STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Aqua Illinois, Inc.	)	
	)	Docket No. 04-0442
Proposed general increase in water rates.	)	

INITIAL BRIEF ON EXCEPTIONS OF AQUA ILLINOIS, INC.

Dated: March 25, 2005

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I.
Introduction

The Proposed Order contains a number of conclusions that are contrary to the law, the evidence and a recent Commission rate case Order involving Kankakee (Docket No. 03-0403 entered April 13, 2004)("Kankakee Order") -- another division of Aqua Illinois, Inc. ("Aqua" or "Company"). This Brief on Exceptions addresses each of the erroneous conclusions. Two conclusions, which are contrary to the recent Kankakee Order, merit further discussion in this Introduction.

This matter cannot be considered in a vacuum. Less than one year ago, the Commission entered its Kankakee Order involving Vermilion's sister division. In the Kankakee Order, among other things, the Commission made determinations with regard to the Company's appropriate return on equity and Incentive Compensation Plan (the "Plan"). Despite the fact that the Commission entered the Kankakee Order less than a year ago, and that these conclusions are relevant to this proceeding, the Proposed Order makes two findings that are fundamentally inconsistent.

The first error concerns the appropriate return on equity for Aqua's divisions. In particular, the Proposed Order determines that Aqua should be allowed a return on equity for Vermilion that is *lower* than what the Commission determined to be appropriate for Aqua in the Kankakee Order. This conclusion fails to reflect the fact that interest rates have increased since the Commission's entry of the Kankakee Order. Moreover, the Proposed Order fails to make an upward 30 basis point ("bps") adjustment for risk evidenced by Aqua's NAIC-2 rating - an exact adjustment that the Commission made in its Kankakee Order. The Proposed Order's conclusion on Aqua's return on equity is in direct contravention to the Kankakee Order. Accordingly, the Commission should amend the Proposed Order as reflected herein.

The second error concerns the Company's Incentive Compensation Plan. In the Kankakee Order, the Commission determined that the Plan was reasonable and that it provided benefits to rate payers. (Kankakee Order, p. 15). The exact same Plan is at issue in this case. The evidence demonstrates that there simply is no material difference as the same Plan applies across all Aqua divisions. In this proceeding, Aqua provided substantial testimony and evidence demonstrating that expenses incurred under the Plan are reasonable. Nonetheless, the Proposed Order disallows all costs incurred under the Plan, stating erroneously that there is insufficient evidence concerning benefits to ratepayers. Such a conclusion disregards the Commission's Kankakee Order of less than a year ago as well as the evidence in this proceeding.

In sum, the Commission must amend the Proposed Order to comport with the law, the evidentiary record and the Kankakee Order. Exception language to make the amendments requested herein along with the resultant changes in rate inputs are set forth in Appendix A.

II.
Argument

A. Return On Equity

The Proposed Order draws the erroneous conclusion to allow Aqua an insufficient 10.07% return on common equity for its Vermilion division when Aqua presented substantial evidence that it should be allowed a return of 10.75%. The 10.07% return is inadequate for numerous reasons but most clearly because it does not reflect risk unique to Aqua, and that the Commission recognized very recently in its Kankakee Order. It is also against the evidence because the allowed return is lower than the 10.16% the Commission authorized for Aqua in the Kankakee Order even though interest rates have increased significantly and continue to rise. While Aqua's requested return of 10.75% is fully supported, correcting for either of these errors would produce a return of either 10.37% or 10.49%, respectively, a more appropriate return than the 10.07% the Proposed Order adopted.

1. The Commission should adjust the authorized return on equity to reflect Aqua's unique risk evidenced by its NAIC-2 rating.

The Proposed Order adopts Staff's common equity analysis as the basis for the approved common equity cost rate of 10.07%. However, Staff's analysis assumes a credit rating of A for Aqua and the sample group companies. (*See* Staff Ex. 3.0, pp. 8-9, 13-14). This assumption does not hold true for Aqua. Rather, the evidence establishes, as it did in the Kankakee Order, that Aqua's debt issuances have been assigned a rating of NAIC-2. (Aqua Ex. 3.0, p. 14; Response to Staff Data Request FD-33). An NAIC-2 rating is equivalent to Moody's Baa1, Baa2 and Baa3 and Standard and Poor's ("S&P's") BBB+, BBB and BBB- bond ratings. (Aqua Ex. 3.0 at 14). Accordingly, the Commission held in its Kankakee Order:

> In this context, it is appropriate to consider all available information of record, including the rating of NAIC-2 on certain of [Aqua Illinois'] securities issues. When compared to the credit rating of A discussed earlier [i.e., the same rating Staff's analysis assumes in this case], the rating of NAIC-2, or a comparable S&P rating of BBB, indicates the presence of some additional risk factor not already explained.

(Kankakee Order, p. 43). The Commission accounted for Aqua's unique risk by adding 30 basis points ("bps") to the return derived by Staff's analysis. (*Id.*) While the Proposed Order states that "the precedential value of [the Kankakee Order] toward the instant case is quite strong," (Proposed Order, p. 43), it nonetheless erroneously departs from the Kankakee Order on this sole return on equity issue by failing to adjust the return Staff's analysis derives by 30 bps to account for Aqua's individual risk that its NAIC-2 rating evidences.[1] (*Id.*, pp. 44-45).

The Proposed Order's rationale for departing from the Commission's holding on this issue is flawed. In particular, the Proposed Order states that no adjustment is necessary in this case because Staff performed a quantitative risk analysis that showed Aqua to be equal in risk to Staff's water utility sample group. (Proposed Order, p. 45). However, Staff's quantitative risk analysis, like the rest of Staff's analysis, erroneously assumed a credit rating of A. (*See* Staff Ex. 7.0, p. 10 (Staff using the same water and utility samples as in its main analysis)). Contrary to Staff's assumption, Aqua's NAIC-2 rating is equivalent to an actual credit rating of BBB. (*See* Kankakee Order, p. 43 (making this very finding)). Moreover, Staff did not do a complete risk analysis but rather, based on only four factors, simply concluded that Aqua, a water utility, is more similar in risk to Staff's water utility sample than to Staff's utility sample, which consists of natural gas distribution and combination electric and gas distribution companies but no water companies. (Staff Ex. 7.0, p. 9, Sch. 7.3). Accordingly, an adjustment is necessary.

Further, the Proposed Order's statement that an adjustment would produce a return of 10.37% that is higher than the 10.18% return that Aqua's own analysis produced is factually incorrect. (Proposed Order, p. 45). Aqua's analysis derived a common equity cost rate of 11.35% even though Aqua only requested a return of 10.75%. (Aqua Ex. 3.0, pp. 3, 62; Proposed Order, p. 43). Even limiting Aqua's analysis to the Discounted Cash Flow ("DCF") and CAPM models, which is what the Proposed Order suggests, (Proposed Order, pp. 44),

[1] The Proposed Order also states incorrectly that Aqua witness Ms. Ahern's reference to Dr. Morin's opinion in support of her empirical Capital Asset Pricing Model ("CAPM") analysis is hearsay. (Proposed Order, p. 43 n.2). However, while the Commission may have found this to be the case in the Kankakee Order, a material change in the facts has occurred. Dr. Morin testified to his opinion on the empirical CAPM. (MidAmerican Ex. 8.2, Docket 01-0444). Dr. Morin's opinion, therefore, is no longer hearsay. (*People v. Lawson*, 193 Ill. App. 3d 396, 398 (1990)). Further, it also qualifies for admission under the Commission's rules because Dr. Morin's testimony as to his opinion is publicly available and is the type of information upon which a reasonably prudent person would rely in the conduct of his affairs. 83 Ill. Adm. Code §200.610.

however, does not support the statement. This is because the return produced by Aqua's DCF and CAPM models, while admittedly 10.18%, does not account for Aqua's NAIC-2 rating any more than Staff's analysis does. The companies that comprise the sample groups in Aqua's analysis, as in Staff's analysis, are companies with A credit ratings. (Aqua Ex. 3.0, pp. 63-64). Therefore, the result of Aqua's analysis also needs to be adjusted to account for Aqua's NAIC-2 rating. (*Id.*) This means that the 10.18% produced by Aqua's DCF and CAPM analysis has to be adjusted to 10.48% to account for Aqua's NAIC-2 rating.

The Proposed Order compares apples to oranges when it compares the 10.37% return supported by Staff's analysis as adjusted for Aqua's NAIC-2 rating to the 10.18% return derived by Aqua's DCF and CAPM analyses *without* adjusting for Aqua's NAIC-2 rating. The 10.18% return as adjusted for Aqua's NAIC-2 rating equals 10.48% -- an amount that is obviously higher than the 10.37% return that the 30 bps adjustment to Staff's analysis would derive. Aqua is not recommending a return that is greater than the return its own analysis supports.

Therefore, the common equity cost rate derived by Staff's analysis should be adjusted for the unique risk evidenced by Aqua's NAIC-2 rating. The Commission should do so by adjusting the return Staff's analysis derives as the Commission did in its Kankakee Order. The Commission should add 30 bps to the results of Staff's analysis for a total return of 10.37%.

2. In the alternative, the Commission should adjust the authorized return on equity to account for a higher interest rate environment.

The ALJ's authorized return of 10.07% is lower than the 10.16% return the Commission authorized for Aqua in the Kankakee Order in April 2004. However, the evidence establishes that interest rates are significantly higher today than in April 2004 and are expected to continue rising.[2] (Aqua Ex. R-3.0, p. 5). Today's higher interest rates means that capital costs, including the cost of common equity, have increased by up to 0.33% since the Commission's Kankakee Order. (*Id.*) It is unreasonable and contrary to the evidence for the Proposed Order to reduce Aqua's return on common equity in stark contrast to what has actually taken place in the economy. The Commission should correct this flaw by adjusting the 10.16% return authorized for Aqua in the Kankakee Order and authorizing a return of 10.49% to reflect increased interest rates.

The Proposed Order mistakenly does not recognize the flaw in its result. Instead, the Proposed Order erroneously rationalizes that, because the interest rate is not the only component of cost of equity, accounting for today's increased interest rates would somehow equate to the replacement of approved financial models with a risk premium process. (Proposed Order, p. 45). This simply is not the case. The 10.16% return the Commission authorized for Aqua in its Kankakee Order is based on approved financial models. This would not change. The 10.16% return derived from the models would simply be updated to recognize today's higher interest rates, which indisputably influence cost of equity as the Proposed Order even recognizes. (*Id.*) The Commission can only maintain full consistency with its Kankakee Order by accounting for the increase in interest rates. The Commission, therefore, should make the correction.

B. Operating Expenses

The Proposed Order also erroneously disallows recovery of a number of Aqua's legitimate operating expenses. These findings are erroneous because they are contrary to the evidence. In part, the findings also are inconsistent with the Commission's Kankakee Order and are based on incorrect legal standards. The Commission should amend the Proposed Order to allow Aqua to recover all of its prudent and reasonable operating expenses.

[2] In fact, on March 22, the Federal Reserve Board raised short term interest rates for the seventh consecutive time.

1. **Incentive Compensation – The Commission should allow recovery of Aqua's $33,790 in incentive compensation expense along with associated payroll taxes as it did in the *Kankakee Order*.**

The Commission found in its Kankakee Order that Aqua is entitled to recover expenses incurred under its Incentive Compensation Plan (the "Plan"). (Kankakee Order, p. 15). The Commission stated unequivocally:

> As a whole, the [incentive compensation] program appears to set targets for a broad range of objectives, rather than tying compensation directly to earnings performance. Many of the goals established by the Company promote ever-increasing water quality, customer service, and system safety. While investors may derive some benefit from certain cost reduction goals, the Commission is of the opinion that ratepayers are the primary beneficiaries of the incentive compensation program as a whole.

(*Id.*) Aqua's incentive compensation expenses at issue in this case are incurred under the exact same Plan.[3] (Aqua Cross Ex. 4). Yet, the Proposed Order disallows recovery. The Commission should correct this inconsistent ruling by allowing Aqua's recovery of its incentive compensation expenses along with associated payroll taxes.

Indeed, the Proposed Order's rationale for its inconsistent ruling – that Aqua did not satisfy its burden of proving that its Plan benefits ratepayers – is both legally and factually erroneous. (Proposed Order, pp. 22-23). The Commission already has ruled, as noted, that "ratepayers are the primary beneficiaries" of Aqua's Plan. (*Kankakee Order*, p. 15). While the Commission's decisions are not *res judicata*, the law is clear that its decisions cannot be arbitrary and capricious. *Commonwealth Edison Co. v. Illinois Commerce Comm'n.*, 180 Ill. App. 3d 899, 907, 536 N.E.2d 724, 729 (1st Dist. 1988) *as modified Feb. 14, 1989*. A clear violation of this standard is a decision that differs from a prior ruling as to the same facts. *People v. United States*, 666 F.2d 1066, 1073-74 (7th Cir. 1981). The Proposed Order's decision is just such a

[3] The evidence demonstrates that the Plan for which expenses are under consideration for recovery in this case is the exact same Plan in all material respects as the Plan the Commission considered in the Kankakee Order. (Tr., pp. 258-59; Cross Ex. 3). Both Plans were introduced into evidence as Aqua Cross Ex. 4.

violation because the evidence establishes the facts are the same. Aqua presented compelling, unrebutted evidence that its Plan is the exact same for Vermilion as it is for Kankakee.

In fact, in *ComEd*, the court held that a Commission decision to supercede rates it had determined to be in the public interest just two months earlier was arbitrary and capricious. 180 Ill. App. 3d at 907, 536 N.E.2d at 729. The Commission issued its Kankakee Order in April 2004 and this case was initiated in May 2004. A decision to supercede the Commission's ruling in its Kankakee Order, made just a single month before the initiation of this case, clearly would be arbitrary and capricious.

Further, while it was unnecessary for Aqua to re-litigate the Kankakee Order, Aqua did satisfy its burden of proof. The Commission has, as a matter of public record, all the information that supports its decision in the Kankakee Order that ratepayers are the primary beneficiaries under Aqua's Plan. Aqua presented undisputed evidence that its Plan for Vermilion is the same as its Plan for Kankakee. Staff did not demonstrate any material difference, nor could it have.[4]

Aqua, moreover, presented substantial evidence in this proceeding that its Plan provides appropriate incentives for its employees to take actions beneficial to ratepayers. (Aqua Ex. S-2.0, pp. 18-19, Sch. S-2.2). Aqua witness Mr. Schreyer testified to 51 examples of employees, including those in Vermilion,[5] who achieved goals that promote ever-increasing water quality, customer service and system safety. (*Id.*) The Proposed Order erroneously discounts these examples simply because some of the employees work in divisions of the Company other than Vermilion. (Proposed Order, p. 22). However, Aqua's Incentive Compensation Plan applies throughout *all* of its divisions including Vermilion. (Tr., pp. 118-19, 135). The Plan provides

[4] In fact, Staff admitted there is no material difference that would be a basis for disallowance. (Aqua Cross Ex. 3).

[5] Indeed, as noted in the payroll expense discussion below, employees in Vermilion managed the unplanned vacancies that occurred in recent years by contributing their unpaid time toward the duties associated with the vacant positions. Those employees certainly did so with the recognition that they worked for a company with an incentive compensation plan.

Aqua's employees with the same incentives regardless of company division. Aqua witness Mr. Schreyer testified without dispute on this issue. (*Id.*)

While the Proposed Order notes that shareholders benefit from some of the actions for which employees received compensation, this does not mean that Aqua's plan does not benefit ratepayers. The Commission's Kankakee Order directly addressed this asserted point when it ruled that "[w]hile investors may derive some benefit from certain cost reduction goals, the *Commission is of the opinion that ratepayers are the primary beneficiaries of the incentive compensation program as a whole*." (Kankakee Order, p. 15 (emphasis added)). Accordingly, Aqua does not need to establish that its Plan only benefits ratepayers to the entire exclusion of shareholders. Rather, it only needs to show that ratepayers are the overall primary beneficiaries.

Moreover, the evidence establishes that goals of improving efficiencies and controlling costs benefit ratepayers as well as shareholders by reducing the need for rate relief. (Aqua Ex. R-2.0, p. 23). Staff witness Ms. Ebrey concurred on this point. (Tr., pp. 263-64). That Aqua's customers have, in fact, received this type of benefit is evidenced by the fact that Aqua did not request rate relief for four years and, when Aqua did, its filing only requested a minimal 3.54% annual increase. (*Id.*)

The Proposed Order's ruling that all of this evidence is, nonetheless, insufficient is erroneous. Requiring even more evidence would, moreover, create an overly burdensome standard going forward. Presumably, the submission and examination of each and every employee's specific goals and targets would be required. While Aqua is a smaller utility, the standard would have to apply utility-wide, and the largest utilities would be burdened with presenting evidence related to potentially thousands of employees. Rather than conducting such a microscopic inquiry, the Commission should examine incentive compensation plans on a whole to assess if the plans are designed to give employees incentives to benefit ratepayers.

As the Company demonstrated before the Commission less than a year ago, incentive compensation is one component of an overall compensation program offered and paid to employees annually in order to attract quality personnel. It is a regular recurring cost of service, and a recognized and normal portion of a qualifying employee's overall compensation. It plays an integral role in Aqua's attraction and retention of qualified employees to the benefit of ratepayers. A decision to disallow these expenses would diminish Aqua's ability to maintain the program and its associated benefits. The Commission should modify the Proposed Order and, consistent with the Kankakee Order, allow Aqua's recovery along with associated payroll taxes.

2. Payroll Expense

a) The Commission should allow Aqua's full payroll expense recovery along with associated taxes because an adjustment based on historical factors will likely lead to future variances.

The Proposed Order mistakenly grants a $41,926 adjustment to Aqua's payroll expense recovery. It does so based on Staff's erroneous argument that an adjustment is necessary because Aqua's payroll expense varied from budget during the 2001 to 2003 period. (Proposed Order, pp. 13-14). The evidence showed Staff's argument to be seriously flawed.

The historical budget variances on which Staff based its argument are not probative of the accuracy of Aqua's test year budget. Rather, the evidence establishes the variances occurred because of intervening events that neither Aqua nor Staff anticipates will occur during the test year or any other future year. (Aqua Ex. R-2.0, pp. 15-17; Aqua Ex. S-2.0, p. 11; Tr., pp. 247-

48). The intervening events were (i) the occurrence of significant but unanticipated capital projects,[6] and (ii) temporary employee position vacancies. (Aqua Ex. R-2.0, pp. 14-15).

The Proposed Order misunderstands how these intervening events caused Aqua's historical payroll expense budget variances. With respect to the occurrence of significant but unanticipated capital projects, the Proposed Order states that "the effect of plant additions or replacements on payroll cost is indeterminate." (Proposed Order, p. 13). With respect to employee position vacancies, the Proposed Order states that it is "unclear" how the vacancies "cause any variance at all." (*Id.*) These statements demonstrate confusion on these points. However, the reasons the intervening events caused payroll expense budget variances are clear.

First, the unanticipated occurrence of significant capital projects necessitates a change in the accounting of labor costs from payroll expense to capitalized payroll. (Aqua Ex. R-2.0, pp. 14-15). In-house labor costs are accounted for as "payroll expense" except when the labor is expended on capital projects in which case the costs are accounted for as capitalized payroll. (*See e.g.*, 83 Ill. Adm. Code §285.3105 (separating payroll related to construction from general payroll)). At the time a budget is prepared, labor costs are allocated between payroll expense and capitalized payroll based on the capital projects that are expected to take place in the budget year. If capital projects are significantly greater than expected, labor costs originally budgeted as payroll expense will be redirected and accounted for as capitalized payroll. A payroll expense budget variance will result. The fact that Aqua had $1,438,518 more in capital projects during the historical period than expected caused just such a variance. (Aqua Ex. R-2.0, pp. 14-15).

Second, temporary employee vacancies also cause payroll expense budget variances because payroll expense is budgeted based on planned employment levels. If a vacancy occurs,

[6] Aqua added $1,438,518 more in property, plant and equipment than was expected during the 2001 to 2003 period. (Aqua Ex. R-2.0, p. 15).

the employee's salary budgeted as payroll expense will not actually be incurred and a budget variance will again result. The temporary vacancies, therefore, contributed to Aqua's historical budget variances. (Aqua Ex. R-2.0, pp. 14-15; Aqua Ex. S-2.0, p. 11).

The Proposed Order overlooked these causative factors when it decided to adjust Aqua's future test year budget due to historical payroll expense variances. This is problematic because, as noted, there is no evidence that these factors will exist to cause future budget variances. In fact, to the contrary, the evidence establishes undisputedly that neither factor is expected to do so. (Aqua Ex. R-2.0, pp. 16-17; Aqua Ex. S-2.0, p. 11). Staff did not even investigate whether either factor would impact Aqua's future budgets. (Tr., pp. 247-48).

It is appropriate to prepare a future budget based on factors that are expected to exist during the budget year. If one were to base a budget on any other factors, then the budget would not set forth accurate projections for the budget year. (Aqua Ex. R-2.0, pp. 15-17). The independent accounting firm London Witte Group, Inc. ("London Witte") found that Aqua correctly prepared its budget in accordance with these accounting guidelines. (Filing, Vol. 1, p. 4). The Proposed Order improperly discounts the importance of this evidence by stating that such compliance "does not imply that the budgeted costs necessarily are recoverable for ratemaking purposes." (Proposed Order, p. 13). However, while other factors such a prudency may factor into recovery, the evidence does demonstrate that Staff's adjustment, which is designed to set a future budget based on conditions that are not projected to exist in the budget year, is not appropriate and should not be adopted.[7]

[7] The Proposed Order also states erroneously that Aqua accepted a similar adjustment in the Kankakee proceeding. (Proposed Order, p. 13 *citing* Kankakee Order, p. 9). Aqua did not accept any such adjustment. The Commission, in fact, rejected Staff's proposal to design Aqua's future payroll expense based on historical conditions. (Kankakee Order, p. 12). The Commission reasoned that "it is *speculative* whether the same [historical] pattern will be observed during the future test year." (*Id.* (emphasis added)). Speculation again underlies Staff's current proposal.

By nonetheless making an adjustment to account for these factors the Proposed Order requires a test year budget that is at odds with projected conditions. This is likely to lead to budget variances rather than eliminate them. Proper accounting and budgeting principles dictate that budgets should reflect conditions that are anticipated to exist in the budget year as Aqua's budget does. (Aqua Ex. R-2.0, pp. 15-17). The Commission should reverse the Proposed Order's payroll expense adjustment and allow Aqua's recovery along with associated taxes.

b) The Commission should allow Aqua's full payroll expense recovery along with associated taxes because its payroll expense is fully supported.

The evidence establishes that Aqua efficiently managed its labor force since Vermilion's last rate case in 2000. Despite the influence of significant factors that drive labor cost increases, i.e., annual cost of living increases and Aqua's addition of more than 31.8% in utility plant plus the acquisition of the Indianola system, the Company requested $68,534 less in payroll expense than the Commission previously authorized. (Aqua Ex. R-2.0, p. 18; Aqua Ex. S-2.0, p. 16). The evidence shows that Aqua maintained its labor costs in check despite its need to manage the unexpected events discussed in the previous section. Aqua limited its overall variances for operations and maintenance, and utility operating expense to only .82% and .46%, respectively. (Aqua Ex. 2.0, p. 10-11).

The Proposed Order's adjustment would effectively penalize the Company for efficiently managing its labor costs. It amounts to a 3% penalty on Aqua for providing quality service almost to the dollar budgeted. To penalize Aqua for this achievement sends the wrong signal and denies Aqua a fair opportunity to earn its allowed return.[8] It sends the message that utilities should hire first and worry about whether the right person was retained later.

It could also have the very real and serious potential to negatively impact Aqua's ability to continue operating and managing its plant efficiently and with high quality service. (Aqua Ex. S-2.0, pp. 16-17). A $41,926 adjustment to an already lean labor force/expense can only risk compromising the high quality of service Aqua's customers demand. Aqua has proven its ability to provide quality service while maintaining its labor costs. The adjustment would place Aqua in the precarious position of maintaining service quality with increasingly limited resources.

Indeed, Aqua's historical payroll variance, as noted, was due in part to *temporary* position vacancies. A *permanent* reduction in payroll would place Aqua in the position of either reducing employee levels or reducing wages in real time. (*Id.*) However, there has been no suggestion that any employee position is unjustified or should be eliminated. (Tr., p. 237-38). Should Aqua be forced to eliminate a position, the position's duties would, nonetheless, still exist and the remaining employees, who would have to makeup for the shortfall, would be unduly burdened. Alternatively, a reduction in real wages would be damaging to employee moral and significantly impair Aqua's ability to maintain and attract quality personnel. (Aqua Ex. S-2.0, pp. 16-17). Cutting funds budgeted to pay for an employee compliment that is fully justified, again, simply sends the wrong signal. The Proposed Order does not mention the impact its adjustment will have on Aqua's ability to maintain a solid and qualified work force.

The irrationality of such a cut is exacerbated by the fact, as noted above, that two factors have been driving payroll increases. First, the annual cost of living drives wage increases in real dollars. (Aqua Ex. S-2.0, p. 16). The Proposed Order does not even mention this factor.

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[8] Importantly, the penalty would also drive Aqua's capital cost higher because it increases risk, a factor that neither Staff nor Aqua witness Ms. Ahern accounted for in their analyses.

Second, Aqua's utility plant in service is projected to have increased by more than 31.8% in addition to the Indianola system, which Aqua acquired in 2003. (Aqua Ex. R-2.0 p. 18). This significant growth drives cost increases because additional labor is required to operate and manage the additional plant. (*Id.*, p. 16). The Proposed Order disregards the importance of this evidence. It states that "[a]lthough the replacement plant or equipment may have a higher original cost attributed to the plant in service, the maintenance cost is lower or comparable to that being replaced." (Proposed Order, p. 13). There is no evidentiary foundation for this conclusion. Staff counsel asked Aqua witness Mr. Schreyer if this very conclusion holds true, and Mr. Schreyer testified that it does not. (Tr., pp. 128-29). Aqua's acquisition of what was the troubled Indianola system certainly did not make the jobs of Aqua's employees easier.

The evidence supports Aqua's full payroll budget. The Commission should not place Aqua in the position of trying to maintain quality service with a shrinking payroll budget, the results of which can only be problematic and unfair. The Commission should allow Aqua to recover its full payroll expense along with associated taxes.

c) In the alternative, the Commission should allow the offsetting adjustment to Contractual Services.

As noted, employee vacancies means some anticipated labor costs are not actually incurred in the form of employee salaries. A position vacancy, however, does not mean that the duties associated with the position have disappeared. Rather, the labor is still performed through alternative means such as by other employees working unpaid overtime or through the hiring of outside contractors. (Aqua Ex. R-2.0, pp. 14-15; Aqua Ex. S-2.0, p. 11). Accordingly, a negative payroll expense variance will also likely lead to a positive contractual services variance.

The evidence establishes that historical contractual services variances, in fact, occurred to offset Aqua's historical payroll expense variances. (Aqua Ex. R-2.0, pp. 13-14). On average, Aqua experienced a $109,259 *positive* budget variance for contractual services compared to the $90,129 *negative* adjustment Staff requested based on Aqua's historical payroll variances. (Tr., pp. 249-50). If the Commission, for some reason, adopts the Proposed Order's $41,926 payroll expense adjustment, then the Commission should also adopt the equal offsetting adjustment to Aqua's account for outside contractual services - other.

In fact, should such an offsetting adjustment not be made, future budget variances will, once again, likely result. To explain, because of the offsetting relationship between payroll and contractual services, Aqua's historical budget was very accurate overall despite its payroll variances. Over the three year combined historical period, Aqua's Vermilion division had an operations and maintenance variance of only .82% and a utility operating expense variance of only .46%. (Aqua Ex. R-2.0, p. 10-11). Had Staff's proposed one-sided payroll adjustment been imposed historically, it would have caused variances of 4.13% and 2.05% respectively rather than the *de minimus* variances of less than a single percent that actually occurred. A one-sided adjustment would likely cause similar variances in future budgets.

The Proposed Order does not address Aqua's request for this offsetting adjustment; but, it does note the fact that Aqua is accounting of sludge hauling expense in contractual services for the first time in the test year budget. (Proposed Order, p. 14). This is an important point because Staff had opposed making the offsetting adjustment to contractual services simply because Aqua's test year budget for contractual services is greater than it has been historically. (Staff Ex. 6.0, p. 5: Tr., p. 252). While Staff testified that it did not investigate or know the reason for the increase, (Tr., pp. 250-54), the undisputed evidence establishes that Aqua's first-time inclusion of sludge hauling expense is the only reason for the increase. Without the sludge hauling inclusion, Aqua's contractual services budget actually fell from historic levels by $122,512.

Accordingly, an offsetting adjustment would be necessary should the Commission adopt the Proposed Order's adjustment to Aqua's payroll expense.

3. Rate Case Expense - The Commission should allow Aqua's recovery of its $102,000 increase in legal fees because the evidence supports the fact that Aqua actually incurred the fees.

The issue before the Commission is whether Aqua supported its increase in rate case expense that is attributable to increased legal fees.[9] Aqua submits that the record contains compelling, unrebutted evidence that fully supports its increase. In particular, Aqua witness Mr. Jack Schreyer testified as to what legal fees Aqua actually incurred and their relationship to the Vermilion rate case. (Aqua Ex. R-2.0, pp. 39-40; Aqua Ex. S-2.0, pp. 30-31). In addition, Aqua presented into evidence invoices that document the facts to which Mr. Schreyer testified as to the legal expenses Aqua incurred in the prosecution of the case. (Aqua Ex. H-2.0).

The Proposed Order, however, disregards entirely Mr. Schreyer's testimony as to the facts and, in so doing, fails to give this testimony any weight. Rather, the Proposed Order incorrectly focuses on Aqua's legal invoices alone, and then draws the erroneous conclusion that they should be "accorded no weight" because Aqua *allegedly* provided "unsupported summaries" rather than actual invoices.[10] (Proposed Order, p. 40). The Proposed Order's conclusion should be reversed because (i) Aqua presented the unrebutted testimony of Mr. Schreyer, and (ii) Aqua submitted its *actual* legal invoices as documentary support of the facts to which Mr. Schreyer testified. (Aqua Ex. H-2.0 (the actual invoices); *see also* Tr., p. 87 (Aqua's

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[9] Aqua included in its filing the original amount it estimated for rate case expense of $220,740 and the Proposed Order allows Aqua's recovery of the original estimate. However, Aqua presented evidence of a $102,000 increase in its legal fees due to the number and significance of issues that have been addressed in this case. The Proposed Order erroneously disallows Aqua's recovery of this increase in its expense.

[10] Staff did not even make this argument. While the Proposed Order states that Staff did, in fact Staff only asserted that Aqua's legal invoices did not look like ones Staff had reviewed in the past. Staff witness Ms. Everson testified that Aqua's legal invoices should not be disallowed as a basis for updated rate case expense simply because they look different than invoices Staff had reviewed previously. (Tr., pp. 220-21). Indeed, the reason Staff would even question the format of the invoices is unknown as Staff accepted invoices from all entities other than Aqua's legal counsel at face value. (Tr., p. 86).

counsel stating that the documents are the actual invoices to Aqua for counsel's prosecution of this case)).

The Proposed Order also compounds this error by applying the wrong standard for analyzing the issue. It states that Staff did not have sufficient time to review Aqua's invoices.[11] The question of how much time Staff may have had to review the information is irrelevant to the analysis. The timeliness of disclosure is a procedural issue that may go to the admissibility of evidence. *See Bachman v. General Motors Corp.*, 332 Ill. App. 3d 760, 791-92 (4th Dist. 2002). But, it is not a factor that goes to the merits of the evidence. It is not a legal basis to disregard evidence once it is admitted into evidence. Aqua's legal invoices were admitted into evidence at the hearing. The invoices support the Company's proposed rate case expense and should be given evidentiary weight.

Irrespective, however, the Company's rate case expense increase is fully supported by Mr. Schreyer's undisputed testimony. Mr. Schreyer established both the amount and the relation of the legal fees to the prosecution of this case. The Commission should reverse the Proposed Order's decision to disallow $102,000 in Aqua's legal fees as rate case expense. Aqua should be allowed to amortize its rate case expense increase over three years at $34,000 annually.

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[11] Indeed, the Proposed Order erroneously states that Staff had insufficient time to review the legal invoices. Aqua informed Staff of the amount of its legal fees months before the hearings. (Aqua Ex. R-2.0, p. 39 (Aqua witness Mr. Schreyer testifying to the amount of Aqua's legal fees)). Staff never questioned the veracity of Mr. Schreyer's testimony on this issue. Aqua's actual bills are simply documentary support. Moreover, as the Proposed Order correctly notes, they are not voluminous -- "[t]he six legal bills are not a voluminous series of documents." (Proposed Order, p. 40). It is not time consuming to confirm the numbers stated on the invoices. Staff simply chose not to look at the bills even though it had them the week before the hearing. (Tr., p. 216).

4. Charitable Contributions

a) The Commission should allow Aqua's recovery of a $10,000 donation to the Danville Area Economic Council because it was for a purpose that satisfies the statutory standard.

The Proposed Order incorrectly finds that Aqua should not recover its Danville Area Economic Counsel donation even though the donation was for a public purpose simply because Aqua made the donation in the form of membership dues payments. (Proposed Order, p. 31). This ruling elevates form over substance, and the Commission should reverse.

Section 9-227 of the Act mandates that the Commission allow as operating expenses donations made "for the public welfare or for charitable scientific, religious or educations purposes, provided that such donations are reasonable in amount."[12] 220 ILCS 5/9-227. Here, the Proposed Order finds that the donation was for a public purpose, and the evidence fully supports this finding. Aqua witness Mr. Schreyer testified that the Council uses the donation in its work to maintain the prosperity and viability of the community, for example by recruiting new businesses, which work benefits all consumers who work and reside in the area. (Aqua Ex. R-2.0, p. 33). Mr. Schreyer also explained that the Council's work benefits consumers in their water rates because community development drives an increase in the number of water customers to share costs. (*Id.*) The statutory purpose is satisfied, as the Proposed Order found.

Nonetheless, the Proposed Order cites to Commission decisions wherein the Commission held that "industry association dues" do not satisfy the standard for recovery. (Proposed Order, p. 31). The Danville Area Economic Council is not an "industry association." The purpose of the Danville Area Economic Counsel is not to provide networking opportunities like an industry association, and Aqua in fact does not receive any such benefits. (Aqua Ex. S-2.0, p. 27). To

[12] There was no question as to the reasonableness of the amount of Aqua's donations.

equate the Danville Area Economic Council with an industry association simply because Aqua makes its donation to the Council in the form of membership dues places form over substance.

Indeed, it is notable that the Proposed Order cites the Kankakee Order as one of the Commission decisions articulating the standard for recovery and notes that Aqua's donation to the Danville Area Economic Council was at issue in that case. (Proposed Order, p. 31). In the Kankakee Order, the Commission did not reach the merits of Aqua's recovery of its donations to community or economic development associations. Rather, the Commission concluded that it was unable to determine recoverability because no evidence was presented as to whether the donations were "for the public welfare" -- the statutory standard for recovery. (Kankakee Order, pp. 18-19). The Commission specifically stated that its decision not to allow recovery for lack of such evidence did not create a presumption as to the merits of the issue for future recoverability. (*Id.*, p. 18).

In this case, Aqua has fully satisfied its burden. It has proven, as the Proposed Order finds, that its donation to the Danville Area Economic Counsel was made for a purpose that is intended to promote the public welfare. (Proposed Order, p. 31). It is appropriate to make this resolution on the merits of an issue the Commission left unresolved in its Kankakee Order. The Commission should allow Aqua's recovery.

b) The Commission should allow Aqua's recovery of $2,225 in educational scholarships because their purpose also satisfies the statutory standard.

The Proposed Order also errs by disallowing Aqua's recovery of donations made for what are indisputably educational purposes. (Proposed Order, p. 32). The Proposed Order, while commending Aqua for making the donations, nonetheless states the expenses are not recoverable simply because the recipients are individuals rather than organizations. (*Id.*) In doing so, the Proposed Order reads into the statutory standard a requirement for recovery that does not exist. (cite). Nowhere within Section 9-227 is there any requirement that a charitable recipient be an organization. Rather, Section 9-227 mandates the Commission "shall" consider as operating expenses donations made "for the public welfare or for … educational purposes." This standard is fully satisfied by Aqua's educational scholarships. The Commission should allow recovery.

5. Advertising Expense - The Commission should allow Aqua's recovery of its customer informative advertisements.

The Proposed Order incorrectly rules that Aqua's advertisements that provide important information to customers regarding water quality, water service and rates are not recoverable. (Proposed Order, pp. 27-28). Section 9-225 of the Act states that utilities should recover the expense of advertisements that are "in the best interest of the Consumer."[13] 220 ILCS 5/9-225. The Proposed Order's ruling is erroneous because it is within customers' best interest to receive the information that Aqua's advertisements provide. Aqua presented undisputed evidence that consumers believe it is in their best interest to receive the information in Aqua's advertisements and that consumers would, in fact, prefer increased advertising.[14] (Aqua Ex. S-2.0, p. 25).

a) Advertisements to inform of environmental compliance.

The Proposed Order erroneously concludes that advertisements informing customers of Aqua's environmental compliance are not recoverable. (Proposed Order, p. 28). However, it is in the best interest of consumers to receive this information. The advertisement in question, in

[13] The Proposed Order notes that Aqua does not agree that Section 9-225 applies to water utilities; and, by its plain language, Section 9-225 does not. The Proposed Order then states incorrectly that if Section 9-225 does not apply then there is no basis for water utilities to recover advertising expenses. (Proposed Order, p. 27). To the contrary, under Section 9-201, the Commission has the authority to establish just and reasonable rates, which should recover all operating expenses. A specific statute authorizing recovery is not necessary.

[14] Staff did not object to the introduction of this evidence. The Proposed Order, nonetheless, incorrectly discounts this evidence as hearsay and speculation. Aqua witness Mr. Schreyer was entitled to introduce the evidence as the basis for his opinion that it is in the best interest of consumers to receive Aqua's advertisements. *Caponi v. Larry's 66*, 236 Ill. App. 3d 660, 676 (2nd Dist. 1992). A reasonably prudent person would also rely on the evidence in the conduct of his affairs. 83 Ill. Adm. Code §200.610. Moreover, consumers' statements about whether they in fact have found Aqua's advertisements beneficial do not constitute speculation. This evidence should be given weight.

particular, informs customers of Aqua's compliance with the Illinois Environmental Protection Agency's drinking water regulations. (Aqua Ex. S-2.0, p. 23). This is information that goes directly to the quality of water that consumers are drinking. Consumers should be informed that the water they drink satisfies environment standards. (*Id.*) Recovery should be allowed.

b) Advertisements to inform of existing rates.

The Proposed Order also finds incorrectly that Aqua's advertisements that inform consumers of their water rates are promotional. (Proposed Order, p. 28). However, Aqua has no need to engage in self-promotional advertising because it is the only company certificated to provide water service in Vermilion. (Aqua Ex. R-2.0, p. 27). Further, Section 9-225 states that "explanations of existing … rate schedules" is a category of advertising that "*shall* be considered allowable." 220 ILCS 5/9-225 (emphasis added). The Commission should allow Aqua's recovery of its advertising expense consistent with this standard.

c) Advertisements to inform of projects impacting service quality.

The Proposed Order recognizes correctly that advertisements to inform customers of service interruptions due to system projects are recoverable and allows $2,000 of Aqua's requested increase in advertising budget for this purpose. (Proposed Order, p. 28). This ruling is appropriate because Section 9-225 states that advertising regarding "service interruptions" is recoverable. 220 ILCS 5/9-225. However, the Proposed Order errs by failing to allow recovery for advertisements related to projects that impact service or water quality. (Proposed Order, p. 28). It is difficult to conceive how advertisements designed to convey this type of information would not be in consumers' best interest to receive -- the statutory standard for recovery. (Aqua Ex. S-2.0, p. 24). Indeed, Section 9-225 states that advertisements to inform consumers of "safety measures" are recoverable. 220 ILCS 5/9-225. The Commission should allow Aqua's recovery of these advertising costs, and should also grant Aqua's remaining $1,000 advertising budget increase to inform customers of these type of projects in the upcoming years.

C. Rate Design

The Proposed Order draws the erroneous conclusion to modify Aqua's rate design with an intent toward moving toward cost-based rates - a radical shift from what the Commission has previously approved as an appropriate rate design for Aqua's Vermilion division. (See Proposed Order, pp. 50, 54). First, and most importantly, the Proposed Order imposes a significant rate increase on Aqua's biggest customer Teepak -- the only customer in the large industrial class -- and Teepak is likely to leave the system as a result. (*Id.*, pp. 53-54). Second, the Proposed Order fails to increase any customer charges with the exception of the charge for Teepak, which decision, if not reversed, would effectively *reduce* rates for many customers and would be inconsistent with the Commission's prior determinations that it appropriate to set charges for Teepak below cost of service, which action necessitates setting all other charges above cost of service. (*Id.*, pp. 49-50). The Commission should reverse in each respect.

1. Large Industrial Class Rate

a) The Commission should increase Teepak's rate by only 6%.

The Proposed Order erroneously decides to increase Teepak's rates by approximately 16%.[15] (Proposed Order, p. 54). This is a drastic increase that will amount to rate shock for Teepak -- a business that is already suffering in an economic cycle that prohibits price increases

[15] Actually, Teepak's rates would increase by 16.89%.

while facing growing costs.[16] Teepak's profit and loss information for Illinois was submitted into the record. (Tr., p. 292; Aqua Cross Ex. 5 (Propriety)).

The importance that Teepak attaches to a potential water rate increase is evidenced by the testimony of Mr. Neidenthal, Teepak's utility engineer, who testified to the seriousness of Teepak's intentions to leave Aqua's system if necessary to forego significant increases in water rates. (Aqua Ex. 5.0, pp. 1-6). Mr. Neidenthal testified that Teepak has taken specific steps to ensure its ability to leave Aqua's system. The steps have been significant -- Teepak has consulted with specialists, it has designed and developed cost models for a Teepak stand-alone treatment plant, and it has obtained all necessary easements. (*Id.*, pp. 1-5). Upper management has been involved in these steps throughout.[17] (*Id.*, p. 3). Aqua witness Mr. Monie testified that a decision to impose a significant increase on Teepak would call Teepak's cards on the chance that Teepak will not leave the system. (Aqua Ex. 4.0, p. 5, Sch. 1, pp. 1, 6; Tr., pp. 189-90).

Mr. Monie further testified that all consumers will be worse off if Teepak leaves the system than if Teepak is only assessed a 6% rate increase. (Tr., p. 184). He explained that other customers will have a minimal (i.e., less than 1%) rate impact as a result of limiting Teepak's rate increase to 6% but that customers will have between a 4.4% to 6.3% rate increase should Teepak leave Aqua's system. (Aqua Ex. R-4.0, p. 8; Aqua Ex. S-4.0, p. 5). Staff agreed that customers will have lower rates if Teepak's rate increase is low enough to maintain its presence on Aqua's system. (Staff Ex. 8.0, p. 11).

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[16] The Proposed Order states that Staff witness Mr. Luth suggested that a rate increase "is very small compared to the assets and investments of Teepak at its Danville facility." (Proposed Order, p. 53). This statement is not correct. Mr. Luth's testimony was based on information obtained from a website for Teepak Holdings, (Staff Ex. 4.0, p. 14), which is information on the operations under Teepak's parent holding company worldwide and does not have any bearing on the profits and losses of Teepak's Danville meat casing operation.

[17] Indeed, a letter from Teepak's President and Chief Executive Officer Mr. Paul Murphy demonstrates the sincerity of Teepak's upper management on this issue. (Aqua Ex. R-4.0, Att. R4-2).

Indeed, the Proposed Order's decision departs drastically from the Commission's past rulings. The Commission previously has deemed it appropriate to balance the needs of the community with cost-of-service principles by granting only minimal rate increases for Teepak. (Docket 00-0339 (limiting Teepak's rate increase to 2.5%)). Staff witnesses have testified that "remaining rate payers benefit from Teepak remaining on the system at a less than full cost of service rate since Teepak will still make a significant contribution to fixed cost." (Docket 00-0339, Staff Ex. 5.0, Pilapil Testimony, pp. 18-19). Community leaders in Aqua's service area, including the Mayor of Danville, support the Commission continuing this course of action by limiting Teepak's rate increase to 6%. (Aqua Ex. R-4.0, Att. R4-2). The Commission should do so by lowering Teepak's rate increase in this proceeding to 6%.

b) At a minimum, the Commission should not increase the percentage of costs that Teepak's rate recovers.

Should the Commission for some reason not limit Teepak's rate increase to 6%, then, at a minimum, the Commission should limit the increase to an amount that would maintain the percentage of cost-of-service covered by Teepak's previously existing rate -- 48.7%. Such an increase would still be significant and amount to rate shock. In particular, it would be a 14.54% increase.[18] However, the Commission previously found that Teepak's contribution to 48.7% of its cost of service strikes an appropriate balance between community needs and cost of service principles. (*See* Proposed Order, p. 54 (recognizing the prior Commission determinations)).

Despite the Commission's previous determination, the Proposed Order would raise Teepak's rate to recover an additional 1% and indicates an intent to gradually raise Teepak's rate to recover 100% cost of service. (*Id.*) Such a slippery slope would gradually erode the balance

[18] The Proposed Order states incorrectly that it would be a 13.7% increase; but, it would actually be a 14.54% increase. The Proposed Order calculates Teepak's increase based on Staff's proposed revenue requirement; but, the Proposed Order adopts a revenue requirement that is 0.75% higher. Assuming the same 0.75% increase to the cost of service for Teepak, the rate increase would be 14.54%.

between the community's needs and cost of service principles the Commission has previously found to be appropriate. The positive impact of the Commission's previous rulings would be deteriorated over time, and Teepak would be likely to leave the system as a result. Therefore, if the Commission decides to increase Teepak's rate by more than 6%, which it should not, then, at a minimum, the Commission should limit the increase to maintaining the percentage of cost of service that Teepak's rate recovers constant at 48.7%.

2. Customer Charges

a) The Commission should increase customer charges above cost of service for the public policy goal of contributing toward Teepak's cost of service.

Because the Commission has previously found it appropriate for customers to bear a portion of Aqua's cost to serve Teepak, it is appropriate for customer charges to exceed cost of service. (*See* Proposed Order, p. 49 (recognizing this fact)). Whenever one or more categories of charges are set below cost of service, it is necessary to set other charges above cost of service. There is no reason that customer charges should be excluded from such a result. Indeed, doing so would only necessitate the increase of consumption or usages charges further above cost of service levels to make up the difference. Because Teepak's charges should be set below cost of service, as the Commission has found in past cases, it is appropriate to increase customer charges as an offsetting measure. Mr. Monie calculated the appropriate percent increase in customer charges to account for Teepak's reduction to be between 4.2% and 5.8% depending on the level of the increase to Teepak. (Aqua Ex. S-4.0, p. 5). For a customer with a 5/8 inch meter, this results in a customer charge of between \$13.13 and \$13.33. (*Id.*) Aqua recommends that the Commission adopt the latter increase of 5.8% or \$13.33 consistent with Aqua's proposal that the Commission limit Teepak's consumption rate increase to 6%. Aqua notes that this is a mere .20¢ increase above the increase of 4.2% or \$13.13 that would be consistent with Staff's proposal.

b) At a minimum, the Commission should increase all customer charges to account for the fact that previous customer charges have already been effectively increased by 5% due to QIPS.

The Proposed Order erroneously finds that no portion of the 5% Qualifying Infrastructure Plant Surcharge ("QIPS") should be added to existing base rate customer charges. Instead, the Proposed Order finds that the 5% QIPS should be treated as a base rate addition and the investment included in the cost of service study for allocation to customers based on the results of the study. (Proposed Order, pp. 49-50). This approach ignores the reality that existing customer charges, along with all other charges, have already been effectively increased by 5% due to the QIPS.[19] (Tr., pp. 182-83). Simply adding QIPS to the cost of service study would fail to recognize the pre-existing QIPS customer charges.

Accordingly, Aqua witness Mr. Monie testified that it is appropriate to adjust all customer charges for QIPS. (Aqua Ex. S-4.0, p. 3). Indeed, some customers will effectively receive rate decreases should the Commission for some reason not do so. (*Id.*) It would also result in radical tariff design changes. Customers' proportional burdens would change as usage rates are increased to make up for the failure to raise customer charges. (*Id.*, pp. 3-4). The Commission should avoid such problematic rate design shifts by simply rolling the customer charge portion of QIPS into each customers' customer charge.

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[19] The Proposed Order states that the "record does not support a finding that QIP investment is entirely related to customer charges." (Proposed Order, p. 50). A 5% increase to customer charges, however, would not relate the entire QIPS increase to customer charges. This is because all tariff charges, not just customer charges, have already been increased by 5% due to QIPS. For example, under current rates, a customer with no water usage pays $12.60 per month, which is equal to the 5% QIPS plus the $12.00 per month set forth in the base tariff. (Aqua Ex. S-4.0, p. 3). Only the portion of QIPS that is currently applied to customer charges would be rolled into customer charges.

III.
Conclusion

WHEREFORE, for each of the foregoing reasons, Aqua Illinois, Inc. respectfully requests that the Commission modify the Proposed Order as discussed herein and as set forth in the exception language attached hereto as Appendix A, and grant any and all other appropriate relief.

Dated: March 25, 2005

Respectfully submitted,

Aqua Illinois, Inc.

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