STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Aqua Illinois, Inc.	)	
	)	Docket No. 10-0194
Proposed increase in general water rates for its Kankakee service area	)	
	)	

Surrebuttal Testimony of

DAVID P. SMELTZER

Chief Financial Officer
Aqua America, Inc.

On Behalf of
Aqua Illinois, Inc.

August 12, 2010

Aqua Ex. 8.0

I. WITNESS BACKGROUND

Q. Please state your name and business address.

A. My name is David P. Smeltzer. My business address is 762 West Lancaster Avenue, Bryn Mawr, Pennsylvania 19010.

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

A. I am employed by Aqua America, Inc. ("Aqua America") as Chief Financial Officer.

Q. Please briefly describe your education and business experience.

A. I graduated from La Salle University in 1980 with a Bachelor of Science degree in Business Administration, majoring in Accounting, and received my C.P.A. Certificate from the Commonwealth of Pennsylvania in 1982. I was employed by KPMG Peat Marwick, Certified Public Accountants ("KPMG"), from June 1980 until March 1986, when I joined Philadelphia Suburban Water Company ("PSW"), the corporate predecessor to Aqua Pennsylvania, Inc. While employed by KPMG, I worked initially as a Junior Accountant, advancing thereafter to Senior Accountant and Manager. My assignments varied, including financial, manufacturing and public utility clients. I was hired by PSW as Controller, was promoted to Vice President Rates and Regulatory Affairs in 1992, and in 1999 to my present position. In these capacities, I have a broad base of experience in the utility finance and regulatory areas.

Q. What are your duties as Chief Financial Officer of Aqua America?

A. As Chief Financial Officer, I am responsible for accounting, SEC and financial reporting, budgeting and planning, treasury (including accounts payable and payroll), regulatory affairs, rate case management and frequent investor relations meetings and presentations.

Q. Before what regulatory agencies have you previously appeared and presented expert testimony?

A. I testified before several regulatory agencies in various states including Pennsylvania, Illinois, New Hampshire, Connecticut, Florida, Virginia and North Carolina.

Q. When did you last testify before the Illinois Commerce Commission?

A. My only testimony before the Illinois Commerce Commission ("Commission") was in 1998, during the regulatory approval process related to Aqua America's (then Philadelphia Suburban Corporation) acquisition of Consumers Water Company, of which Aqua Illinois (then Consumers Illinois) was a subsidiary.

II. INTRODUCTION

Q. What is the purpose of your surrebuttal testimony?

A. My testimony responds to the rebuttal testimony of Staff witness Kight-Garlisch, who continues to propose a 9.61% return on equity ("ROE") for Aqua Illinois, Inc.'s ("Aqua") Kankakee Division. (Staff Ex. 8.0) Specifically, my surrebuttal testimony will address Staff's proposal in terms of its implications on Aqua and Aqua America. I respond to Ms. Kight-Garlisch's claims concerning how her proposal will impact Aqua America's finances, and I will discuss how Aqua America's ability to borrow is directly linked to the regulatory treatment now being proposed by Staff regarding return on equity. In addition, I will discuss how Aqua America's **actual** return on equity is far different than its historically awarded return on equity, which is far lower due to effects of regulatory lag.

Q. Staff witness Kight-Garlisch states that the investor-required rate of return on common equity for Aqua is 9.61%. (Staff Ex. 8.0, p. 2). Do you agree with this proposal?

A. No, I do not. I will not comment on the specific mathematical nuances and various source data that Ms. Kight-Garlisch and Mr. Walker dispute in reaching their respective calculations. However, given that Ms. Kight-Garlisch has not altered her proposal in rebuttal testimony, despite Mr. Walker's testimony, I would like to focus on the policy ramifications of Ms. Kight-Garlisch's recommendations and relay my concerns to the Commission based on my more than 20 years experience working with the investment community.

Q. Can you please elaborate on your concerns?

A. Aqua is an important part of the Aqua America corporate family of companies. Aqua is considered one of Aqua America's larger corporate entities and has benefited from a well defined and highly regarded regulatory compact with the Commission. To that end, Aqua has invested over $163 million in water infrastructure improvements in Illinois since its acquisition in 1999. In exchange for that significant investment, over the past ten years and the last three rate cases, the Kankakee division has always received a return on equity related to these investments in excess of 10% (**10.15%, 10.16% and 10.40%**).

Q. The Commission has awarded Aqua a return on equity above 10% for the last ten years. If Staff's proposed 9.61% ROE is adopted, how would this departure from a long-standing range of returns on equity affect Aqua's financial health?

A. I believe that this will be received negatively by investors and will have a negative impact on both Aqua's and Aqua America's financial health as more fully described below.

Q. Ms. Kight-Garlisch's rebuttal testimony notes that the common equity of Aqua is obtained indirectly from investors through Aqua America, a much larger organization. (Staff Ex. 8.0, p. 13). Can you comment on this statement?

A. Yes. From a policy perspective, I am concerned by Staff's failure to consider how the actual investment community views Aqua's financial health. In today's world, investors and analysts do not simply review Aqua America's performance. As stated by one research analyst, "Regulation can make or break a utility. As such, we believe it is imperative to follow the regulatory nuances at the state level across the water utility sector." See Exhibit 8.1. The investment community certainly considers the regulatory climate and awarded ROEs in each of the states that Aqua America operates in order to fully analyze their investment decision. See attached Exhibits 8.1 through 8.7.

Q. Please provide further insights into the investment community thought process.

A. The following excerpts are taken from full reports or presentations attached as exhibits hereto:

Per a Janney Montgomery Scott (Janney) Research Note on Aqua America dated July 18, 2008:

> Recent water rate cases in Pennsylvania have netted … ROE rates believed to be in the 10.5% range, so we view yesterday's decision as a positive development, signaling that the agency understands the need to provide a fair return to support ongoing infrastructure investment.

See Exhibit 8.2.

Per an April 27, 2009 presentation by Janney analyst Heike Doerr:

> Allowed ROE's are "the most important consideration in assessing regulatory climate.
>
> **Allowed ROE's are typically not achievable/maintainable due to regulatory lag.**
>
> Capital spending levels are only sustainable if "water utilities can regularly access the equity and debt markets and receive fair (and timely) returns on their investments.

See Exhibit 8.3.

Per an excerpt is taken from "Water Utilities 101: A Primer for Investors," published by Janney Montgomery Scott for investor clients in November 2007:

We believe a fair and consistent regulatory environment is one of most important factors in valuing the earnings capabilities of water utilities. We view ratemaking as the most important interaction that a utility has with the Commission, and the main driver of its ability to generate sustainable earnings. The objective of ratemaking is to establish rates that provide reliable service at a reasonable cost to customers AND provide utility shareholders a fair return on invested capital. It is no easy task to balance the needs of this diverse constituent base. While mechanisms to minimize regulatory lag are very important, we believe the single most important metric contained in a rate stipulation is the allowed return on equity and the ability to earn that allowed return. In fact, most water utilities struggle to actually earn their Commission-allowed ROEs, given their ongoing capital investment requirements and rate case timing.

. . . [I]t is increasingly our view that sufficient risk exists that shareholders should be fairly compensated if the industry is to continue to attract the level of equity capital that it will need to meet its infrastructure investment requirements over the coming decade.

Consider the following operating risks:

• Earnings variability related to water supply shortages and seasonal weather patterns, which appear likely to be exacerbated by climate change

• Risks associated with distributing an ingestible product critical to public health and welfare, not new but more apparent as environmental litigation has increased over the past decade

• Accelerating costs related to replacing aging infrastructure and meeting increasingly stringent environmental standards

• Risks of regulatory lag on recovering those costs

• Risk of eminent domain by municipal governments, which creates a form of competition, and potential for loss of assets

• In the last five years, the potential risk of terrorism threats to water facilities, though fortunately, this last risk seems remote so far

• Long-lived assets with lengthy depreciation schedules and slow cost recovery

• High capital intensity, as water is the most capital intensive of all utilities.

> In our view, **these risks deserve consideration of an additional risk premium, rather than a reduction of ROEs in a declining interest rate environment**, as some consumer advocates have argued. In addition, increased market volatility has caused a rise in the beta for many water utility stocks, the typical measure of equity risk. Currently, allowed ROEs for water utilities in the United States range from 9.0%-12%, although more recent cases are coming in around 10.0% to 10.5%.

See Exhibit 8.4.

Per an August 10, 2010 Standard & Poor's Industry Report Card for investor-owned water utilities noted:

> Fair and timely regulation remains the most important rating factor for a water utility's credit quality.

See Exhibit 8.5.

Lastly, at a June 28, 2010 commission regulatory conference, Richard Cortright from Standard & Poors discussed a number of credit quality matters, and rated the US State Commission policies on their level of credit support to jurisdictional utilities. In this rating, the state of Illinois was rated "Less Credit Supportive." See Exhibit 8.6

Q. Can you elaborate on the relationship between Aqua and Aqua America and its credit rating?

A. Yes. In addition to the policy concern mentioned above, I do not believe it is appropriate to portray Aqua America as an entity entirely unrelated and distant to Aqua. (See Staff Ex. 8.0, 13:255-14:284). While I understand Ms. Kight-Garlisch's general description of how Aqua obtains common equity through its shareholders, I would like to point out the shortcomings of Staff's argument. Aqua America is the parent corporation, but it is not a "larger organization." Without the individual state operations there would be no Aqua America. Nearly 100% of the revenue reported by Aqua America is generated through its regulated utility operations, of which Aqua is a large portion; fourth largest Aqua

America jurisdiction by customer count (62,000) and second largest Aqua America jurisdiction by investment, over $150 million. Investors, analysts, and credit agencies look to the individual state operations and respective commissions to evaluate the credit worthiness of the parent. Unreasonable returns and/or unjustified departures from long standing precedents are typically viewed unfavorably by investors, analysts and credit agencies.

Q. Do you agree with Ms. Kight-Garlisch's statement that "Aqua IL has only one common equity investor, Aqua America, which incurs costs to raise common equity commensurate with Aqua America's liquidity, not Aqua IL's liquidity?" (Staff Ex. 8.0, 13:270-72).

A. Again, I respectfully disagree with the Staff's myopic view of how the investment community views Aqua and Aqua America in making investment decisions. As stated above, investors, analysts, and credit agencies look to the individual state operations and respective regulatory environment resulting from commission decisions to evaluate whether to invest with Aqua.

Q. Based on your experience, how will the investment community view an ROE below 10%?

A. Based on my experience, I believe that the investment community will view this low return as unreasonable, and an unnecessary penalty to a well managed Company that is prudently investing in its aging infrastructure. Clearly, returns of this nature covering a significant share of the company's revenues would signal a likely decline in key ratios and benchmarks that could result in reduced optimism on the company's future and actually increase the company's cost of capital.

Q. What facts support this belief?

A. Just four months ago, Illinois-American Water Company ("Illinois-American") was awarded an ROE of 10.38%. Docket No. 09-0319, Order (Apr. 13, 2009). In my view, Aqua is just as efficient and dedicated to customer service as its fellow water company, Illinois-American. I seriously doubt the economy has changed that dramatically in the last four months to warrant this disparity in returns on equity for water companies making significant investments in our community's infrastructure. The staff witness has failed to explain this difference and the investment community will be left to guess and surmise why drastically different ROEs have been awarded to two similar water utilities.

Further, in a recent Janney update on Connecticut Water (dated August 11, 2010, attached as Exhibit 8.7), the analyst noted that "Despite raising our current year earnings estimates to reflect the final rate decision, we lower our fair value to $21 from $23 to reflect a valuation discount to peers that is warranted due to the company's sub-par allowed return on equity below 10%."

Q. What do you mean when you say that a 9.61% ROE will have a negative impact on Aqua?

A. To me, this issue is more than just an argument between Mr. Walker and Ms. Kight-Garlisch about sample size, make up and what goes into the specific mathematical calculation to arrive at a reasonable ROE. Based on my experience, I believe that Staff's unprecedented departure to a 9.61% ROE, without any consideration for Aqua's historical, Commission-approved ROEs, could impact Aqua America's bond ratings and the recommendations by Analysts on Aqua America's common stock, both of which could result in a higher cost of capital in the future to continue the company's infrastructure rehabilitation. Moreover, I respectfully assert that Ms. Kight-Garlisch's assessment of the situation does not capture the investment community's real world demands.

Q. Has Aqua earned its Commission-authorized ROE in the past?

A. No, it has not. In the past ten years, Aqua has never earned its allowed return on equity.

Q. Why are many utilities unable to achieve their authorized ROE?

A. As is the case for most utilities that are required to file rate cases, there will always be a certain amount of regulatory lag and disallowances (i.e., power and chemicals adjusted for unaccounted-for water) that will prohibit the utility from earning its authorized ROE from the first day new rates go into effect.

Q. What does this mean for Aqua?

A. It means that its actual return on equity will be ***even lower*** than 9.61%.

Q. Do you have data that will support this historic pattern?

A. Yes. Please see below for the Kankakee Division.

		Kankakee	
	Allowed	Actual	Difference
2000		8.32%	
2001	10.15%	9.27%	-0.88%
2002		8.70%	-1.45%
2003		5.18%	-4.97%
2004	10.16%	7.02%	-3.14%
2005		6.59%	-3.57%
2006	10.40%	5.90%	-4.50%
2007		10.03%	-0.37%
2008		6.16%	-4.24%
2009		6.39%	-4.01%
Average			-3.01%

Q. Based on the above data, can you explain what the 9.61% recommended award will mean for the Kankakee Division?

A. Yes. As you can see, due to regulatory lag and other disallowances, the typical ROE in the Kankakee Division over the last 10 years has fallen short of the authorized ROE by over 300 basis points on average. In other words, on average over this period, the Commission has awarded Aqua ROE's of more than 10%, while Aqua has only been able to earn ROE's of just over 7%, a difference of about 300 basis points. So, should the Commission award Aqua a 9.61% ROE, we could expect this division, based on past performance and the continuing need to expend capital, to earn in the range of 6.6% ROE. This is far too low to sustain viable investor interest and falls well below even Staff's range of acceptable ROEs.

Q. Could you further explain how the 9.61% ROE recommendation compares to the awarded ROE's in the past 10 years?

A. Certainly. Exhibit 8.8 reflects a summary of comparative information which I believe serves as a reasonableness test to Staff's proposed return on equity. With regard to line 1, Company witness Harold Walker has expressed concern about the reduced number of companies in the water sample (5 versus a historical average of 7), and the skewed ROE results such a reduced number might produce. That the reduced number of companies may in fact have skewed Staff's ROE results is supported by the comparisons which follow.

Line 2 shows that the ROE per Order in excess of the risk free rate from the average of seven prior Aqua and Illinois American proceedings is 570 basis points whereas Staff's currently proposed ROE is only 495 basis points greater than the risk free rate.

Line 3 addresses the percentage of the water beta to the utility beta from the average of the seven prior Orders noted. Whereas the seven Order average shows a water to utility beta percentage of 93%, Staff's currently proposed water to utility beta is just 85%. This is significant in that Staff recommends a 67% and 33% water and utility weighting, respectively. While not reflected on this schedule, it should be noted that the seven Order average reflects a 48% and 52% water and utility weighting, respectively.

Line 6 shows that while the water to utility average ROE from the average of the seven prior Orders noted is the same (i.e., 100%), Staff's currently calculated water ROE is only 87% of its utility ROE. Again, this is significant in that Staff recommends a 67% weighting to water. It is thus not surprising to find that per line 7, Staff's currently proposed ROE of 9.61% is 93 basis points lower than the average of 10.54 per the prior seven noted Orders.

Whereas typically in ROE recommendations some of the metrics shown on this schedule would suggest an above average ROE, while others would suggest a below average ROE, balanced result is achieved. In the instant proceeding, all of the metrics reviewed suggest a below average ROE. Staff's proposed ROE is not only clearly skewed from the prior seven Orders referenced, it is 84 basis points lower than Value-Line's water ROE of 10.45 as projected for the years 2013-2015—the second half of Aqua's anticipated rate effective period. While the individual calculations of Staff's current analysis may not reflect dramatic departures from the past, when put together to form a whole, the 9.61% result does in fact reflect a sizable departure. Whether this end result departure stems entirely from the reduced water sample group is not clear. However there is no question that the outlier American States Water has a much greater downward effect on the proposed DCF estimate with only four other companies in the sample. Just as a high DCF outlier was excluded in Staff's Docket 04-0442 ROE recommendation, I believe the Commission should consider excluding American States from the sample group, and perhaps replacing it with the more mainstream American Water Works for purposes of the average DCF estimate.

To summarize, Staff stresses the need for "informed judgment" in a return on equity analysis per page 33 of its direct testimony. I respectfully submit that, with the best of intentions, Staff's judgment with regard to the reasonableness of its 9.61% recommendation is lacking as evidenced by a differential of 84 and 93 basis points looking forward per Value-Line and backward per the seven prior Orders, respectively. I therefore would ask Staff to reconsider its position and add a "zone of reasonableness" adjustment of no less than 40 and more realistically as much as 100 basis points.

Q. How has the Staff's ROE proposal further penalized Aqua?

A. Staff seems to want to have it both ways. On one hand, Ms. Kight-Garlisch relies on Aqua America's current capabilities of borrowing and providing equity to Aqua. On the other hand, she wants to prevent this type of advantageous position for customers in the future. As noted above, Aqua makes up part of the Aqua America corporate structure. Penalizing Aqua now will penalize customers with a higher cost of capital in the future.

III. CONCLUSION

Q. Does this conclude your surrebuttal testimony Mr. Smeltzer?

A. Yes, it does.