**STATE OF ILLINOIS**

**ILLINOIS COMMERCE COMMISSION**

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| **Aqua Illinois, Inc.** | **:** | |
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| **Proposed general increase in water rates. (Tariffs filed on May 28, 2004.)** | **:** | **ICC Docket No. 04-0442** |
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**REPLY BRIEF ON EXCEPTIONS OF THE STAFF OF**

**THE ILLINOIS COMMERCE COMMISSION**


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April 1, 2005

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**REPLY BRIEF ON EXCEPTIONS OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION**

Now comes the Staff of the Illinois Commerce Commission ("Staff"), by its undersigned attorneys, pursuant to Section 200.830 of the Illinois Commerce Commission's ("Commission") Rules of Practice (83 Ill. Adm. Code 200.830), and respectfully submits this Reply Brief on Exceptions to the Initial Brief On Exceptions Of Aqua Illinois, Inc. ("Aqua BOE") filed in response to the Administrative Law Judge's Proposed Order issued on March 11, 2005 ("Proposed Order").

# I. ARGUMENT

## A. Return On Equity

Aqua Illinois, Inc. ("Aqua" or the "Company") argues that at least 30 basis points should be added to the Proposed Order's authorized rate of return on common equity. (Aqua BOE, pp. 4, 6.) Aqua suggests that two factors support a higher authorized rate of return on common equity: (1) Aqua is allegedly riskier than the utility samples that served as proxies for Aqua; and (2) interest rates are allegedly higher today than in April 2004 when the Commission last authorized a rate of return on common equity for Aqua in Docket No. 03-0403. As Staff will demonstrate below, those arguments mischaracterize the record. Therefore, Aqua fails to demonstrate that adding 30 basis points to its allowed cost of equity is warranted.

### 1. Aqua is not riskier than Staff's water and utility samples

Aqua argues that a 30 basis points adjustment is necessary to reflect Aqua's "unique" risk as evidenced by its NAIC-2 debt rating. (Aqua BOE, pp. 3-4.) Yet, Aqua has not cited any evidence that supports its claim. In contrast, Staff performed a quantitative risk analysis, which demonstrated that Aqua is not riskier than Staff's water and utility samples. (Staff IB, p. 54, citing ICC Staff Exhibit 7.0, pp. 10-11, lines 186-194.)

Aqua makes two baseless assertions concerning Staff's quantitative risk analysis, which do not even appear in the testimony of Aqua's hired cost of common equity witness. (*See* Aqua BOE, pp. 3-5; Aqua Ex. S-3.0, lines 77-86.) First, Aqua incorrectly asserts that Staff's risk analysis erroneously assumed a credit rating of A. (Aqua BOE, p. 4.) Staff's quantitative risk analysis compared risk measures derived from twelve financial and operating ratios for Aqua and the water and utility samples. (ICC Staff Exhibit 7.0, pp. 8-9, lines 136-166.) Hence, for Aqua's allegation to have a modicum of validity, Staff would have had to substitute financial and operating ratios that were meant to be representative of a credit rating of A for Aqua's actual financial and operating ratios. No such substitution occurred. (Id., lines 149-151.)

Second, Aqua alleges that "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…" (Aqua BOE, p. 4.) Aqua failed to define what constitutes "complete risk analysis" through either the testimony of its hired witness or its BOE. Further, Staff's risk analysis was more thorough than the analysis Aqua's witness used to select a utility sample as a proxy for Aqua, which began with eight operating and financial ratios as measured over a three-year measurement period. (Aqua Ex. 3.0, p. 16, lines 13-27.) This is shown in the table below, which compares the eight operating and financial ratios Aqua's witness used to select a utility sample to the twelve operating and financial ratios that Staff used in its quantitative risk analysis. The table shows that not only did Staff include more financial and operating ratios than Aqua's analysis (i.e., twelve vs. eight), but five out of eight of the ratios used in Aqua analysis were included in the Staff analysis.

**COMPARISON OF RATIOS USED IN STAFF'S QUANTITATIVE RISK ANALYSIS TO THOSE USED IN AQUA'S LEAST RELATIVE DISTANCE ANALYSIS**

| Description of Ratio | Staff's Quantitative Risk Analysis (ICC Staff Exhibit 7.0, lines 136-151.) | Aqua's Least Relative Distance Analysis (Aqua Ex. 3.0, p. 16, lines 16-27.) |
|---|---|---|
| Common equity to capitalization | X | X |
| Cash flow to capitalization | X | X |
| Cash flow to debt | X | |
| Fixed asset turnover | X | X |
| Free cash flow to capitalization | X | |
| Funds flow interest coverage | X | X |
| Gross utility plant additions to net plant | X | |
| Net cash flow to gross utility plant additions/ expenditures | X | X |
| Operating profit margin | X | |
| Revenue stability | X | |
| Earnings before interest and taxes stability | X | |
| Earnings stability | X | X |
| Pre-tax interest coverage | | X |
| Allowance for funds used during construction to net income | | X |

Furthermore, the "four factors" to which Aqua refers (*i.e.*, principal component scores) are complex statistical indices of the twelve financial and operating ratios, which represent financial risk, risk related to sales and costs variability,[1] construction risk and capital intensity, respectively. (ICC Staff Exhibit 7.0, pp. 9-10, lines 152-166 and

[1] Contrary to Footnote 8 of Aqua's BOE, which is unsubstantiated and unsupported by record evidence, Staff's analysis did account for cost variability risk.

169-175.) Those four factors with which Staff evaluated Aqua's risk relative to the risk of Staff's samples reflect all of the business and financial risk factors that Aqua's witness described as critical to estimating Aqua's cost of equity. (Aqua Ex. 3.0, pp. 7-12.)

In summary, all the allegations Aqua makes in its BOE lack any foundation and are completely without merit. Staff's quantitative risk analysis was thorough and proved, independently of credit ratings, that adding an investment risk premium to Aqua's cost of equity is unwarranted. In contrast, Aqua provided no evidence that Aqua's NAIC designation reflects a higher degree of risk than its samples but rather relied on hollow claims, which Staff has already rebutted at length throughout this proceeding. (*See* Staff IB, pp. 58-62; Staff RB, pp. 16-17.)

**2. Interest Rate Levels Do Not Support a Higher Rate of Return on Common Equity**

Aqua argues that if the Commission rejects Aqua's arguments regarding the NAIC debt designation, then the Commission should increase Aqua's allowed cost of equity by more than 30 basis points to reflect an allegedly higher interest rate environment than existed when the Commission entered its Order in Aqua's last rate case (Docket No. 03-0403, hereafter referred to as the "Kankakee Order"). (Aqua BOE, p. 5.) Specifically, Aqua argues that the Commission should add 33 basis points to Staff's cost of equity recommendation in the instant proceeding due to the higher interest rate environment. (Id., p. 6.) Aqua's argument relies upon incorrect comparisons and faulty rationale as already explained in Staff's Reply Brief. (Staff RB, pp. 17-22.)

Nevertheless, two of Aqua's arguments regarding its allowed cost of equity in the Kankakee Order relative to interest rates need clarification. First, Aqua asserts that Staff's 10.07% cost of equity recommendation in the current case is lower than the 10.16% return on equity authorized in the Kankakee Order. (Aqua BOE, p. 5.) Aqua argues further than the 10.16% rate of return authorized in the Kankakee Order should be adjusted upward to 10.49% to reflect a higher interest rate environment. (Id., p. 6.) To clarify, the Commission-authorized rate of return in the Kankakee Order started with Staff's 9.86% cost of equity recommendation and then added 30 basis points for unspecified investment risks. (Order, Docket No. 03-0403, April 13, 2004, p. 43; Staff RB, p. 17.) In this proceeding, the Proposed Order rejects the investment risk premium. Thus, Aqua is comparing apples, an authorized rate of return on common equity that includes an investment risk premium, to oranges, a Proposed Order--recommended rate of return on common equity that explicitly excludes an investment risk premium. To compare interest rate changes to cost of common equity estimates, exogenous adjustments to those cost of common equity estimates, such as the investment risk premium, must be removed. Moreover, Aqua's assertion that the 10.16% rate of return authorized in the Kankakee Order is based on approved financial models is misleading. (Aqua BOE, p. 6.) The 9.86% cost of common equity that Staff recommended in Docket No. 03-0403 was estimated using approved models. As noted above, the 10.16% authorized rate of return on common equity starts with Staff's recommended rate of return but adds 30 basis points for an unspecified risk factor, which Staff has proven is not warranted in the current case.

Second, Aqua's BOE refers to the Federal Reserve Board's recent decision to raise short-term interest rates. (Id., p. 6.) Staff submits that rising short-term interest rates do not necessarily translate into rising long-term interest rates, which were the rates against which both Aqua's and Staff's cost of equity witnesses compared their estimates of Aqua's cost of common equity. (ICC Staff Exhibit 3.0, p. 30, lines 559-561; Aqua Ex. S-3.0, p. 4.) Moreover, as Staff noted previously in rebuttal testimony, Aqua's arguments regarding rising interest rates should be rejected because those arguments are based on the incorrect assumption that cost of equity estimates are solely a function of interest rates. In contrast, costs of equity estimates are not only a function of interest rates, but also a function of the price of risk at a given point in time. (Staff RB, p. 21, citing ICC Staff Exhibit 7.0, pp. 12-13, lines 219-228.) Nonetheless, Staff notes that its 10.07% cost of equity recommendation in the current case exceeds Staff's cost of equity recommendation in the Kankakee Order by 21 basis points. Thus, if one assumed that Aqua's argument that cost of equity estimates are solely a function of interest rates, which they are not, Staff's cost of equity recommendation already reflects a higher interest rate environment.

In summary, all of the arguments presented in Aqua's BOE should be rejected and the Proposed Order should not be modified with respect to its conclusions regarding Aqua's allowed rate of return.

## B. Operating Expenses

### 1. Incentive Compensation

The Company continues to argue that the Commission cannot depart in this proceeding from the ultimate conclusions made in Docket No. 03-0403 (Aqua's

Kankakee Division rate case). (Aqua BOE, p. 7.) The Company makes this argument despite the Proposed Order's characterization of it as "frivolous". (Proposed Order, p. 22.) Staff, on the other hand, believes that the Proposed Order correctly finds that "Aqua failed to provide almost any of the support the Order in 03-0403 directed the Company to provide to justify recovery of incentive compensation costs." (Id., p. 23.) Failure to provide this support fully justifies the Proposed Order's decision in this regard.

While Staff recommended early in this proceeding that the Commission disallow the costs associated with Aqua's incentive compensation plan (the "plan") for five different reasons (ICC Staff Exhibit 2.0, p. 10), the Company did not respond to Staff's arguments until surrebuttal testimony. The Company's responses were inadequate at that time. (*See* Staff IB, pp. 13-23.) Aqua's arguments continue to be inadequate now.

The Company tries to point to evidence in this proceeding regarding the incentives for its employees to take actions beneficial to ratepayers. (Aqua BOE, p. 8.) The Company also claims that the evidence establishes goals of improving efficiencies and controlling costs. (Id., p. 9.) However, under cross-examination, Company witness Schreyer was unable to indicate the detailed objectives, quantifiable results of the objectives, specific dollar savings or the benefits to ratepayers he purported his Schedule S-2.2 presents. (Staff RB, p. 7, citing Tr., pp. 119-120.) There is no evidence of the type the Commission directed the Company to provide in the record in this case as the Company insinuates.

The Company also asserts that Staff concurred with the Company's claim that "the evidence establishes goals of improving efficiencies and controlling costs benefit ratepayers as well as shareholders by reducing the need for rate relief." (Aqua BOE, p.

9.) Staff's reading of the transcript pages cited indicate that Staff agreed hypothetically that reduced expenses would be passed through to ratepayers in a future test year and that generally, efficiencies would reduce expenses. At no time did Staff opine that any current or hypothetical goals benefit ratepayers as well as shareholders by reducing the need for rate relief. In fact, how goals benefit anyone was not even discussed on the transcript pages cited by the Company.

The Company claims that requiring more evidence regarding its plan would create an overly burdensome standard going forward, especially for the largest utilities. (Aqua BOE, pp. 9-10.) This argument is equally frivolous. The burden of proof in a rate case lies with the Company, no matter what the size. There is no new standard being proposed in this case, as the Company seems to imply.

The Company offers replacement language regarding incentive compensation expense which mischaracterizes Staff's argument when it states that Staff argued that "the Company had to present detail of each employee's specific goals and rewards in order to recover its expenses." (Aqua BOE, Appendix A, p. 7.) In fact, Company witness Schreyer was unable to identify a single goal listed on Company Schedule S-2.2 or to indicate whether or not a specific goal was met. (Tr., pp. 119-120.) No goals or objectives were provided in support of the Company's claims. The Proposed Order is absolutely correct when it states:

> A cornerstone of the program approved in 03-0403 is the series of goals promoting water quality, system safety, and customer service. The Company indicates that the plan approved in 03-0403 is the same plan in all material aspects as the one at issue in the instant case. If so, the Company presumably should have the same types of goals and measurements. Yet the Company, clearly having been instructed to provide such evidence in 03-0403, does not articulate or list any such objectives or performance measurements. Instead, it argues that the 03-

> 0403 Order was addressed to all of the utilities in Illinois that did not participate in the case. The Commission agrees with Staff that this argument is frivolous. (Proposed Order, p. 22.)

The Company's attempt to overestimate the amount of work or detail involved (Aqua BOE, Appendix A, p. 7) only continues the tactic it used throughout the case when a request for information was made. Since the burden of proof in a rate case lies with the Company, the Commission should not relax that requirement based on the complaining of the Company involved.

The Company's replacement language that indicates that the "design" of the incentive compensation plan to produce ratepayer benefits is sufficient for recovery of the associated costs of the plan in a rate proceeding must likewise be rejected. (Aqua BOE, Appendix A, p. 7.) While it could be argued that a plan is designed to produce ratepayer benefit, recovery should be based on the costs reasonably expected to occur. Staff's analysis indicates that the costs at issue in the instant case are not reasonably expected to occur regardless of the arguable "design" of the plan. This "design" language must be rejected.

The Company also offers replacement language on the bottom of page 7 and top of page 8 of its Appendix A which should be rejected by the Commission. This language is merely the Company's attempt to soften the Commission's standard in light of the fact that the Company failed to meet the Commission's standard as reflected in the Proposed Order. The Company is correct that "ratepayers must be the primary beneficiaries of incentive compensation plans for recovery to occur." The Company's failure to demonstrate that its plan meets this requirement in light of the issues raised in this case goes to the heart of the matter. Nowhere has Staff indicated incentive compensation plans cannot also address other appropriate issues. However, the fundamental issue is that the Company must demonstrate ratepayer benefit. The Company has not done so in this particular case and attempts to sidestep that issue by inferring that other considerations offset the need to demonstrate ratepayer benefit.

Therefore, Staff recommends that the Proposed Order's conclusion regarding incentive compensation expense be approved, including the one sentence deletion discussed on page 5 of Staff's Brief on Exceptions.

**2. Payroll Expense**

The Company argues that Staff's adjustment is based on Aqua's payroll **expense** variance from budget during 2001 to 2003. (Aqua BOE, p. 10.) The Company's main argument seems to be focused on the payroll **expense** budget variances and does not address the **Total** payroll budget variances. (Id., p. 11.) As illustrated by ICC Staff Exhibit 6.0, Schedule 6.1, page 2, the Company's over budgeting for **Total** Payroll Costs has 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. (Staff IB, p. 10.) The Proposed Order correctly agrees with Staff's position. (Proposed Order, p. 14.)

The Company claims that Staff's adjustment is designed to set a future budget based on conditions that are not projected to exist in the budget year. (Aqua BOE, p. 12.) Staff does not propose to set any budget for the Company, especially not based on conditions, which are not anticipated to exist during the budget period. This statement is as illogical as the Company's question to Staff during the hearing regarding Staff's awareness of any unanticipated event that is going to occur in 2005. (Tr., p. 248.) Staff's adjustment is based on the Company's historical over budgeting of total payroll costs in order to arrive at a normal level of total payroll cost to be included in the revenue requirement in this case. (Staff IB, p. 9.)

The Company appears to equate the amount of payroll expense included in a revenue requirement for the purpose of setting rates with a payroll expense operating budget for some future period. (Aqua BOE, pp. 13-15.) Staff's proposed payroll expense and capitalized payroll included in the revenue requirement are simply those costs Staff determined to be appropriately recovered from ratepayers. Staff does not develop operating budgets in its revenue requirement analysis.

The Company once again campaigns for an offsetting adjustment to Contractual Services to counter Staff's payroll expense adjustment. (Id., pp. 15-17.) Staff does not agree that the contractual services and labor expense items are sufficiently similar as to require or merit the same treatment. The information provided to Staff regarding capitalized payroll indicated a history of under budgeting. There is no evidence 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 IB, pp. 12-13.)

The Proposed Order incorrectly gives some weight to this argument by the Company. (Proposed Order, p. 14.) As Staff explains in its Brief on Exceptions, the Proposed Order should provide a complete explanation for the limitation placed on the adjustment to payroll expense if Staff's adjustment is not accepted in total. (Staff BOE, pp. 1-3.)

Therefore, Staff recommends that the Proposed Order's conclusion regarding payroll expense should be approved, incorporating Staff's replacement language on pages 3-4 of its Brief on Exceptions.

### 3. Rate Case Expense

Aqua argues that the Commission should allow recovery of its $102,000 increase in legal fees because the Company actually incurred the fees. (Aqua BOE, pp. 17-18.) To the contrary, the Proposed Order correctly concludes that Aqua failed to support its untimely request for increased rate case expense. (Proposed Order, pp. 40-41.) While Aqua may have incurred legal expenses beyond those estimated in its original filing for the Vermilion Division ratemaking proceeding, Staff maintains that bill summaries presented on the eve of trial are inadequate to justify approval of the alleged increases.

Staff disagrees with Aqua's simplistic characterization of the issue regarding rate case expense. (Aqua BOE, p. 17.) The rate case expense issue to be decided in this proceeding is whether Aqua properly proposed and supported an addition to its original estimate of rate case expense. (Staff RB, p. 14.) As Staff has argued and as the Proposed Order affirms, Aqua has not met its burden.

Aqua contends that the Proposed Order inappropriately disregards Mr. Schreyer's testimony with respect to the billing documents (Aqua Ex. H-2.0) that were offered so late in the proceeding. (Aqua BOE, p. 17.) While Aqua calls these billing documents "invoices", the record in this proceeding belies Aqua's claim. A review of these documents indicates that they contain lists of names, hours and dollars per hour for each name on the list plus miscellaneous other expenses purporting to be invoices from Aqua's legal counsel. At the evidentiary hearing, 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. (Staff IB, p. 43, citing Tr., pp. 219-220.) In light of Staff witness Everson's statements and Company witness Schreyer's testimony under cross-examination that the billing documents are summaries (Tr., p. 93), Aqua's continued characterization of these documents as "*actual* legal invoices" (Aqua BOE, p. 17) is disingenuous. The Proposed Order's conclusion that these documents should be given no weight is correct and should remain intact.

Aqua argues that the Proposed Order applies the wrong standard by focusing on whether Staff had sufficient time in which to review the billing documentation. In support of the proposition that timeliness of disclosure is a procedural issue that may go to the admissibility of evidence, Aqua cites *Bachman v. General Motors Corp*., 332 Ill. App. 3d 760, 791-92 ($4^{th}$ Dist. 2002) ("*Bachman*"). (Id., p. 18.) *Bachman* is a personal injury case regarding disabling injuries received as the result of an automobile collision that was appealed on several evidentiary issues. The particular pages cited by Aqua address arguments regarding the trial court's decision to decline to bar certain opinion witnesses for alleged discovery violations. (*Bachman*, pp. 790-792.) The Court noted that an abuse of discretion standard applied, and that the record did not show an abuse of discretion by the trial court in allowing the testimony. Id.

The relevance of the *Bachman* opinion to the instant case is unclear at best. The instant case does not involve a discovery dispute or appropriate discovery sanctions. Further, there is no pending challenge to the testimony and evidence admitted by the Administrative Law Judge. Aqua then goes on, without the citation of any additional authority, to contend that timeliness of disclosure "is not a factor that goes to the merits of the evidence" and "is not a legal basis to disregard evidence once it is admitted into evidence." (Aqua BOE, p. 18.) The *Bachman* opinion provides no support for these assertions. Therefore, Aqua has failed to cite any authority for the proposition that an administrative body, such as the Commission, should not take into account whether there was sufficient time to review relevant evidence. As such, the Proposed Order was correct in giving Aqua's last minute billing documentation "no weight". (Proposed Order, p. 40.)

Staff, on the other hand, argues that it is Aqua that applies the wrong standard by ignoring long-standing Commission policy. For example, 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 limited the utility to its originally filed estimate pursuant to its policy of restricting such expense to initial estimates unless extraordinary or compelling circumstances otherwise dictate. (*See* Staff IB, pp. 40-41.) In addition, 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.4$^{th}$ 131 (May 11, 1994) ("*Consumers Order*") – 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, stating that,

> [p]ro 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 prepare their case. (*Consumers Order*, p. 7.)

(*See* Staff IB, pp. 43-45.)

Staff's position is that the Company supported only its original estimate for rate case expense in this proceeding. The Company failed to provide any supporting documentation regarding a new estimate for rate case expense until the Friday afternoon before a Tuesday morning evidentiary hearing (not a week before the hearing implied in Aqua BOE, p. 18, footnote 11) and that new estimate was insufficient. Not only is Aqua's request contrary to the Commission's general practice of limiting recovery of rate case expense to the utility's filed estimate but it is also contrary to the Commission's practice of declining to consider any revision made in a time and manner that prejudices Staff's or other parties' ability to prepare its case. Therefore, the arguments advanced in Aqua's Brief on Exceptions and the language proposed in Appendix A should be rejected by the Commission and the language in the Proposed Order should be approved.

### 4. Charitable Contributions

#### a) Danville Area Economic Council

The Company argues that a donation made to the Danville Area Economic Council should be recoverable as a Charitable Contribution even though Aqua made the donation in the form of membership dues payments. (Aqua BOE, p. 19.)

The invoices reviewed by Staff for the payment to the 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 its rebuttal testimony in this case. While the Danville Area Economic Council may be a worthwhile organization, ratepayers should not bear the expense of the Company taking part in this community organization. (Staff IB, pp. 28-29.)

The Company is correct that the Commission's decision regarding these donations in Docket No. 03-0403 was based on the lack of evidence to determine if payments to economic development organizations are within the scope of Section 9-227 of the Act. (Aqua BOE, p. 20.) However, the language quoted from the Order in Docket No. 03-0403 cites language from an Order in a previous proceeding (Docket No. 90-0169), which addresses the Company's attempt to "blur the distinguishable categories of industry dues and charitable contributions". (Proposed Order, p. 31.) The Proposed Order correctly finds that the argument presented by the Company in this case, the eventual public purpose of its membership dues in the Danville Area Economic Council, is insufficient to qualify those dues for recovery pursuant to Section 9-227 of the Act and thus is not recoverable as a Charitable Contribution.

### b) Educational Scholarships

The Company claims that the Proposed Order errs by disallowing donations made for educational purposes because the recipients are individuals rather than organizations. (Aqua BOE, p. 20.) In fact, Aqua would have the Commission agree that these educational scholarships to individuals are “for the public welfare”. (Id., p. 21.) While it is commendable that the Company provides these funds for students to continue their education, these students are not considered charities. In addition, the Company provides no persuasive arguments with respect to how the general public benefits from the continued education of these individuals. (Staff IB, p. 30.) Therefore, the Proposed Order correctly finds that these are more properly characterized as private donations to individuals and properly excludes them from the revenue requirement. (Proposed Order, p. 32.)

The Proposed Order’s conclusion with regard to these two categories of costs correctly excludes them from the approved revenue requirement. However, Staff recommends the Commission adopt Staff’s proposed language changes to page 32 of the Proposed Order that would eliminate sponsorships from the revenue requirement. (Staff BOE, pp. 7-8.)

### 5. Advertising Expense

The Company argues that the Proposed Order incorrectly rules that Aqua’s advertisements that provide information regarding water quality, water service and rates are not recoverable. (Aqua BOE, p. 21.) Aqua further alleges that it “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." (Id.) However, the citation provided for that statement is Aqua witness Schreyer's Surrebuttal Testimony in which he discusses a recommendation made by Aqua Illinois' Community Advisory Panel. Staff argues that the record is devoid of any evidence with respect to the composition of Aqua Illinois' Community Advisory Panel. Whether that panel even includes ratepayers from the Vermilion Division is questionable.

In fact, the authority of this Advisory Panel has been questioned before in this proceeding. The Company has claimed that an undefined "sufficient level of market saturation" must occur at the direction of its own Community Advisory Panel. (Aqua IB, p. 22.) Staff has argued that 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. (Staff IB, pp. 26-27.)

The Company cites three categories of advertisements it believes expenses for which should be recoverable since the advertisements are informative to its customers. (Aqua BOE, pp. 21-23.) Staff has never disputed the "informative value" of the advertisements. Rather, Staff's adjustment is based on the fact 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. (Staff IB, p. 24; Staff RB, p. 9.) Therefore, these costs are not appropriately considered for recovery in rates.

The first category of advertisement for which the Company claims recovery is that which discusses Aqua's compliance with the Illinois Environmental Protection Agency's drinking water regulations. (Aqua BOE, p. 22.) Staff argues that this category of advertisement does not inform customers of anything except that the Company is following regulations, something customers should expect from their water provider. (Staff IB, p. 25.)

The second category of advertisement for which the Company claims recovery is characterized as that which informs consumers of their existing water rates. (Aqua BOE, p. 22.) In reality, a transcript reviewed by Staff for this category of advertisement provides 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. (Staff IB, p. 25.)

The Company further claims Section 9-225 of the Act states that "'explanations of existing...rate schedules' is a category of advertising that '*shall* be considered allowable'". (Aqua BOE, p. 22.) However, upon review, the advertisement to which the Company refers does not explain rate schedules, but simply promotes the Company stating, "It's nice to know there are still some great bargains available". (ICC Staff Exhibit 6.0, Attachment C, page 1 of 2.) How can this be looked upon as anything but promoting the Company to its captive ratepayers, who cannot be on the lookout for "great bargains"? (Staff RB, p. 11.)

The third category of advertisement for which the Company claims recovery is information regarding service interruptions due to system projects. (Aqua BOE p. 22.) While Staff does agree that the Company has provided information regarding projects it anticipates for the 2005 test year, the Company has failed to show how those projects represent the **increased** level of newspaper advertising it has projected in test year expense. It is that increased level with which Staff has taken issue and has disallowed through its proposed adjustment. Nothing in the record supports the Proposed Order's inference that the projects anticipated in the test year represent an **increase** in notification for service interruptions. (Staff BOE, pp. 5-6.)

Therefore, Staff's full adjustment to Advertising Expense of $9,540 should be approved by the Commission.

### C. Rate Design

Aqua takes issue with the Proposed Order's rate design determinations regarding the large industrial rate class (i.e., Teepak) and customer charges. (*See* Aqua BOE, pp. 23-27.) Aqua characterizes these determinations as "a radical shift from what the Commission has previously approved as an appropriate rate design for Aqua's Vermilion division." (Id., p. 23.) While the Proposed Order does adopt a rate design for Teepak that increases Teepak's contribution to recovery of its cost of service by 1% -- from 48.7% of its cost of service to 49.7% (Proposed Order, pp. 53-54) -- it is simply ridiculous to characterize the Proposed Order's determination in this regard as a radical shift from the Commission's previous determinations. An accurate and fair characterization of the Proposed Order is that it adopts what is essentially the same rate design for Teepak adopted by the Commission in the last Vermilion division rate case (in terms of percentage contribution towards Teepak's cost of service), making what is essentially the smallest movement possible towards recovery of cost of service (i.e., a one percentage point change). Aqua's assertions with respect to the customer charge are similarly inappropriate, and unfairly disregard the Proposed Order's analysis and balancing of the varied and sometimes conflicting goals and interest at issue here. Although the Proposed Order departed from Staff's recommendations (and Staff continues to stand behind those recommendations), Staff supports the Proposed Order's determinations as a reasonable rate design for Teepak. Aqua's proposed exceptions are inappropriate and must be rejected.

### 1. Large Industrial Rate Class (Teepak)

Aqua continues to contend that Teepak's rates should increase by only 6% and further asserts that the Proposed Order's 16% increase in rates for Teepak (which rates recover only 49.7% of Teepak's cost of service) is a drastic increase that amounts to rate shock. (Aqua IB, pp. 23-24.) Aqua raises no new facts or information in this regard, but instead raises the information and concerns -- fully acknowledged and addressed in the Proposed Order -- regarding the possibility that at some level a rate increase might encourage Teepak to leave the system.[2] Aqua would have the Commission **totally** disregard cost of service principles in setting Teepak's rates. While it may be appropriate to take into account factors other than cost of service (as the Proposed Order does in continuing significantly discounted rates for Teepak), it would certainly be inappropriate to totally disregard cost of service principles. Although it would have been appropriate to make a more substantial movement towards cost of service (i.e., to move to recovery of approximately 60% of Teepak's cost of service as recommended by Staff), the Proposed Order's decision to set rates for Teepak at 49.7%

[2] Aqua contends that "Teepak is likely to leave the system as a result" of the Proposed Order's determination to increase Teepak's rates by 16%. (Aqua BOE, p. 23.) Aqua's statement is not supported by the record. As the Proposed Order correctly notes, Mr. Niedenthal, a Teepak employee, testified that "if the Commission approves Staff's 38.5% rate increase proposal, Teepak would reexamine the cost and return on investment of its well water project." (Proposed Order, p. 50.) While all parties and the Proposed Order recognize that Teepak might leave the system at some level of rate increase, there is no evidence that Teepak is likely to leave the system at Staff's proposed 38.5% rate increase much less at the 16% increase adopted by the Proposed Order.

of Teepak's cost of service is reasonable and Aqua's arguments to the contrary must be rejected.

In attacking the conclusions reached by the Proposed Order in its Brief on Exceptions, Aqua assiduously avoids putting its argument in the proper context. In earlier arguments on this issue, Aqua repeatedly notes that Staff's proposal would increase Teepak's rates by approximately 35%. (See Proposed Order, pp. 50; Aqua IB, pp. 38-40; Aqua RB, pp. 33-34.) Although Staff's proposal was reasonable and continued steep discounts for Teepak, the Proposed Order declined to accept Staff's recommendation as well as Aqua's recommendation for a 6% increase, and instead adopted a moderate increase of 16% to minimize any concerns regarding rate shock and the possibility of Teepak leaving the system. When viewed in this proper context, Aqua's arguments and criticisms of the Proposed Order fall flat and must be rejected.

**2. Customer Charges**

Aqua also takes exception to the Proposed Order's determination to maintain customer charges at their current level for all customer classes except the large industrial rate class. (Aqua BOE, pp. 26-27.) Aqua attempt to present this issue as a continuation of the Teepak rate design issue addressed above. Although Teepak's customer charge is at issue, it must be noted that the customer charge issue is not an issue that directly involves the discount provided to Teepak. Rather, the customer charge issue involves a determination of the particular charges through which the revenue requirement allocated to each customer class is recovered.

As explained in Staff's prior briefs and found in the Proposed Order, current customer charges already produce revenues in excess of customer costs for all customer classes except Teepak. (Proposed Order, p. 50.) Further, the QIPS is not based on cost of service principles, and therefore the inclusion of the plant forming the basis for QIPS in the revenue requirement in this docket does not provide an appropriate basis to increase customer charges. (See Staff IB, pp. 85-86; Staff RB, pp. 29-31.) Thus, the Proposed Order correctly decides to maintain customer charges at their current level for classes other than the large industrial rate class, and to set the volumetric charges at a level that will produce the revenues allocated to the rate classes. Accordingly, Aqua's arguments to the contrary must be rejected.

## II. CONCLUSION

WHEREFORE, the Staff of the Illinois Commerce Commission respectfully requests that its recommendations be adopted in this proceeding and that the Proposed Order be modified as set forth in this Reply Brief on Exceptions and Staff's Brief on Exceptions.

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April 1, 2005