

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Aqua Illinois, Inc.	:	
	:	
Proposed general increase in water and sewer rates for the Woodhaven Water Division. (Tariffs filed on December 22, 2004)	:	05-0071
	:	
	:	(Cons.)
	:	
Proposed general increase in water rates for the Oak Run Water Division. (Tariffs filed on December 29, 2004)	:	05-0072
	:	
	:	

PROPOSED ORDER

DATED: October 5, 2005

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By the Commission:

I. INTRODUCTION

On December 22, 2004, Aqua Illinois, Inc. (“Aqua”) filed with the Illinois Commerce Commission (“Commission”) revised tariff sheets proposing general increases in water and sewer rates for its Woodhaven Water Division (“Woodhaven”).¹ The revised Woodhaven tariff sheets were to become effective on February 7, 2005. On December 29, 2004, Aqua filed with the Commission revised tariffs sheets proposing general increases in water rates for its Oak Run Water Division (“Oak Run”).² The revised Oak Run tariff sheets were to become effective on February 12, 2005.

In accordance with the requirements of Section 9-201(a) of the Public Utilities Act (“Act”), 220 ILCS 5/1-101 et seq., and 83 Ill. Adm. Code 255, notices of Aqua’s filings with the Commission were timely published four times in newspapers of general circulation in the Woodhaven and Oak Run service areas. The first notice concerning each division was published within ten days of the respective filings. Aqua indicates further that a copy of a public notice was posted and a copy of the tariffs and applicable rules and regulations was made available at its Kankakee, Illinois office.

On February 2, 2005, the Commission entered Suspension Orders suspending the revised tariff sheets proposed by Aqua until May 20, 2005. The investigations into Aqua’s Woodhaven and Oak Run filings initiated by the Suspension Orders are

¹ The revised tariff sheets concerning Woodhaven are Ill. C. C. No. 47, Section 5, 2nd Revised Sheet No. 2, 2nd Revised Sheet No. 3, 2nd Revised Sheet No. 4, and Ill C. C. No. 48, Section 4, 1st Revised Sheet No. 2.

² The revised tariff sheets concerning Oak Run are Ill. C. C. No. 47, Section 7, 1st Revised Sheet No. 1, 1st Revised Sheet No. No. 2, 1st Revised Sheet No. 3, and 1st Revised Sheet No. 4.

identified as Docket Nos. 05-0071 and 05-0072, respectively. On May 17, 2005, the Commission entered Resuspension Orders in the dockets extending the suspension of the revised tariff sheets until November 20, 2005.

The Woodhaven Association (“WA”), Oak Run Property Owners Association (“ORPOA”), and Monica Sadler, an owner of multiple properties within the Oak Run development, filed petitions to intervene on February 16, 2005, April 8, 2005, and September 23, 2005, respectively. The Administrative Law Judge granted the petitions to intervene. Commission Staff (“Staff”) participated as well.

Pursuant to due notice, a status hearing was held in these matters before a duly authorized Administrative Law Judge of the Commission at its offices in Springfield, Illinois on March 3, 2005. At this hearing, the dockets were consolidated and a procedural schedule was established. Following discovery and the submission of prepared testimony, evidentiary hearings were held on July 27 and 28, 2005. Testimony and exhibits from Aqua, Staff, WA, and ORPOA were admitted into the record. At the conclusion of the hearing on July 28, the record was marked “Heard and Taken.” The record was later reopened to permit Aqua to submit evidence of compliance with the publication requirements. Thereafter the record was marked “Heard and Taken” on October 3, 2005. Aqua, Staff, WA, and ORPOA each submitted an Initial Brief and Reply Brief. A Proposed Order was served on the parties.

Aqua is a subsidiary of Aqua America, Inc., a Pennsylvania corporation with offices in Bryn Mawr, Pennsylvania. Aqua is engaged in providing public water and/or sewer service to fifteen tariff areas in seven counties in Illinois. According to its 2004 Annual Report to the Commission, Aqua altogether serves approximately 53,632 water customers and 10,535 sewer customers in Illinois.

Aqua’s Woodhaven Water Division provides water and sewer service exclusively to the Woodhaven Lakes Community, a private, gated community in Lee County that consists of 6,142 individually-owned recreational campsites, 38 commercial lots, and seven residential lots on 1,756 acres of woodlands, lakes, and prairies. WA is a not-for-profit corporation established in 1971 comprised of the owners of property in the Woodhaven Lakes Community. All members of WA are property owners. Covenants of ownership restrict usage of the campsites to recreational use only and overnight stays are restricted to less than 184 days per year. WA’s records show that 76% of the owners spend less than 30 nights per year on the property and 91% spend less than 60 nights per year. Water service is available to all campsites and lots. Sewer service is available to approximately 5,400 campsites, the 38 commercial lots, and the seven residential lots. None of the campsites are metered as all are charged a flat rate for water, regardless of use, and, if provided, sewer service. Where sewer service is provided, the sewer bill is combined with the water bill. All residential and commercial water customers are metered. There are approximately 61 permanent residents.

Aqua’s Oak Run Division provides water service exclusively to the Oak Run development in Knox County. The Oak Run development is a residential and

recreational community consisting of 2,600 single-family residential lots in eight subdivisions on about 4,000 acres. ORPOA is a not-for-profit corporation whose membership is comprised of persons who own lots in the Oak Run development. The corporate purpose of ORPOA is to maintain and preserve the property for the benefit of its members. Ownership of a lot is necessary in order to use the lake and related amenities. Approximately 80% of the lots are undeveloped. Aqua considers the owners of these undeveloped lots “availability” customers since water service is available if the owners ever want to utilize the service. Of the 20% of the lots that have been built upon, half of those residences are owned as a second home or a weekend retreat. Fourteen commercial customers also exist within the Oak Run development. All 14 commercial customers are metered.

Woodhaven last experienced a sewer rate increase and Oak Run last experienced a water rate increase in 1998 in Docket No. 97-0351. The rates approved at that time were based on a historical test year ending December 31, 1996. The Commission approved a base rate increase for Woodhaven Sewer³ of 20.45%. Additional annual revenues for the sewer division amounted to \$126,068. The base rate increase for Oak Run was 28.76%. Additional annual revenues for Oak Run amounted to \$69,370. The Order included a return on equity of 10.06% and an overall rate of return of 9.41% for both Woodhaven Sewer and Oak Run. Woodhaven last experienced a water rate increase in 2001 in Docket No. 00-0338. The rates approved at that time were based on a future test year ending December 31, 2001. The Commission approved a base rate increase for Woodhaven Water⁴ of 48.01%. Additional annual revenues for the water division amounted to \$245,433. The Order included a return on equity of 10.15% and an overall rate of return of 9.30% for Woodhaven Water.

Under the proposed rates, Woodhaven Sewer would see an increase in annual revenue of \$459,314, or about 61.19%, Woodhaven Water would see an increase in annual revenue of \$500,284, or 62.67%, and Oak Run would see an increase in annual revenue of \$213,209, or 64.63%. Aqua asserts that the rate increases are necessary in light of its return on common equity having fallen considerably under current rates. For the 2005 test year it uses, Aqua reports that the rate of return on common equity for Woodhaven Sewer, Woodhaven Water, and Oak Run has fallen to -0.24%, 6.95%, and -2.76%, respectively. No party opposes the use of the 2005 calendar year as a future test year, of which the Commission approves.

II. RATE BASE

The rate base represents the net level of investment that a utility company has dedicated to public service on which it is entitled to earn a return. The rate base consists principally of book investment in plant and working capital, less deductions to

³ For ease of reference, that portion of the Woodhaven Water Division providing sewer service is referred to as “Woodhaven Sewer.”

⁴ For ease of reference, that portion of the Woodhaven Water Division providing water service is referred to as “Woodhaven Water.”

reflect other sources of funds, such as deferred taxes. Schedules showing Aqua's rate base for the three operating entities at present and recommended rates for the future test year were presented by Aqua and Staff.

A. Summary of Uncontested Issues

1. Cash Working Capital

Staff proposes adjustments to calculate the Cash Working Capital component of rate base after giving effect to its operating expense adjustments to the 2005 test year revenue requirement for Woodhaven Water, Woodhaven Sewer, and Oak Run, using the same methodology reflected in Aqua's Schedules B-2.3. While Aqua does not agree with some of Staff's adjustments to operating and maintenance expense, the methodology Staff employed to calculate Cash Working Capital is not contested.

2. Deferred Charges for Tank Painting

Staff proposes adjustments for Woodhaven Water, Woodhaven Sewer, and Oak Run with respect to deferred charges for tank painting to reflect updated information provided by Aqua regarding the cost of the tank painting projects and to remove the cost of repairs from the deferred charges to be amortized. As a result of the adjustments, adjustments to test year amortization expense for the change in the yearly amortization of the deferred charges and to Accumulated Deferred Income Taxes ("ADIT") were necessary. Aqua accepts in total the proposed adjustments to rate base and operating expense for tank painting at all three divisions.

3. Accumulated Deferred Income Taxes—Woodhaven Sewer and Oak Run

In its original Woodhaven Sewer and Oak Run filings, Aqua did not average its adjustments to ADIT for its proposed changes in depreciation rates in the future test year. As a result, Staff finds Aqua's proposed adjustments to ADIT to be inconsistent with the average balances presented for rate base components in the future test year. In addition, Aqua did not include ADIT related to "Oak Run Negative Excess Depreciation" with the ADIT allocated to Oak Run, which Aqua now agrees should have been included. Aqua and Staff have agreed on the appropriate means to resolve these discrepancies.

4. Depreciation Rates—Woodhaven Sewer and Oak Run

a. Woodhaven Sewer

In the test year, Aqua proposes to replace the 2% composite depreciation rate applied to all depreciable plant at Woodhaven Sewer with depreciation rates by primary account approved in Docket No. 98-0632 for its Candlewick Sewer Division and Docket Nos. 00-0337/00-0338/00-0339 (Cons.) for its Kankakee, Vermilion, and Woodhaven

Water Divisions. Staff does not object to the change in depreciation rates; however, Staff notes that several of Aqua's proposed depreciation rates are not the rates approved or are rates for accounts not found in the dockets identified by Aqua as the sources of the proposed depreciation rates. Staff therefore proposes to replace the unapproved rates with rates approved in the aforementioned dockets and to replace the rates for which Aqua could not identify the source with the more conservative 2% composite depreciation rate that Aqua currently applies to its depreciable plant. Staff identifies its recommended depreciation rates for Woodhaven Sewer in its Initial Brief. (See Staff Initial Brief, pp.9-10) Aqua indicates that it agrees with Staff's depreciation rates, but, based on the language used by Aqua, Staff is uncertain whether or not Aqua intends to utilize the specific rates approved in this proceeding to calculate depreciation expense going forward. Section 5-104(a) of the Act requires Aqua to "conform its depreciation accounts to the rates so ascertained, determined and fixed." For this reason, Staff requests that the Commission order Aqua to utilize the depreciation rates approved in this proceeding on a going-forward basis. Although the Commission understands that Aqua intends to do what Staff requests, for the sake of clarity the Commission directs Aqua to use as the depreciation rates for Woodhaven Sewer the depreciation rates set forth by Staff in its Initial Brief.

b. Oak Run

In the test year, Aqua proposes to replace the 2% composite depreciation rate applied to all depreciable plant at Oak Run with depreciation rates by primary account as approved in Docket Nos. 00-0337/00-0338/00-0339 (Cons.). Staff indicates that because of the wide range in asset lives, depreciation rates by primary accounts seem more reasonable than one rate for all depreciable plant. As such, Staff does not contest the proposed depreciation rates for Oak Run. Staff identifies the depreciation rates for Oak Run in its Initial Brief. (See Staff Initial Brief, pp.11-12)

5. Radium Removal Treatment Plant–Woodhaven Water

Aqua proposes adjustments related to an increase in the projected cost of the radium removal treatment plant for Woodhaven Water. Since Aqua provided information to adequately support the operating cost estimate and the increase to the projected cost of the facility, Staff does not object to Aqua's adjustments.

6. Original Cost Determination

Requirements regarding preservation of records are associated with an original cost determination. 83 Ill. Adm. Code 615, "The Preservation of Records of Water Utilities (General Order 189)" governs the preservation of records. Section 12(b)(1) of Appendix A of Part 615 provides that the records that support journal vouchers and journal entries charging plant accounts are to be maintained "7 years prior to date as of which original cost of plant has been unconditionally determined or approved by this Commission" in an original cost determination or a rate case. Staff recommends that the Commission conclude and make a finding in the order in this proceeding that Aqua's

December 31, 2003 plant balances reflected in Aqua Schedules B-5, Page 1 of 3, Column (C) for Woodhaven Water, Woodhaven Sewer, and Oak Run are approved for purposes of an original cost determination, subject to any adjustments ordered by the Commission. Aqua does not contest this recommendation. Accordingly, the Commission finds that Aqua's December 31, 2003 plant balances reflected in Aqua Schedules B-5, Page 1 of 3, Column (C) for Woodhaven Water, Woodhaven Sewer, and Oak Run are approved for purposes of an original cost determination.

7. Pension Update

In rebuttal testimony, Aqua proposes pension related adjustments to reflect updated actuarial information for 2005. Although Staff considers the effect of recognizing the updated amounts on the revenue requirement of each division immaterial and does not deem any adjustment warranted, Staff does not object to Aqua's inclusion of the updated amounts in its rebuttal position. Staff states that the adjustments affect rate base and operating expense accounts.

8. Plant in Service Adjustments

Staff proposes adjustments for Woodhaven Water, Woodhaven Sewer, and Oak Run utility plant for those items listed on Aqua's Continuing Property Records which have been removed from service or are no longer used and useful. Staff's proposed plant in service adjustments are incorporated in Schedules 2.05 (WW), (WS), and (OR) attached to Staff Exhibit 2.0. Aqua accepts Staff's adjustments. Staff adds, however, that during cross-examination Thomas Bunosky, the Vice President and Regional Manager of Aqua, testified that while Aqua for some time has had procedures in place by which it can verify the accuracy of its Continuing Property Records, there were some individuals who may not follow through on those procedures. (Tr. 105-107.) Given these statements, Staff is concerned that Aqua's Retirement Procedures implemented pursuant to the Commission's Order in Docket Nos. 00-0337/00-0338/00-0339 (Cons.) are not being adequately followed. As such, Staff requests that the Commission order Aqua to renew its efforts to successfully implement those Retirement Procedures. The Commission shares Staff's concern and directs Aqua to improve its implementation of the Retirement Procedures. As part of its improvement efforts, Aqua shall develop specific training procedures meant to ensure that all of the relevant employees are informed of the Retirement Procedures and their obligation to follow them. If such training procedures already exist, Aqua must ensure that the relevant employees are reminded to follow them and must be able to provide evidence of having done so if requested in its next rate case.

B. Contested Issues

1. Reverse Osmosis Plant-Oak Run

Aqua obtains water for its Oak Run customers from a well. Aqua reports that the well water is high in fluoride, total dissolved solids, sodium, and chlorides. The

concentration of these amounts exceeds the Illinois Environmental Protection Agency ("IEPA") secondary standards. Secondary standards are not required to be met but are a recommended standard. Aqua explains, however, that exceeding the secondary standards for fluoride requires an annual public notice to all of the Oak Run customers advising them of the health effects of elevated fluoride levels in the water. To determine the best available technology to remove the fluoride, total dissolved solids, sodium, and chlorides, Aqua reports that it spent \$32,958 in 2004 developing engineering plans. Aqua states that a pilot study has been conducted to determine that reverse osmosis is the best technology for removal. Aqua spent an additional \$35,222 on the pilot study. Aqua states further that the engineering plans are being finalized to determine the cost of the reverse osmosis treatment. Once the cost is determined, Aqua states that it will ask Oak Run customers if they are willing to accept the additional cost of a reverse osmosis plant. Aqua anticipates placing the matter before customers for a vote in the summer of 2006. If a favorable vote is obtained, Aqua anticipates that it will install the plant in 2007, when it also intends to file a new rate case to include the plant cost in rates.

In his rebuttal testimony, Mr. Bunosky offered a preliminary analysis concerning the reverse osmosis plant costs. Aqua's preliminary groundwork has identified an estimated capital cost for the facility of \$1,400,000. The revenue requirement for the capital would be approximately \$238,000 (17% of \$1,400,000). The increased operating costs (chemicals, power, etc.) are currently estimated to be approximately \$65,000 per year. He concludes that the total increased revenue requirement is estimated at \$303,000 per year. Mr. Bunosky calculates that this would result in an approximate rate increase of \$9.72 per month for all 2,600 customers.

When it filed its revised tariff sheets, Aqua included the cost of the engineering plans and pilot study in Account 101, Utility Plant in Service. Staff notes, however, that costs recorded as plant in service should reflect plant in place and must be used by a company in its utility operations. Because Aqua does not anticipate that the reverse osmosis plant will be in place by the end of the 2005 test year, Staff recommends that the \$68,180 be removed from Account 101 and recorded in Account 183, Preliminary Survey and Investigation Charges. Aqua agrees that the expenses should be recorded in Account 183, but only if the Commission agrees that it is reasonably certain that the reverse osmosis plant will be built. If the Commission concludes that the plant's construction is unlikely, Aqua believes that it is appropriate to amortize the \$68,180 over a ten year period to Account 675, Miscellaneous Expenses. Staff objects to amortizing the amount to Account 675 if the project is abandoned. In contrast, if the project is abandoned, Staff contends that the expenses for the engineering plan and pilot study should be recorded in Account 426, Miscellaneous Non-utility Expenses.

Whether the reverse osmosis plant is built is in question because ORPOA maintains that a favorable vote on the plant is unlikely. ORPOA's General Manager, Michael Davison, testifies that a favorable vote is unlikely for several reasons, including the demographics of the community, the level of the rates already charged by Aqua, and the relationship between Aqua and its customers. With regard to demographics,

ORPOA notes that most of the property owners (2,000 of 2,600) do not use any water at all. Of the roughly 600 residential lots that have been built upon, ORPOA points out that approximately half of these residents are part-time residents. Because the vast majority of property owners are not full-time residents, and therefore do not use Aqua's water, ORPOA considers it highly unlikely that a majority would agree to an additional monthly charge. ORPOA also accuses Aqua of ignoring the fact that 50% of all full-time residents have already installed private reverse osmosis systems in their homes. ORPOA does not believe that these property owners will support another rate increase. Any increase in rates as a result of the reverse osmosis plant would also only exacerbate the impact of the rate increase approved in this docket, further reducing the odds of a favorable vote, according to ORPOA. ORPOA also describes the relationship between Aqua and Oak Run customers as "very poor," which it believes is hardly conducive to obtaining a favorable vote for building the plant.

Aqua disagrees with ORPOA's prediction of the vote outcome. Aqua contends that customers will not consider the additional monthly charge so onerous, particularly after some of the reductions recommended by Staff in this proceeding. Aqua states further that some of the availability customers may someday decide to tap onto the water system and recognize that improved water quality would increase their property value. ORPOA's assertion that 50% of full-time residents already have private reverse osmosis systems is questioned by Aqua as well. Even if this assertion is true, however, Aqua states that its reverse osmosis plant would still benefit these customers. Aqua also characterizes as speculative ORPOA's description of the relationship between Aqua and its customers. Moreover, Aqua claims that a majority of Oak Run customers have expressed overwhelming support for the reverse osmosis plant. Aqua states that it received this feedback when it conducted a customer survey during the pilot study.

Because the reverse osmosis plant will not be constructed by the end of the 2005 test year, the Commission concurs with Staff that the \$68,180 representing the cost of the engineering plan and pilot study should be removed from Account 101 and recorded in Account 183. Furthermore, these expenses will not be reflected in the rates adopted in this proceeding. If the possible construction of a reverse osmosis plant is abandoned, these expenses should be transferred to Account 426 and continue to be excluded from rate base. A ten year amortization of these costs through Account 675 is not appropriate. Exclusion from rate base and below the line amortization of these costs in the event of abandonment would be appropriate because this project was initiated solely at the election of Aqua. In other words, while seeking to improve water quality is laudable, Aqua is under no obligation to meet the IEPA's secondary standards. Additionally, given the nature of the Oak Run customer base, Aqua should not have assumed that recovery of preliminary expenses would be approved if the project was ultimately abandoned.

2. 1998 Sewer Main Extension and Lift Station Project-Woodhaven Sewer

In 1998, Aqua's predecessor, Consumers Illinois Water Company ("CIWC"), initiated in conjunction with WA a sewer main extension and lift station project. The total cost of the project was approximately \$244,851. Under their agreement, WA was to pay \$216,230 and CIWC would pay the remainder. WA now wants to be certain that none of its contribution is reflected in the rate base calculation for Woodhaven Sewer. Aqua's Schedule B-15(WS) reflects a customer advance in the amount of \$184,207. Aqua's Schedule B-1(WS) reflects a deduction from rate base in an equal amount. In its Reply Brief (see p.4), Aqua agrees to an additional adjustment of \$21,623 to increase the amount of customer advances for this project to \$205,830. Aqua indicates that research conducted after reviewing WA's Initial Brief lead to its Reply Brief adjustment. Aqua maintains that the \$10,400 difference between what it and WA believe should be reflected as a deduction from rate base is accounted for by refunds paid to WA in 1999. Aqua relies on Aqua Cross Exhibit 1 to support its contention.

Neither party's arguments definitively resolve this issue. Aqua acknowledges that WA contributed \$205,830 to the project, which is \$10,400 less than what WA says it contributed. While Aqua seems to believe that its Cross Exhibit 1 disposes of this issue, the Commission simply does not see how the calculation offered in the cross exhibit reconciles the discrepancy in the parties' numbers. WA, on the other hand, offers several documents in its Exhibit 1.07 concerning its agreement with CIWC. Although none of these documents are dispositive either, they support WA's contention that it contributed at least \$216,230. What tips the scales in WA's favor on this issue is Aqua's apparent inability to fully account for WA's contributions at the outset. The Commission commends Aqua for being honest and disclosing its recent discovery of another \$21,623 contributed by WA. While it does not mean to punish Aqua for its honesty on this issue, and given the poor record on this issue, the Commission is inclined to believe that the remaining amount in dispute was paid by WA and not refunded by Aqua. The burden of proof lies with Aqua and, on this issue, Aqua's position is not persuasive. Accordingly, the rate base for Woodhaven Sewer should be adjusted to reflect a deduction of \$216,230 for WA's contribution to the sewer main extension and lift station project.

3. Sewer Service Installations-Woodhaven Sewer

As previously noted, not all of the campsites in the Woodhaven Lakes Community receive sewer service. From time to time, campsite owners request a sewer connection. Aqua explains that it views the installation of sewer service to a campsite as consisting of three steps. The first step is to ensure that a portion of the sewer main is located in a place from where the new service line can extend to the property seeking service. If the main is in such a location, such as in the street in front of the property in question, step one is not necessary. If the main is not so located, however, Aqua has to extend the main from its current location to a new location from where the new sewer service line can extend to the property. Aqua states that any

costs to extend the existing sewer main from its current location to one from where the property can be accessed with a new service line is borne by the customer who applies for the new service.

The next two steps, Aqua continues, pertain to the installation of the new service line. Step two is the installation of the service line from the sewer main to the property line. Step three is the installation of the service line from the property line to the property's structural improvement. Aqua states that it is responsible for the costs associated with step two and the new customer is responsible for the costs associated with step three. Aqua, or its subcontractor, actually does all of the work for both steps two and three. When it comes to paying for the costs of steps two and three, Aqua states that it charges the customer a fixed amount per foot to complete both steps two and three, and pays the difference between the amount collected from the customer and the actual cost to complete steps two and three. Because, according to Aqua, a sewer installation is two (or perhaps even three) projects, it would be difficult, costly, and subjective to try to assign costs to each of three steps of the project. To simplify the matter, Aqua states that it charges the fixed per foot charge and only seeks to include what it estimates its costs to be (the estimated difference between that collected from the customer and the actual project cost) in rate base capital additions.

In contrast to Aqua's description of the matter, WA maintains that each new sewer customer bears 100% of the installation costs. To support this position, WA relies on a July 30, 2003 letter from CIWC to WA describing its policy regarding new sewer connections. The letter has been entered into the record as WA Exhibit 1.08. WA contends that the third step is not at issue and has only been identified by Aqua to confuse what is at issue. WA asserts that the costs that customers pay represent Aqua's engineering and permitting costs as well as an estimate based on Aqua's actual costs incurred from other sewer extensions. WA contends that Aqua's actual costs do not materially differ from the estimates. WA observes that Aqua seeks to include in rate base as capital additions \$25,105 that Aqua claims to have spent on new sewer service installations in 2004. Because it believes that customers pay the entire cost of new service installations, WA argues that it is inappropriate for Aqua to include any amount in Woodhaven Sewer's rate base for sewer service installations.

Staff states that it reviewed the matter and believes that Aqua is correct. Staff adds that the relevant tariff sheets may be found at: Ill. C. C. No. 48, Section No. 1, Original Sheet Nos. 4, 6, 17, and 28.

To resolve this issue, the Commission begins by reviewing the relevant tariffs. Ill. C. C. No. 48, Section No. 1, Original Sheet No. 6 discusses customer sewer lateral connections. Section II.B. provides that the customer desiring service shall bear all costs and expenses incident to the installation and connection of that portion of the project on the customer's property. Ill. C. C. No. 48, Section No. 1, Original Sheet No. 28 discusses extension of sewers. Section XI.A.2. provides that upon application being made for an extension of a sewer, Aqua shall estimate the cost of the proposed extension. Section XI.A.3. states that if the estimated cost is not greater than 1½ times

Aqua's estimate of annual revenue to be received from the customer, Aqua will finance and make the extension without the requirement of any payment. If the estimated cost exceeds 1½ times Aqua's estimate of annual revenue from the customer, the customer shall contract for such extension and shall deposit with Aqua the estimated cost of the extension less 1½ times such estimated annual revenue. When the actual cost of the extension is known, the tariff sheet provides for a "true-up" mechanism. Ill. C. C. No. 48, Section No. 4, Original Sheet No. 2 specifies that the flat monthly charge for sewer service to each campsite is \$10.68, whether or not there is an actual discharge of sewage. One and one-half times the estimated annual revenue from each campsite customer is therefore \$192.24.

Accordingly, under its tariffs, Aqua would pay \$192.24 for each new sewer extension and the customer served by the new service would pay the remainder of the costs of the extension. To determine what amount should be included in Woodhaven Sewer's rate base representing Aqua's share of sewer extension costs, WA Exhibit 2.02 must be used. WA states that it obtained this document from Aqua. WA Exhibit 2.02 consists of a list of the individual lots that received sewer extensions in 2004. The list reflects five projects carried over from 2003 as well. Altogether, the list reflects 37 sewer extension projects. The record identifies no other such projects. Therefore, under its tariffs, Aqua would have invested \$7,112.88 as its portion of the total cost of the 37 projects. This is the appropriate amount to include in Woodhaven Sewer's rate base as capital additions for new sewer extensions.

Based on the descriptions provided by the parties, it does not appear that Aqua is installing new sewer extensions in a manner consistent with its tariffs. The source of this "policy," as CIWC refers to it in the June 30, 2003 letter identified as WA Exhibit 1.08, is unclear. Regardless of the source of the policy, however, Aqua must not act outside of the terms of its tariffs. Because it has done so, over- and/or undercharges may have occurred. Aqua is directed to assess future sewer extension charges in the manner specified in its tariffs.

C. Commission Conclusion on Rate Bases

Giving affect to the adjustments to the rate bases approved above, the Commission concludes that the original cost rate bases for the 2005 test year for three operating entities are as follows:

Woodhaven Water	\$2,831,454
Woodhaven Sewer	\$2,869,390
Oak Run	\$1,589,806

The appendices attached hereto provide supporting calculations for the rate bases approved herein.

III. OPERATING REVENUES AND EXPENSES

Schedules showing the operating revenues, expenses, and income at present and recommended rates for the test year ending December 31, 2005 were presented by Aqua and Staff.

A. Summary of Uncontested Issues

1. Interest Synchronization

Staff proposes adjustments for Woodhaven Water, Woodhaven Sewer, and Oak Run to interest synchronization in order to ensure that the revenue requirement reflects the tax savings generated by the interest component of the revenue requirement. While Aqua accepts the mechanics of Staff's calculation, it points out that the actual interest synchronization depends on the final rate base and weighted cost of debt the Commission adopts in this case. Staff agrees that the ultimate amount of synchronized interest expense will be determined after the rate base and weighted cost of debt components are finalized, using the methodology Staff propounds.

2. Gross Revenue Conversion Factor

The Gross Revenue Conversion Factor ("GRCF") is applied to the operating income deficiency to derive the total amount of revenue required for the income deficiency and the associated increase in income tax expense and uncollectibles expense change. The GRCF is based upon the applicable federal tax rate, state income tax rate, and uncollectibles rate. Staff proposes an adjustment to Aqua's GRCF as presented on Aqua Schedules A-2.1 for Woodhaven Water, Woodhaven Sewer, and Oak Run. While Aqua used a state income tax rate of 7.18%, Staff points out that the state income tax rate is actually 7.30%. Staff explains that the statutory rate for Illinois income tax on the income of a corporation changed because there is no longer a credit for replacement tax paid. The credit was available for years ending prior to December 31, 2003. Accordingly, Staff states that the statutory income tax rate of 4.80% and replacement tax rate of 2.50% equal a combined rate of 7.30% for years ending subsequent to December 31, 2003. Staff further adjusts Aqua's GRCF for Woodhaven Water and Woodhaven Sewer to incorporate the uncollectibles rate of 4.2298%. While Aqua agrees with the concepts and approaches of arriving at the proper GRCF amounts, Aqua indicates that the uncollectibles rate used by Staff for Woodhaven Water and Woodhaven Sewer is understated and should be based on the Commission's final determinations regarding the uncollectibles expenses. Staff concurs with this assessment.

3. London Witte Group Audit Services Fees

Staff proposed an adjustment to the audit services fees of the London Witte Group based on a pro-ration of the total \$45,000 audit fee among the five divisions included in its engagement letter with Aqua. Staff's adjustment limited the auditing

expenses to \$9,000 (exclusive of travel expenses) for each of the three divisions in this proceeding. While Aqua accepts the adjustment, it challenged the disallowance of \$4,200 additional costs billed by London Witte Group for its trip to meet with Staff in Springfield and provided supporting documentation. Based on its review of the additional information provided by Aqua, Staff concludes that it was reasonable to allocate the total cost of the London Witte Group \$4,200 invoice equally among the three divisions, resulting in an allowed \$31,200 for audit services.

B. Contested Issues

1. Uncollectible Expense-Oak Run

a. Aqua's position

Aqua calculates bad debt expense as a percentage of revenue. Under current rates, bad debt expense represents 0.4911% of revenue, or \$1,620. Because of difficulty in collecting amounts owed by Oak Run availability customers, Aqua originally proposed to increase the percentage of revenue reflected as bad debt expense from 0.4911% to 2.0%. This change, in combination with the Oak Run rates requested by Aqua, resulted in a proposed bad debt expense of \$12,847.

In response to Staff's objections to its proposal, Aqua now proposes to include \$6,449 as bad debt expense in Oak Run's rates. This amount represents the \$1,620 currently collected plus one third of \$14,487, or \$4,829. Aqua explains that there are currently \$14,487 of receivables over 91 days due for Oak Run. Aqua proposes to evenly divide the amount of receivables over a three year period. Why Aqua has chosen to spread the receivables over a three year period is not exactly clear.⁵ Under Aqua's revised proposal, the revenue percentage reflected as bad debt is reduced from 2.0% to 1.38%.

Aqua explains that collecting from availability customers is a problem because they are not connected to the system but rather pay for the opportunity to take service. Therefore, when an availability customer does not pay, Aqua can not terminate service. As a result, availability customers who are delinquent remain customers. Aqua maintains that the only way to collect the amounts owed is through foreclosures, which cost approximately \$2,000 per account. Aqua argues that it would constitute a forgiveness of debt to write-off existing customers' delinquent accounts, so it does not write-off the unpaid amounts. Consequently, Aqua continues, historical write-offs only identify the amount of bad debt expense Aqua is able to write-off—the amount of bad debt expense caused by Oak Run consumption customers. Aged receivables past 91 days due are not likely to be collected, according to Aqua, and therefore demonstrate the amount of bad debt expense Oak Run availability customers are causing, which will not be written off. Aqua contends that Staff and ORPOA's analyses fail to recognize the

⁵ Whether Aqua's proposal to divide the receivables over three years is tied to the three year amortization period it has requested for Oak Run is unclear.

distinction between consumption customer's unpaid bills, which are written off, and an availability customer's unpaid bills, which are not written off.

b. Staff's position

Staff opposed Aqua's original proposed uncollectible expense on the grounds that Aqua's 2.0% proposal was based on its experience with its Candlewick Division, not Oak Run. Staff's analysis of Aqua's actual write-offs during the past five years indicates that Aqua has experienced average write-offs approximating 0.3696% of annual revenue. Even regarding Aqua's revised proposal, Staff does not believe that Aqua's actual write-offs support a 1.38% uncollectibles rate for Oak Run. Staff also avers that Aqua's revised method of estimating annual bad debt expense is highly unorthodox and bears no apparent relationship to the experience of Aqua in its ability to predict future write-offs. Specifically, Staff complains that Aqua presented no evidence to support its claim that Oak Run availability customer accounts over 91 days due will not be collected or that one third of the amount is reflective of actual bad debts. For these reasons, Staff urges the Commission to retain the current 0.4911% uncollectibles rate for Oak Run.

c. ORPOA's position

Because it believes Aqua's write-offs have been decreasing over recent years, ORPOA finds any increase in Aqua's bad debt expense for Oak Run inappropriate.

d. Commission conclusion

As Staff suggests, Aqua's revised method of calculating bad debt expense is unorthodox. The Commission, however, understands the position that Aqua finds itself in concerning Oak Run availability customers. Availability customers who do not pay their bills represent a cost to Aqua which only grows over time. Forgiveness of such irresponsible behavior of such customers is not appropriate under the circumstances. The Commission is concerned by the unorthodox calculation method employed by Aqua, the unexplained use of a three year denominator, and unexplained change in its calculation method in its rebuttal testimony, but is mindful of the absence of any other alternative reflecting the impact of delinquent availability customers. Thus, given the record in this proceeding, the Commission believes that the most reasonable action is to adopt an uncollectibles rate of 0.3696%, the five year historical average of Aqua's actual write-offs, but also include an adjustment of \$4,829 to the test year reflecting bad debt expense caused by availability customers. In other words, Aqua's uncollectibles expense for Oak Run will reflect two components—the historical average of actual write offs and a separate factor reflecting bad debt caused by delinquent availability customers. This conclusion recognizes the distinction between bad debt that Aqua writes off and bad debt that Aqua, for good reason under the circumstances, does not write off.

This conclusion is by no means an endorsement of Aqua's methodology; rather, it represents the selection of the least objectionable alternative. The Commission encourages the parties to explore means of resolving this collections problem, including the possibility of bulk billing ORPOA. Failure to develop a better alternative does not mean that the same or a similar methodology will be used in a future rate case. ORPOA must also understand that the rate increase approved in this proceeding is in part driven by those ORPOA members who have not paid their water bills.

2. Uncollectible Expense-Woodhaven Water and Sewer

a. Aqua's position

Under current rates, bad debt expense represents 6.6579% of Woodhaven Water's annual revenue, or \$53,148, and 7.1576% of Woodhaven Sewer's annual revenue, or \$53,724. Aqua does not propose to change the percent of revenue reflected as bad debt expense. Based on the revenue at its proposed rates, Aqua's original proposed bad debt expense for Woodhaven Water was \$86,456 (Schedule C-2.3(WW)) and for Woodhaven Sewer was \$86,600 (Schedule C-2.3(WS)).

Aqua asserts that uncollectibles are a problem for Woodhaven Water and Sewer because shut-off valves are not built into the systems and it would be cost prohibitive to do so. With very limited exceptions where Aqua has determined it is appropriate to install a shut-off valve, customers who do not pay for service remain active customers. Aqua contends that it would be a forgiveness of debt for Aqua to write-off amounts due from active customers. As a result, Aqua writes off uncollectibles in Woodhaven Water and Sewer at a significantly reduced rate and is in the atypical situation of having past amounts due reserved against it.

Although Staff made no adjustments to bad debt expense for Woodhaven Water or Sewer in its direct testimony, Aqua, in its rebuttal testimony, asserted that its updated projection for bad debt expense for Woodhaven Water was \$103,394 and for Woodhaven Sewer was \$112,174. In explaining how it calculated its updated projections, Aqua stated that there were approximately 536 active, delinquent accounts for which Aqua had no expectation of payment for both Woodhaven Water and Sewer. For Woodhaven Water, at the proposed water rate of \$16.075 per month, Aqua expected the annual bad debt expense to be \$103,394 on a pro forma basis prior to the addition of late payment fees. For Woodhaven Sewer, at the proposed sewer rate of \$17.44 per month, Aqua expected the annual bad debt expense to be \$112,174 on a pro forma basis prior to the addition of late payment fees. Aqua stated that it calculated bad debt expense based on the number of active, delinquent accounts instead of as a percentage of projected revenue because bad debt expense is more directly tied to actual accounts that exhibit no desire to pay than to revenues. Aqua argued that the current existence of 536 delinquent accounts for which there was no expectation of payment was very likely representative of the circumstances throughout the remainder of this 2005 test year. Despite claiming the higher bad debt expenses in its rebuttal testimony, Aqua's rebuttal schedules did not appear to reflect the higher numbers.

In its surrebuttal testimony, Aqua again offered an update on bad debt expense. Aqua claims that as of May 31, 2005 it had 552 accounts delinquent across both divisions with liens filed totaling \$451,991. Even with liens filed, Aqua contends that very little of this amount will be recovered. Aqua states further that it is pursuing some foreclosures depending on its assessment of relevant factors, such as amount owed versus foreclosure cost, whether the customer has paid association dues and taxes, and whether there is a clean title. Aqua is also pursuing some personal judgments. Aqua contends that these actions, however, are expensive and typically are not expected to yield an overall benefit.

Additionally, Aqua acknowledges that it expects to write off a portion of the delinquent amount. Aqua explains that approximately 49 of the current 552 delinquent accounts were to be sold at a tax auction on July 15, 2005, for non-payment of taxes. These accounts amount to \$76,000 of the \$451,991 in water and sewer bill delinquencies. Aqua states that the new owners will not be liable to Aqua for the past due amounts—thus, the \$76,000 will likely be written off.

Aqua states further in its surrebuttal testimony that the \$76,000 that will likely be written off represents only a small portion of the true annual expense. Aqua contends that it is imperative that Staff and the Commission recognize the total expense, both write offs and the larger remainder of uncollectible expense that results from increases to the uncollectible reserve. Aqua states that the Commission recognized a combined allowance of \$92,165 in Woodhaven Water and Sewer's most recent rate cases. Because the problem has worsened, Aqua indicates that its combined test year expense of \$106,872, if adjusted, should be increased. The combined test year expense of \$106,872 referenced by Aqua is the sum of \$53,148 and \$53,724. Aqua's surrebuttal schedules, however, do not reflect this amount. Nor did Aqua acknowledge in its surrebuttal testimony that it had revised its original position.

In its Initial Brief, Aqua claims that its original test year bad debt expense request for Woodhaven Water was \$53,148 and for Woodhaven Sewer was \$53,724. Aqua cites Schedule C-16(WW) and Schedule C-16(WS), respectively. Later in its Initial Brief, Aqua states that it "only seeks to recovery (sic) \$53,148 and \$53,724 in the test year and \$85,279 and \$82,576 at surrebuttal proposed rates" (p.11) for Woodhaven Water and Woodhaven Sewer, respectively.

Aqua also argues in its Initial Brief that Staff's position improperly focuses on historical write-offs and fails to consider the bad debt expense that Aqua can not write-off. Aqua asserts that actual write-offs are significantly smaller than the bad debt expense Aqua incurs as a result of Woodhaven customers who do not pay but whose service can not be shut off.

Aqua's Initial Brief also addresses WA's request to implement bulk billing pursuant to which Aqua would issue a single bill to WA for all non-metered properties and WA would be responsible for payment irrespective of its ability to collect from the

ultimate end users. Despite having raised the issue, Aqua contends that WA has not said it will implement bulk billing—only that it is interested and that it requires further study. Aqua asserts that a bulk billing option could be a good resolution to the division’s uncollectibles problem. In fact, Aqua continues, it is an option first raised by Aqua with WA at a May 15, 2003 meeting with WA. Aqua states further that it attempted to pursue the option with WA in early 2004.

Despite its interest in pursuing bulk billing, however, Aqua argues that the Act does not grant the Commission legal authority to implement a bulk billing option. Nowhere in the Act, Aqua maintains, is the Commission given authority to require a property owners association to assume legal responsibility for third party customers’ utility bills, nor can it (a) impose on an association the costs associated with billing and collecting from end users, or (b) regulate the manner in which an association bills and collects for utility service. Aqua’s customers are those individuals that take service, not the association that operates the campsite facilities. Unless WA voluntarily agrees to assume these responsibilities, Aqua states that it is the customers themselves that are responsible for paying the bills.

In any event, Aqua points out that there is no evidence as to what a bulk billing option would specifically entail. As an example, Aqua notes that WA alleges generally that some of Aqua’s administrative costs would be reduced, but does not identify those costs specifically. As such, Aqua contends that WA has not presented even a minimal evidentiary foundation from which a bulk billing option could be constructed and implemented. Consequently, Aqua maintains that the Commission has no evidentiary record to adjust Aqua’s expenses in the event a bulk billing option is somehow adopted.

Furthermore, even in WA’s general discussion of costs that its proposal would allegedly reduce, Aqua claims that WA identifies costs that are entirely unrelated to the uncollectibles problem. Aqua states that WA alleges that bulk billing would reduce the management expenses related to the customer count allocation issue. Aqua responds that the expenses that are the subject of the customer count allocation issue are common costs incurred at Aqua’s corporate parent and Illinois corporate levels to operate all divisions. Aqua states that the division-specific costs it incurs in relation to the uncollectibles problem are not common costs that are allocated among all divisions by customer count.

b. Staff’s position

Because it was still waiting for responses to discovery requests, Staff explains that it made no adjustments to bad debt expense for Woodhaven Water or Sewer in its direct testimony. Upon receiving the requested information, Staff averaged the last five years’ actual write-offs to derive the combined uncollectibles rate of 4.2298%. This rate is utilized as the basis for the 2005 test year bad debt expense proposed by Staff for Woodhaven Water and Sewer in its rebuttal testimony.

Although Aqua criticizes Staff's position for failing to consider the position that Aqua is in, Staff contends that Aqua's position is unreasonable. Aqua maintains that it would be too expensive to install shut-off valves for every Woodhaven customer, but not every customer needs a shut-off valve. With regard to the 552 delinquent accounts owing \$451,991, Staff notes that at \$400 per customer to install a shut-off valve, it would cost Aqua \$220,800 (552 x \$400) to install shut-off valves that would enable it to discontinue service to such delinquent customers. Rather than address the situation, Staff points out that Aqua asks the Commission to approve higher rates, which it will then bill to the same customers that it claims will not pay, so that by the next rate proceeding for Woodhaven Aqua's purported bad debt expense will be even higher. Staff maintains that there is no rational basis for allowing Aqua to recover the level of uncollectibles expense that it seeks in its rebuttal position when doing so would reward Aqua for poor management of its uncollectibles problem. Staff recommends that the Commission reject Aqua's substantially higher requested bad debts expense in favor of Staff's proposed adjustments to the uncollectibles rates.

With regard to WA's bulk billing proposal, Staff observes that bulk billing has been recognized as a possible solution to the collections problem at the divisions since at least May 2003, when it was an item on the agenda of a meeting between Aqua and WA. Staff further notes that while both purport to be interested in exploring a bulk billing arrangement, Aqua and WA have been unable to come to any agreement regarding bulk billing. In light of the circumstances, Staff points out that the record in this case does not address the impact that bulk billing would have on the revenue requirement for Woodhaven Water and Sewer customers. Therefore, Staff does not believe that the Commission can address the impact of bulk billing on the test year revenue requirement. In any event, Staff does not believe that the Commission is in the business of supervising the conduct of a utility's management of its customer relations; nevertheless it is apparent from the record that Aqua and WA are not on the best of terms. As such, Staff states that it would be in the best interest of a continued relationship between Aqua and WA to actively explore the possibility of bulk billing and the resulting impact on a test year revenue requirement.

c. WA's position

WA acknowledges the problem that Aqua is having collecting amounts owed from certain WA members. WA, however, contends that much of it is a problem of Aqua's own making. Specifically, WA cites a statement by Aqua's Chief Financial Officer indicating that Aqua lacks experience with such resort type areas. WA also notes that Aqua has allowed a small minority of the delinquent customers to accrue a significant portion of the identified bad debt. WA complains that only a relatively small number of these customers have been disconnected for non-payment. WA criticizes Aqua for not being diligent in its collection efforts. WA does not believe it is appropriate for Aqua to pass on costs that they have compounded over many years because no actions were taken by Aqua to address on-going collection issues. Not pursuing more aggressive collection efforts was Aqua's decision, not WA's decision; and WA does not

believe that it should be responsible for excessive delinquencies that have accumulated.

WA notes that Aqua bases its bad debt expense request upon a percentage of its overall revenue projections. WA asserts that the bad debt expense revenue requirement would go away if WA paid the water and sewer bills. WA has proposed that Aqua bill it directly for the service provided to the more than 6,000 customers of the division. Bulk billing, according to WA, eliminates entirely the collection issue for Aqua and significantly reduces administrative costs to process this income. Such uncollectibles would no longer be an issue in Woodhaven Water and Sewer rate cases and ensures that Aqua will receive 100% of its revenue request. WA notes that Aqua's own witness admits that the uncollectibles problem at Woodhaven requires more effort by management and other Aqua employees. (Tr. p.120) In the absence of the Woodhaven uncollectibles problem, WA asserts that Aqua will experience cost savings in variety of areas. WA urges the Commission to require the implementation of bulk billing.

d. Commission conclusion

At the outset the Commission must note its dissatisfaction with Aqua's inability to clearly and concisely state its position on this issue. Schedule C-2.3(WW) and Schedule C-2.3(WS) of Aqua's December 2004 tariff filing reflected proposed bad debt expense at the proposed rates of \$86,456 for Woodhaven Water and \$86,600 for Woodhaven Sewer. Throughout its rebuttal and surrebuttal testimony, Aqua then discusses updates to its bad debt expense projections. Schedule 8.1(WW) and Schedule 8.1(WS) attached to Aqua's surrebuttal testimony reflects pro forma proposed uncollectible expense for Woodhaven Water of \$85,279 and for Woodhaven Sewer of \$82,576, respectively. Then, in its Initial Brief, Aqua touts the generosity of its "original" test year proposals of \$53,148 and \$53,724 for Woodhaven Water and Sewer, respectively, (p.11), while the schedules attached to its Initial Brief reflect its surrebuttal proposal. Aqua's cites Schedule C-16(WW) and Schedule C-16(WS) in its Initial Brief as the source for its for \$53,148 and \$53,724 figures for Woodhaven Water and Sewer, respectively. These schedules, however, reflect Aqua's uncollectibles based on *current* rates (See Schedule C-2.3(WW) and Schedule C-2.3(WS)). Clearly what Aqua refers to as its test year proposal in its Initial Brief is not what Aqua actually proposed in its December 2004 tariff filing. The fact that Aqua can not even keep straight it own position after discussing its numerous updates demonstrates the problems that the Commission experienced in following Aqua's proposals. Given the resources that Aqua brought to bear in this case, the Commission would expect a better presentation of its position.

Regardless of whatever amount Aqua seeks to recover for Woodhaven bad debt, however, the Commission is not inclined to adopt Aqua's position. As with Oak Run, the Commission understands Aqua's difficulties in collecting payment from Woodhaven Water and Sewer customers that it is unable to disconnect. Uncollectibles resulting in actual write-offs and uncollectibles resulting from delinquent customers that Aqua can

not disconnect accumulate over time. But unlike Oak Run, Aqua and WA agree in concept on a way to mitigate or perhaps even eliminate the uncollectibles problem—bulk billing. To ignore this alternative and include in rates a significant sum of money reflecting what a minority of delinquent customers owe is unreasonable. Doing so would not encourage the parties to come to any resolution of this issue and would most likely only exacerbate the problem and lead to Aqua seeking to include a larger amount of such bad debt expense in its next rate case.

But the Commission will not order the implementation of the bulk billing alternative in this docket. As a practical matter, insufficient information exists in the record to establish such an arrangement and reflect its impact in Woodhaven Water and Sewer rates. Logically, Aqua would expend fewer resources if it did not have to deal with this uncollectibles problem, but the record simply does not contain adequate detail on this question. Rather than require bulk billing, the Commission strongly encourages Aqua and WA to negotiate in good faith means of implementing bulk billing, or any other mutually acceptable alternative, to resolve this problem to their mutual satisfaction. How to address recovery of currently delinquent accounts may be discussed as well, but need not be reflected in any forward looking arrangement. Staff shall make itself available to help mediate such discussions if requested. In encouraging Aqua to discuss bulk billing and/or other alternatives, the Commission does not mean to suggest that Aqua should not feel free to take other steps to encourage payment, such as installing shut off valves when appropriate.

Until the next rate case for Woodhaven Water and Sewer, however, Aqua's rates should include some level of uncollectibles expense reflecting its actual write offs. Staff identifies 4.2298% as the five year average combined uncollectibles rate for Woodhaven Water and Sewer. This percent of the revenue received by Woodhaven Water and Sewer shall be reflected in their respective rates as uncollectibles expense.

Having come to this conclusion, WA, as the party requesting bulk billing, is strongly advised not to "lose interest" in bulk billing since Aqua's new rates will not reflect the delinquent accounts that Aqua does not write off. While the current threat of higher rates from such delinquent accounts has subsided, the Commission will not look favorably upon similar WA objections in the next rate case if it comes to light that WA failed to make the best of this opportunity.

3. Allocation of Management Expense-Woodhaven Water and Sewer

Under the current rates for Woodhaven Water, Woodhaven Sewer, and Oak Run, the costs in Account 634, Contractual Services – Management Fees (water), and Account 734, Contractual Services – Management Fees (sewer), are allocated based on rate base. These accounts include contractual costs paid for the performance of management functions. Aqua states that these management expenses are common costs incurred at the Illinois corporate level and Aqua America, Inc. parent level to operate/manage all of the Illinois divisions. Aqua offers as examples of these types of

costs the cost to prepare an overall state budget and the salaries and wages of Aqua's President and Chief Financial Officer. Aqua represents that specific divisions within Aqua do not cause these costs to be incurred.

Because common costs can not be assigned to specific divisions, Aqua uses an allocation methodology to assign such costs across customers in all divisions. Rather than use the rate base methodology previously employed by Aqua, in these proceedings Aqua proposes to use customer count. In other words, common costs in Accounts 634 and 734 would be allocated based on the number of customer accounts in each division. WA objects to the customer count methodology. Staff proposes an alternative to the rate base methodology and the straight customer count methodology.

a. Aqua's position

Aqua contends that its customer count allocation method is fair because it results in every single customer bearing an equal amount of the costs. Aqua points out that the Commission approved the use of this allocation method for management expenses in Aqua's most recent rate cases for its Kankakee and Vermilion divisions. (See Sch. A-5, WP-A5 in Docket Nos. 03-0403 and 04-0442) Because allocation methodologies distribute 100% of common costs among all customers, Aqua complains that reducing the allocation to any set of customers will result in either an under-recovery or the allocations to all other customers increasing such that 100% of the costs are still allocated in total. Aqua asserts that either scenario results in an unequal distribution of common costs.

In support of alternatives to Aqua's proposed allocation methodology, WA and Staff argue that reductions in allocated expenses would be appropriate because Woodhaven Water and Sewer customers do not use their properties on a year around basis. Usage, however, results in direct costs; not common costs like those costs in Accounts 634 and 734. Because it has to be prepared to provide service 24 hours a day, 365 days a year, Aqua asserts that it incurs all common costs found in Accounts 634 and 734 regardless of the actual level of usage.

WA also argues that Aqua treats customers who take both water and sewer service as a single customer and therefore a customer receiving both water and sewer service should be counted only once.⁶ How it "treats" customers, Aqua responds, also only affects direct costs. While WA notes that (1) Aqua sends a single bi-monthly bill with both service charges to people who are customers of both divisions, and (2) Aqua provided WA with uncollectibles information based on a per lot rather than customer-by-division basis, Aqua maintains that the only costs it avoids by issuing a single bill are the variable costs directly related to billing, *i.e.*, the cost of paper and postage to send a second bill when customers take both services.⁷ Aqua avers that it still incurs the cost

⁶ Aqua has 11,575 customers across both Woodhaven divisions (6,169 water customers and 5,406 wastewater customers).

⁷ Aqua states that it did not save any costs by the mere fact that it reported uncollectibles to WA on a per lot basis.

of deriving the bill amounts and applying payments for both services. Aqua contends that common operational costs are not reduced as a result of issuing a single bill because the services are still separate. Aqua has a water plant and distribution system through which it provides water service, and a sewer plant and distribution system through which it provides sewer service.

Moreover, Aqua argues that reducing the common costs allocated simply because direct costs are not incurred would double count the savings resulting from the avoided direct costs. As an example, Aqua explains that to the extent it is able to share its direct operating costs between Woodhaven Water and Sewer, it divides the costs between them. As such, the employees who operate in both divisions track their work and activities, and Aqua assigns the proportionate share of their salaries directly between the two divisions via the Labor Expense account. Each Woodhaven division saves the portion of the employee's salary that is directly proportionate to the amount of time and work the employee performs for the other Woodhaven division.

Aqua also argues that neither Staff nor WA has identified a reasonable basis to treat Woodhaven Water and Sewer customers differently when it comes to the allocation of common costs. Because the factors those parties identified relate to direct costs, Aqua maintains that they are not reasonable bases to distinguish or differentiate the allocation of common costs. In the absence of such a reasonable basis founded in the record, any reduced allocation would amount to preferential treatment. Aqua contends that Oak Run, for example, is similarly situated to Woodhaven Water and Sewer in that customers do not take service all year. But if Woodhaven Water and Sewer customers see a reduced allocation of common costs from Accounts 634 and 734, Aqua asserts that Oak Run customers would see an increased allocation of the common costs (assuming 100% recovery of the costs).

Aqua acknowledges WA's claim that its members are treated unfairly under the customer count methodology, but counters that WA offers no compelling argument in support of its position. Being allocated more common costs under one method than another is not, Aqua avers, a sound basis for allegations of unfair treatment. Aqua states that WA clearly favors the method that will allocate less common costs to its members irrespective of the resultant effect on customers in Aqua's other divisions. Aqua accuses WA of disregarding the fact that customers in other divisions will pay more than their equal shares of common costs so that Woodhaven customers can pay less. In fact, Aqua continues, allocating less than equal shares to Woodhaven customers would cause increased allocations to customers in mostly smaller divisions.

In contrast to WA's allegations of unfairness, Aqua maintains that there is substantial evidence that customer count allocations are equitable. First, Aqua notes again that the customer count method produces equal allocations, which is inherently fair for common costs that are driven equally by all customers. The rate base method, Aqua adds, would allocate unequal customer shares. Second, Aqua states that customer counts better reflect the fact that the more customers a water or sewer system has the more issues arise that require customer support, engineering, accounting,

operations, maintenance, planning, forecasts, budgets, etc. Third, Aqua indicates that customer count is consistent with the manner in which its parent company allocates common costs and, therefore, the simplest for Aqua to administer.

b. WA's position

WA observes that the largest jump in costs to Woodhaven Water and Sewer comes not from an increase in expenses but rather by simply changing the cost allocation methodology for management expenses and other contractual service based expenses from a rate base allocation to a customer count allocation. This increase, WA continues, is exacerbated by what it believes to be an inflated count of customers. WA complains that this change is being made without Aqua presenting any studies or analysis on why the current methodology is inappropriate to accurately track cost-causation.

WA asserts that the change in allocation methodology is significant. WA relies on the following calculations by Staff:

<u>Allocation Method</u>	<u>Woodhaven Water</u>	<u>Woodhaven Sewer</u>
Customer Count	\$238,669	\$208,228
Rate Base	\$ 58,921	\$ 59,671
Difference	\$179,748	\$148,557

WA also offers the following charts depicting the impact of changes in allocation methodologies on Woodhaven Water and Sewer compared to Aqua's other divisions:

Aqua Illinois Divisions	Customer Count %	Ave 2005 Plant %	Diff. From CC	Aqua Illinois Divisions	Customer Count %	2005 Rate Base %	Diff. From CC
Woodhaven W&S	18.01%	4.81%	13.20%	Woodhaven W&S	18.01%	4.78%	13.23%
Tower Lakes Water	0.62%	0.00%	0.62%	Tower Lakes Water	0.62%	0.00%	0.62%
Oak Run Water	1.97%	1.61%	0.36%	Oak Run Water	1.97%	1.40%	0.57%
Sublette Water	0.33%	0.00%	0.33%	Sublette Water	0.33%	0.00%	0.33%
Candlewick W&S	5.94%	6.51%	-0.57%	Ivanhoe W&S	0.80%	0.63%	0.17%
Kankakee w/ Corporate	35.94%	36.59%	-0.65%	Kankakee w/ Corporate	35.94%	36.75%	-0.81%
Ivanhoe W&S	0.80%	1.50%	-0.70%	Candlewick W&S	5.94%	6.78%	-0.84%
Willowbrook W&S	3.30%	5.24%	-1.94%	Willowbrook W&S	3.30%	4.66%	-1.36%
Vermillion	26.85%	30.82%	-3.97%	University Park	6.24%	9.73%	-3.49%

University Park W&S	6.24%	12.93%	-6.69%	W&S Vermillion	26.85%	35.28%	-8.43%
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WA states that these charts demonstrate that Woodhaven Water and Sewer are allocated costs that are approximately 3.75 times higher than allocations based on plant asset or rate base allocation factors. WA points out that the Willowbrook, Vermillion, and University Park Divisions benefit significantly at the expense Woodhaven Water and Sewer. WA does not see how Aqua can argue that an allocation method using only customer counts is fair to Woodhaven Water and Sewer.

Concerns regarding the tracking of direct costs lead WA to criticize Aqua's ability to allocate common costs. During the hearing, Aqua witness Bunosky testified that certain direct cost items, such as an air compressor and other tools, which are shared between Woodhaven Water and Sewer are typically allocated to one division one time and the other division the next time a purchase is made. He indicates that Aqua simply "hope[s] it averages out over time without getting into a lot of allocations and a lot of accounting for all this stuff between the two separate rate entities." (Tr. 110) If Aqua is not concerned about allocating down to the fundamental level, WA wonders how the Commission can have any assurance that a switch in allocation methodology that has the impact of a 300% and 250% increase in revenue requirements is any more reliable.

WA also complains that none of Aqua's in-house labor tracks actual hours. If there are no records as to how a person spends his time for the various divisions, WA questions how Aqua can justify the change in cost allocation methodology. According to WA, the answer appears to be that since Aqua changed the methodology internally, then it must be an appropriate methodology. WA asserts that this is not adequate justification. In fact, WA continues, it is not reflected in this record what methodology was used to allocate costs in the most recent rate case for most of Aqua's Illinois divisions.

As alluded to earlier, the manner in which Aqua counts Woodhaven Water and Sewer customers troubles WA. Even if Aqua had provided studies concerning the appropriateness of using the number of customers in a division to allocate costs, WA contends that it is inappropriate for Aqua to count 11,575 customers at Woodhaven Water and Sewer. Although the division is divided between water and sewer customers, WA notes that customers receive one bill for both services, not two. Thus, billing costs are combined not separated. WA goes on to state that Aqua's "this-tool-for-sewer-the-next-tool-for-water-system" allocation methodology belies using 11,575 customers for the allocator. WA argues that Aqua's description of operations at Woodhaven Water and Sewer further supports WA's contention that Aqua treats the division as a single entity providing both water and sewer service. (See Tr. 108-109)

WA acknowledges Staff's recommendation that only one half of the customers of Woodhaven Water and Sewer be used for the customer count methodology in order to

lessen the impact of the change in methodology. WA opposes Staff's recommendation. WA urges the Commission to retain the current rate base allocation methodology, not the compromise offered by Staff.

c. Staff's position

Staff states that the effect of the allocation methodology change for expenses previously allocated by rate base is a 305% increase for Woodhaven Water and a 249% increase for Woodhaven Sewer. Together, Staff calculates, Woodhaven Water and Sewer account for 18% of total Aqua customers, but only 4.8% of total Aqua rate base. Staff points out that the disparity between percent of rate base and percent of customers is more pronounced for Woodhaven Water and Sewer than for Aqua's other divisions, except for the Ivanhoe Water Division, and it is the reason a change in allocation methodology from rate base to customer count results in a large increase in those expenses to which it is applied. Staff states further that every rate proceeding stands on its own merits and that the instant rate proceeding is the first one filed since the allocation methodology change, as identified by Aqua, that highlights the adverse effect of the change on certain Aqua divisions. According to Staff, the impact of the change was not as overt in Aqua's two previous rate proceedings, Docket No. 04-0442 for the Vermilion Division and Docket No. 03-0403 for the Kankakee Division, because the percent of change was more reasonable at 24% and 2%, respectively.

In order to mitigate the large adverse impact that Aqua's change in allocation methodology would have on Woodhaven Water and Sewers' respective revenue requirements, Staff proposes to modify the customer count allocation factors by weighting Woodhaven Water and Sewer customers by one-half. While other weighted allocation factors were considered, Staff contends that the selected allocation weighting is reasonable because: (1) the area served is a campground and customers are permitted to use their properties only six months of the year, and (2) Aqua has indicated that it would be willing to consider weighting customers in conjunction with a bulk billing agreement with WA. Staff's proposed test year management expense is therefore based on a modified customer count allocation factor. Also, Staff notes that Aqua has already adopted a reduced customer allocation in this proceeding that was not used in the two previous proceedings, i.e., the weighting of Oak Run's availability customers at one-third. Staff argues that the fact that Aqua weighted Oak Run's availability customers belies its declaration that every single customer must bear an equal amount of costs. In response to Aqua's argument that a reduction in direct costs does not reduce common costs, Staff states that insufficient information exists to confirm or deny the claim. Staff requests that the Commission approve its test year management expense for Woodhaven Water and Sewer based on a modified customer count allocation factor applied to actual 2004 management expense.

d. Commission conclusion

Both the customer count and rate base allocation methodologies have been used by the Commission in the past. The decision to be made here is which methodology is

more appropriate under the circumstances. The starting point for such a determination is what are the costs to be allocated. As previously noted, Accounts 634 and 734 contain contractual costs paid for the performance of management functions. Aqua asserts that the cost to prepare an overall state budget and the salaries and wages of Aqua's President and Chief Financial Officer are among the costs included in these accounts. No one disputes this assertion. Such costs are typically considered common costs and as such are not allocated to specific divisions.

Allocating such common costs on a customer count basis is not inherently wrong. Moreover, the Commission can discern no reason why these particular types of costs should not be allocated using a customer count methodology in light of the arguments of record. Although Aqua's costs in Accounts 634 and 734 in current rates for Woodhaven Water and Sewer are allocated using a rate base methodology, this does not prohibit Aqua from ever using a different allocation methodology. Nor does the fact that Woodhaven Water and Sewer customers do not take service all year require a finding in WA's favor. Aqua must still maintain the water and sewer system all year and be ready to provide service. The common costs in question would not, from the record, appear to diminish any in light of the customer usage. Furthermore, WA must realize as well that Aqua is operating both a water and sewer system, which at the corporate level are separate entities despite appearances to the customer. This is not to say that certain savings would never be realized at the corporate level, but this record does not reflect any such diminished costs. Therefore, counting each water customer and sewer customer, even if they are in fact the same person, is not inappropriate. For the same reasons, Staff's proposal to weight customers at one half is not adopted. Aqua's proposal in its December 2004 rate filing to allocate costs in Accounts 634 and 734 using a customer count methodology is reasonable and adopted.

This is not say, however, that the Commission has no concerns about Aqua's allocation methodologies. While not raised as a disputed issue in and of itself, the Commission notes that Aqua directly allocates the cost of certain items shared between Woodhaven Water and Sewer by simply "taking turns" with which division recovers the cost and hopes that it all averages out in the end. Aqua witness Bunosky admits that he is not sure if this method is working as intended. (See Aqua Exhibit 1.2(WW), Aqua Exhibit 1.2(W.S), and Tr. 107-111) Although essentially the same customers pay for the shared items, the seeming lack of formality or structure to this method troubles the Commission. The Commission strongly advises Aqua to develop a better means of recording and allocating costs shared between the water and sewer operations within a division prior to its next rate filing for such a division.

4. Rate Case Expense

Aqua is entitled to recover reasonable rate case expenses. Aqua's rate case expenses include costs for outside legal counsel, outside consultants, support from its own rate department, and other miscellaneous items and activities. Aqua's December 2004 filing estimated total rate case expenses of \$160,950, \$160,950, and \$129,875 for

Woodhaven Water, Woodhaven Sewer, and Oak Run, respectively.⁸ (See Schedules C-10(WW), C-10(WS), and C-10(OR)) Prior to filing its surrebuttal testimony, Aqua attempted to justify each individual component of its overall rate case expense for each division. As the evidentiary hearings approached, actual expenditures for some components were less than initially projected while actual expenditures for other components exceeded initial projections. Staff recommends several adjustments to rate case expenses, including limiting recovery to actual expenses where actual expenses do not exceed the initial projection. Where the actual expenses exceed the initial projection, Staff recommends capping recovery at the level of the initial projection.

In its surrebuttal testimony, Aqua began arguing that its overall rate case expense projections should be considered rather than the individual components. Because rate case expense is incurred over the course of rate proceedings, Aqua points out that the final amounts are not known until case completion. Aqua also claims that the Commission allows recovery of actual costs incurred plus a reasonable estimate of the costs that will be incurred through the conclusion of the case. Aqua adds that the Commission has accepted actual costs to complete similar cases as a reasonable basis to estimate costs through case completion. Aqua contends that the most recent rate case for its Vermillion Division, Docket No. 04-0442, is a similar case and as such can be used to justify Aqua's projected overall rate case expenses through the conclusion of this proceeding.

Aqua characterizes as one-sided Staff's proposed downward adjustments for those rate case components that have experienced actual expenses that are less than the originally projected amounts while at the same time capping those components that have experienced actual expenses that are above the originally projected amounts. Given the uncertainty in projecting costs, Aqua argues that it is only natural for some expense projections to be exceeded while others are not. In these cases, Aqua contends that actual events drove costs away from two rate case expense component areas to two other rate case expense component areas. If the Commission does not consider overall rate case expense and instead examines each component, Aqua urges the Commission to make upward adjustments to individual components as well as downward adjustments, contrary to Staff's position.

In response to Aqua's comparison to the Vermillion Division's most recent rate case, Staff states that the number of issues remaining to be litigated during the hearing and briefing stages of that proceeding far exceeded the number of issues remaining in the instant proceeding. Staff also denies that it conducted a more thorough review in this proceeding than it did in the Vermillion Division's most recent rate case. Staff adds that the Commission does not routinely allow utilities to include in rates estimates of expenses yet to be incurred in a rate case. In Docket No. 93-0183, Staff notes, the Commission did not allow Illinois Power Company to recover un-itemized rate case expenses, which Staff believes is essentially what Aqua requests here.

⁸ The rate case expenses for Woodhaven Water, Woodhaven Sewer, and Oak Run's prior rate cases amounted to \$44,855, \$62,491, and \$24,096, respectively. (See Schedules C-10.1(WW), C-10.1(WS), and C-10.1(OR))

Rather than being one-sided as Aqua claims, Staff views its position as permitting some level of review of individual rate case expenses. Staff maintains that each component should be considered separately as there should be some limit to what is prudently incurred as rate case expense. Staff observes that Aqua did not develop documentation to support its initial estimate of rate case expense. All that Aqua has provided are copies of invoices and a discussion in its Initial Brief of expenses incurred in the Vermillion Division's most recent rate case. Without documentation to support Aqua's original estimate for rate case expense, Staff asserts that there was no basis to determine a reasonable level. By the time actual invoices supporting Aqua's original estimate were provided, Staff contends that there was insufficient time to review the documentation and formulate a position.

In response to Aqua's claim that it should not suffer as a result of the inherent difficulty in predicting rate case expenses, Staff points out that Aqua conveniently forgets that it filed the instant rate requests with a 2005 future test year, in which none of the cost or revenue components are known with certainty. Everything contributing toward the revenue requirement is a projection. Staff avers that truing-up only one component to the actual cost incurred is without justification. If Aqua's rationale were applied to other components of the revenue requirement, Staff opines that it would not take long to find original estimates for other revenue and cost items that are overstated in the proposed revenue requirement based on more current information. Staff urges the Commission to reject Aqua's proposal to allow it to trade off various components of rate case expense.

The Commission is troubled by two aspects of Aqua's surrebuttal proposal to consider only the overall rate case expense projection rather than individual expense components: (1) Aqua's proposal contradicts the typical manner in which adjustments to operating expenses in a rate case test year are considered, and (2) Aqua's attempt to update certain rate case expense components comes relatively late in the proceeding. Regarding the Commission's first concern, with any future test year, nearly everything contributing toward the revenue requirement is a projection, as Staff suggests. Aqua's desire to lump individual rate case components together (regardless of the reason) fails to appreciate the differences between the varied components of a revenue requirement. If in the course of a rate case proceeding using a future test year it is realized that salary expenses are significantly higher than anticipated and material and supply costs are significantly lower, the overall proposed revenue requirement is not considered in deciding whether it is appropriate to allow an adjustment for the higher salary expenses. In other words, salaries and materials and supplies are not lumped together to see if the overall proposed revenue requirement is exceeded before determining whether to allow recovery of higher than anticipated salary expenses. Each component of the overall revenue requirement is looked at individually. While some components may be more related to each other than other components, the reasonableness of the components and any adjustments thereto are not evaluated with regard to the overall revenue requirement.

The relative lateness of Aqua's proposal is troubling in that it limits the Commission's ability to review the reasonableness of expenses within the individual rate case expense components. For example, the Commission may agree that for a utility of a particular size an overall rate case expense of \$100,000 may seem reasonable. But if upon review of the individual rate case components the Commission learns that the utility spent half that amount on one hired consultant who contributed little to the case, the Commission would not be inclined to view that expense as reasonable and therefore not allow its recovery in rates. The opportunity to conduct this review is curtailed if the utility does not provide justification for individual rate case expense components in a manageable and timely manner. In the instant case, Staff withdrew via its rebuttal testimony a proposed adjustment for one expense component after it concluded that Aqua had justified the expense in its rebuttal testimony. Through its surrebuttal testimony, however, Aqua sought recovery of subsequent additional expenses in that same expense component despite the fact that the additional expenses exceeded Aqua's initial projection for that component. Under Aqua's approach, because there was insufficient time for review, other parties to the case and the Commission would have little choice but to accept the reasonableness of these additional expenses so long as they did not exceed the overall rate case expense projection. This approach is dangerous in that it would allow utilities to add (and recover) "expenses" late in a rate proceeding with no review upon realizing that rate case expense components are less than anticipated. The Commission is not suggesting that Aqua has "padded" its rate case expenses upon realizing that other expenses are less than expected, but the potential for abuse under Aqua's approach is apparent.

With regard to Aqua's argument that it be allowed to recover a reasonable estimate of rate case expenses through the completion of a case, the Commission does not disagree. But this does not mean that Aqua can simply wait until its surrebuttal testimony to provide a final estimate. Aqua must do a reasonable job of estimating rate case expenses when preparing its initial filing and do its best to work within those estimates. This is not to say, however, that unforeseen situations never arise that warrant late adjustments to rate case expenses.

Accordingly, the Commission will not limit its review to Aqua's overall rate case expense projections for each of the three divisions. The contested rate case expense components will be discussed in turn.

a. outside counsel expense

In the prior rate case for Woodhaven Sewer (Docket No. 97-0351), Aqua's total estimated outside legal service expenses amounted to \$47,716. In the prior rate case for Oak Run (Docket No. 97-0351) and Woodhaven Water (Docket No. 00-0338), Aqua incurred no costs for outside legal services. In the pending rate cases, Aqua originally projected outside legal services to cost Oak Run, Woodhaven Water, and Woodhaven Sewer \$50,900, \$50,450, and \$50,450, respectively. Concerning this disparity in costs, Aqua indicates in its schedules that in the prior Oak Run and Woodhaven Sewer rate cases, the divisions benefited from greater economies as a result of being filed with

several other divisions, including the much larger Kankakee and Vermillion Divisions. With regard to Woodhaven Water's prior rate case, Aqua explains that the docket was settled and there were no costs for an evidentiary hearing or briefs. Aqua adds that Woodhaven Water also benefited from greater economies as a result of being filed with rate cases for the Kankakee Division (Docket No. 00-0337) and the Vermillion Division (Docket No. 00-0339). (See Schedule C-10.1(OR), Schedule C-10.1(WW), and Schedule C-10.1(WS))

When Aqua filed its surrebuttal testimony on July 19, 2005 it stated that it had incurred actual outside legal fees of \$46,760, \$45,069, and \$44,427 for Oak Run, Woodhaven Water, and Woodhaven Sewer, respectively. Aqua also projected in its surrebuttal testimony that its outside legal fees would reach, at a minimum, \$65,000 for each division by case completion. In its Initial Brief, however, Aqua revised its estimate again and projected that its outside legal expenses would at least amount to \$79,366, \$77,675, and \$77,033 for Oak Run, Woodhaven Water, and Woodhaven Sewer, respectively.

Aqua proposes in its surrebuttal testimony that it be allowed to recover all of its legal fees so long as the total recovered rate case expense does not exceed its original total rate case expense projection. Aqua believes it is appropriate to recover more for outside legal fees because actual expenses for other rate case expense components have been less than projected. Aqua maintains that it should be allowed to recover these amounts because this proceeding has involved two active interveners and Staff has, in its opinion, conducted a more thorough review than it did in Aqua's most recent rate case for its Vermillion Division (Docket No. 04-0442). Aqua also states that it used its outside counsel for miscellaneous activities, such as copying, postage, transcript fees, and filings, rather than handling the activities in-house. Overall, Aqua indicates that it simply relied on outside counsel to a much greater extent than anticipated. Aqua seems to suggest that the invoices attached to its surrebuttal testimony justify recovery of the legal fees.

Staff initially proposed adjustments to the cost of outside legal services for each division due to the dramatic increase in such costs for which Staff did not perceive adequate justification. After receipt of additional information, Staff withdrew its proposed adjustment via its July 7, 2005 rebuttal testimony. Staff raises a new objection to Aqua's outside counsel fees, however, upon receipt of Aqua's surrebuttal testimony and attachments. Because it was provided with neither the documentation nor information at the time of filing its rebuttal testimony, Staff argues that it was denied the opportunity to adequately review the information, analyze it, and provide an expert opinion. Staff contends that it was inappropriate and prejudicial to deluge Staff with a stack of 279 pages of invoices accompanied by a new proposal to "trade" higher legal fees for lower Rate Department and miscellaneous expenses during the surrebuttal phase of the proceeding. Staff asserts that the surrebuttal phase of a Commission proceeding is one during which the issues are narrowed, not expanded.

As a general matter, Staff maintains that Aqua's request to update components of its estimated rate case expense is contrary to long-standing Commission policy. In *Lincoln Water Company, Proposed general increase in water rates*, Docket No. 84-0011, Order, pp. 16-17, (October 17, 1984), Staff reports that the Commission was presented with a similar water utility request to revise and increase its estimated rate case expense due to greater than anticipated discovery and other activity. According to Staff, 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 dictated otherwise. Staff avers that Aqua presented no evidence of extraordinary or compelling circumstances justifying its revised estimates of components of its rate case expense.

Furthermore, Staff continues, in *Consumers Illinois Water Company*, Docket Nos. 93-0253; 93-0303 (Cons.), Order, pp. 4-8 (May 11, 1994), a case involving Aqua's predecessor, the Commission declined to consider the company's revisions to rate base made and supported late in that proceeding to the prejudice of Staff and other parties. Faced with a scenario involving the same eleventh-hour support offered in the instant case with respect to Aqua's updates to rate case expense, Staff in *Consumers* pointed out "that the Company submitted its first documentation to justify known and measurable changes to University Park's sewage treatment plant three working days prior to the final evidentiary hearings in this proceeding." (*Id.*, p. 6.) Additionally, similar to Staff's testimony in the instant proceeding that it did not have sufficient time to review and analyze Aqua's support for its revised estimates of components of rate case expense, Staff in *Consumers* explained "that receiving the executed construction contract immediately prior to hearings did not afford sufficient time for the various Staff members to adequately review the contract terms, the reasonableness of the construction schedule, and the attendant ratemaking ramifications if it were to be accepted." (*Id.*) Although it acknowledged that it is generally desirable to reflect known changes in rates, the Commission made clear that that goal does not supersede the requirement to conduct rate proceedings in a manner that is not prejudicial to the ability of Staff or other parties to prepare their case. (*Id.*, pp.6-7) Staff contends that the principles that guided the Commission's decision in *Consumers* are fully applicable here, and the Commission should similarly decline to consider Aqua's revised estimates of various components of rate case expense because Aqua's support for its updates to rate case expense was provided without timely presentation of supporting documentation.

Additionally, Staff contends that Aqua is confused regarding its rate requests based on a future test year. 83 Ill. Adm. Code 287 sets forth the Commission's rules regarding rate case test years. Section 287.20 provides a utility a choice of either a historical or future test year. Aqua has chosen a 2005 future test year in these proceedings. Section 287.30 sets forth the criteria upon which updates to future test year data are allowed. When Aqua witness Schreyer attempted to increase outside counsel expenses, he described them as "known and measurable" changes. (Aqua Ex. 8.0, p. 15.) Pursuant to Section 287.40, "known and measurable" changes apply only to a historical test year. If Aqua wanted to apply the concept of known and measurable

changes, Staff states that Aqua should have chosen a historical test year when it made its initial filings. As such, Staff argues that the increases from Aqua's original estimates for the outside counsel component of rate case expense are inappropriate.

If the Commission were to allow Aqua to recover all outside legal costs through case completion, Staff contends that it would be as if the Commission were giving Aqua a credit card with the bill being charged to the ratepayers. Staff explains that there would be no incentive for Aqua to be conservative in applying the minimum cost to achieve the result. Aqua would be rewarded, Staff continues, for using outside legal counsel to perform tasks that could have been performed by Aqua's in-house Rate Department, such as copying, postage, transcript fees and filings. Staff avers that the cost for these services would have been far less if the services had been performed by Aqua's in-house Rate Department. For all of the reasons stated above and found in its briefs, Staff recommends that the Commission limit Aqua's recovery of outside legal expenses to the projected amount reflected in its December 2004 rate filing.

WA and ORPOA express concern over the amount Aqua's rate case expenses and support Staff's position. WA specifically comments that the hourly rate charged by Aqua's counsel is not the norm in its area.

Aqua is entitled to recover in rates the expenses incurred to support its rate filing, but only those expenses that are reasonable. The notion underlying Aqua's position on the recovery of its outside legal expenses seems to be that because Aqua paid the invoices for the outside legal services, the expenses must be reasonable. The Commission notes that there is minimal discussion in the record of exactly what services were rendered in return for outside legal expenses. While it is obvious that counsel for Aqua attended hearings and assisted with and prepared certain filings, it is not clear whether all of the time and resources devoted by outside counsel were reasonable.

Aqua argues that invoices for outside legal services contained in Exhibit D attached to its Exhibit 8.0 support its calculation of total outside legal expenses. Actual invoices are generally good evidence of an expense having been incurred, but the offered invoices tell the Commission nothing about the service provided or the reasonableness of the expense incurred. The Commission observes that none of the many invoices from Aqua's outside counsel contain any narrative of the activities engaged in. In fact, the "narrative" column on each invoice is blank. If the narrative column was blank when Aqua received the invoices, the Commission questions the wisdom and reasonableness of paying such bills without an explanation of services rendered. If the narrative column was redacted for purposes of this proceeding, the Commission questions the appropriateness of offering an incomplete document into the record without any clear statement that information has been removed. While it is possible that Aqua and its counsel feared that narratives of some of the activities might have revealed privileged information, such a concern does not explain why no narratives were provided. Accordingly, the invoices for outside legal services contained in Exhibit D are accorded little weight as support for the reasonableness of such costs.

One discussion of the activities engaged in that purportedly support the reasonableness of Aqua's expenses for outside legal counsel indicates that Aqua used its outside counsel for miscellaneous activities, such as copying, postage, transcript fees, and filings, rather than handling the activities in-house. Why Aqua chose to use its outside counsel in this manner is unclear. Staff suggests that the cost for certain activities would likely have been cheaper had they been done in-house. The most recent invoices in Exhibit D reflect hourly rates for Aqua's two outside counsel of \$400 \$430 and an hourly rate of \$175 for their assistant. While it is reasonable to assume that Aqua did not pay counsel to complete the more routine tasks, the Commission believes that it is also reasonable to expect that Aqua's fully loaded hourly in-house rate for handling many of the same activities is less than \$175. Accordingly, the Commission views as evidence of the unreasonableness of Aqua's outside counsel expenses the fact that Aqua paid its outside counsel to perform tasks that could have been performed less expensively in-house. The fact that Aqua even planned to use its own resources for such activities and did not do so further demonstrates poor judgment.

Aqua also asserts that more effort was required of its attorneys because Staff has engaged in a more thorough review of Aqua's pending rate filings. As evidence of Staff's heightened review, Aqua cites the number of data requests issued by Staff. Staff counters that the number of data request neared 700 because Aqua requested that if Staff wanted to ask the same question of each division, that Staff submit an individual requests to each division asking the same question. In other words, with regard to at least some of the data requests, Staff indicates that it submitted three data requests to accommodate Aqua when it otherwise would have submitted only one data request for all three divisions. While some of the many data requests issued in this proceeding have been admitted into the record, how many of the total number of data requests represent the "redundancy" complained of by Staff is unknown. But whether Staff issued one or three data requests for all three divisions is not reflective of the amount of effort necessary to respond to the data requests. What is more determinative is the questions asked by Staff. Some questions are clearly easier to answer than others.

The questions alone, however, are not the only factor to consider when trying to determine who is responsible for the effort required to respond to data requests. Aqua characterizes itself as a victim of Staff's many questions. But the Commission knows that sometimes the party answering questions may be responsible for causing follow up questions. Follow up questions may be spurred by information or statements provided in response to the initial question. Sometimes a party may ask follow up questions because it does not view the initial answer as complete. Regardless of the actual questions asked by Staff or the reason(s) for follow up questions, if any, the Commission simply can not determine from the record how much effort was reasonably required to respond to Staff's data requests. Even if the sheer number of questions asked could be determinative, the Commission is typically not involved in discovery among parties and does not know what volume (or type) of questions is considered the norm for a case of this nature. Accordingly, the Commission can not say with any

certainty whether Staff conducted a more thorough review in this proceeding than it has in prior rate proceedings.

Even if Aqua had provided more explanation of its outside legal expenses, the Commission is still concerned by the level of Aqua's most recent expense estimates. Aqua's most recent estimates are significantly higher (over 50%) than what it originally projected for each division. Moreover, Aqua suggests that total invoices from its outside counsel will possibly be even higher. The Commission understands that accurately projecting expenses is very difficult, but the growing disparity between Aqua's projected expenses and invoiced expenses indicates that Aqua needs to give more thought to the activities likely to occur in a rate case and/or the fees it pays for services. Aqua is free to use in-house or outside counsel, but whichever alternative it chooses, it must realize that the higher the fee it agrees to pay, the faster the expense projection will be met. Absent unusual circumstances, Aqua is not free to simply update its projections during the course of a proceeding and expect to pass higher costs along to customers without question. Nor should a utility consider itself free to simply agree to any fee structure and pass those costs on to ratepayers without question. If a utility were allowed to do so, the rate case expense component for legal expenses could be astronomical. To be clear, Aqua can agree to pay any rate for any service it chooses, but complete recovery of such expenses is not guaranteed. A utility has an obligation to ensure that those costs it seeks to pass on to ratepayers are reasonable. The Commission offers these remarks to assist Aqua in developing its projections for its next rate case, not to criticize the fees charged by Aqua's outside counsel.

Aqua clearly incurred legal expenses in this proceeding, but absent a sufficient showing or explanation of the work behind the invoices for outside legal services, the Commission is unable to conclude that *all* of the billed amounts are reasonable and should be recovered from customers. Accordingly, in light of the foregoing and in the absence of any extenuating circumstances, the level of outside legal expenses that Aqua is allowed to recover in rates for each division is limited to its original projection contained in its December 2004 filing for each division. The Commission notes further that had it accepted Aqua's proposal to limit review to overall rate case expense, Aqua would have avoided scrutiny of expenses found unsupported by the Commission.

b. G.P.M. Associates Inc. expense

G.P.M. Associates Inc. ("GPM") is a water engineering and management consulting firm hired by Aqua to provide services in this proceeding. David Monie, president of GPM, offered testimony regarding rate design issues for Oak Run. Mr. Monie notes in his surrebuttal testimony that in addition to preparing schedules for Oak Run, GPM also provided assistance in preparing schedules and testimony for Woodhaven Water and Sewer. He adds that GPM assisted in responding to requests for information regarding all three divisions. Aqua states that it originally projected GPM's fees for Oak Run to be \$5,000 and \$2,500 each for Woodhaven Water and Sewer.

When Aqua filed its surrebuttal testimony it stated that it had incurred actual GPM fees of \$8,751, \$7,378, and \$7,506 for Oak Run, Woodhaven Water, and Woodhaven Sewer, respectively. Mr. Monie contends that GPM's fees exceeded original estimates because the work involved in responding to the information requests on rate design issues was much greater than originally anticipated. He adds that the work involved in reviewing Staff's rate design proposals and identifying a billing determinant error, as well as the resultant need to prepare surrebuttal testimony and schedules to address the error, was not anticipated in advance. On top of these overruns, Aqua anticipates that it will incur an additional \$1,500 for each division in fees for GPM to handle duties necessitated up through the date of generating final compliance tariffs, including Mr. Monie's testimony during hearings and support in the briefing phase and final tariff review. Accordingly, in its surrebuttal testimony Aqua estimates total fees for GPM to be \$10,251, \$8,878, and \$9,006 for Oak Run, Woodhaven Water, and Woodhaven Sewer, respectively. Aqua argues that it should be allowed to recover GPM's total fees because actual expenses of other rate case expenses components were less than anticipated.

Staff made no adjustment to the estimate regarding the GPM component of rate case expense. Staff points out that the first time GPM's costs were mentioned in this proceeding was in Aqua's surrebuttal testimony, when Aqua witness Schreyer indicated that Aqua's original projections for its rate design expert were inadequate and thus Aqua was requesting additional expenses for "known and measurable" changes. Within the 279 page attachment to his surrebuttal testimony, Mr. Schreyer included invoices from GPM as support for the increase. Staff asserts that it had insufficient time prior to the evidentiary hearing to adequately review the invoices. Staff also questions the amount of GPM expenses.

In discussing the amount of GPM expenses, Staff states that its rate design witness only asked two questions regarding Oak Run rates (CLH 2.01-2.02) and four questions regarding Woodhaven Water and Sewer rates (CLH 1.01-1.04). In light of the number of data requests it submitted, Staff characterizes Aqua's claim that Mr. Monie had to respond to very time consuming rate design data requests as sheer misrepresentation. Staff states further that its rebuttal testimony rate design Schedule 9.01 was not significantly different from its direct testimony rate design Schedule 4.01, to which Mr. Monie could have responded had he decided to file rebuttal testimony. Instead, Staff continues, Mr. Monie waited until surrebuttal testimony to advance an alternative method regarding billing determinants, which caused Staff's rate design witness to be called to the stand three times during the evidentiary hearings.

Staff also takes issue with Aqua's estimate that it "will incur an additional \$1,500 per Division for Mr. Monie's testimony during the hearings and assistance on the briefs." (Aqua Initial Brief, p.35.) Staff points out that Mr. Monie attended the evidentiary hearing by telephone and was asked neither cross nor clarifying questions. Staff adds that Aqua's Initial Brief addressed no rate design issues since Aqua accepted Staff's rate design proposal during the evidentiary hearings. As such, Staff argues that what it

perceives as Aqua's gross misrepresentations regarding its costs for its rate design witness should not be allowed to increase rate case expense.

WA and ORPOA express concern over the amount Aqua's rate case expenses and support Staff's position.

As with outside legal expenses, Aqua is entitled to recover reasonable expenses for consultants and expert witnesses hired to support Aqua's rate request. Aqua hired GPM to assist with issues concerning rate design. The Commission must now determine whether Aqua should be allowed to recover amounts billed by GPM above what Aqua originally estimated GPM's services would cost. Given the level of GPM's involvement in the case, Staff challenges Aqua's effort to pass on to ratepayers the full amount invoiced by GPM. Aqua suggests that Staff fails to appreciate just how much GPM did in this proceeding.

At the outset, the Commission notes that by the time of the evidentiary hearing, disagreements concerning rate design issues had been resolved. In fact, the full extent of Mr. Monie's involvement in the hearing is reflected on roughly five pages of the transcript (Tr. 168-172) when he identified and affirmed his previously submitted written testimony. As Staff points out, Mr. Monie appeared at the hearing by telephone and was asked no cross or clarifying questions. From the transcript, it appears that he also "hung up" after the admission of his testimony. These facts draw into question just how much Mr. Monie could have contributed to the hearing and to briefs which do not address any contested rate design issues.

Despite the resolution of issues, Aqua notes that GPM incurred expenses responding to Staff data requests and filing surrebuttal testimony regarding Oak Run's rate design. As with the discussion of Aqua's outside legal expenses, the Commission can not know what effort was necessary to respond to Staff's data requests. Undoubtedly, some work had to be done. The filing of surrebuttal testimony also requires some effort. But it occurs to the Commission that Aqua surely did not project expenses for GPM under the assumption that all rate design issues would be resolved. If Aqua was acting reasonably, it would have assumed some disagreement on rate design issues that would necessitate a greater advocacy role for Mr. Monie than what actually occurred.⁹ Moreover, Aqua would have also planned for Mr. Monie's involvement in the hearing and preparing briefs. As such, Aqua would have been expected to include in its estimate of GPM's expenses some level of costs associated with Mr. Monie's involvement with any disputed issues. Any costs avoided by the absence of disputed issues arguably could have been made up by the costs incurred in making clarifications and corrections. Instead, the clarifications and corrections made by Mr. Monie resulted in the GPM expense projection for Oak Run doubling and the GPM expense projection for both Woodhaven Water and Sewer more than tripling.

⁹ If Aqua was not acting reasonably and assumed (1) no contested rate design issues and (2) that it could simply increase the amount it wanted to recover for GPM's services upon its projection being exceeded, Aqua was in error and should not expect to be rewarded now for its poor judgment.

Rather than support the reasonableness of the GPM expenses, Aqua's defense of the expenses casts further doubt on their reasonableness.

While not dispositive, the amounts that Aqua spent for all outside consultants and witnesses in the prior rate cases for the divisions is noteworthy. In the last rate case for Oak Run (Docket No. 97-0351), Aqua spent an estimated total of \$7,470 for all outside consultants and witnesses. (See Schedule C-10.1(OR)) In the last rate case for Woodhaven Water (Docket No. 00-0338), Aqua spent an estimated total of \$13,905. (See Schedule C-10.1(WW)) In the last rate case for Woodhaven Sewer (Docket No. 97-0351), Aqua spent an estimated total of \$10,144. (See Schedule C-10.1(WS)) What Aqua anticipates spending on GPM for these three divisions now (\$28,135) is nearly what Aqua estimates it spent on *all* consultants and witnesses for the prior rates cases for these three divisions (\$31,519).

Accordingly, in light of the foregoing and in the absence of any extenuating circumstances, Aqua's recovery in rates for each division of GPM's fees is limited to its original projection contained in its December 2004 filing for each division. Aqua must realize that simply paying an invoice does not mean that the expense is reasonable and recoverable from customers.

c. Aqua Rate Department expense

Aqua uses its own Rate Department to prepare filings in rate cases and handle day-to-day aspects of rate cases, including discovery requests. The value of the resources expended by the Rate Department is billed to the relevant division. Aqua originally estimated that Oak Run, Woodhaven Water, and Woodhaven Sewer would incur expenses to its Rate Department in the amounts of \$32,725, \$46,750, and \$46,750, respectively. (See Schedule C-10(OR), Schedule C-10(WW), and Schedule C-10(WS)) When it filed its surrebuttal testimony, Aqua indicated that it had incurred 32%, 38%, and 29% of the projected Rate Department expenses for the respective divisions. Aqua further indicated in its surrebuttal testimony that it expects to incur 75% of the projected expense for each division. In support of Rate Department expenses incurred at the time of its surrebuttal testimony, Aqua included in the 279 page attachment to its surrebuttal testimony invoices from its Rate Department.

Staff recommends disallowing 50% of Aqua's Rate Department component of rate case expense for each division. Staff bases the proposed disallowances on an analysis of actual costs incurred during the course of the instant proceeding compared to Aqua's projected Rate Department expenses for the pro forma 2005 test year. Staff reviewed cost summaries and copies of invoices supporting Rate Department expenses for each division. Staff reports that these summaries reflected that as of April 30, 2005 (the last date for which actual information was available at the time Staff filed its rebuttal testimony on July 7, 2005), actual hours spent by individuals in the Rate Department were 134 for Oak Run, or 25% of the estimated 544 hours reflected in the filing; actual hours spent for Woodhaven Water were 202.5, or 26% of the estimated 777 hours reflected in the filing; and actual hours spent for Woodhaven Sewer were 132.5 hours,

or 17% of the estimated 777 hours reflected in the filing. Given that the actual hours expended through April 30, 2005 were not more than 26% of the original estimates included in the filing, Staff concluded that the estimated Rate Department costs were not adequately supported. As such, Staff proposed reducing the amount of Rate Department expense to half of what Aqua originally proposed.

Staff acknowledges that Aqua provided additional supporting documentation with its surrebuttal testimony, but argues that it was provided too late in the proceeding for Staff to give it more than a “cursory” review. Staff asserts that the overwhelming amount of documentation filed with Aqua’s surrebuttal testimony was inappropriate and prejudicial to Staff. Accordingly, Staff recommends that the Commission adopt its proposed 50% reduction of Rate Department expense for each division.

WA and ORPOA express concern over the amount Aqua’s rate case expenses and support Staff’s position.

Because the Rate Department expenses that Aqua presently seeks to recover for the three divisions are less than its original estimate, the Commission is not inclined to scrutinize Aqua’s Rate Department expenses as closely. Had the Rate Department expenses for any of the divisions exceeded the original projection, the Commission would have devoted greater resources to considering the expenses. Because approximately one quarter of the projected expenses were incurred during the first four months of 2005, the 75% estimate for the calendar year seems reasonable. Therefore, the Commission is satisfied that Aqua will incur approximately 75% of its projected expenses and will allow Aqua to include in rates 75% of the originally projected Rate Department expense for each division. Aqua is again cautioned, however, to give more consideration to its expense projections for its next rate case and make every effort to stay within those projections.

d. miscellaneous rate case expense

One of Aqua’s rate case expense components reflects projected costs for miscellaneous items and activities, such as transcripts, notification, printing, and engineering. Aqua originally estimated that Oak Run, Woodhaven Water, and Woodhaven Sewer would incur miscellaneous expenses in the amounts of \$10,000, \$25,000, and \$25,000, respectively. (See Schedule C-10(OR), Schedule C-10(WW), and Schedule C-10(WS)) When it filed its surrebuttal testimony on July 19, 2005, Aqua indicates that it had incurred 11%, 2%, and 2% of the estimated miscellaneous expenses for Oak Run, Woodhaven Water, and Woodhaven Sewer, respectively. Aqua anticipates that it will incur 50% of the estimated expenses. Aqua acknowledges in its surrebuttal testimony that the amounts incurred at that time appeared low, but adds that that is partly because miscellaneous items such as copies, postage, and transcript fees are handled through outside counsel even though they are included in the miscellaneous expense projection. The 50% it anticipates incurring for this rate component through case completion, Aqua continues, includes miscellaneous amounts that will be invoiced through outside counsel.

Staff recommends disallowing 75% of Aqua's miscellaneous expense component of rate case expense for each division. Staff bases its recommendation on an analysis of actual costs incurred during the course of the instant proceeding compared to Aqua's estimates of miscellaneous expenses for the pro forma 2005 test year. Staff reviewed cost summaries and copies of invoices supporting Aqua's miscellaneous expenses for each division. Staff reports that its analysis indicated that actual miscellaneous expenses incurred through April 30, 2005 (the last date for which actual information was available at the time Staff filed its rebuttal testimony on July 7, 2005), did not adequately support the estimates in the initial filing for each division. Staff notes that actual miscellaneous expenses on the summary for Oak Run (OR 000803) totaled \$1,050.72, or 10.5%, compared to the estimate of \$10,000 included in the filing. Actual miscellaneous expenses on the summary for Woodhaven Water (WH001971) totaled \$588.25, or 2.35%, compared to the estimate of \$25,000 included in the filing. Actual miscellaneous expenses on the summary for Woodhaven Sewer (WH002011) totaled \$635.71, or 2.54%, compared to the estimate of \$25,000 included in the filing. Staff notes further that Aqua's initial responses to Data Requests BAP 1.08(a), 2.07(a), and 3.06(a) described the projected miscellaneous expenses as "estimated costs for transcripts, notification, printing, copying, conference calls, etc." Given that the actual expenses through April 30, 2005 were not more than 11% percent of the original estimates included in the filing, Staff concludes that the estimated miscellaneous expenses were still not adequately supported.

Staff acknowledges that Aqua provided additional supporting documentation with its surrebuttal testimony, but argues that it was provided too late in the proceeding for Staff to give it more than a " cursory" review. Staff asserts that the overwhelming amount of documentation filed with Aqua's surrebuttal testimony was inappropriate and prejudicial to Staff. Accordingly, Staff recommends that the Commission adopt its proposed 75% reduction in miscellaneous expenses for each division.

WA and ORPOA express concern over the amount Aqua's rate case expenses and support Staff's position.

Because the miscellaneous expenses that Aqua presently seeks to recover for the three divisions are less than its original estimate, the Commission is not inclined to scrutinize Aqua's miscellaneous expenses as closely. Had the miscellaneous expenses for any of the divisions exceeded the original projection, Commission would have devoted greater resources to considering the expenses. As it stands, the Commission is satisfied that Aqua will incur approximately 50% of its projected expenses and will allow Aqua to include in rates 50% of the originally projected miscellaneous expense for each division. Again, Aqua is cautioned to give more consideration to its expense projections for its next rate case and make every effort to stay within those projections.

e. AUS Consultants expense

AUS Consultants (“AUS”) is a consulting firm hired by Aqua to prepare and support Aqua’s proposed cost of equity for the three divisions. Pauline Ahern, a vice president of AUS, testified on behalf of Aqua. Aqua’s December 2004 rate filing included projected expenses for AUS’ services of \$13,000, \$15,500, and \$15,500 for Oak Run, Woodhaven Water, and Woodhaven Sewer, respectively.

Staff proposes to disallow most of Ms. Ahern’s consulting fees because Aqua submitted the same analysis for three consecutive filings instead of filing one consolidated proceeding. Staff notes that Ms. Ahern utilized the same methodology to estimate the cost of common equity for Aqua in Docket No. 03-0403, Docket No. 04-0442, and the instant proceeding. If Aqua had filed its requests for all of these divisions in one consolidated rate case, Staff believes that Ms. Ahern’s fees would have been significantly lower—reducing the burden on Aqua’s customers.

Staff also argues that Ms. Ahern’s fees should not be allowed because her methodology was flawed on many levels and was rejected in both Docket No. 03-0403 and Docket No. 04-0442. The Commission’s rejection of Ms. Ahern’s methodology is explained in the Order in Docket No. 03-0403 (pp. 41-43) and affirmed in the Order in Docket No. 04-0442 (pp. 42-46). Staff points out that the Commission rejected Ms. Ahern’s cost of equity analysis in Docket No. 04-0442 because she did not present a convincing argument as to why the Commission decision in Docket No. 03-0403 should not be followed. In the instant proceeding, Staff asserts that Ms. Ahern once again failed to provide a convincing argument for the modification or reversal of the Commission’s prior analysis and decisions. Staff observes that she offered substantially the same analysis and opinions without attempting to reconcile them with the Order in Docket No. 03-0403. Where the Commission has rejected a financial model or technique as fundamentally unsound, Staff contends that expenses incurred to present that same financial model or technique in a subsequent case are not just, reasonable, or prudent absent a good faith argument that leads the Commission to modify or reverse its decision.

In rebuttal testimony, Aqua claimed that Ms. Ahern’s fees were justified because her cost of equity analysis constituted a good faith basis for her opinion, which did not change simply because it was not accepted by the Commission. Whether Ms. Ahern’s analysis was a good faith basis for her opinion is not relevant, according to Staff. Staff states that its proposed adjustment has nothing to do with whether Ms. Ahern truly believes that her analysis is valid. Rather, Staff bases its adjustment on whether the Commission has found Ms. Ahern’s analyses and recommendations to be valid. Excepting the adjustment for the National Association of Insurance Commissioners (“NAIC”) designation, Staff reports that the Commission did not find Ms. Ahern’s analysis as offered in Docket No. 03-0403 and Docket No. 04-0442 to be valid, credible, or useful. Yet, Staff continues, Ms. Ahern did nothing to address the specific concerns the Commission expressed regarding her analysis. She merely updated the same analysis a third time. Therefore, Staff recommends that the Commission disallow most

of the rate case expense attributable to Ms. Ahern's cost of equity analysis due to her continued reliance on methodology and arguments that the Commission has previously rejected. Staff insists that ratepayers should not compensate a utility for the cost of expert testimony containing analyses that the Commission has consistently rejected in previous proceedings as fundamentally unsound.

The Commission adopted Staff's cost of equity estimate in Docket No. 03-0403 and Docket No. 04-0442, but added 30 basis points to incorporate an additional risk factor not included in Staff's analysis. Since the Commission accepted the 30 basis point business risk adjustment that Ms. Ahern proposed in the last two proceedings, Staff recommends that the Commission allow Aqua to recover a portion of Ms. Ahern's consulting fee for that aspect of Ms. Ahern's analysis. The 30 basis point adjustment as a percentage of Staff's cost of equity recommendation of 10.10% is approximately three percent. Hence, Staff reasons that three percent of Ms. Ahern's fees would be fair compensation for that adjustment, which equates to \$390 (3% * \$13,000) for Oak Run and \$465 (3% * \$15,500) each for Woodhaven Water and Sewer.

If the Commission adopts its recommendation to disallow most of the fees attributable to Ms. Ahern's cost of equity analysis, Staff maintains that it would not eliminate Aqua's right to present a cost of equity analysis using any methodology, including the use of previously-rejected techniques. The adoption of Staff's proposal would merely prohibit Aqua from collecting from ratepayers expenses incurred for the presentation of analyses that have been consistently and repeatedly rejected in previous cases without some new, good faith support for reliance on such analyses. If the specific concerns raised by the Commission in previous Orders are addressed and those arguments are persuasive, Staff offers that recovery of the cost of analyses that the Commission has previously rejected would remain a possibility.

Aqua, noting that it has the right to seek a reasonable return on equity and that it has the burden of supporting its rate request, objects to Staff's criticism of Ms. Ahern's testimony. With regard to Staff's assertion that Aqua could have avoided the expense if it had filed these three divisions earlier with either the Vermilion Division in May 2004 (seven months) or with the Kankakee Division in May 2003 (nineteen months), Aqua avers that Staff fails to consider the full impact of its proposal on ratepayers. Specifically, Aqua points out that all other aspects of these rate cases would have occurred earlier, including the rate increases, if Aqua had filed its rate requests for these divisions earlier. While Staff presumes ratepayers would have received a net benefit, Aqua calculates that they would have seen a net detriment. In its Initial Brief, Aqua calculates how combining the present filing with the May 2004 Vermilion Division filing would have resulted in ratepayers paying \$677,721 more in revenues. Combining the present filing with the May 2003 Kankakee Division filing would have resulted in ratepayers paying \$1,839,528 more in revenues. Even if the combined cases would have resulted in savings in other areas as well, Aqua disputes that the overall impact would have been more favorable to ratepayers.

Aqua also maintains that it would be illegal to condition expense recovery on postponing rate case filings. Aqua understands that WA believes Aqua could have avoided its equity witness expense if it had postponed these cases from December, 2004 until early 2006 when it intends to file its next rate case for Kankakee. Once again, however, Aqua asserts that the quantitative analysis would show that a postponed filing would impose greater costs than savings on witness expense, but this time on Aqua rather than ratepayers. Aqua explains that it would incur significant costs in foregone revenue during the postponement. Furthermore, because rates from the anticipated Kankakee Division filing would not be in effect until 2007, Aqua argues that if it had delayed these cases it also would have forgone at least a year's recovery of the significant carrying costs and expenses associated with the radium removal project for Woodhaven Water. Aqua asserts that the fact that it would bear these costs rather than ratepayers does not make it reasonable. Aqua adds that under-earning can not be legally imposed for any period of time as a condition to the recovery of return on equity witness expense. Accordingly, Aqua concludes that WA's suggestion that Aqua should have under-earned its allowed return (and, in fact, provided service at a loss) for more than an additional year in order to save ratepayers witness expense is unfair and illegal.

Aqua understands Staff's other criticism to be based on the notion that Ms. Ahern did not testify in good faith. In response, Aqua insists that Ms. Ahern testified in good faith. Aqua further asserts that she is a recognized expert in her field and possesses the relevant expertise to form a good faith opinion on return on equity. Her opinion is based on her education and experience; it is not, Aqua contends, dependent on whether it is adopted by the Commission or any other third party. Moreover, Aqua points out that the Commission's decisions are not *res judicata*. Parties always have the opportunity to argue for the Commission to change its position on an issue, including return on equity. Nor is there any prohibition in the Act or the Commission's rules on what positions parties may advance. The Commission can change its position on any issue provided it has a reasonable basis for doing so. Aqua argues that Ms. Ahern's expert opinion would be a reasonable basis for the Commission to adopt a new position on return on equity.

Staff's proposal, Aqua adds, is contrary to its own actions. Staff argues that Ms. Ahern's opinion is not in good faith because it is not consistent with past Commission decisions; but, Aqua observes, Staff testifies to positions that are contrary to Commission decisions all the time. In these pending cases, Aqua notes that Staff is testifying that Aqua should not recover its return on equity witness expense because Aqua did not file these cases with either the Vermilion Division or Kankakee Division. But in Docket No. 99-0288, a rate case concerning Aqua's Candlewick Division, Aqua relates that the Commission concluded that there is no legal basis on which to penalize Aqua and disallow a portion of the proposed rate case expense for not combining this rate filing with rate filings for other divisions. Similarly, in the 2003 Kankakee Division rate case (Docket No. 03-0403), the Commission held that 30 basis points ("bps") should be added to return on equity to account for Aqua's NAIC-2 rating. Yet, in the 2004 Vermilion Division case (Docket No. 04-0442), Staff testified against the Commission's decision. When asked if Staff would testify against the Commission's

decision in future cases, Staff witness Freetly testified she could not guarantee that Staff would not. Aqua therefore concludes that Staff freely advances positions that are contrary to prior Commission orders but argues that when other parties do so that it is somehow in bad faith. Aqua considers this an unreasonable and discriminatory position.

Aqua also complains that it had no notice that its witness expenses would be objected to on these grounds. Aqua states that it is unaware of any instance when a party's recovery of witness expense has been disallowed on the grounds Staff proposes. Aqua urges the Commission to allow full recovery of AUS fees.

On the surface, Staff's position is appealing. Upon further reflection, however, Staff's position raises some concerns. Unlike its objections to expenses for GPM, Staff does not dispute that AUS put forth sufficient effort to warrant the fees charged. Rather, Staff and WA suggest that the fees could have been spread over a larger customer base had Aqua combined its rate request with other larger divisions. This proposal fails to consider the impact on customers of an earlier rate increase and the impact on Aqua of a delayed rate increase. Staff also argues that most of the AUS fees should be excluded from rates because the Commission has rejected Ms. Ahern's position on prior occasions. While it is true for the most part that the Commission has previously rejected Ms. Ahern's viewpoint, Aqua is still entitled to present its position on the cost of equity. Admittedly, the Commission is puzzled by a party's insistence on presenting the same rejected position over and over. But if the Commission rejects Ms. Ahern's fees in this instance, how much must she change her position or further explain her position in a future rate case before Aqua can recover Ms. Ahern's fees in rates? The witnesses of other companies also from time to time present the same or similar testimony in successive dockets. How different must their testimony be from one occasion to the next or from another witness' testimony that was previously rejected in order to ensure recovery in rates? In other words, the Commission fears that Staff's proposal will sit it atop a slippery slope that it is not prepared to navigate at this time. Rather, the Commission strongly advises Aqua and Ms. Ahern to consider the Commission's concerns with her approach. If Aqua continues to present the same rejected position over and over again, the Commission may have to navigate that slippery slope. The Commission also suggests again that Aqua be more conscious of its rate case expenses and what it seeks to pass along to customers. Accordingly, the Commission finds that Aqua may reflect in rates for each division its original projection for AUS expenses.

5. Staff's proposals regarding future rate case filings

Staff recommends that the Commission make the following findings regarding future rate case filings for divisions of Aqua:

1. Aqua must consolidate future rate filings for several of its divisions simultaneously, rather than filing separate divisions on a piecemeal basis.

2. Aqua must file rate cases for the smaller divisions simultaneously with at least one of the larger divisions.
3. Back-to-back Aqua rate cases must not use the same test year.

These recommendations appear to be part of Staff's efforts to encourage Aqua to reduce rate case expenses as well as reduce the amount of such expenses passed on to ratepayers.

Aqua objects to Staff's three proposals and claims that it already has sufficient incentives to keep rate case expenses to a minimum. Aqua claims this is so, in part, because the deferred rate case expense is not included in rate base. Aqua further contends that Staff's recommended rules will almost always dictate either hasty action or improper delay. In Aqua's view, the timing of rate cases is fact dependent, and Staff's proposals, as a matter of policy, would send the wrong signals because it considers only a single factor to the exclusion of all others. Aqua further contends that it must, to the extent possible, schedule its rate applications such that its limited amount of resources can adequately process them. With regard to Staff's third recommendation, Aqua argues that utilizing the same test year in a subsequent filing should produce some economies of scale-type savings. Aqua asserts that the test year information would have already been developed by Aqua and examined by Staff.

Aqua also expresses concern that Staff's proposal is exclusively for Aqua. In its view, such discriminatory application is inherently unfair. Aqua also contends that Staff is, in essence, proposing a retroactive application of these proposed rules to Aqua's current filing. While it appreciates Staff's suggestions that might lower rate case expenses, Aqua does not believe the advance determination of future rate case timing would be workable or, ultimately, beneficial to anyone.

According to Aqua, there is no legal requirement as to when a utility must file a rate case. Aqua argues that the proper process for promulgating administrative rules to govern rate filings is a rulemaking proceeding, the result of which would apply to all utilities equally and Staff has not presented any basis to justify promulgating rules via a rate proceeding or applying the rules to Aqua alone. In Aqua's view, Staff's proposal is a clear example of discriminatory rulemaking.

Aqua complains that requiring it to file different divisions at the same time would require it to ignore the divisional-specific factors. Aqua says it would necessitate the acceleration or postponement of filings solely to enable different divisions to be filed together. Aqua contends that if cases are accelerated, ratepayers will be harmed whereas if postponed Aqua will be subject to an illegal condition to its right to earn a reasonable return.

While the Commission believes that Staff's concern regarding the amount of money Aqua has incurred as rate case expenses is legitimate, the Commission will not adopt any of Staff's proposed restrictions at this time. Significantly, it is not clear under what authority the Commission could impose any of the three restrictions enumerated

by Staff. Section 9-201 of the Act governs changes in utility rates and Staff does not identify the portion of Section 9-201, or any other provision in the Act, that authorizes the Commission to impose either of Staff's first two proposed restrictions on Aqua. 83 Ill. Admin. Code 287 governs the test year for utility rate cases. Staff has not explained how the Commission can impose restrictions on the test year beyond those already contained in the Commission's rules.

As for its concern with the upward trend and level of Aqua's rate case expenses, the Commission urges Aqua to take the necessary steps to regain control of rate case expenditures and encourages Aqua to give thorough consideration to the Staff proposals. Aqua is on notice that in future rate case proceedings, the Commission intends to closely scrutinize rate case expenses and will only allow Aqua to pass on to ratepayers that level of expenses reasonably necessary to complete a rate case.

The Commission also takes this opportunity to challenge Aqua to complete its next rate case without filing successive corrections and amendments to its testimony. In this proceeding, Aqua submitted testimony in which it simply indicated that its witness was not prepared to answer certain questions yet. Later, without seeking leave to submit amended testimony, Aqua filed its amended testimony. Obviously such efforts require additional resources. Had Aqua complied with the testimony filing date that it had agreed to, the expenditure of additional resources, and additional rate case expense, would not have been necessary.

6. Amortization period of rate case expense

The period over which Aqua should amortize its rate case expenses in all three divisions is also in dispute. Aqua proposes a three year amortization period for Oak Run and four year periods for Woodhaven Water and Sewer. Aqua contends that these are reasonable projections of when Aqua is likely to file its next rate cases. In particular, Aqua anticipates it will file cases within these periods to capture the effects of inflation and capital projections that are routinely incurred and, thereby, avoid any degree of rate shock that would result from longer intervals. Aqua notes Staff's agreement that rate case expense should be recovered over the period of time that the subject tariffs are reasonably anticipated to be in effect.

In addition, Aqua anticipates it will build the Oak Run reverse osmosis plant in 2007. Aqua will ask Oak Run consumers to vote on whether to install the plant and expects a favorable vote. Aqua reiterates that the plant would produce substantial water quality benefits by bringing it into compliance with IEPA secondary and health industry standards for fluoride, total dissolved solids, sodium and chlorides. Aqua explains that the capital expenditure for the reverse osmosis plant will necessitate a rate filing in 2007.

Aqua criticizes Staff's historical analysis used to recommend longer amortization periods. Staff's position, Aqua continues, improperly penalizes Aqua simply for delaying a rate increase as long as it has for these divisions. Aqua also objects to WA and

Staff's assertion that Aqua over-recovered rate case expense because it delayed a rate filing longer than the amortization periods the Commission ordered in its last cases. In response to the allegation of over-recovery, Aqua claims that it has been losing money in the divisions. No division that loses money during the extra interval it stays out of the rate arena "over-recovers" rate case expense, according to Aqua.

Aqua states further that the deferred balance on rate case expense is un-earning even though it is capital Aqua has already expended. If the amortization period is too long, *i.e.*, beyond the time in which the evidence establishes Aqua is likely to file its next cases, Aqua fears that it will not be able to achieve its allowed return. A fundamental principle of ratemaking, Aqua points out, is that the Commission should set balanced rates so that Aqua is kept whole. Aqua argues that it would be inconsistent with this principle for the Commission to set amortization periods that are longer than when the evidence establishes it is likely to file its next cases for these Divisions. At a minimum, Aqua contends that the Commission should allow it to recover its rate case expenses for all three divisions over four years.

Staff proposes alternative amortization periods based on the historical periods between rate cases for the three divisions. Staff states that the prior rate case history of a company is an objective method of determining the period of time the rates in the instant proceeding are likely to remain in effect in the absence of supportable evidence to the contrary. With regard to Woodhaven Water, Staff proposes a five year amortization period rather than Aqua's proposed four year period. Staff argues that a five year period is appropriate because it is the average time between Woodhaven Water's last two rate cases: Docket No. 00-0071, five years ago, and Docket No. 95-0641, five years earlier. For Woodhaven Sewer, Staff proposes an alternative amortization period of seven years rather than Aqua's proposed four-year period. Staff argues that a seven year period is appropriate because it is the average time between Woodhaven Sewer's last two rate cases: Docket No. 97-0351, eight years ago, and Docket No. 91-0317, six years earlier.

With regard to Oak Run, Staff recommends a seven year amortization period rather than the three year period requested by Aqua. Staff reports that seven years is the average time between Oak Run's last two rate cases: Docket No. 97-0351, eight years ago, and Docket No. 91-0317, six years earlier. Aqua's plans to build a reverse osmosis plant for Oak Run do not convince Staff that a rate case will be filed in three years. Staff observes that a decision as to whether a plant will be installed has not been made. Staff notes further that Aqua has been considering the installation of a reverse osmosis treatment plant since at least May 2003, two years ago, when Aqua delayed filing the instant proceeding with the much larger Kankakee Division (filed in May 2003 as Docket No. 03-0403) or the Vermilion Division (filed in May 2004 as Docket No. 04-0442). In addition, even after Aqua makes a determination that the plant should be built, Staff understands that Aqua plans to survey Oak Run customers as to whether the customers are agreeable to paying the cost of the treatment plant. Whether the plant will be installed depends on the willingness of Oak Run customers to pay for it. Staff does not share Aqua's optimism about the vote outcome and, in fact,

doubts that customers will support another rate increase in three years after the rate increase approved in this proceeding.

Staff adds that in the previous Oak Run and Woodhaven Sewer rate proceeding (Docket No. 97-0351), Aqua initially requested a two year recovery period for rate case expense for both divisions. Staff proposed a five year amortization period, which Aqua accepted. Staff notes that the methodology it used to estimate the amortization period for rate case expenses in the instant proceeding is consistent with the methodology used by Staff in Docket No. 97-0351. Total rate case expense to be amortized in Docket No. 97-0351 amounted to \$29,580 for Oak Run and \$5,916 of annual rate case expense was approved. Total rate case expense to be amortized in Docket No. 97-0351 amounted to \$59,160 for Woodhaven Sewer and \$11,832 of annual rate case expense was approved. Staff further indicates that since these rates have been in effect for approximately eight years, Aqua has over-recovered three years of rate case expense, or \$17,748 for Oak Run and \$35,496 for Woodhaven Sewer. Given Aqua's history of filing rate cases, Staff maintains that it would be conservative and reasonable to amortize current rate case expense over a seven-year period for Oak Run and Woodhaven Sewer.

Concerning the amortization period approved in the last general rate case for Woodhaven Water (Docket No. 00-0338), Aqua initially requested a three year recovery period for rate case expense. Staff proposed a four year amortization period, which Aqua accepted. Total rate case expense to be amortized in Docket No. 00-0338 amounted to \$51,090 for Woodhaven Water and \$12,773 of annual rate case expense was approved. Since these rates have been in effect for approximately five years, Staff states that Aqua has over-recovered one year of rate case expense or \$12,773 for Woodhaven Water. Given Aqua's history in filing rate cases, Staff contends that it would be conservative and reasonable to amortize rate case expense over a five year period for Woodhaven Water.

ORPOA argues that it is inappropriate for Aqua to shorten the rate case amortization period to three years from the average seven years based the erroneous assumption that there will be a favorable vote for the reverse osmosis plant. ORPOA also questions the proposed three year period in light of the fact that Aqua has over-recovered rate case expenses since the last rate case to the tune of \$17,748. Given the large amount of rate case expenses sought in this docket from ORPOA members, ORPOA states that the probability of a significant over-recovery by Aqua of rate case expenses must weigh against any request for an expedited recovery of rate case expenses over three years

WA supports Staff's recommended amortization periods for Woodhaven Water and Sewer. WA is concerned by the over-recovery of rate case expenses resulting from the longer than anticipated period between rate cases. Since Aqua does not refund over-recoveries, WA cautions the Commission to not shorten the amortization period, particularly in light of the significant rate case expenses that Aqua seeks to recover.

The Commission generally concurs with Staff's approach to determining appropriate rate case expense amortization periods. As Staff suggests, examining a company's historical pattern of submitting rate increases is objective. Good reasons may exist and situations may arise that warrant deviating from a historical pattern, but absent such, Staff's analysis of historical patterns is the generally preferred approach.

The historical pattern of rate filings for Woodhaven Water leads to the adoption of a five year amortization period of rate case expense. The Commission can not perceive any reason why adherence to the historical pattern is not warranted for Woodhaven Water. Staff's proposed seven year amortization period for Woodhaven Sewer, however, is not adopted even though it is based on a historical analysis of rate filings. The Commission rejects Staff's seven year period because it contradicts another of Staff's recommendations—that Aqua combine rate filings to save on rate case expense. Combining Woodhaven Water and Sewer rate filings seems logical and consistent with Staff's proposals to minimize rate case expense, but Staff's amortization period proposal runs afoul of this effort. Accordingly, the Commission concludes that the greater good is served by adopting a five year amortization period for Woodhaven Sewer as well, thereby encouraging Aqua to file its next rate cases for Woodhaven Water and Sewer together.

With regard to Oak Run, the Commission is not convinced that the reverse osmosis plant will be built when Aqua expects, if at all.¹⁰ Therefore, Oak Run's rate case expense will not be amortized over a three year period. Nor, however, will it be amortized over a seven year period either. In order to further encourage Aqua to combine rate case filings to lessen rate case expense, the Commission will adopt a five year rate case expense amortization period for Oak Run as well.

7. State and Federal income tax calculation

In its surrebuttal testimony, Aqua asserted that Staff's pro forma proposed income tax calculations are incorrect. Aqua suggests that what it characterizes as miscalculations may have resulted from Staff's inappropriate insertion of numbers from Aqua's rebuttal positions into Aqua's pro forma present positions and subsequent associated adjustments. Aqua claims that Staff also inserted gross revenue conversion factor adjustments in the Woodhaven schedules but that there is no support for those numbers.

According to Aqua, taxable income can be calculated as pro forma proposed revenue requirement less operating expenses before income taxes less synchronized interest. Aqua states that the taxable income is then multiplied by the State tax rate of 7.30% to produce the State income tax. Aqua argues that each division's taxable income multiplied by the State tax rate of 7.30% produces State income tax amounts different than those shown in the Schedules attached to Staff's rebuttal testimony. Aqua further contends that using either the correct or Staff incorrect state income tax as

¹⁰ In making this statement, the Commission is expressing no opinion on the merits of a reverse osmosis plant for Oak Run.

the deduction for Federal purposes does not result in the Federal income tax amounts Staff identifies in the Schedules attached to its rebuttal testimony.

To further support its assertion that Staff has miscalculated income taxes, Aqua states that with regard to the two Woodhaven divisions, Staff increases its rate base amount in rebuttal relative to its direct case and proposed a higher rate of return on rate base in its rebuttal case. Aqua argues that these changes should lead to increased State and Federal income tax amounts; yet, Staff's rebuttal income tax amounts are lower than in its direct case. In its Reply Brief, Aqua maintains that the income tax calculations presented in Staff's Initial Brief remain incorrect.

According to Staff, Aqua's assertion that Staff's gross revenue conversion factor adjustment is unsupported fails to recognize that Staff proposed a reduction in the uncollectibles rate that was proposed by Aqua. Staff concedes, however, that columns (f) of ICC Staff Exhibit 6.0, Schedules 6.01 (WW) and (WS) are incomplete. Revised schedules, intended to resolve the problem, are attached to Staff's Initial Brief as Appendix B. Staff believes any other differences between Aqua's calculations of income tax expense and the amounts reflected in Appendix B attached to Staff's Initial Brief arise from two factors: (1) Aqua's incorrect usage of a 7.18% State income tax rate versus the correct rate of 7.30%, and (2) the likelihood that Aqua deducted a different amount of interest expense in its rebuttal testimony than the amount used by Staff.

The Commission has reviewed the Schedules attached to Staff's Initial Brief and there are, in fact, erroneous levels of income tax expense stated therein. This problem appears to stem from Aqua's original filing which incorporated an incorrect State income tax rate and produced an incorrect State income tax expense for each operating division. This problem has been corrected in the Appendix attached to this Order. The Commission has added column (e) on page 2 of each operating division's Statement of Operating Income With Adjustments. This column removes the effect of the incorrect State income tax rate incorporated in Aqua's original and rebuttal filings. Column (h) on that page, which carries forward to column (b) on page 1 of each operating division's Statement of Operating Income With Adjustments comport to what Aqua characterizes as the "well established calculation" used to identify taxable income and associated State income tax.

While it is appropriate to allow Aqua, or any utility, the opportunity to recover its income tax expenses, the Commission is somewhat disappointed that this issue was identified for the first time in Aqua's surrebuttal testimony. Had this problem, which clearly existed earlier in the case, been identified and addressed in a more timely manner, it could have been resolved and the Commission would not be placed in the difficult situation of attempting to develop the proper method for calculating Aqua's State income tax expense in this Order.

8. Representation of proposed revenue increase

Aqua takes issue with the manner in which Staff calculated the revenue increases Staff recommends as well as the percentage increase in revenues that Staff recommends. According to Aqua, in making its calculations, Staff understated Aqua's pro forma present revenues. As a result, Aqua believes that Staff has overstated the resulting increases in revenue as well as the percentages of increase in revenue. In its Reply Brief, WA concurs in Aqua's position on this issue.

In its Reply Brief, Staff agrees with Aqua that there is no revenue or revenue requirement adjustment associated with this issue. Staff states that the calculations to which Aqua objects are informational in nature and do not affect the dollar amount of the proposed revenue requirement. Staff indicates it does not oppose a change in the method of performing the calculations in question should the Commission prefer to represent the revenue increases and associated percentage increases in the manner Aqua proposes.

C. Commission Conclusion on Operating Income/Revenue Requirements

Giving effect to the adjustments approved above and the rates of return on rate base authorized hereafter in this Order, the Commission concludes that the net operating income for Woodhaven Water, Woodhaven Sewer, and Oak Run are \$250,300, \$253,654, and \$140,539, respectively. The net operating income for Woodhaven Water reflects a revenue increase of \$433,984 or 54.37%, which is authorized by this Order. The operating income for Woodhaven Sewer reflects a revenue increase of \$345,271 or 46.00%, which is authorized by this Order. The net operating income for Oak Run reflects a revenue increase of \$169,861 or 51.49%, which is authorized by this Order. The appendices attached hereto provide supporting calculations for the conclusions contained herein.

IV. COST OF CAPITAL/RATE OF RETURN

Three witnesses presented testimony regarding Aqua's cost of capital. Aqua witness Schreyer presented testimony regarding capital structure and the costs of debt and preferred stock. Aqua witness Ahern presented testimony regarding the cost of common equity. Staff witness Freetly presented testimony regarding Aqua's overall cost of capital, including capital structure and the costs of debt, preferred stock, and common equity. For purposes of this proceeding, Aqua accepted Staff's estimate of Aqua's overall cost of capital of 8.84%.

Staff proposes an average 2005 capital structure comprising 47.68% long-term debt, 0.32% preferred stock, and 52.00% common equity, which was accepted by Aqua for purposes of this proceeding.

In rebuttal testimony, Staff recommended a 7.15% embedded cost of long-term debt for Aqua. Aqua accepted Staff's cost of debt for setting rates in this proceeding. Staff's 7.15% estimate of the embedded cost of debt included two types of adjustments. First, Staff adjusts the annual amortization of debt discount, premium, and expenses to reflect straight-line amortization of the respective unamortized balances over the remaining life of each issue. Second, Staff removes 100 days of Series W and P debt discount and expense amortization from Aqua's total annual debt expense.

Concerning the second adjustment, in its Order in Docket No. 04-0626, in which the Commission had authorized the issuance of the Series W and redemption of the Series P bonds, the Commission also ordered Aqua to file quarterly reports on the amount, expense, and use of proceeds from the debt issuance as specified in 83 Ill. Adm. Code 240 ("Part 240 Reports"). Since Aqua filed that Part 240 Report 100 days late, and has a recent history of failing to file Part 240 Reports on a timely basis, Staff recommended the 100-day amortization adjustment as a penalty.

Staff and Aqua agree that Aqua's embedded cost of preferred stock is 5.48%.

Staff estimates Aqua's cost of common equity with the Discounted Cash Flow ("DCF") and risk premium models. DCF and risk premium models can not be applied directly to Aqua because its common stock is not market traded. Therefore, Staff applies those models to two samples. The first sample comprises six market-traded water utilities within the Standard & Poor's Utility Compustat database for which Zacks Investment Research ("Zacks") growth forecasts were available ("water sample"). The second sample consists of nine public utilities selected on the basis of a principal components analysis of twelve financial and operating ratios ("utility sample"). Water utilities that were included in the water sample were not included in the utility sample to avoid giving the water utilities double weight. Companies that were rated below investment grade by Standard & Poor's, lacked Zacks growth rates, or were involved in significant acquisition activity, were also excluded from Staff's utility sample.

DCF analysis assumes that the market value of common stock equals the present value of the expected stream of future dividend payments. Staff applies a constant-growth quarterly DCF model, which properly accounts for the quarterly payment of dividends by the companies comprising its samples. DCF analysis requires a growth rate that reflects the expectations of investors. Staff measures the market-consensus expected growth rates with projections published by Zacks. The growth rate estimates were combined with the closing stock prices and dividend data as of April 7, 2005. Based on this growth, stock price, and dividend data, Staff's DCF-derived cost of equity estimate is 10.66% for the water sample and 9.33% for the utility sample.

According to financial theory, the required rate of return for a risky security equals the risk-free rate of return plus a risk premium associated with that security. The risk premium methodology is consistent with investors' risk-aversion. Staff uses a one-factor risk premium model, the Capital Asset Pricing Model ("CAPM"), to estimate the cost of common equity. In the CAPM, the risk factor is market risk, which can not be

eliminated through portfolio diversification. The CAPM requires the estimation of three parameters: beta, the risk-free rate, and the required rate of return on the market. First, using Value Line beta estimates and regression analysis, Staff estimates forward-looking betas of 0.57 for the water sample and 0.64 for the utility sample. Second, Staff considers two current estimates of the risk-free rate of return as of April 7, 2005: the 2.65% yield on four-week U.S. Treasury bills and the 4.96% yield on twenty year U.S. Treasury bonds. Forecasts of long-term inflation and the real risk-free rate suggest that the long-term risk-free rate is between 5.4% and 5.8%. Thus, Staff concludes that the U.S. Treasury bond yield is currently the superior proxy for the long-term risk-free rate. Finally, to measure the expected rate of return on the market, Staff conducts a DCF analysis on the firms composing the Standard & Poor's 500 Index. That analysis estimates that the expected rate of return on the market equals 13.44%. Using those three parameters in its risk premium model, Staff estimates the cost of common equity is 9.79% for the water sample and 10.39% for the utility sample.

Staff testifies that a thorough cost of common equity analysis requires both the application of financial models and the analyst's informed judgment. A cost of common equity recommendation based solely upon judgment is inappropriate. However, because cost of common equity measurement techniques necessarily employ proxies for investor expectations, judgment is necessary to evaluate the results of such analyses. Along with DCF and CAPM analyses, Staff considers the observable 5.56% rate of return the market currently requires on A-rated utility long-term debt.

Based on quantitative analysis, Staff determined that Aqua is closer in risk to the water sample than the utility sample. Therefore, Staff applied two-thirds weight to the water sample investor-required rate of return on common equity and one-third weight to the utility sample investor-required rate of return on common equity to arrive at a 10.10% recommended cost of equity for Aqua. Staff testifies that an additional investment risk premium to Aqua's cost of common equity is not necessary because Aqua's financial strength is consistent with an A credit rating, not the BBB-level rating implied in its NAIC-2 designation. Nevertheless, based upon recent Commission orders for Aqua, Staff adds 30 basis points to the cost of equity estimate for Aqua to acknowledge the significance the Commission afforded to the NAIC-2 rating in its previous two rate orders for Aqua, resulting in a 10.40% estimate of Aqua's cost of common equity.

Staff's overall rate of return on rate base recommendation, incorporating its recommended capital structure, embedded cost of long-term debt, embedded cost of preferred stock, and cost of common equity, is 8.84%. Aqua accepted Staff's overall rate of return on rate base recommendation for purposes of this proceeding.

The Commission has reviewed the record and for purposes of establishing rates in this proceeding adopts Staff's proposed capital structure as well as Staff's proposed costs of debt, preferred stock, and common equity. The Commission authorizes Aqua the opportunity to earn an 8.84% rate of return on rate base. The derivation of that rate of return on rate base is shown in the table below:

Aqua Illinois, Inc.
Weighted Average Cost of Capital

Class of Capital	2005 Average Balance	Percent of Total Capitalization	Cost	Weighted Cost
Long-term debt	\$56,756,561	47.68%	7.15%	3.41%
Preferred Stock	382,372	0.32%	5.48%	0.02%
Common Equity	61,900,673	52.00%	10.40%	5.41%
Total	\$119,039,606	100.00%		8.84%

Finally, the Commission observes that the parties in this case have agreed that a reasonable estimate of the cost of common equity in this proceeding, 10.40%, should include a 30 basis point “investment risk premium” and thus, such a return is supported by the record. Nevertheless, the Commission finds it significant that Staff testifies that such an investment risk premium is unnecessary and may not be recommended by Staff in future Aqua rate proceedings. (Staff Exhibit 3.0 at 37, Tr. 388) Thus, in Aqua’s next rate proceeding, the Commission expects to reconsider the propriety of an incremental investment risk premium on the cost of common equity.

V. COST OF SERVICE AND RATE DESIGN

Cost of service studies were not performed by either Aqua or Staff for Woodhaven Water, Woodhaven Sewer, or Oak Run. Ultimately, all rate design issues in these proceedings were agreed upon by Aqua and Staff.

A. Woodhaven Water

The existing tariffs for Woodhaven Water include a domestic flat rate of \$9.35 per month for each campsite in the area authorized to be served by Aqua from the service branch installed by Aqua, whether or not there was an actual use of water. For all other residential and commercial customers, the current tariffs reflect a Customer Charge based on the size of the meter and a flat Usage Charge of \$4.11 for each 1,000 gallons of water consumed.

Aqua proposed an across the board increase whereby all rates would be increased by the same percentage. Under Aqua’s proposed revenue requirement, all rate components would have increased by approximately 72%. Staff did not object to Aqua’s proposed across the board increase. Under Staff’s proposed revenue requirement, each of Woodhaven Water’s rate components would have increased by approximately 44%.

Because there is no cost of service information in the record regarding Woodhaven Water, the Commission finds the across the board increase proposed by

Aqua and Staff to be adequate and it is hereby approved. Aqua should file rates for Woodhaven Water reflecting this conclusion designed to produce revenue equal to the revenue requirement associated with Woodhaven Water approved in this Order.

B. Woodhaven Sewer

The existing tariffs for Woodhaven Sewer include a domestic flat rate of \$10.68 per month for each campsite in the area authorized to be served by Aqua whether or not there was an actual discharge of sewage. The current tariffs also reflect a rate for commercial sewer service equal to 130% of the billing for water service furnished during the corresponding billing period. Under Aqua's proposed tariffs, the Commercial rate would remain at 130% of the billing for water service (which Aqua also proposed to increase) and the residential/campsite rate, under Aqua's proposed revenue requirement, would increase to \$17.44 per month, an increase of approximately 63.3%.

Staff objects to the Commercial rate structure for Woodhaven Sewer asserting that the 130% of the water bill is not a cost-based charge. Staff instead proposes that the Commercial sewer rate be set at the same flat rate as the residential/campsite rate. Under Staff's proposed revenue requirement all Woodhaven Sewer charges would be set at \$14.30 per month regardless of usage, if any.

Having reviewed the arguments of the parties, the Commission is puzzled how Staff concluded that the existing sewer rate for commercial customers is not cost based when the record is devoid of any cost of service data or analyses. Under the existing rate structure, the monthly sewer charge is a function of the customer's water bill for the same month, which is a function in part of the customer's water usage for that month. The Commission simply disagrees that Staff's proposed flat rate for commercial customers reflects movement toward cost based rates.

Additionally, the Commission is concerned that under Staff's proposal, at Staff's proposed revenue requirement, the commercial rate class would see a rate decrease of approximately 83% resulting in more than \$15,000 in additional annual revenue responsibility imposed on the residential/campsite rate class. Thus, the Commission concludes that the better result is to adopt Aqua's original proposal and maintain the existing commercial rate design where the monthly sewer charge is set at 130% of the billing for water service furnished during the corresponding billing period. The residential/campsite flat monthly rate should be set at a level that will produce revenues equal to the Woodhaven Sewer revenue requirement established in this Order.

C. Oak Run

For Oak Run, the present water rate structure for metered customers consists of a monthly Customer Charge of \$8.67 per customer and a Usage Charge of \$5.19 per 1,000 gallons of water used that is billed quarterly for all general water service customers. Aqua proposed increasing the monthly Customer Charge to \$15.77 per customer and the Usage Charge to \$6.434 per 1,000 gallons of water used. Staff's

proposal, which reflects Staff's revenue requirement, is for a monthly Customer Charge of \$14.50 per customer and a Usage Charge of \$7.87 per 1,000 gallons of water.

Aqua proposed increasing the monthly Availability Charge at Oak Run for unmetered customers from \$6.90 per month to \$12.55 per month. Staff recommended a monthly Availability Charge of \$9.45 per month. Aqua believes the monthly Availability Charge and Customer Charge should be increased by the same percentages and the Consumption Charge should be increased by a smaller percentage. Staff believes the monthly Availability Charge should not be increased, on a percentage basis, as much as the Customer Charge and believes the Consumption Charge should be increased by a greater percentage than Aqua proposes. In fact, in the absence of rate shock concerns Staff would prefer not to increase the Availability Charge at all. Staff posits that usage customers should bear the bulk of the cost of providing water service and that over time; the rate structure should shift the burden of the cost to the metered customers.

While Aqua does not agree with Staff regarding the relative level of the Availability Charge, for purposes of this proceeding, Aqua is willing to accept Staff's overall structure of tariff design.

Having reviewed the record, it appears that Staff would prefer to minimize or perhaps even eliminate the Availability Charge. While there may be sound policy or economic reasons for this preference, any such explanation is missing from the record. Because it is not possible to differentiate between the fixed and variable costs of providing service, whether the rate design proposed by Staff and accepted by Aqua reasonably reflects the cost of service is unknown. In the absence of any cost of service study, the Commission finds that the Oak Run customer charges and availability charges should be increased by 67.2% and 37%, respectively, as agreed to by Aqua and Staff. Consumption charges for Oak Run customers should be set so as to recover the remainder of the Oak Run revenue requirement established in this Order. Consumption charges shall be the same for all consumption customers.

D. Other

The Commission recognizes that this case involves relatively small operating divisions of Aqua with somewhat unusual operating characteristics, that the conduct of cost of service studies is not cost free, and that the level of costs incurred to undertake this rate case is a concern here and could be an issue in future rate cases. Nevertheless, the Commission is dissatisfied with the cost of service and rate design presentations in this proceeding and prefers not being forced to establish just and reasonable rates in the total absence of cost of service information. After considering all of the foregoing, the Commission directs Staff to work with Aqua to develop cost of service studies for future Aqua rate proceedings. The Commission understands that Staff has independently performed cost of service studies in previous water rate cases. (See, e.g. 02-0690, Order at 82-84) If for some unforeseen reason Staff and/or Aqua are unable to develop reasonable cost of service studies for future Aqua rate cases,

Aqua and Staff are directed to provide an explanation for this outcome in testimony filed in future Aqua rate cases.

Staff recommended that the Commission order Aqua to file the rate tariffs for Oak Run, Woodhaven Water, and Woodhaven Sewer within 10 days of the final order in these proceedings with an effective date of not less than 10 working days after the date of filing, for service rendered on and after their effective date, with individual tariff sheets to be corrected within that time period, if necessary. Resolution of this Staff recommendation will be a function of the date this Order is approved and the expiration of the resuspension period.

VI. FINDINGS AND ORDERING PARAGRAPHS

The Commission, having given due consideration to the entire record herein and being fully advised in the premises, is of the opinion and finds that:

- (1) Aqua provides water and sewer service to the public within the State of Illinois and is a public utility as defined in Section 3-105 of the Act;
- (2) the Commission has jurisdiction over the parties hereto and the subject matter herein;
- (3) the recitals of fact and conclusions of law reached in the prefatory portion of this Order are supported by the evidence of record, and are hereby adopted as findings of fact and conclusions of law; Appendix A attached hereto provides supporting calculations for those portions of this Order concerning Woodhaven Water; Appendix B attached hereto provides supporting calculations for those portions of this Order concerning Woodhaven Sewer; and Appendix C attached hereto provides supporting calculations for those portions of this Order concerning Oak Run;
- (4) the test year for the determination of the rates herein found to be just and reasonable should be the 12 months ending December 31, 2005, as adjusted; such test year is appropriate for purposes of this proceeding;
- (5) for purposes of this proceeding, the net original cost rate base for Woodhaven Water operations for the test year ending December 31, 2005, as adjusted, is \$2,831,454;
- (6) for purposes of this proceeding, the net original cost rate base for Woodhaven Sewer operations for the test year ending December 31, 2005, as adjusted, is \$2,869,390;
- (7) for purposes of this proceeding, the net original cost rate base for Oak Run operations for the test year ending December 31, 2005, as adjusted, is \$1,589,806;

- (8) a just and reasonable return which Woodhaven Water, Woodhaven Sewer, and Oak Run should be allowed to earn on its net original cost rate base is 8.84%; this rate of return incorporates a return on common equity of 10.40%;
- (9) Woodhaven Water's rates which are presently in effect are insufficient to generate the operating income necessary to permit it the opportunity to earn a fair and reasonable return on net original cost rate base; these rates should be permanently canceled and annulled;
- (10) Woodhaven Sewer's rates which are presently in effect are insufficient to generate the operating income necessary to permit it the opportunity to earn a fair and reasonable return on net original cost rate base; these rates should be permanently canceled and annulled;
- (11) Oak Run's water rates which are presently in effect are insufficient to generate the operating income necessary to permit it the opportunity to earn a fair and reasonable return on net original cost rate base; these rates should be permanently canceled and annulled;
- (12) the specific rates proposed by Woodhaven Water in its initial filing do not reflect various determinations made in this Order; Woodhaven Water's proposed rates should be permanently canceled and annulled consistent with the findings herein;
- (13) the specific rates proposed by Woodhaven Sewer in its initial filing do not reflect various determinations made in this Order; Woodhaven Sewer's proposed rates should be permanently canceled and annulled consistent with the findings herein;
- (14) the specific rates proposed by Oak Run in its initial filing do not reflect various determinations made in this Order; Oak Run's proposed rates should be permanently canceled and annulled consistent with the findings herein;
- (15) Woodhaven Water should be authorized to place into effect tariff sheets designed to produce annual base rate revenues of \$1,167,657, which represent an increase of \$433,984 or 54.37%; such revenues will provide Woodhaven Water with an opportunity to earn the rate of return set forth in Finding (8) above; based on the record in this proceeding, this return is fair and reasonable for Woodhaven Water;
- (16) Woodhaven Sewer should be authorized to place into effect tariff sheets designed to produce annual base rate revenues of \$1,049,321, which represent an increase of \$345,271 or 46.00%; such revenues will provide

Woodhaven Sewer with an opportunity to earn the rate of return set forth in Finding (8) above; based on the record in this proceeding, this return is fair and reasonable for Woodhaven Sewer;

- (17) Oak Run should be authorized to place into effect tariff sheets designed to produce annual base rate revenues of \$494,149, which represent an increase of \$169,861 or 51.49%; such revenues will provide Oak Run with an opportunity to earn the rate of return set forth in Finding (8) above; based on the record in this proceeding, this return is fair and reasonable for Oak Run;
- (18) the determinations regarding rate design contained in the prefatory portion of this Order are reasonable for purposes of this proceeding; the tariffs filed by Aqua for Woodhaven Water, Woodhaven Sewer, and Oak Run should incorporate the rates and rate design set forth and referred to herein;
- (19) new tariff sheets authorized to be filed by this Order shall reflect an effective date not less than five working days after the date of filing, with the tariff sheets to be corrected, if necessary, within that time period; and
- (20) all motions, petitions, objections, and other matters in this proceeding which remain unresolved should be disposed of consistent with the conclusions herein.

IT IS THEREFORE ORDERED by the Illinois Commerce Commission that the tariff sheets presently in effect for service rendered by Aqua Illinois, Inc. in its Woodhaven Water Division, Woodhaven Sewer Division, and Oak Run Division are hereby permanently canceled and annulled effective at such time as the new tariff sheets approved herein become effective by virtue of this Order.

IT IS FURTHER ORDERED that the proposed tariffs seeking a general increase in rates for the Woodhaven Water Division and Woodhaven Sewer Division filed by Aqua Illinois, Inc. on December 22, 2004 are permanently canceled and annulled.

IT IS FURTHER ORDERED that the proposed tariffs seeking a general increase in water rates for the Oak Run Division filed by Aqua Illinois, Inc. on December 29, 2004 are permanently canceled and annulled.

IT IS FURTHER ORDERED that Aqua Illinois, Inc. is authorized to file new tariff sheets with supporting workpapers for its Woodhaven Water Division in accordance with Findings (5), (8), and (15) of this Order, applicable to water service furnished on and after the effective date of said water tariff sheets.

IT IS FURTHER ORDERED that Aqua Illinois, Inc. is authorized to file new tariff sheets with supporting workpapers for its Woodhaven Sewer Division in accordance

with Findings (6), (8), and (16) of this Order, applicable to sewer service furnished on and after the effective date of said sewer tariff sheets.

IT IS FURTHER ORDERED that Aqua Illinois, Inc. is authorized to file new tariff sheets with supporting workpapers for its Oak Run Division in accordance with Findings (7), (8), and (17) of this Order, applicable to water service furnished on and after the effective date of said water tariff sheets.

IT IS FURTHER ORDERED that the original costs of plant at December 31, 2003 for Woodhaven Water Division, Woodhaven Sewer Division, and Oak Run Division, as those plant balances are reflected in Aqua Illinois, Inc.'s Schedule B-5, page 1 of 3, Column (C) for each division, are approved as the original cost of plant for purposes of 83 Ill. Adm. Code 615, Appendix A.

IT IS FURTHER ORDERED that all motions, petitions, objections, and other matters in this proceeding which remain unresolved are disposed of consistent with the conclusions herein.

IT IS FURTHER ORDERED that subject to the provisions of Section 10-113 of the Act and 83 Illinois Administrative code 200.880, this Order is final and is not subject to the Administrative Review Law.

DATED: October 5, 2005.

Briefs on Exceptions must be received by October 13, 2005

Briefs in Reply to Exceptions must be received by October 19, 2005

Administrative Law Judge