compelling circumstances dictate otherwise:

> In its initial filing the Company estimated rate case expenses to total $50,500 to be amortized over a two-year period. On rebuttal the Company explained that the instant case had significantly more active party participation, interrogatories, hearings, witnesses and audit activity than the prior case, and as a result required considerably more time and expense by the Company. The Company requests that its updated estimate of $113,643 be used for ratemaking purposes. Staff witness Hetherington testified that only the original rate case expense estimate should be considered in this proceeding, and that this expense should be amortized over a three year period. The Intervenors endorse the staff recommendation. With regard to rate case expense, the Commission agrees that Respondent was cooperative and prompt in responding to numerous data requests and in other aspects of the case, and that the instant case required more activity by Respondent than did the prior rate case. The Commission agrees with the staff witness, however, the recovery of rate case expense should be limited to the utility's filed estimate based on the Commission's policy of restricting such expense to initial estimates unless extraordinary or compelling circumstances dictate otherwise. With respect to the amortization period, the Commission agrees with the Company that a two-year period is reasonable based on past filings by the utility, test year considerations and recent rate decisions for other water utilities.

(*Id.*) Aqua presented no evidence of extraordinary or compelling circumstances justifying its revised estimate of rate case expense. Indeed, the only evidence of extraordinary or compelling circumstances was Staff's evidence that the Company's request was provided without timely presentation of supporting documentation, thus depriving Staff of a reasonable opportunity to review the Company's revised rate case estimate.

Company witness Schreyer indicated on cross-examination that the Company did not provide support for the increased rate case expense between August 17, 2004 and November 12, 2004 because November 11, 2004 was a holiday. (Tr., p. 92, lines1-3; p. 100, lines 10-12.) The original data request was issued on July 20, 2004. (Tr., p.

84, line 12.) The Company's response was dated August 17, 2004. (Tr., p. 79, line 18.) Mr. Schreyer did not offer any explanation for not updating the Staff data request with the amounts known as of June 14, July 23 and August 12 either with the response on August 17, 2004 or during the intervening time period between August 17, 2004 and November 12, 2004, except for the November 11, 2004 holiday. (Tr., p. 92, lines1-3; p. 100, lines 10-12.)

Mr. Schreyer admitted that the Company failed to provide updated supporting documentation to support its additional rate case expense between August 17, 2004 and November 12, 2004, even though the Company knew of the existence of outside legal costs to date as of June 14, July 23, and August 12, 2004. (Tr., p. 99, lines 1-5.)

By not disclosing information it should have supplied to Staff in a timely manner, the Company prevented any discovery on this documentation that would enable Staff to make a recommendation on these additional amounts to the Commission. (Tr., p. 77, lines 17-21.) Mr. Schreyer also admitted that he did not reflect the change in estimate in his rebuttal or surrebuttal revenue requirement proposals, even though the Company clearly seeks to recover the increased amount. (Tr., p. 100, lines 13-14.)

The Company appears to argue that Ms. Everson should have sent a new data request asking for supporting documentation; however, Ms. Everson stated that it was unnecessary to ask for additional supporting documentation when the Company could update Staff data request MHE 1.10. (*See* Tr., p. 212, lines 13-21.)

In addition, Ms. Everson indicated on redirect examination that Instruction 13 for preparation of responses to Staff data requests includes the following instruction:

> The Company must seasonably supplement or amend any prior answer or response whenever new or additional information subsequently becomes

> known to the Company. The Company must also seasonably supplement any prior response to the extent of documents, objects or tangible things which subsequently come into the Company's possession or control or become known to the Company. (Tr., p. 218, lines 3-10.)

No other updates were provided to Staff between August 17, 2004 and November 12, 2004, even though Ms. Everson stated in her rebuttal testimony that the Company could have but failed to update data request MHE 1.10. (Tr., p. 218, lines 11-21.) The Company provided a listing of names, hours and dollars per hour for each name on the list plus miscellaneous other expenses purporting to be invoices from its legal counsel at the evidentiary hearing. (Tr., p. 80, line 17-18.) Staff witness Everson stated that this listing was unlike any invoice she had ever reviewed. It lacked certain elements that typically distinguish an invoice, such as a cover page with the name of the addressee, the billing party's letterhead and address, as well as descriptions of the services performed. (Tr., p. 219, lines 1-22; p. 220, line 1.)

Since Staff was precluded from conducting any review or discovery on this listing, Staff witness Everson stated that she could only recommend to the Commission that it approve the Company's original amount of rate case expense contained in its filing in the amount of $73,580. (Tr., p. 210, lines 5-9.)

In *Consumers Illinois Water Company*, Ill. C.C. Docket Nos. 93-0253; 93-0303 Cons., Order, 1994 Ill. PUC LEXIS 207, 152 P.U.R.4th 131, pp. 4-8[5] (May 11, 1994) – a case involving Aqua's predecessor -- the Commission declined to consider the Company's revisions to rate base made and supported late in that proceeding to the prejudice of Staff and other parties. Faced with a scenario involving the same eleventh-

[5] The Consumers Order available through Lexis does not contain page information for the Ill. PUC Lexis or P.U.R. 4th citations. All page citations herein are to the original pagination of the Order entered and released by the Commission.

hour support offered in the instant case with respect to the Company's revised rate case expense, Staff in *Consumers* pointed out "that the Company submitted its first documentation to justify known and measurable changes to University Park's sewage treatment plant three working days prior to the final evidentiary hearings in this proceeding." (*Id*., p. 6.) Further, similar to Staff's testimony in the instant proceeding that it did not have sufficient time to review and analyze the Company's support for its revised rate case expense, Staff in *Consumers* explained "that receiving the executed construction contract immediately prior to hearings did not afford sufficient time for the various Staff members to adequately review the contract terms, the reasonableness of the construction schedule, and the attendant ratemaking ramifications if it were to be accepted.". (*Id*.) Although the Commission acknowledged that it is generally desirable to reflect known changes in rates, the Commission made clear that that goal does not supercede the requirement to conduct rate proceedings in a manner that is not prejudicial to the ability of Staff or other parties to prepare their case:

> The Commission is sympathetic to the Company's argument that newly established rates should ideally reflect all plant in service providing benefit to ratepayers at the time the new rates will go into effect. **However, the Commission must also ensure that proceedings are fair to all parties, and that our rules are not interpreted and applied in a manner which forecloses consideration of significant matters.**
>
> Part 285 of the Commission's rules allow pro forma adjustments to the historical test year provided that such changes are reasonably certain to occur within 12 months of the filing date of the tariffs and the level of each change is known and measurable. . . . **Pro forma changes must be identified with specificity and documented as known and measurable sufficiently early in the process to permit the Staff and interested parties an adequate opportunity to review them and to prepare their case.**
>
> Just and orderly processing of rate increase requests mandates that we cannot permit a utility, which has complete discretion over the timing of its rate filings, to use the flexibility afforded by the known and

> measurable provision of our rules to transform a rate proceeding into a guessing game, in which the Commission and the parties are left merely to await the ultimate resolution of the Company's plans, with large rate impacts hanging in the balance.
>
> * * *
>
> Staff's adjustment to proposed rate base denying the inclusion of the University Park Plant Improvements is reasonable and is adopted.

(Id., pp. 6-7 (emphasis added).) The principles that guided the Commission's decision in *Consumers* are fully applicable here, and the Commission should similarly decline to consider the Company's revised estimate of rate case expense because the Company's support for its revised rate case expense was provided without timely presentation of supporting documentation.

IV. CAPITAL STRUCTURE AND COST OF CAPITAL

A. Overview

Aqua requests a 9.18% cost of capital. Staff estimated Aqua's overall cost of capital is 8.66%. (Aqua Schedule D-1, p. 1; ICC Staff Exhibit 7.0, Schedule 7.1.) Three witnesses presented testimony regarding Aqua's cost of capital. Company witness Pauline M. Ahern presented testimony regarding the costs of debt and common equity. (Aqua Exhibits 3.0, R-3.0 and S-3.0.) Company witness Jack Schreyer presented testimony regarding capital structure and the cost of preferred stock. (Aqua Exhibits 2.0, R-2.0 and S-2.0.) Staff witness Rochelle Phipps presented testimony regarding Aqua's overall cost of capital, including capital structure and the costs of preferred stock, debt and common equity. (ICC Staff Exhibits 3.0 and 7.0.)

Aqua accepted Ms. Phipps' proposed average 2005 capital structure comprising 51.64% common equity, 47.79% long-term debt, 0.32% preferred stock and 0.25% short-term debt. (ICC Staff Exhibit 7.0, Schedule 7.1; Aqua Exhibit S-2.0, p. 2.) Aqua and Staff also agree that Aqua's cost of preferred stock is 5.48%. (ICC Staff Exhibit 3.0, p. 12, Schedule 3.4; Aqua Ex. R-3.0, p. 2.) The Company and Staff did not reach agreement on the appropriate costs for debt and common equity.

B. Contested Issues

1. Long-Term Debt Cost

Aqua estimated its long-term debt cost is 7.57% (Aqua Exhibit 5, Schedule D-3), which reflects a 6.50% interest rate for the proposed Series W debt issuance that is expected to occur during December 2004. Staff witness Phipps estimated Aqua's long-term debt cost is 7.18%, which reflects a 5.42% interest rate for the proposed Series W indebtedness. (ICC Staff Exhibit 7.0, p. 2, Schedule 7.2.) Aqua's interest rate estimate is based on a forecasted U.S. Treasury bond yield, plus a premium totaling 150 basis points due to Aqua's NAIC-2 designation. In contrast, Ms. Phipps' interest rate estimate equals the current yield for 10-year U.S. Treasury bonds, plus 112 basis points, which is based on the spread between the concurrent yields for Aqua's December 2003 Series V bonds and 10-year U.S. Treasury bonds. (ICC Staff Exhibit 3.0, lines 208-221.)

The Commission should reject Aqua's forecasted interest rate for the Series W bonds because interest rate forecasts are very inaccurate. (ICC Staff Exhibit 3.0, lines 1115-1120.) Furthermore, Aqua's 6.50% estimate of the interest rate on its projected Series W 12-year bonds (as provided in Aqua Schedule D-3) exceeds Aqua's more recent 6.30% interest rate it forecasted it would pay for 30-year bonds, which it provided in its

Informational Statement, Docket No. 04-0626, filed on October 11, 2004. (ICC Staff Exhibit 7.0, p. 4.) Indeed, in that same Informational Statement, Aqua estimated it would pay a 5.33% interest rate on ten-year bonds, which supports Ms. Phipps' 5.42% recommendation for the Series W bonds, given the similar maturities. (*Id.*) Moreover, Aqua's long-term debt estimate fails to reflect its decision to refund higher cost debt with proceeds from an expanded Series W bonds issuance. (ICC Staff Exhibit 7.0, p. 4, lines 57-78.) In contrast, Ms. Phipps' long-term debt estimate reflects Aqua's proposed refinancing activity. (ICC Staff Exhibit 7.0, pp. 2-3.) Therefore, the Commission should adopt Ms. Phipps' 7.18% embedded cost of long-term debt recommendation, which reflects (1) a 5.42% interest rate estimate for the Series W bonds; and (2) Aqua's expectation that it will refinance some of its higher cost debt. (ICC Staff Exhibit 7.0, Schedule 7.2.)

2. Short-Term Debt Cost

The Commission should reject Aqua's 3.07% short-term debt cost estimate (Aqua Exhibit 5, Schedule D-2, p. 1) because it is based on interest rate forecasts, which are very inaccurate, and includes alleged issuance expenses that it failed to document. Conversely, Ms. Phipps' 2.52% short-term debt cost estimate reflects the current LIBOR rate (rather than interest rate projections) and does not reflect the undocumented issuance expense. (ICC Staff Exhibit 3.0, pp. 10-11; ICC Staff Exhibit 7.0, p. 5) Thus, the Commission should reject Aqua's proposed short-term debt cost.

3. Cost of Common Equity

Ms. Ahern estimated Aqua's cost of equity is 11.35%; however, Aqua requests a 10.75% cost of equity. (Aqua Exhibit 2.0, p. 9.) Ms. Phipps estimates the investor-required rate of return of common equity for Aqua is 10.07%. (ICC Staff Exhibit 7.0, Schedule 7.1.)

a) Company Witness Ahern's Analysis

Ms. Ahern estimated Aqua's cost of common equity using the same forms of the discounted cash flow ("DCF") model, the Capital Asset Pricing Model ("CAPM"), the risk premium model ("RPM"), and the comparable earnings model ("CEM") the Commission rejected in Docket No. 03-0403. (*See* Aqua Exhibit 3.0, p. 5; 03-0403 Order, pp. 41-43.) Ms. Ahern's cost of common equity estimate includes an investment risk premium due to Aqua's size and its NAIC-2 designation. (Aqua Exhibit 3.0, pp. 61-62.) Ms. Ahern applied the DCF, CAPM and RPM analyses to a sample of six water utilities ("water sample") and a sample of fifteen utilities based on least relative distance ("utility sample"). (Aqua Exhibit 3.0, p. 5.) The RPM analysis was also applied to the Standard & Poor's Utility Index. (Aqua Exhibit 3.0, Schedule 13, p. 8.) In addition, Ms. Ahern performed a CEM analysis on two proxy groups consisting of 103 and 40 non-utility companies allegedly similar in risk to her water sample and utility sample, respectively. (Aqua Exhibit 3.0, p. 56.)

In her DCF analysis, Ms. Ahern averaged the spot dividend yields on March 11, 2004, with the average dividend yield for the three months ended February 29, 2004. Ms. Ahern estimated her growth rates from historical and projected growth rates in earnings and dividends per share. Finally, Ms. Ahern included only DCF-derived cost of equity estimates that exceeded her personally forecasted 6.6% yield on long-term A-rated utility bonds. Ms. Ahern's DCF analyses estimated the cost of common equity is 10.7% for the water sample and 10.3% for the utility sample. (Aqua Exhibit 3.0, pp. 31-37.)

Ms. Ahern's CAPM analysis used a 5.5% U.S. Treasury bond yield forecast as a proxy for the risk-free rate of return. Ms. Ahern estimated the market risk premium equals 5.9%, which is the average of two market risk premium estimates: (1) the 4.7% difference between her estimate of the risk-free rate and a 10.2% Value Line-derived estimate of the market return; and, (2) a historical market risk premium of 7.0%. (Aqua Exhibit 3.0, Schedule 14, p. 4, note 1.) Despite her contention that a rate of return analyst must examine **all** the data and models available to investors, Ms. Ahern relied exclusively on Value Line to compute the 0.63 and 0.70 betas for her water and utility samples, respectively. (Aqua Exhibit 3.0, Schedule 13, p. 9 and Aqua Exhibit R-3.0, lines 299-302; 553-554; 608-609; 657-658; 701-703; 732; 938; and 959-960.) Ms. Ahern's CAPM analysis estimated a 9.8% cost of common equity for her water sample and 9.9% for her utility sample. (Aqua Exhibit 3.0, pp. 48-51.)

Ms. Ahern's RPM analysis started with a forecasted 6.6% yield on long-term A-rated utility bonds, to which she added equity risk premiums of 3.7% for the water sample and 3.8% for the utility sample. Ms. Ahern calculated the equity risk premium by averaging two risk premium estimates: (1) her Value Line beta estimate times the difference between her estimate of the market rate of return (as calculated in her CAPM analysis) and a forecasted yield on Aaa-rated bonds; and, (2) the difference between the average historical realized return on the Standard & Poor's Utility Index public utilities and

A-rated bonds. The resulting estimates of the cost of common equity are 10.3% and 10.4% for the water sample and utility sample, respectively. (Aqua Exhibit 3.0, pp. 37-45.)

Ms. Ahern's CEM analysis measured returns on book equity on a sample of 103 non-price regulated companies allegedly comparable in risk to her water sample ("water subgroup") and a sample of 40 non-price regulated companies allegedly comparable in risk to her utility sample ("utility subgroup"). Ms. Ahern based her 13.5% and 13.1% estimates of the return on book common equity for her water and utility subgroups, respectively, on two calculations: (1) a 5-year historical return on book equity of 13.5% and 13.0% for the water and utility subgroups, respectively; and (2) Value Line's 5- year projected return on book common equity of 13.4% and 13.1% for the water and utility subgroups. Ms. Ahern also eliminated all rates of return that exceeded 20% or fell below her forecasted 6.6% A-rated bond yield. (Aqua Exhibit 3.0, pp. 54-59.)

Ms. Ahern concluded that Aqua's cost of equity equals 11.35%. Ms. Ahern's conclusion is based upon the averages the results of the DCF, CAPM, RPM, and CEM for each sample group plus an investment risk premium of 0.30% for the water sample and 0.40% for the utility sample due to Aqua's size relative to the companies comprising Ms. Ahern's water and utility samples and Aqua's NAIC-2 designation. (Aqua Exhibit 3.0, pp. 61-62.)

b) Staff Witness Phipps' Analysis

Staff witness Rochelle Phipps estimated Aqua's cost of common equity with the DCF and risk premium models. DCF and risk premium models cannot be applied directly to Aqua because its common stock is not market-traded. Therefore, Ms. Phipps applied those models to two samples. The first sample comprises six market-traded water utilities within the *Standard & Poor's Utility Compustat* database for which Zacks Investment Research ("Zacks") growth forecasts were available ("water sample"). The second sample consists of seven public utilities selected from the *Standard & Poor's Utility Compustat* database that matched Aqua's implied business profile score of 2, had an S&P debt rating of AA, AA-, A+, A, or A-, were not in the process of being acquired by another company and for which Zacks growth forecasts were available ("utility sample"). (ICC Staff Exhibit 3.0, lines 232-259.)

(1) DCF Analysis

DCF analysis assumes that the market value of common stock equals the present value of the expected stream of future dividend payments. (ICC Staff Exhibit 3.0, lines 269-272.) Ms. Phipps applied a constant-growth quarterly DCF model, which properly accounts for the quarterly payment of dividends by the companies comprising her samples. (ICC Staff Exhibit 3.0, lines 283-286.)

DCF analysis requires a growth rate that reflects the expectations of investors. Ms. Phipps measured the market-consensus expected growth rates with projections published by Zacks. The growth rate estimates were combined with the closing stock prices and dividend data as of August 26, 2004. (ICC Staff Exhibit 3.0, lines 293-308.) Based on this growth, stock price, and dividend data, Ms. Phipps' DCF-derived cost of equity estimate is 10.76% for the water sample and 8.92% for the utility sample. (ICC Staff Exhibit 3.0, lines 345-347.)

(2) Risk Premium Analysis

According to financial theory, the required rate of return for a risky security equals the risk-free rate of return plus a risk premium associated with that security. The risk premium methodology is consistent with investors' risk-aversion. Ms. Phipps used a one-factor risk premium model, the Capital Asset Pricing Model ("CAPM"), to estimate the cost of common equity. In the CAPM, the risk factor is market risk, which cannot be eliminated through portfolio diversification. (ICC Staff Exhibit 3.0, lines 353-375.)

The CAPM requires the estimation of three parameters: beta[6], the risk-free rate, and the required rate of return on the market. First, using Value Line beta estimates and regression analysis, Ms. Phipps estimated forward-looking betas of 0.54 for the water sample and 0.65 for the utility sample. (ICC Staff Exhibit 3.0, lines 543-544.) Second, Ms. Phipps considered two current estimates of the risk-free rate of return as of August 26, 2004: the 1.56% yield on U.S. Treasury bills and the 5.17% year on long-term U.S. Treasury bonds. (ICC Staff Exhibit 3.0, lines 438-440.) Forecasts of long-term inflation and the real risk-free rate suggest that the long-term risk-free rate is between 6.0% and 6.8%. Thus, Ms. Phipps concluded that the U.S. Treasury bond yield is currently the superior proxy for the long-term risk-free rate. (ICC Staff Exhibit 3.0, lines 456-460.) Finally, to measure the expected rate of return on the market, Ms. Phipps conducted a DCF analysis on the firms composing the Standard & Poor's 500 Index. That analysis estimates that the expected rate of return on the market equals

[6] Beta measures risk that investors cannot eliminate through diversification. When multiplied by the market risk premium (i.e., the market rate of return less the risk-free rate of return), a security's beta produces a market risk premium specific to that security. (ICC Staff Exhibit 3.0, lines 491-493.)

13.54%. (ICC Staff Exhibit 3.0, lines 478-489.) Using those three parameters in her risk premium model, Ms. Phipps estimates the cost of common equity is 9.69% for the water sample and 10.61% for the utility sample. (ICC Staff Exhibit 3.0, lines 547-549.)

(3) Recommendation

Ms. Phipps testified that a thorough cost of common equity analysis requires both the application of financial models and the analyst's informed judgment. A cost of common equity recommendation based solely upon judgment is inappropriate. However, because cost of common equity measurement techniques necessarily employ proxies for investor expectations, judgment is necessary to evaluate the results of such analyses. Along with DCF and CAPM analyses, Ms. Phipps considered the observable 5.81% rate of return the market currently requires on A-rated utility long-term debt. (ICC Staff Exhibit 3.0, lines 553-561.)

Ms. Phipps' DCF analysis estimated a 10.76% cost of equity for the water sample and 8.92% for the utility sample. Ms. Phipps' CAPM analysis estimated a 9.69% cost of equity for the water sample and 10.61% for the utility sample. To determine the appropriate weighting of the water and utility samples, Ms. Phipps performed a quantitative risk analysis of Aqua and her water and utility samples that revealed Aqua is closer in risk to the water sample than the utility sample. (ICC Staff Exhibit 7.0, lines 169-170.) Nonetheless, Ms. Phipps did not rely exclusively on her water sample estimates to estimate Aqua's cost of common equity because cost of equity estimates for water samples are prone to larger measurement error than those for utility samples given water utilities are not as widely followed as other utilities. (ICC

Staff Exhibit 7.0, lines 204-208.) Moreover, water utility betas might be less reliable beta estimates because water utility securities trade less frequently than utility securities. (ICC Staff Exhibit 7.0, lines 213-214.) Thus, Ms. Phipps used both her water and utility samples to estimate Aqua's cost of common equity, but assigned the water sample estimates twice the weight that she assigned the utility sample estimates. (ICC Staff Exhibit 7.0, lines 197-198.) Ms. Phipps assigned two-thirds weight to the water sample estimates and one-third weight to the utility sample estimates to derive her 10.07% cost of equity recommendation for Aqua. (ICC Staff Exhibit 7.0, lines 197-203.) Thus, Staff recommends that the Commission adopt a 10.07% cost of equity in determining Aqua's overall cost of capital.

Ms. Phipps did not add an "investment risk premium" to her recommendation. She testified that an investment risk premium, such as the premium Ms. Ahern recommended, would be warranted only if Aqua were riskier than <u>both</u> of her samples (ICC Staff Exhibit 7.0, lines 191-194.); however, Ms. Phipps' quantitative risk analysis of Aqua demonstrates that Aqua and the water samples are equivalent in risk. (ICC Staff Exhibit 7.0, lines 186-188.) As Ms. Phipps testified, investors require the same rate of return from investments with equal quantities of risk. (ICC Staff Exhibit 3.0, lines 368-369.) Investors will only require an "investment risk premium" from one security in relation to another if they believe that security is riskier. (ICC Staff Exhibit 3.0, lines 362-364.) Since Ms. Phipps found that Aqua and the water sample are equivalent in risk, an additional "investment risk premium" for Aqua is not warranted.

(4) Comparison of Staff and Company Cost of Equity Findings and Recommendations

For the benefit of the Commission, the following table compares Staff's and the Company's cost of equity recommendations:

Comparison of Cost of Equity Findings/Recommendations				
	Staff		Company	
	Water Sample	Utility Sample	Water Sample	Utility Sample
DCF	10.76%	8.92%	10.7%	10.3%
CAPM	9.69%	10.61%	9.8%	9.9%
RPM			10.3%	10.4%
CEM			13.5%	13.1%
Investment Risk Premium	0.0%	0.0%	0.3%	0.4%
Estimated Cost of Equity	10.07%		11.35%	
Requested Cost of Equity			10.75%	

c) Staff's Criticisms of Ms. Ahern's Analysis

Ms. Phipps found several errors in Ms. Ahern's analysis that led Ms. Ahern to overestimate Aqua's cost of common equity. Ms. Phipps found that critical errors occur in, or are the result of, her DCF, CAPM, RPM, and CEM analyses. Ms. Phipps also determined that Ms. Ahern's inclusion of an investment risk premium due to Aqua's size and NAIC-2 designation is unwarranted. (ICC Staff Exhibit 3.0, lines 587-605.) Staff's Brief will focus on the most critical of those errors.

(1) Size-Based Risk Premium

Ms. Ahern asserts Aqua's size, relative to the size of the companies comprising her water sample, warrants an upward risk premium adjustment to Aqua's cost of equity of 277 basis points for her water sample and 370 basis points for her utility sample. Ms. Ahern's estimates of size-based risk premiums are based upon historical, realized size premiums for market-traded companies during 1926-2002, as reported by Ibbotson Associates. (Aqua Exhibit 3.0, pp. 62-63.) Ms. Phipps testified that Ms. Ahern's size-based risk premium has no theoretical basis. Rather, it is based on an empirical study that is not applicable to Aqua. (ICC Staff Exhibit 3.0, lines 646-648.) Ms. Phipps testified that the only published study of the relationship of utility size to risk did not find one. (ICC Staff Exhibit 3.0, lines 706-708.)

Ms. Ahern did not provide any evidence to demonstrate that a size premium is warranted for utilities. The Ibbotson Associates ("Ibbotson") study, which forms the basis of Ms. Ahern's size-based risk premium adjustment, is not restricted to utilities. (ICC Staff Exhibit 3.0, lines 687-694.) Ms. Ahern claimed that Ibbotson verifies that a size premium does apply to utilities such as Aqua because Ibbotson provides historical excess returns for companies assigned an SIC (Standard Industry Code) of 49. To the contrary, Ibbotson states that those excess returns should <u>not</u> be construed as size premia. (ICC Staff Exhibit 7.0, lines 516-523.) Further, the companies within SIC 49 include unregulated entities such as steam and air-conditioning supply companies and irrigation system companies in addition to regulated utilities. (ICC Staff Exhibit 7.0, lines 526-531.) In contrast, the published study cited by Ms. Phipps in her direct testimony, which did not find a relationship between utility size and risk, specifically applied to regulated utilities. (ICC Staff Exhibit 7.0, lines 539-541.) In addition, the Brigham text ("Brigham") that Ms. Ahern also cited in support of her sized-based premium adjustment does not specifically refer to utility stocks. Further, Brigham defines a company as "small" if its market capitalization is under $20 million, far below Aqua's $113 million in book capital. (ICC Staff Exhibit 3.0, lines 693-698.) Thus, the entire basis of Ms. Ahern's size-based risk premium is unfounded.

Furthermore, Ms. Phipps argued that, should a size-based risk premium be adopted, and it should not, it should be based on the size of Aqua's parent company, Aqua America, Inc. ("Aqua America") because Aqua obtains common equity financing from its parent company. If the risk inherent in a utility common stock is a function of that utility's size, then the larger size of Aqua America should translate into a decreased cost of common equity, in comparison to a company the size of Aqua. If a risk premium were based on the size of Aqua, ratepayers would be denied a portion of the benefits associated with combined entity's stronger financial profile. (ICC Staff Exhibit 3.0, lines 651-668.) In fact, in support of the Company's request to merge with Philadelphia Suburban Corporation ("PSC", now known as Aqua America), the Consumers Illinois Water Company ("Consumers Illinois", now known as Aqua) President testified that the merger "should enhance the ability of PSC and Consumers Illinois to access capital markets on reasonable terms." (Order, Docket No. 98-0602, January 21, 1999, p. 3.) Similarly, another Company witness testified, "the combined entity will have a stronger financial profile," which "should enhance the ability of PSC and Consumers Illinois to access the capital markets on reasonable terms." (*Id.*)

A size-based risk premium was presented in Consumers Illinois' rate case, Docket No. 97-0351, but it was rejected because the company witness failed to demonstrate that there is a direct relationship between the size of a utility and its risk. (Amended Order, Docket No. 97-0351, June 17, 1998, p. 39.) Ms. Ahern has not remedied that defect. Moreover, in Aqua's most recent rate case, Docket No. 03-0403, the Commission Order stated, "The Commission does not conclude that the size of [Aqua] warrants a risk premium. [Aqua] is a wholly-owned subsidiary within a much larger organization, and in that sense is distinguishable from an independent utility of the same size as Aqua." (Order, Docket No. 03-0403, April 13, 2004, p. 43.)

(2) NAIC-2 Designation

The Company has certain debt issues that have been assigned an NAIC-2 designation by the National Association of Insurance Commissioners ("NAIC"), which Ms. Ahern alleges reflects a higher degree of credit risk for Aqua than exists for either of her proxy groups. Ms. Phipps testified that Ms. Ahern's adjustment for a credit risk premium due to Aqua's NAIC-2 designation is inappropriate for several reasons. First, the NAIC does not rate companies such as Aqua; the NAIC only rates specific security issues. Specifically, the NAIC "is responsible for the day-to-day credit quality assessment and valuation of securities owned by stated regulated insurance companies." (ICC Staff Exhibit 3.0, lines 819-822.)

Second, the NAIC designation is not intended for use by investors. The NAIC website clearly states, "These designations and unit prices are produced solely for the benefit of NAIC members.… Unlike the ratings of nationally recognized statistical rating organizations, NAIC designations are not suitable for use by anyone other than NAIC members." (ICC Staff Exhibit 3.0, lines 822-827.) In response, Ms. Ahern argued that notwithstanding the NAIC's disclaimer that their designations are for the sole use of the NAIC membership, investors are aware that Aqua's debt has been assigned an NAIC-2 designation based on her contention that that designation is a matter of public record. (Aqua Exhibit R-3.0, lines 528-531.) That assertion is baseless and nonsensical. Ms. Ahern presented no evidence that investors will ignore the NAIC's disclaimer, let alone that investors are even aware of NAIC designations. (ICC Staff Exhibit 7.0, lines 469-477.) To the contrary, Ms. Ahern admitted that she did not know whether the companies comprising her proxy groups have been assigned NAIC designations. (Aqua Exhibit R-3.0, lines 541-542.)

Third, Ms. Ahern was unable to provide documentation from either S&P or Moody's that states their credit ratings are equivalent to NAIC designations. (ICC Staff Exhibit 3.0, lines 847-850.) Lacking any demonstrable proof of their NAIC designations, Ms. Ahern assumed the companies comprising her samples likely have debt rated NAIC-1 as "both proxy groups are in the A bond ratings categories of Moody's & S&P." (Aqua Exhibit R-3.0, lines 541-545.) Although alphanumeric methodologies, such as those provided by S&P and Moody's, are usually granted automatic translation into NAIC designations by the Securities Valuation Office ("SVO") of the NAIC, even in those cases, the NAIC reserves the right to downgrade any translation when deemed necessary. (Aqua Schedule R-3.9, p. 5.) In other words, Ms. Ahern drew untenable conclusions about the riskiness of samples that have Moody's and S&P credit ratings but unknown NAIC designations relative to Aqua that has NAIC designations but no Moody's or S&P credit ratings.

Fourth, an NAIC designation is not a measure of general investment risk. That is, the NAIC considers security-specific terms when assigning NAIC designations, including covenants, structure, collateral, credit enhancements and any other credit-related factor specific to the security under review. (Aqua Schedule R-3.9, p. 6.) Thus, the companies composing Ms. Ahern's proxy samples might have debt securities that merit a lower NAIC designation than the company's credit rating would suggest. Similarly, Aqua's NAIC-2 designated debt securities might include terms that merit a lower NAIC designation than the general level of investment risk for the Company. (ICC Staff Exhibit 7.0, lines 460-468.)

In this proceeding, making speculative inferences about the equivalence of water and utility sample credit ratings and NAIC designations for Aqua's debt is unnecessary. Unlike Docket No. 03-0403, Staff witness Phipps performed a quantitative risk analysis of Aqua in comparison to her samples and concluded that an investment risk premium is not warranted for Aqua. (ICC Staff Exhibit 7.0, lines 189-203 and 254-256.) Ms. Phipps' direct quantitative analysis of Aqua and her samples renders Ms. Ahern's reliance on the flawed "apples to oranges" comparison on NAIC designations with S&P and Moody's credit ratings unnecessary. (ICC Staff Exhibit 7.0, lines 254-262.) Thus, adding an investment risk adjustment to Aqua's cost of common equity is unwarranted.

In summary, the Commission should not assume that utilities with "A" credit ratings have no debt with NAIC-2 designations or that Aqua would not merit an "A" credit rating from S&P and Moody's despite having debt with NAIC-2 designations. Ms. Phipps' quantitative risk analysis, which Ms. Ahern argued should be performed, indicates those assumptions are unwarranted. (Aqua Exhibit R-3.0, lines 212-226.)

The Commission considered the impact of NAIC-2 designations on Aqua's cost of equity in the Company's last rate case. (*See* 03-0403 Order, pp. 29-30, 36, 43.) Based on the facts presented in that docket, the Commission decided to incorporate a business risk premium in determining Aqua's cost of equity based on the NAIC-2 designation of certain Company securities. (*Id.*, p. 43). In reaching this decision the Commission relied on a narrow finding that the facts presented demonstrated the existence of some risk not captured by the financial model analyses utilized to estimate Aqua's cost of equity. (*Id.*) The Commission did not specifically reject Staff's arguments directed to the NAIC-2 designations, but instead explained its ruling as follows:

> Although the size of [Aqua] does not warrant a premium, other factors might warrant a business risk adjustment. In this context, it is appropriate to consider all available information of record, including the rating of NAIC -2 on certain of [Aqua]'s securities issues. When compared to the credit rating of A discussed earlier, the rating of NAIC-2, or a comparable S&P rating of BBB, indicates the presence of some additional risk factor not already explained. The Company also asserts that, on average, [Aqua] faces risk from the need to renew and replace certain infrastructure at higher replacement cost per dollar of net plant. In this light, the Commission concludes that a business risk premium is warranted under the facts of this case as applied to [Aqua], and should be included in the cost of equity in the amount of the 30 basis points proposed by the Company.

(*Id.*) The facts presented in the instant case regarding the NAIC-2 designation for certain debt issues of the Company do not – as explained above – justify a finding that the financial model analyses conducted by the Staff and Company finance witnesses to estimate the Company's cost of equity failed to capture some element of risk unique to Aqua. Accordingly, a different result is appropriate and required in the instant case to avoid the overestimation of Aqua's cost of equity. Staff further recommends that the Commission make clear that its ruling in Docket 03-0403 should not be interpreted to establish a general rule providing a business risk premium for Aqua or any other utility that has an NAIC-2 designation for some of its debt issues. Rather, the adoption of a business risk premium due to NAIC-2 designations is the exception to the Commission's normal determination of cost of equity, and is only appropriate, if at all, when the need for such a premium is clearly demonstrated by the facts.

(3) Improper Reliance on Historical Data

Ms. Ahern's use of historical data in her various models is problematic. (ICC Staff Exhibit 3.0, lines 866-878.) First, historical data improperly weights outdated information that investors in the market no longer consider relevant. Second, historical data reflects conditions that are unlikely to continue in the future. In other words, use of average historical data wrongly implies that securities data will revert to a mean, which research has found to be untrue. Even if stock and bond data were mean reverting, there is no method for determining the true value of that mean. Consequently, historical sample means, which are a function of the measurement period used, are substituted. Since any chosen measurement period will be arbitrary, the results will be uninformative.

The Commission has repeatedly rejected the use of historical data in determining an appropriate cost of equity. In Docket No. 92-0357, a rate proceeding for Iowa-Illinois Gas and Electric Company, the Commission Order stated, "The Commission notes that the investor-required return on common equity is a forward-looking concept. [The company witness], in many instances, inappropriately utilized historical data to determine the Company's cost of equity." (Order, Docket No. 92-0357, p. 66 (July 21, 1993).) Similarly, in Docket No. 95-0076, a rate proceeding for Illinois-American Water Company, the Commission Order stated:

> The Commission also concludes that Staff's criticism of [company witness] Dr. Phillips' use of two-month average historical stock prices and historical growth rates in his traditional DCF analysis, and historical risk premiums in his risk premium analysis are valid. Historical data is inappropriate in determining a forward-looking cost of equity because it contains information that may no longer be relevant to investors.

(Order, Docket No. 95-0076, p. 69 (December 20, 1995).) The Commission also rejected using historical data to estimate a utility's cost of equity in numerous other cases. (*See* Order, Docket Nos. 99-0122/0130 Consolidated, p. 10 (August 25, 1999); Order, Docket Nos. 01-0528/0628/0629 Consolidated,, p. 12 (March 28, 2002); and, Order, Docket No. 02-0837, p. 37 (October 17, 2003).) Most recently, the Commission rejected Ms. Ahern's use of historical dividend yields in the Docket No. 03-0403 Order (Aqua's prior rate proceeding):

> The Commission also accepts Staff's DCF analysis. The Commission notes that both the Company and Staff used similar sample groups, and views the difference in the results to stem from certain differences in the inputs used, such as the historical data and growth rate estimates discussed subsequently….
>
> The Commission is aware that historical data has a place in many cost of capital analyses. The instant objective, however, is to estimate the

> forward-looking cost of common equity. For this reason, the Commission has consistently rejected the use of average common stock prices, and has accepted the use of spot common stock prices when implementing the DCF model. The Commission continues to believe that the use of spot common stock prices in the DCF model is superior to the use of average prices.

(03-0403 Order, p. 42.)

(4) Ms. Ahern's DCF Analysis

Ms. Ahern's growth rate estimates reflect two major problems. First, missing data undermines the integrity of Ms. Ahern's growth rate estimates. Ms. Ahern's averages of all growth rate types for each proxy group are uninformative because both Value Line Projected 2000-2002 to 2006-2008 growth rates for earnings and dividends per share are not available for all of her sample companies. Consequently, the DCF analysis of the water sample overweights three companies. (ICC Staff Exhibit 3.0, lines 994-1003.) Ms. Ahern argued that since the sample companies were selected on the basis of similar risk, it is reasonable to assume that the missing growth rate estimates equal the average for each proxy group. (Aqua Exhibit R-3.0, lines 628-631.) But this argument fails as growth is only tangentially related to risk.[7] Since Ms. Ahern failed to show that the companies missing Value Line growth rates have the same dividend payout policies as those with Value Line growth rates and no definitive conclusions can be drawn, Ms. Ahern's supposed average Value Line earnings per share growth estimates should be disregarded. (ICC Staff Exhibit 7.0. lines 730-745.)

[7] Ms. Ahern's argument is also surprising since she uses the formula "BR+SV" to estimate growth rates. (Aqua Exhibit 3.0, p. 3.) As Ms. Ahern's "BR+SV" growth rate formula demonstrates, growth is also a function of dividend policy (i.e., "B" equals one minus the ratio of dividends paid to earnings), which has no direct relationship to risk.

Second, Ms. Ahern improperly used a "BR+SV" growth estimate in her DCF analysis. (ICC Staff Exhibit 3.0, lines 997-998.) The BR+SV growth estimate introduces circularity into the return on common equity estimate (i.e., "R") because Ms. Ahern must first estimate "R" in order to estimate a growth rate using the BR+SV methodology. The resulting growth estimate is then used in a calculation to estimate the return on common equity, "R". (ICC Staff Exhibit 3.0, lines 1004-1010.)

Ms. Ahern's BR+SV growth estimate also suffers from (1) the same missing data problem discussed previously; (2) a need to estimate four variables, which increases the sources of estimation error four-fold compared to the single source of estimation error when growth is estimated directly; and (3) Ms. Ahern's incorrect substitution of the average return on all equity investment for "R", which should be defined as the return on incremental investment only. The "BR+SV" growth estimate is supposed to measure sustainable growth, which is derived from new investment. Obviously, the average return on all equity investment includes existing assets, which cannot sustain growth beyond their capacity. (ICC Staff Exhibit 3.0, lines 1011-1021.) A review of the BR+SV formula demonstrates the rate of return on new investment to be the correct rate of return. The "B" factor to which the rate of return (i.e., "R") is applied is retained earnings, which are the earnings the company plows back into the company as *new investment.* The sustainable growth is the return the company is expected to earn on the reinvestment of those retained earnings. (ICC Staff Exhibit 7.0, lines 772-777.)

Dr. Morin, whom Ms. Ahern cites as an authority on this issue, wrote that growth in earnings is based on <u>future</u> equity investment. That is, if a company continued to earn the same return on its existing equity, but had no new investment (including retained earnings), it could not grow. (ICC Staff Exhibit 7.0, lines 779-787.) An investment textbook reinforces this point, stating:

> How do stock analysts derive forecasts of g, the expected growth rate of dividends? …They try to relate the expected growth rate of earnings to the expected profitability of the firm's future investment opportunities.
>
> The exact relationship is
>
> $$g = b \times ROE \qquad (17.2)$$
>
> where b is the proportion of the firm's earnings that is reinvested in the business, called the plowback ratio or the earnings retention ratio, and the ROE is the rate of return (return on equity) on new investment.

A footnote to that excerpt clarifies that "The appropriate measure of ROE in equation 17.2 is really the internal rate of return (IRR) on the firm's future investments of equity capital." (ICC Staff Exhibit 7.0, lines 788-802.) Finally, Ms. Phipps testified that it has been demonstrated mathematically that the "R" component of the BR+SV method should be based upon incremental investment only. (ICC Staff Exhibit 7.0, lines 803-805.)

Finally, Ms. Ahern eliminated DCF-derived cost of equity estimates that were equal to or below her excessive 6.6% A-rated bond yield forecast, but did not assess whether any of those DCF estimates were too high. (*See* Aqua Exhibit 3.0, pp. 34-35.) Ms. Ahern's arbitrary elimination criterion inflated her DCF-derived cost of equity estimate for Aqua. Including the "low" estimates (i.e., those at or below 6.6%) results in DCF-derived cost of equity estimates of 9.7% for her water sample and 9.1% for her utility sample. (ICC Staff Exhibit 3.0, lines 1041-1059.)

(5) CAPM Analysis

Ms. Ahern's CAPM Analysis employs two estimates of the market risk premium. The first, an Ibbotson-based estimate, is based entirely on historical data, the use of which has several shortcomings, as discussed previously. (*See* Section IV.B.3.c)(3) above.) Ms. Ahern's second estimate, which was calculated from Value Line median market dividend yields and price appreciation, contains two critical errors. First, while the median identifies the middle value of a data set, it provides no information about the magnitude of the difference between the middle value and other data points. (ICC Staff Exhibit 3.0, lines 1063-1089.)

In particular, the median fails to properly weight the relative value of the securities composing the market portfolio. The common stocks of larger companies have a greater effect on market returns because they constitute a greater proportion of the market than those of smaller companies. Nevertheless, the median growth estimate does not apply higher weights to larger companies, and thus over-weights the contributions of smaller companies, which tend to have greater growth potential. (ICC Staff Exhibit 3.0, lines 1090-1097.)

Ms. Ahern compounded that problem by improperly drawing the median dividend yield and growth rates from two different samples. Common stocks that do not pay dividends were excluded from the sample from which the median dividend yield was derived. Conversely, the median appreciation projection reflects <u>all</u> 1700 stocks in Value Line's hypothesized economic environment, dividend paying or not. Obviously the dividend yield of non-dividend paying stocks is 0%. Thus, by adding the dividend yield of only dividend paying stocks to the estimated price appreciation of all stocks, Ms. Ahern over-estimated the overall return on the market. (ICC Staff Exhibit 3.0, lines 1098-1111.)

In defense of her estimated Value Line market rate of return, Ms. Ahern argued, “information provided by Value Line is investor influencing and should not be rejected by any rate of return analyst.” (Aqua Exhibit R-3.0, lines 706-707.) Ms. Ahern’s argument wrongly implies that investors use the same incorrect methodology as she does to estimate the market rate of return. First, Value Line never suggests that its median total market price appreciation and dividend yield should be combined to form a market return estimate. In fact, Value Line does not add those numbers together. (ICC Staff Exhibit 7.0. footnote 83.) Second, Ms. Ahern failed to demonstrate that investors do, in fact, use Value Line data in the same flawed manner she employs. (ICC Staff Exhibit 7.0, lines 831-837.) Third, Ms. Ahern could not affirm that any regulatory agencies estimate the required rate of return on the market using her methodology. (Staff Cross Exhibit 10) Accordingly, the Commission should not adopt Ms. Ahern’s CAPM and RPM analyses, which reflect Ms. Ahern’s flawed market return estimate.

(6) Ms. Ahern’s Empirical CAPM

Some quantitative research suggests the relationship between risk and return is flatter than the CAPM predicts. The Empirical CAPM attempts to reproduce the observed relationship between risk and realized returns. Since the adjustments to the CAPM that result in the Empirical CAPM are based on empirical testing rather than financial theory, the Empirical CAPM should be applied in a manner that is consistent with the conditions under which it was developed. Specifically, the measure of risk used within the Empirical CAPM must be consistent with that used in the empirical studies from which the model was developed. Ms. Phipps provided testimony explaining that Ms. Ahern failed in that regard. (ICC Staff Exhibit 3.0, lines 1136-1144.)

The basis of Ms. Ahern's Empirical CAPM is a book entitled *Regulatory Finance: Utilities' Cost of Capital* by Roger A. Morin. (ICC Staff Exhibit 3.0, lines 1144-1146.) That text, in turn, cites another study by Litzenberger, et al. ("Litzenberger"). (*Id*., lines 1146-1147.) Litzenberger adopts <u>raw beta</u> as the measure of risk in its tests of the relationship between risk and realized returns. In contrast, Ms. Ahern applied Value Line <u>adjusted</u> betas to her Empirical CAPM rather than the raw betas used by Litzenberger. (*Id*., lines 1147-1151.) Importantly, Litzenberger indicates that globally adjusted betas, such as those Value Line publishes, are a <u>solution</u> to the discrepancy between the theoretically predicted and empirically observed relationship between risk and return. In other words, by using adjusted betas, Ms. Ahern has already effectively transformed her "Traditional" CAPM into an Empirical CAPM. Therefore, including an additional beta adjustment in her Empirical CAPM model results in inflated estimates of her samples' cost of common equity. (*Id*., lines 1151-1158.)

The Commission rejected Ms. Ahern's Empirical CAPM analysis in Aqua's most recent rate proceeding, Docket No. 03-0403. That Commission Order states,

> The Commission also rejects the empirical CAPM model as implemented by the Company. …Furthermore, the Commission continues to be of the opinion that the use of adjusted betas in the ECAPM is improper and leads to unreliable results.

(03-0403 Order, pp. 41-42.)

Ms. Ahern did not modify her Empirical CAPM in the current case to address the Commission's concerns identified in the 03-0403 Order. Ms. Ahern asserted that her testimony is consistent with Dr. Roger Morin's testimony in Docket No. 01-0444. (ICC Staff Exhibit 3.0, lines 1206-1228.) However, in Docket No. 01-0444, the Commission also explicitly rejected Dr. Morin's Empirical CAPM analysis. (Order, Docket No. 01-0444, March 27, 2002, pp. 16-17.) Despite Ms. Ahern's attempt to validate her Empirical CAPM analysis by noting that two other State regulatory agencies use the Empirical CAPM (Aqua Exhibit 3.0, pp. 53-54), she admitted that the majority of regulatory commissions do not use the Empirical CAPM. (Staff Cross Exhibit 8.)

(7) Ms. Ahern's Risk Premium Analysis

Ms. Phipps addressed three errors in Ms. Ahern's risk premium analysis: (1) improper application of a market risk premium-based beta to a non-market risk premium; (2) inappropriate substitution of two different long-term corporate bond yields for the risk-free rate within the same risk premium model; and (3) an inaccurate estimate of the common equity risk premium. (ICC Staff Exhibit 3.0, lines 1267-1276.)

Ms. Ahern's application of a market risk premium-based beta to a non-market risk premium is improper because beta measures a particular type of risk and cannot be assumed to accurately measure any other type of risk. Ms. Ahern's RPM is derived from the CAPM but substitutes a corporate bond yield for the risk-free rate (hereafter referred to as the "Beta RPM"), a substitution which has no basis in financial theory. Ms. Phipps mathematically proved that the Beta RPM systematically underestimates the cost of equity for companies with a beta greater than one and overestimates the cost of common equity for all companies with betas less than one. Since Ms. Ahern's water and utility samples have betas below one, the Beta RPM systematically over-estimates their costs of common equity. (ICC Staff Exhibit 3.0, lines 1277-1295.)

Ms. Ahern incorrectly claims that "company-specific, unsystematic, non-market risk is fully captured in the RPM" without overestimating the cost of equity. (Aqua Exhibit R-3.0, lines 925-932.) According to portfolio theory, investors are only compensated for risk that cannot be eliminated through diversification (i.e., systematic risk). Since Ms. Ahern claims that her RPM estimates a cost of equity that reflects total risk rather than just non-diversifiable risk, as captured by the CAPM, the estimated cost of equity using Ms. Ahern's RPM should be systematically greater than the same estimates the CAPM produces for companies with betas greater than 1. To the contrary, inputting a 5.4% risk-free rate, 15% rate of return on the market, a beta equaling 1.5 and a 7.2% yield on A-rated bonds, results in an 18.9% cost of equity estimate using Ms. Ahern's RPM. Inputting those data in the CAPM results in a 19.8% cost of equity estimate. (ICC Staff Exhibit 7.0, lines 990-1024.) Clearly, Ms. Ahern's RPM estimates a *lower* cost of equity than the CAPM for companies with betas greater than 1.

In addition, Ms. Ahern's Beta RPM wrongly uses <u>two different</u> long-term corporate bond yields. Ms. Phipps proved that the use of two different corporate bond yields causes Ms. Ahern's Beta RPM to estimate different rates of return for samples that have the same level of risk. Thus, Ms. Ahern's Beta RPM violates a fundamental tenet of financial theory: investors require identical returns from two securities with identical risk. (ICC Staff Exhibit 3.0, lines 1299-1324.) In Docket No. 02-0837, the Commission rejected the use of a Beta RPM like the one used by Ms. Ahern in the instant docket. (Order, Docket No. 02-0837, p. 38 (October 17, 2003).) Moreover, Ms. Ahern admitted that most regulatory commissions do not use the RPM. (Staff Cross Exhibit 9.)

Finally, the adjusted equity risk premium in the Ahern Utility Historical RPM is inappropriate for two reasons. First, it uses historical data, which, as discussed previously in Section IV.B.3.c)(3) above, is inappropriate. Second, it is based upon S&P's Public Utility Index, which Ms. Ahern neglected to demonstrate to be comparable in risk to Aqua. (ICC Staff Exhibit 3.0, lines 1343-1347.) In Docket Nos. 99-0122/0130, an electric delivery services rate proceeding for MidAmerican Energy Company ("MidAmerican"), the Commission rejected MidAmerican's RPM because the company witness failed to show that MidAmerican is similar in risk to the S&P Utility Index, which formed, in part, the basis for his risk premium. (Order, Docket Nos. 99-0122/0130 Cons., p. 10 (August 25, 1999).)

(8) Ms. Ahern's CEM Analysis

Ms. Ahern's CEM analysis is distorted by historical data, inconsistencies in the data set, potential differences in accounting practices across industries, reliance on book returns and an arbitrary criterion for eliminating certain returns for her CEM proxy groups. Moreover, Ms. Ahern's CEM analysis relies on the erroneous notion that a combination of realized and expected returns on book value ("accounting earnings") is an appropriate estimate for the investor-required rate of return. To the contrary, the cost of common equity is the market-required rate of return demanded by investors. In contrast, the CEM relies on the accounting return on book value of common equity, which may be more or less than the investor-required rate of return. These shortcomings inexorably lead to the conclusion that CEM analysis is not an appropriate method for estimating Aqua's cost of common equity. (ICC Staff Exhibit 3.0, lines 1372-1384.)

Ms. Ahern claimed that her CEM is market-based because she used market-based measures of risk to select the CEM samples. If the required return from Ms. Ahern's CEM model is market based, then the measures of risk would be positively related with the measures of return. However, analysis of Ms. Ahern's data shows that the statistical relationship of her measures of risk with her measures of return is either negative or insignificantly different from zero. (ICC Staff Exhibit 3.0, lines 1413-1420.) Thus, forming samples from market measures of risk is insufficient to convert accounting rates of return into market-based rates of return.

Ms. Ahern also eliminated those rates of return that are greater than 20% and less than 6.6% in order to be conservative, but she failed to justify (1) those "limits" for her CEM results and (2) why the elimination criterion she applied to her CEM analysis is different than that which she applied to her DCF analysis. Despite this attempt to provide a "conservative" cost of equity estimate for Aqua, Ms. Ahern's CEM-derived cost of equity estimates are the highest presented in this case (i.e., 13.5% for her water sample and 13.1% for her utility sample). (ICC Staff Exhibit 7.0, lines 1432-1435.) Staff submits that the resulting extreme CEM estimates demonstrate that Ms. Ahern's "limits" failed. In summary, Ms. Ahern's attempt to provide a conservative CEM-derived cost of equity estimate relies on an arbitrary criterion and her CEM analysis should be rejected. (ICC Staff Exhibit 3.0, lines 1421-1431.)

Finally, the validity of the data Ms. Ahern utilized in her CEM is questionable. Reviewing Ms. Ahern's source documents revealed that the majority of Value Line betas presented in her testimony are incorrect. Ms. Phipps testified that of the 103 companies comprising Ms. Ahern's first CEM sample (which serves as a proxy for her water sample), approximately two-thirds of the Value Line betas are incorrect. Of the 40 companies comprising Ms. Ahern's second CEM sample, more than half of the Value Line betas are incorrect. (ICC Staff Exhibit 3.0, lines 1438-1445.) Ms. Ahern used a proprietary Value Line database to obtain beta estimates for her CEM sample companies, which directly contradicts her assertion that analysts should only use information that is available to investors. Even more problematic than the inconsistency of Ms. Ahern's arguments is the fact that she could not provide any supporting documentation for either the Value Line betas used in her CEM analysis or the regression statistics she used as "market-based" measures of risk, which they, in fact, are not. (Staff Cross Exhibit 6.)

The Commission has repeatedly rejected use of CEM analysis. (*See* Order, Docket Nos. 02-0798/03-0008/03-0009 Cons., p. 88 (October 22, 2003); Order, Docket Nos. 01-0528/0628/0629 Cons., p. 13 (March 28, 2002); Order, Docket No. 99-0121, p. 67 (August 25, 1999); Order, Docket No. 92-0448/93-0239 Cons., p. 173 (October 11, 1994); Order, Docket No. 91-0147, p. 149 (February 11, 1992); and, Order, Docket No. 89-0033, p. 15 (November 4, 1991).) Most significantly, the Commission rejected Ms. Ahern's CEM analysis in Aqua's most recent rate proceeding, Docket No. 03-0403. That Order states:

> First, the Commission rejects the use of the comparable earnings analysis. The Commission has repeatedly found that the comparable earnings approach is an unsound basis for estimating a utility's cost of common equity. In the view of the Commission, there is no economic basis for concluding that the comparable earnings approach provides a valid estimate of the forward-looking, investor-required rate of return for the Company. The Commission is not convinced that looking to the return on book equity of non-price regulated firms provides meaningful information when estimating the Company's cost of common equity.

(03-0403 Order, p. 41.) Ms. Ahern has failed to provide the Commission with any valid reason for reversing this Commission policy.

d) Staff Response to the Company's Criticisms of Staff Analysis

(1) Alleged Exclusive Reliance on DCF Model

Ms. Ahern alleged that Ms. Phipps' entire analysis relies exclusively on the DCF, since the market return used in her Risk Premium model was derived through a DCF calculation. (Aqua Exhibit R-3.0, lines 153-158.) Ms. Ahern is mistaken. First, Ms. Phipps' risk premium model uses a DCF calculation only to derive the market return ("R_M"), one input required for CAPM analysis. Second, the R_M used in Ms. Phipps' risk premium model comprises 369 different companies not used in her DCF analysis. Third, Ms. Ahern's criticism is disingenuous since in addition to using an historical return on the market, Ms. Ahern's Risk Premium and Capital Asset Pricing models also estimate the rate of return required on the market with the DCF. That is, both the Value Line and DCF-based estimates of R_M equal a dividend yield, plus a growth rate. Finally,

R_M, which is a forward-looking measurement, can only be estimated through a DCF calculation without resorting to untimely, obsolete historical data. (ICC Staff Exhibit 7.0, lines 274-277.)

(2) Alleged Downward Bias in DCF Estimates of the Cost of Common Equity when Market Value of Equity Exceeds Book Value Equity

Ms. Ahern asserted that there is a "tendency of the DCF model to mis-specify investor's required return rate when the market value of common stock differs significantly from its book value." (Aqua Exhibit R-3.0, lines 177-181.) Ms. Phipps testified that this could occur only if the investor-required rate of return has fallen or expectations of future earnings have risen. The investor-required rate of return on an investment in a utility would fall if either the risk premium has fallen or if investors' perceived level of risk in that utility has fallen. If a utility's stock price grows to exceed its book value due to a decline in investors' required rate of return for that utility, then it obviously follows that the Commission should authorize a lower rate of return. In contrast, Ms. Ahern would illogically conclude that the Commission should authorize a utility a higher rate of return whenever that utility's investor-required rate of return declines. (ICC Staff Exhibit 3.0, lines 920-932.)

An increase in investors' expectations of future returns could also cause a rise in market values over book values. Such an increase in expectations may be due to positive deviations (e.g., higher than projected sales) from the test year amounts upon which the company's rates are set or from earnings from sources other than the revenue requirement. Regardless of the cause, if the Commission were to authorize a utility to earn a rate of return on equity rate base in excess of the market required rate of return on common equity then earnings would increase further still, which in turn would inexorably increase the market value of that utility's common stock. The result is a never ending upward spiral as each successive increase in market value would lead to another increase in the allowed rate of return, which in turn would lead to a further increase in market value. (ICC Staff Exhibit 3.0, lines 933-949.)

Ms. Ahern also claimed that the R_M used in Ms. Phipps' CAPM is grossly understated because the market value of the S&P 500 was much higher than its book value and consequently the results of Ms. Phipps' risk premium analysis are understated. (Aqua Exhibit R-3.0, lines 181-186.) Ms. Phipps testified that Ms. Ahern confused required rates of return on market equity with expected rates of return on book equity. The market value of an investment is an estimate of future earnings discounted at the required rate of return. The required rate of return is based on investors' time value of money and the assessed risk of the investment. If the required rate of return rises, all else held constant, the price of an investment will fall. Conversely, if the price of an investment has risen, all else constant, the investor required rate of return must have fallen. The market price of a common stock does not achieve equilibrium until the expected rate of return on the common stock equals the investor-required rate of return. In contrast, the book value of common stock does not respond to changes in the investor-required rate of return. (ICC Staff Exhibit 3.0, lines 1398-1413.)

The groundless nature of Ms. Ahern's claim that Ms. Phipps' estimate of R_M for her CAPM analysis is grossly understated due to a DCF bias is clear given that Ms.

Phipps' 13.54% estimate of R_M is higher than the 12.2% estimate of R_M Ms. Ahern calculated from historic, non-DCF, data. Ms. Ahern's claim of a downward DCF bias is unfounded. (ICC Staff Exhibit 7.0, lines 331-337.)

The Commission has rejected similar market-to-book value arguments in prior rate cases (*e.g.*, Order, Docket Nos. 02-0798/03-0008/03-0009 Cons., p. 87 (October 22, 2003); Order, Docket Nos. 92-0448/03-0239, p. 89 (October 11, 1994,); Order, Docket No. 97-0351, p. 24 (June 3, 1998).) Importantly, in Aqua's most recent rate proceeding, Docket No. 03-0403, the Commission's Order stated:

> The Commission also rejects the Company's suggestion that the DCF model produces a downward-biased cost of common equity due to a variation between the book and market values of common equity. The argument for a market-to-book ratio adjustment has been made, and has been rejected by this Commission, numerous times in previous cases. The Company's arguments here are not significantly different, and the Commission continues to find such arguments to be without merit.

(03-0403 Order, p. 42.)

(3) Capital Asset Pricing Model Beta

Ms. Ahern criticized Ms. Phipps for computing beta directly rather than using betas readily available from Merrill Lynch. (Aqua Exhibit R-3.0, lines 302-308.) Nothing in financial theory posits that it is inappropriate for an investor (or analyst) to calculate her own betas. Moreover, the Commission has approved Staff's regression beta estimates in past rate cases (*e.g.*, Order, Docket No. 02-0837, pp. 37-38 (October 17, 2003,); Order, Docket No. 02-0798/03-0008/03-009 Consolidated, p. 85 (October 22, 2003); Order, Docket No. 00-0340, p. 25 (February 15, 2001).) Importantly, the Commission Order for Aqua's last rate case, Docket No. 03-0403, states:

> Although the Company offered several criticisms of Staff's CAPM analysis, the Commission finds that it is reasonable. The Company failed to demonstrate a significant problem with either the betas or the market returns calculated by Staff. The Company's arguments that Staff's calculations are unnecessary and do not model investor behavior are unavailing. Estimating the Company's cost of common equity necessarily involves using proxies for unobservable information.

(03-0403 Order, p. 42.)

Despite Ms. Ahern's assertion to the contrary, Ms. Phipps did not have access to Merrill Lynch's published betas. Ms. Phipps was able to reproduce Merrill Lynch's beta estimation methodology, however, resulting in adjusted beta estimates of 0.36 for Ms. Phipps' water sample and 0.42 for her utility sample. Ms. Phipps confirmed the accuracy of her Merrill Lynch beta estimates by comparing them to Yahoo's published beta estimates, which are calculated using the same methodology as Merrill Lynch. The Merrill Lynch and published Yahoo betas are lower than Ms. Phipps' regression betas; hence, if she were to include the Yahoo/Merrill Lynch betas in her CAPM analysis, as Ms. Ahern's interpretation of EMH would require, her CAPM-derived cost of common equity estimate would be lower rather than higher. (ICC Staff Exhibit 7.0, lines 341-362.)

(4) Cost of Common Equity Recommendation

Ms. Ahern made the unfounded claim that Ms. Phipps' cost of common equity cost provides an insufficient risk premium. (Aqua Exhibit R-3.0, lines 337-351.) Ms. Phipps' cost of common equity is 10.07% and the concurrent yield on A-rated utility long-term debt was 5.81%. Thus, Ms. Phipps' cost of equity recommendation produces a risk premium of 4.26%.

In her attempt to demonstrate the insufficiency of Ms. Phipps' recommended rate of return on common equity, Ms. Ahern resorted to an invalid comparison of Ms. Phipps' cost of equity estimate to Aqua's embedded cost of debt, which reflects interests rates that Aqua locked in as early as 1988, rather than the interest rate Aqua would pay on new debt capital. (ICC Staff Exhibit 7.0, lines 399-415.) Ms. Ahern compounded her error by comparing Ms. Phipps' recommended cost of common equity and Aqua's embedded cost of debt, which Ms. Ahern infers has the investment risk of BBB-rated debt, to a risk premium calculated in relation to less risky Aaa-rated corporate bond yields. (ICC Staff Exhibit 7.0, lines 421-426; Aqua Exhibit R-3.0, lines 57-63.) That comparison is not useful since an equity risk premium measured relative to riskier debt rates will always be smaller than an equity risk premium measured relative to the rate on less risky, Aaa-rated debt.[8] Ms. Ahern's reliance on invalid comparisons to criticize Ms. Phipps' cost of common equity analysis once again only serves to demonstrate the validity of Ms. Phipps' cost of common equity analysis.

4. Conclusion

Ms. Phipps' overall cost of capital recommendation, incorporating her recommended capital structure, embedded cost of short-term debt, embedded cost of long-term debt, embedded cost of preferred stock and cost of common equity, is 8.66%. (ICC Staff Exhibit 7.0, Schedule 7.1.) The record demonstrates Ms. Phipps' recommendations are based upon the valid application of sound financial theory, and Ms. Ahern's criticisms are without merit. Therefore, Staff recommends that the

[8] While Staff does not agree that Aqua's debt would merit a BBB rating from S&P, Staff agrees that it would not merit a Aaa rating from Moody's.

Commission adopt Ms. Phipps' cost of capital recommendations to set rates in this proceeding.

Staff Proposal: Aqua Illinois, Inc.'s Average 2005
Weighted-Average Cost of Capital

Class of Capital	**Average 2005 Balance**	**Percent of Total Capitalization**	**Cost**	**Weighted Cost**
Short-Term Debt	$301,839	0.25%	2.52%	0.006%
Long-Term Debt	56,728,177	47.79%	7.18%	3.431%
Preferred Stock	382,372	0.32%	5.48%	0.018%
Common Equity	61,298,813	51.64%	10.07%	5.200%
Total	$118,720,615	100.00%		**8.655%**

V. 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

a) Staff’s Proposal

Staff witness Luth recommended the elimination of the current fourth usage block from the Vermilion rate structure (ICC Staff Exhibit 4.0, page 13, lines 249-255). Mr. Luth recommended the elimination of the fourth usage block because billed usage through the fourth usage block during the test year is insignificant, accounting for only ½ of one percent of total Vermilion usage, and only four percent of billed usage for the industrial customer class, which is the only customer class to which the rate would apply.

Company witness Monie objected to Mr. Luth’s proposed elimination of the fourth usage block, contending that the fourth usage block reflects that it is cheaper to provide large quantities of water to one customer and that the fourth usage block can be used by community leaders to attract and maintain industry (Aqua Ex. 4.0, page 10, line 246 through page 11, line 257).

In rebuttal testimony, Staff witness Luth retained his recommendation that the fourth usage block at Vermilion should be eliminated (ICC Staff Exhibit 8.0, page 8, line 163 through page 10, line 195). Mr. Luth explained that his proposed last block, the third block, already reflected a lower cost to provide large volumes of water to Vermilion customers with sufficient usage, and that the Company's proposed fourth usage block did not provide a significant discount in the total bill for a large customer who accounted for all of the test year usage billed through the fourth usage block. The Large Industrial usage rate, currently applicable only to Teepak in the Vermilion service area, demonstrates that the Commission will work with the Company to attract potential large water customers should the opportunity develop (ICC Staff Exhibit 8.0, page 8, line 163 through page 9, line 179).

In his surrebuttal testimony, Company witness Monie did not provide any additional reasons or reply to Mr. Luth's rebuttal testimony, except to repeat his opposition to the elimination of the fourth usage block (Aqua Ex. S-4.0, page 3, lines 42 through 45).

b) Argument

As Staff witness Luth demonstrated, the fourth usage block does not provide significant benefits to Vermilion customers because billing through the fourth usage block does not represent significant usage, only ½ of one percent of overall Vermilion usage and four percent of the Vermilion industrial class usage. Additionally, the reduction from the Company's proposed third usage block to the Company's proposed fourth usage block is not enough to make the fourth usage block something that might attract a potential large water usage customer to the Vermilion service area. Staff's proposed third usage block represents a significant reduction from the first two usage blocks. Staff's proposed third usage block rate is approximately only 51 percent of Staff's proposed first usage block, and only 66 percent of Staff's proposed second usage block (ICC Staff Exhibit 8.0, page 9, lines 169 through 171). Therefore, Staff's proposed three-usage block rate structure does reflect a lower cost of providing large volumes of water to a single customer. Indeed, Company witness Monie admitted that the difference between the third and fourth usage blocks (based on Staff's rebuttal position) is not significant. Tr., pp. 177-178. Since a three-usage block rate structure reduces billing complexity, with a third block rate significantly less than the rates for the provide a significant further reduction in test year billings for affected customers, Staff's proposed elimination of the fourth usage block from the Vermilion rate structure is appropriate.

2. Increase in Customer Charges

a) Staff's Proposal

Staff witness Luth proposed no changes in current customer charges, except the 6-inch turbine meter customer charge currently applicable only to Teepak (ICC Staff Exhibit 4.1, page 1 of 18, ICC Staff Exhibit 8.00, page 10, line 196 through page 11, line 215). Company witness Monie disagreed with Mr. Luth's proposed customer charges (Aqua Ex. R-4.0, page 11, line 259 through page 12, line 282, and Aqua Ex. S-4.0, page 3, line 48 through page 5, line 94). Among his other comments in surrebuttal testimony, Mr. Monie pointed out that Staff's proposed customer charge for the Teepak 6-inch turbine meter is higher than Staff's proposed customer charge that would be applicable to other customers with a 6-inch turbine meter (Aqua Ex. S-4.0, page 4, lines 73 through

75). Staff did not have an opportunity to respond to Mr. Monie's observation put forward for the first time in his surrebuttal testimony. Staff can accept a Teepak 6-inch turbine meter customer charge that would be the same as the 6-inch turbine meter customer charge for other Vermilion customers ($505.00 as proposed by Staff), but in order to recover 60 percent of Teepak's cost of service as recommended by Mr. Luth, the Teepak usage rate would necessarily be higher than the rate proposed by Staff because Teepak customer charge revenues would be lower under a lower customer charge.

b) Argument

As Mr. Luth explained, Staff's cost of service study ("COSS") shows that customer charges, at present rates, recover revenues in excess of customer costs (ICC Staff Exhibit 8.00, page 10, lines 196 through 208). As a result, an increase in customer charges is unnecessary and inappropriate. The Commission should reject the Company's various proposals to increase customer charges.

The purpose of a COSS is to determine how much of a utility's cost of service should be recovered from each group of customers (ICC Staff Exhibit 4.0, page 4, lines 64 through 68). Customer costs are recovered through the customer charge (ICC Staff Exhibit 4.0, Appendix A, page 19, lines 49 through 59). It is acceptable for some customers to pay a higher percentage increase than other customers within the same customer group if the COSS shows that increased test year costs should be recovered through the usage charge rather than the customer charge, as in this docket. Mr. Monie's comparison of two customers, one with a 6.5 percent increase versus an increase of 11.2 percent increase to the other customer, does not amount to rate shock for the customer with the larger increase, nor does it suggest discriminatory rates in favor of the customer with the lesser increase (Aqua Ex. R-4.0, page 11, lines 269-271).

Mr. Monie also suggested taking into consideration the effects of the Vermilion Qualifying Infrastructure Plant Surcharge ("QIPS") when determining the customer charge (Aqua Ex. S-4.0, page 3, lines 53 through 60). Mr. Monie is partially correct in pointing out that the QIPS indirectly increases the amount paid as a customer charge because the QIPS is applied to all billing components, but it would not be correct to assume that because a customer's billing increases through the QIPS percentage applied to all charges that a customer charge in the next rate proceeding should remain at the QIPS-adjusted amount. Mr. Monie agreed that the QIPS is not a substitute for a COSS in future rate cases (Tr., p. 181, lines 10 through 14), and was not aware of any Company plans to cancel the QIPS tariff (Tr., page 180, line 17 through page 181, line 1). As a result, Vermilion customers will be subject to a QIPS that will continue to increase their billings. Using Mr. Monie's reasoning, the customer charge would continue to increase in future rate cases as a result of future QIPS, regardless of whether a COSS in a future rate case indicates that the customer charge should remain unchanged. Since the COSS in this docket indicates that the current customer charge, "unadjusted" for the current QIPS, overrecovers customer costs, the current customer charge should not be increased, even if it means that billings to very small-volume customers would be increased by a percentage less than the amount of increase to higher-volume customers. Customer charges should not be increased simply because of a QIPS that does not take into consideration cost of service differences.

Since the COSS indicates that customer charges should not be increased, the Commission should accept Staff's proposal to leave current customer charges unchanged.

3. Teepak (Large Industrial Customer Class)

a) Staff's Proposal

Staff witness Luth proposed an increase in rates applicable to the Large Industrial rate, which currently has one customer -- Teepak, to a level that would recover only 60 percent of the Teepak cost of service (ICC Staff Exhibit 4.1, page 2 of 18). Staff's proposed increase is more than the percentage increase Staff proposes for other classes (Id., ICC Staff Exhibit 8.1, page 2 of 18), but Staff's proposed rates for Teepak nevertheless recover considerably less than the Teepak cost of service while recovering more than cost of service from the other Vermilion rate classes (Id.) The Company opposes Staff's proposed rates for Teepak and proposes an increase of approximately six percent, which is one percent above the current Teepak rates adjusted by the QIPS (Aqua Illinois Exhibit 4.0, page 5, lines 15 through 24).

b) Argument

Teepak represents approximately 18.49 percent of the Vermilion test year usage, but only 5.96 percent of metered revenues under Staff-proposed rates (ICC Staff Exhibit 8.00, page 11, lines 225 through 229). Staff's proposed rates for Teepak therefore represent less than one-third of the average cost per unit of water from Vermilion (5.96 divided by 18.49), while recovering only 60 percent of the Teepak cost of service. With an average cost per unit of water under Staff's proposed rates of only one-third of the

Vermilion-wide average cost per unit of water, and revenue recovery of only 60 percent of Teepak's cost of service, it is clear that Teepak would be receiving a significant benefit from the Commission relative to Aqua's costs if Teepak continued to be an Aqua customer under Staff's proposed rates.

The Company provided two basic reasons for proposing an increase to Teepak that is significantly less than the overall percentage increase to other customers. In direct testimony, the Company's proposed Teepak rates were based primarily upon the belief that increased water rates would present a threat to Teepak's continued presence in the Vermilion service area, and the consequence to the Danville area economy in general and current Teepak employees specifically should Teepak close its Danville plant (Aqua Illinois Exhibit 4.0, "Cost of Service and Tariff Design Studies, page 6). Staff witness Luth evaluated this threat and concluded that, Staff's proposed increase in water rates represents a minor increase in comparison to Teepak's annual revenues and would not be a sufficient reason for Teepak to leave an established manufacturing facility with experienced workers producing its products (ICC Staff Exhibit 4.0, page 14, line 278 through page 15, line 283). Staff's proposed increase would represent less than 2/10^{ths} of one percent of Teepak's revenues from North America, and provide Teepak with a subsidy from other Vermilion customers of 40 percent of its cost of service. Staff finds it difficult to accept that Teepak, with $100 million in annual revenues, would leave its established manufacturing facility solely as a result of Staff's proposed increase in water rates of less than $200,000 compared to Aqua's proposed $27,000 increase. Staff reasonably believes that if Teepak were to leave the Danville area, the reasons for leaving would involve more significant costs than Staff's proposed increase in water costs.

Aqua then offered the rebuttal testimony of a Teepak employee, Mr. Mark Niedenthal, in support of a percentage increase less than the increase to other Vermilion customers (Aqua Ex. R-5.0). Mr. Niedenthal's testimony discussed Teepak's consideration of constructing its own treated water supply as a substitute for continuing to purchase treated water from Aqua. While his rebuttal testimony stated Teepak's current estimate of constructing a well water treatment plant (Id., page 3, line 58 through page 4, line 77), it did not address the operating and maintenance costs of owning its own water treatment facility. Mr. Niedenthal's rebuttal testimony discussed how operating costs for the water treatment facility at a South Carolina location formerly owned by Teepak did not increase during the years 1997-2000 (*Id*. page 4, line 78 through page 5, line 90), but his testimony did not provide the actual costs of operating that facility. Without the operating and maintenance costs of the potential Teepak water treatment facility, it is not possible to determine whether Aqua's proposed rates for Teepak are adequate.

If Teepak was able to build and operate a new water treatment facility with the result that Teepak was able to provide its own treated water for a small percentage of the cost from Aqua, the question becomes: How can Teepak, which is not a water treatment or distribution company, build and operate a new water treatment facility at a small percentage of the cost from Aqua, a professional water treatment and distribution company, even if the rate from Aqua is less than one-third of the average cost per unit of water? The answer to that question would be that Teepak is overly optimistic in its estimated costs to treat water for its needs, that Aqua's costs are excessive, or some combination of an understated Teepak estimate and excessive Aqua costs. An overly optimistic Teepak estimate of the costs to build, operate, and maintain its own water treatment facility would make that option less attractive to Teepak in reality.

Staff's proposed Teepak rates are reasonable and represent a significant effort to retain Teepak as an Aqua customer based upon Aqua's costs by continuing to provide a significant discount from Teepak's actual cost of service. Staff's proposed rates for Teepak would require other Vermilion customers to pay more than each customer would otherwise pay if Teepak were to pay its full cost of service. If Teepak were to leave the Vermilion service area as an employer and economic presence, the reasons for its departure would have far more to do with other costs than Staff's proposed increase in Teepak's water supply costs. If Teepak were to leave Aqua's system as a customer, but remain in Danville because it was able to cost-effectively build, operate, and maintain a new water treatment facility, despite Staff's proposed steeply discounted rate, Aqua should strongly consider why it cannot competitively provide water to Teepak under those apparently favorable conditions. While it may be appropriate to take into account factors other than cost of service in setting class revenues, cost of service principles should not be totally disregarded. Staff's proposal strikes an appropriate accommodation of cost of service principles and the non-cost of service factors advanced by the Company. In this docket, the Commission should adopt Staff's proposed rate design for Teepak and all other Vermilion customers.

VI. CONCLUSION

WHEREFORE, for all the reasons set forth herein, the Staff of the Illinois Commerce Commission respectfully requests that its recommendations be adopted in this proceeding. Specifically, Staff, as presented in Appendix A attached hereto, requests that the Illinois Commerce Commission approve its recommended rate base of $42,003,186, as found on ICC Staff Exhibit 5.0 C, Schedule 5.3 C; cost of capital of 8.66%, as found on ICC Staff Exhibit 5.0 C, Schedule 5.1 C and ICC Staff Exhibit 7.0, Schedule 7.1; revenue requirement of $11,827,417, as found on ICC Staff Exhibit 5.0 C, Schedule 5.1 C; and rate design as found on ICC Staff Exhibit 8.1, page 1 of 2.

Respectfully submitted,

____

LINDA M. BUELL
Office of General Counsel
Illinois Commerce Commission
527 East Capitol Avenue
Springfield, IL 62701
Phone: (217) 557-1142
Fax: (217) 524-8928
e-mail: lbuell@icc.state.il.us

CARMEN L. FOSCO
Office of General Counsel
Illinois Commerce Commission
160 North LaSalle Street
Suite C-800
Chicago, IL 60601
Phone: (312) 814-2865
Fax: (312) 793-1556
e-mail: cfosco@icc.state.il.us

Counsel for the Staff of the Illinois Commerce Commission

December 10, 2004