DIRECT TESTIMONY

OF

ROCHELLE PHIPPS

FINANCE DEPARTMENT

FINANCIAL ANALYSIS DIVISION

ILLINOIS COMMERCE COMMISSION

AQUA ILLINOIS, INC.

PETITION FOR ISSUANCE OF A CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY TO OPERATE A WATER SUPPLY AND DISTRIBUTION SYSTEM IN KANKAKEE COUNTY, ILLINOIS AND FOR THE ISSUANCE OF AN ORDER APPROVING RATES, ACCOUTING ENTRIES AND TARIFF LANGUAGE

DOCKET NO. 06-0203

NOVEMBER 15, 2006

1. Q. Please state your name and business address.

A. My name is Rochelle Phipps. My business address is 527 East Capitol Avenue, Springfield, Illinois 62701.

2. Q. By whom are you employed and in what capacity?

A. I am employed by the Illinois Commerce Commission ("Commission") as a Senior Financial Analyst with the Finance Department of the Financial Analysis Division.

3. Q. Describe your qualifications and background.

A. I received a Bachelor of Arts degree in Finance from Illinois College, Jacksonville, Illinois. I received a Master of Business Administration degree from the University of Illinois at Springfield. I have been employed by the Commission since June 2000.

4. Q. What is the purpose of your testimony in this proceeding?

A. Pursuant to Section 8-406(b) of the Illinois Public Utilities Act ("Act"), for the Commission to determine that proposed construction will promote the public convenience and necessity, a utility must satisfy three criteria. I will present my evaluation of Aqua Illinois, Inc.'s ("Aqua" or the "Company") financial ability to construct, operate and maintain a water supply and distribution system for the Village of Manteno (“Manteno Water System”) pursuant to Section 8-406(b)(3) of the Act.

5. Q. Please summarize your conclusions.

A. Following Aqua’s proposed purchase of the Manteno Water System and the related construction, the Company’s financial strength will be commensurate with a very strong A credit rating and Aqua will continue to have access to the capital markets on reasonable terms. Thus, in my judgment, Aqua has the financial ability to construct, operate and maintain the Manteno Water System.

6. Q. What are the requirements of Section 8-406(b)(3) of the Act?

A. Section 8-406(b)(3) of the Act requires the Commission to determine that the proposed construction will promote the public convenience and necessity only if a utility demonstrates that it is capable of financing the proposed construction without significant adverse financial consequences for the utility or its customers. (220 ILCS 5/8-406(b)(3).)

7. Q. Please describe the estimated cost for Aqua to purchase and make capital improvements to the Manteno Water System.

A. Pursuant to Section 1.3 of the “Asset Purchase Agreement for the Acquisition of the Water System Assets of Village of Manteno by Aqua Illinois, Inc.,” dated February 21, 2006, (the “Agreement”) Aqua will purchase the Manteno Water System for $4,500,000 and incur transaction-related expenses (*i.e.* closing costs) totaling $100,000. (Company response to ICC Staff data request FD 1.02.) Effective with the acquisition, Aqua will assume responsibility for making capital improvements to the Manteno Water System (Company response to ICC Staff data request FD 1.09), which Aqua estimates will total $3,373,020 during the years 2007 through 2011. The majority of the capital improvements, totaling more than $2.3 million, are expected to occur during 2007. (Company response to ICC Staff data request FD 1.10.)

8. Q. How will Aqua finance the cost of the proposed Manteno Water System purchase and the related construction?

A. Aqua will use short-term debt to pay for the Manteno Water System and the related capital improvements. According to Aqua, the Company will subsequently adjust its capital structure through dividend policy, an equity infusion and long-term debt issuances in order to maintain a capital structure comprising 52% equity and 48% debt. (Company responses to ICC Staff data requests FD 1.03 and FD 2.05.)

9. Q. How does the estimated cost of the Manteno Water System purchase and proposed construction compare to Aqua's water utility assets and revenue?

A. At December 31, 2005, Aqua's net plant totaled $179,390,951 and Aqua's utility revenue for the twelve months ended December 31, 2005, totaled

$34,275,720. (Aqua Illinois, Inc. 2005 Form 22 ILCC Annual Report.) In comparison, the purchase price for the Manteno Water System, plus the closing costs, equals $4,600,000. For years 2007 through 2011, Aqua estimates capital improvements will cost an additional $3,373,020. Thus, the total cost of purchasing and improving the Manteno Water System is $7,973,020, or approximately 4.5% of total plant and 23% of total utility revenue. Due to the size of this transaction vis-à-vis the Company's net plant and utility revenues, I performed a ratio analysis of Aqua following the proposed purchase of the Manteno Water System to assess whether Aqua is capable of financing the proposed construction without significant adverse financial consequences for the utility or its customers.

10. Q. Aqua indicates that it will finance the Manteno Water System purchase and proposed capital improvements with debt and equity in addition to internally generated funds. Does Aqua have access to the capital markets on reasonable terms?

A. Yes. Aqua indicates it has bank lines of credit totaling $20 million dollars available to finance capital improvements and provide working capital to operate the Manteno Water System. (Company response to ICC Staff data request FD 1.06.) Additionally, Aqua has access to the financial resources of its parent company, Aqua America, Inc., to finance the development and growth within the Village of Manteno. (Company responses to ICC Staff data requests FD 2.01 and FD 2.02.) Specifically, Aqua obtains equity capital through its parent company, Aqua America, Inc., whose total assets exceed $2.6 billion. (Aqua America, Inc. 2005

Annual Report, provided by the Company in response to ICC Staff data request FD 2.01.) Aqua America, Inc. has access to the capital markets on reasonable terms. Standard & Poor's ("S&P") categorizes debt securities on the basis of the risk that a company will default on its interest or principal payment obligations. The resulting credit rating reflects both the operating and financial risks of a utility. (Standard & Poor's, "Research: Standard & Poor's Ratings Definitions," December 10, 2002, p. 5.) S&P rates Aqua's affiliate, Aqua Pennsylvania, Inc. A+. According to S&P, an A-rated utility has a strong capacity to meet its financial obligations. (*Id.*) This credit rating reflects the consolidated credit profile of Aqua America, Inc. (Standard & Poor's, "Research: Aqua Pennsylvania, Inc.," July 14, 2006.) Given Aqua's parent company, Aqua America, Inc., is a financially strong company and ultimately responsible for providing Aqua with equity capital, in my judgment, Aqua currently has access to the capital markets on reasonable terms.

11. Q. Did you assess Aqua's stand-alone financial strength to determine whether Aqua will have access to the capital markets on reasonable terms following the proposed purchase and construction of the Manteno Water System?

A. Yes. I assessed Aqua's stand-alone financial strength using financial ratio targets that S&P publishes for the following three ratios (collectively, the "S&P benchmark ratios") that it uses in its analysis of investor-owned utilities: (1) funds from operations ("FFO") interest coverage; (2) FFO to total debt; and (3) total debt to total capital. The S&P benchmark ratios measure financial risk and vary with its business profile score. (Standard & Poor's, "Research: New Business Profile Scores Assigned for U.S. Utility and Power Companies; Financial Guidelines Revised," June 2, 2004.) Using projected financial statements for Aqua, as provided by the Company in response to ICC Staff data request FD 2.04, I calculated S&P benchmark ratios for Aqua for years 2006 through 2010. For the 2006-2010 period, Aqua's projects its FFO interest coverage ratio will be 4.0X; its FFO to total debt ratio will be 18%; and its total debt to total capital ratio will be 48%. Table 1 below presents Aqua's current and projected ratios and the S&P benchmark ratio financial targets for comparative purposes. Based on the results of the S&P benchmark ratio analysis for Aqua, in my judgment, Aqua will still have access to the capital markets on reasonable terms following the proposed transaction.

Table 1: Standard & Poor's Benchmark Ratios for Aqua Illinois, Inc.

	Actual Ratios for Aqua	**Projected** Ratios for Aqua	S&P Benchmark Ratios for Utilities with Business Profile Score of "2"		S&P Benchmark Ratios for Utilities with Business Profile Score of "3"	
	2003-2005	2006-2010	AA	A	AA	A
FFO Interest Coverage	3.8X	4.2X	4.0X – 3.0X	3.0X – 2.0X	4.5X – 3.5X	3.5X – 2.5X
FFO to Total Debt	19%	19%	25% - 20%	20% - 12%	30% - 25%	25% - 15%
Total Debt to Total Capital	50%	48%	45% - 52%	52% - 58%	42% - 50%	50% - 58%

12. Q. Why did you compare Aqua's S&P benchmark ratio values to the ranges S&P established for the business profile scores of 2 and 3?

A. A firm's market-required return on common equity is a function of its operating and financial risks. S&P business profile scores reflect the operating risk of a utility. S&P focuses on industry characteristics as well as the company's competitive position and management. A utility's business profile score is evaluated on a scale of one to ten. A rating of one denotes below average business risk, while a rating of ten denotes above average business risk. (Standard & Poor's, "Research: New Business Profile Scores Assigned for U.S. Utility and Power Companies; Financial Guidelines Revised," June 2, 2004.) I imputed an S&P business profile score for Aqua since it does not have one. I began with 10 water companies with business profile scores listed in S&P *Utilities & Perspectives*. Of these 10 water utilities, 1 is assigned a business profile score of "1"; 4 are assigned a business profile score of "2"; 4 are assigned a business profile score of "3"; and 1 is assigned a business profile score of "4". (Standard & Poor's, "Research: Issuer Ranking: U.S. Utility and Power Companies, Strongest to Weakest," September 22, 2006.) The average business profile score of the 10 water utilities is 2.5. Additionally, Aqua's A+-rated affiliate, Aqua Pennsylvania, has also been assigned an S&P business profile score of 2. (Standard & Poor's, "Research: Aqua Pennsylvania, Inc.," July 14, 2006.) Based on the average business profile score of 2.5 for S&P-rated water utilities and the S&P business profile score of 2 for Aqua Pennsylvania, I concluded that a business profile score of 2 to 3 would be a reasonable estimate for Aqua.

13. Q. What is your recommendation regarding Aqua?

A. In my judgment, the proposed transaction meets the requirements of Section 8-406(b)(3) of the Act. Therefore, I recommend the Commission find that Aqua is capable of financing the Manteno Water System purchase and proposed construction without significant adverse financial consequences for the utility or its customers.

14. Q. Does this conclude your direct testimony?

A. Yes, it does.