STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Aqua Illinois, Inc.	:	
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Proposed General Increase in Water And Sewer Rates	:	11-0436
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	:	
(Tariffs filed April 6, 2011).	:	

INITIAL BRIEF OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION

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INITIAL BRIEF OF THE STAFF
OF THE ILLINOIS COMMERCE COMMISSION

Staff of the Illinois Commerce Commission ("Staff"), by and through its undersigned counsel, pursuant to Section 200.800 of the Illinois Commerce Commission's ("Commission" or "ICC") Rules of Practice (83 Ill. Adm. Code 200.800), respectfully submits its Initial Brief in the instant proceeding.

I. BACKGROUND

On April 6, 2011, Aqua Illinois, Inc. (the "Company" or "Aqua") filed with the Illinois Commerce Commission ("Commission" or "ICC") revised tariffs in order to petition for a general increase in water sewer rates, pursuant to Section 9-201 of the Illinois Public Utilities Act (the "Act"), 220 ILCS 5/9-201. On May 18, 2011, the Commission entered Suspension Orders commencing the investigation concerning the propriety of Aqua's proposed rate increase and on August 17, 2011 entered a Resuspension Order extending the suspension through March 2, 2012. In due course,

the Administrative Law Judge assigned to this proceeding established a schedule for the submission of pre-filed testimony, hearings, and briefs (*Tr.*, Jun. 16, 2011, pp. 7-8).

In response to the Company's filings, the following parties filed Petitions to Intervene, which were granted: the Illinois Attorney General ("AG"), the Citizens Utility Board ("CUB"), the Village of University Park ("Village"), Viscofan USA, Inc. ("Viscofan"), and the County of Lake ("County").

At the October 25, 2010 evidentiary hearing in this matter, Christopher Boggs, Rates Analyst in the Rates Department of the Financial Analysis Division, testified on behalf of Staff. Prefiled testimony from Staff's other witnesses was also entered into the record.

This Initial Brief will summarize some of the Uncontested and Contested Issues between the parties. Staff reserves the right to discuss any other issues brought up by parties' Initial Briefs in its Reply Brief.

II. RATE BASE

A. Forecast Plant Additions (Uncontested)

Staff witness Bridal proposed an adjustment to reduce Forecast Plant Additions for the years ending December 21, 2011 and December 31, 2012 based on the Company's history of actual capital spending compared to capital spending for the years 2007, 2008, 2009, and 2010. Staff argued that the Company on average had less capital spending than planned from 2007 through 2010, and that adjusting the 2011 and 2012 forecast plant additions to reflect the Company's historical spending variance from planned capital expenditures provides a more realistic projection of the 2011 and 2012

additions to plant-in-service. (Staff Ex. 2.0, pp. 7-9; Staff Ex. 7.0, pp 5-6) Aqua does not contest the adjustment to Forecast Plant Additions. (Aqua Ex. 10.0, pp. 2-3; Aqua Ex. 14-0, p. 1)

III. OPERATING EXPENSES

A. Uncontested Issues

1. Corporate Management Fees

Staff witness Jones proposed an adjustment to reduce Corporate Management Fees, which are charges the Company receives for services from its parent, Aqua America, Inc., because: (1) the Company incorrectly calculated the four-year average inflation factor of 10% that it applied to its 2011 budget amount to calculate the test year fees; and (2) the projected increase in 2012 is inconsistent with the rate of increase projected for all other expenses. (Staff Ex. 1.0, p. 18.) Aqua does not contest the adjustment to Corporate Management Fees. (Aqua Ex. 10.0, p. 2.)

2. Accumulated Deferred Income Tax ("ADIT")

Staff witness Jones proposed an adjustment to reflect the impact on ADIT of the increase in the Illinois SIT rate from 7.3% to 9.5%, effective January 1, 2011. There are three parts to the adjustment:

1) An increase to ADIT for the shortfall resulting from the tax rate increase;

2) Creation of a regulatory asset for the future recovery of the additional ADIT liability; and

3) Amortization of the regulatory asset over the remaining life of the depreciable assets that gave rise to the ADIT.
(Staff Ex. 1.0, pp. 20 – 22.)

Staff witness Jones also proposed an adjustment to reflect the impact on ADIT of Illinois' allowance of 100% federal bonus depreciation in 2011, which means the Company can defer payment of state income tax on the amount of the 100% federal bonus depreciation for 2011. The Company's filing reflected the State's usual position regarding federal bonus depreciation, which is to disallow federal bonus depreciation in the calculation of a taxpayer's state income tax obligation. (*Id*., p. 23.)

Aqua does not contest the adjustments to ADIT. (Aqua Ex. 10.0, p. 3.)

3. Rate Case Expense

Staff witness Jones proposed an adjustment to reduce the amount of estimated rate case expense for Guastella Associates ("Guastella"), which was hired to provide consulting services in connection with a depreciation study, because the estimate for Guastella's services was overstated. Ms. Jones' adjustment reflects the actual expense incurred. (Staff Ex. 6.0, pp. 6 – 7.) Aqua does not contest the adjustment to rate case expense. (Aqua Ex. 14.0, p. 2.)

Ms. Jones recommended that Aqua incorporate into its surrebuttal testimony the responses to certain Staff DRs to support the recovery of rate case expenses as just and reasonable. (Staff Ex. 6.0, pp. 7 – 8.) Aqua incorporated the DR responses into the surrebuttal testimony of Company witness Paul Hanley. (Aqua Ex.14.0, pp. 3 – 4.)

Section 9-229 of the Act requires the Commission to expressly address in its final order the justness and reasonableness of any amount expended by a public utility to compensate attorneys or technical experts to prepare and litigate a general rate case filing. Ms. Jones recommends that the Commission make the following finding in its final order:

> The Commission finds that the amounts of compensation for attorneys and technical experts to prepare and litigate this proceeding, as adjusted by Staff, are just and reasonable pursuant to Section 9-229 of the Public Utilities Act (220 ILCS 5/9-229).

(Staff Ex. 6.0, pp. 7 – 8.)

4. Cash Working Capital

Staff witness Jones proposed an adjustment to the Cash Working Capital component of rate base to reflect the derivative impact of Staff's other adjustments on the cash working capital calculation. (Staff Ex. 1.0, p. 8.) Company witness Hanley identified an error related to Real Estate Tax Expense in Staff's calculation. (Aqua Ex. 10.0, p. 2.) Ms. Jones agrees with the Company. (Staff Ex. 6.0, pp. 5 – 6.) The correction is reflected in Staff's rebuttal schedules.

B. Contested Adjustments

1. Incentive Compensation

Staff witness Jones proposed an adjustment to reduce the incentive compensation expenses included in the Company's operating expenses. There are three parts to the adjustment:

1) Disallowance of 2009 Omnibus Equity Compensation Plan ("ECP") costs;

2) Disallowance of the increase in test year Management Improvement and Employee Recognition Plan ("MIP") costs for Dividend Equivalents; and

3) Disallowance of MIP costs.

(Staff Ex. 1.0, p. 9.)

2. 2009 Omnibus Equity Compensation Plan ("ECP")

The ECP is dependent upon financial goals of the Company that primarily benefit

shareholders, and the Commission has a long history of disallowing such costs. (*Id*., pp. 10 – 13) In fact, the Commission recently concluded the following in its Order in Docket Nos. 09-0166/0167 Cons., rate proceedings for North Shore Gas Company and Peoples Gas:

> For the most part, the Commission agrees with Staff. Incentive compensation related to financial goals, affiliate goals or shareholder goals should not be recoverable from ratepayers. The Commission has long held that costs related to incentive compensation are recoverable in rates only if the utility demonstrates tangible benefits to ratepayers. *See, e.g., Docket 03-0403* at 15 ("[T]o recover incentive compensation, the plan must confer upon ratepayers specific dollar savings or other tangible benefits. Furthermore, the degree of benefit that accrues directly to ratepayers, rather than to other stakeholders, is a significant factor in determining whether incentive compensation should be recovered in rates."); *Docket 01-0696* at 10 (requiring evidence of "specific dollar savings or any other tangible benefit for the ratepayers"); *Docket 01-0432* at 42-43 ("the Commission has generally disallowed such expenses except where the utility has demonstrated that its incentive compensation plan has reduced expenses and created greater efficiencies in operations. … [I]f a utility is seeking to recover such projected expenses from ratepayers, the utility should demonstrate that its plan can reasonably be expected to provide net benefits to ratepayers."). The utility bears the burden to establish that such tangible benefits accrue to ratepayers, in order to prove that the recovery of incentive compensation costs is just and reasonable. See 220 ILCS 9-201(c).
>
> This long line of Commission precedent was recently affirmed. In ComEd's appeal of the Commission's decision in Docket 05-0597, the court stated that "there is ample precedent making a benefit to ratepayers a condition upon which the recovery of salary-related expense depends" *ComEd Appeal* at 12. The Commission's decision here conforms to this standard. […]
>
> Moreover, the *ComEd Appeal* found that attracting good employees was too remote a benefit for ratepayers to support recovery from ratepayers. *ComEd Appeal* at 13.
>
> (ICC Docket Nos. 09-0166/0167 Cons. (Order, January 21, 2010) p. 58-59 (emphasis added).)

3. Increase in MIP Costs for Dividend Equivalents

There is nothing in the MIP document that suggests that Dividend Equivalents are a form of compensation under the MIP. However, Dividend Equivalents are a form of compensation under the ECP, the costs of which Ms. Jones proposes to disallow. (Staff Ex. 1.0, p. 15) It follows that, if the costs of the ECP are disallowed, the costs for the Dividend Equivalents should be disallowed, also.

The Company did not rebut Ms. Jones' proposed disallowance of costs for the ECP and the Dividend Equivalents. (Staff Ex. 6.0, p. 10)

4. Management Improvement and Employee Recognition Plan

The Company modified its MIP in 2011 to remove language regarding financial goals that must be met in order for employees to receive incentive compensation payments, but it included a mechanism in the plan that achieves the same end: language was added to the plan that allows the Company to decrease a participant's award based on "other factors" that are undefined. (Staff Ex. 1.0, pp. 15 – 16.) The Company counters that a participant's award may be increased, as well as decreased, by "other factors" and that such factors are listed in the participant's individual objectives. (Aqua Ex. 9.0, p. 2.) However, the actual language in the MIP indicates that the "other factors" are separate and apart from a participant's individual objectives.

> A participant's actual MIP Award can range from 0% to 185% of the participant's Target MIP Award depending exclusively on the Board of Directors' assessment of the participant's performance against the participant's objectives, and other factors as deemed appropriate by the Board of Directors. The percentage to be applied to the participant's Target MIP Award will be determined based on the points earned by the participant against his or her objectives, plus or minus whatever discretionary points are determined to be applied to the participant's point total by the Board of Directors.
>
> (Staff Cross Exhibit 7 (Part 2), Section 2.2.2.)

A participant must earn at least 70 points to be eligible for an award, and the maximum points a participant can earn is 110. To receive an award, the total of a participant's earned percentage points and discretionary percentage points must total at least 25. If the Board of Directors were to decide to deduct the maximum 75 discretionary points from a participant's earned points because of "other factors," a participant would have to earn at least 100 out of the maximum 110 points in order to receive any award under the MIP (100 – 75 = 25). Further, under this scenario, the maximum amount the participant could earn would be 35% of the maximum target award[1] (110 – 75 = 35). (Staff Ex. 1.0, p. 17.)

Other than a statement that there is no evidence to suggest that the Company has any intention of awarding incentive compensation to participants on anything but customer-centered objectives, Aqua provided no information to dispel the ambiguity surrounding the "other factors." Neither did the Company deny that the "other factors" could include financial goals which, if not met, would result in the Board of Directors reducing the points a participant had earned by meeting stated goals that provide a benefit to ratepayers. (Staff Ex. 6.0, p. 11 – 12.)

Staff makes no recommendation regarding how the Company should structure its incentive compensation package. However, in order to recover incentive compensation expense from ratepayers, the Commission has made it clear that the incentive compensation should provide tangible benefits to ratepayers and should not be related to financial goals, affiliate goals or shareholder goals. (*Id*.)

Staff believes its adjustment to disallow incentive compensation is appropriate

[1] Maximum target award equals 5-20% of base salary, depending on the participant's duties and responsibilities, as approved by the Board of Directors.

and should be approved by the Commission. However, should the Commission decide that it is appropriate for Aqua to recover incentive compensation costs from ratepayers, only 93% of the Company's budgeted test year amount should be included in the revenue requirements. In rebuttal testimony, the Company stated that its incentive compensation awards have averaged 93% of the annual budgeted amount over the past six years. (*Id*., pp. 12 – 13.)

5. Depreciation Rates

Company witness John F. Guastella, Sr. performed a depreciation analysis and proposed depreciation rates for the Candlewick water and sewer Division, Hawthorn Woods water and sewer Division, Ivanhoe water and sewer Division, University Park water and sewer Division, Willowbrook water and sewer Division, Fairhaven Estates water Division, Oak Run water Division, Ravenna water Division, Vermilion water Division, and Ellwood Greens sewer Division. (Aqua Ex. 7.0.) Aqua's proposed depreciation rates are identified on Aqua Revised Ex. 7.2.

Staff Witness William R. Johnson examined the Company's proposed depreciation analysis and stated that he had not objection to the Company's proposed depreciation rates. (ICC Staff Ex. 5.0. p. 10.) Mr. Johnson stated that the proposed average service lives, net salvage, and depreciation rates were approved by the Commission in Aqua's most recent rate case, Docket Nos. 07-0620/07-0621/08-0067 (consolidated). Additionally, Staff witness Johnson found that the proposed average service lives and depreciation rates were within the comparable range of average service lives and depreciation rates outlined in the Company's comparative range of utilities found in Aqua Revised Ex. 7.1. (*Id.*, p. 9.) Staff also had no objection to the

Company using similar depreciation rates across all of its divisions, pointing out that Illinois-American Water Company and Utilities, Inc. utilize similar deprecation rates across divisions or districts. (*Id.,* p. 10.)

Staff recommended that the Company make sure it is maintaining the necessary information so that a comprehensive depreciation study utilizing Company specific data can be performed in the future. (*Id.*, p. 11)

6. Miscellaneous Expenses

Staff witness Bridal proposed an adjustment to remove Fines and Penalties and dues to the Chamber of Commerce from test year operating expenses. Aqua included in its test year operating expenses Fines and Penalties incurred by the Aqua corporate division. Staff averred that it is not reasonable for ratepayers to bear expenses such as Fines and Penalties which the Company could have avoided and which are not necessary in the provision of utility service. Staff also argued that Chambers of Commerce are community and economic development organizations, and contribution to such organizations is a promotional and goodwill practice. While perhaps such contributions may demonstrate good corporate citizenship, Staff argued they are not necessary in providing utility service. Consequently, ratepayers should not be burdened with the expense of the Company's contributions to these community and economic development organizations. (Staff Ex. 2.0, pp. 3-5; Staff Ex. 7.0, pp. 3-4) Aqua does not contest the adjustment to Miscellaneous Expenses. (Aqua Ex. 10.0, pp. 2-3; Aqua Ex. 14.0, p. 1)

Charitable Contributions

Staff witness Bridal proposed an adjustment to reduce test year Charitable

Contributions for an amount for the City of Danville for Community and Economic Development. Staff argued that contributing for community and economic development purposes is a promotional and goodwill practice. Section 9-227 of the Act allows as an operating expense donations made by a utility for the public welfare or for charitable scientific, religious, or educational purposes. Staff argued the contribution to the City of Danville is not for the allowable purposes defined by the act; consequently, ratepayers should not be burdened with the expense of the Company's contributions for community and economic development purposes, and the expense should be removed from the Company's revenue requirement. (Staff Ex. 2.0, pp. 5-6; Staff Ex. 7.0, pp. 4-5) Aqua does not contest the adjustment to Miscellaneous Expenses. (Aqua Ex. 10.0, pp. 2-3; Aqua Ex. 14.0, p. 1)

Industry Association Dues – Lobbying

Staff witness Bridal proposed an adjustment to remove certain industry association dues attributable to lobbying activities. Section 9-224 of the Act states that the Commission shall not consider as an expense of any public utility company, for the purpose of determining any rate or charge, any amount expended for political activity or lobbying as defined in the "Lobbyist Registration Act." (Staff Ex. 2.0, pp. 6-7; Staff Ex. 7.0, p. 5) Aqua does not contest the adjustment to Industry Association Dues. (Aqua Ex. 10.0, pp. 2-3; Aqua Ex. 14.0, p. 1)

IV. COST OF CAPITAL/RATE OF RETURN

Two witnesses presented testimony regarding Aqua's cost of capital: Mr. Harold Walker, III presented cost of common equity testimony on behalf of the Company (Aqua Exhibits 5.0, 11.0, and 15.0) and Ms. Sheena Kight-Garlisch presented Staff's testimony

concerning Aqua's capital structure, cost of equity and overall cost of capital (Staff Exs. 3.0 and 8.0C). The Company and Staff do not agree on the appropriate cost of equity for Aqua. However, the Company and Staff agreed on the costs and balances of long-term debt, short-term debt and preferred stock. (Aqua Ex. 11.0, pp. 27-28.)

A. Capital Structure (Uncontested)

The Company proposed using a forecasted average 2012 capital structure that contains 0.69% short-term debt, 45.77% long-term debt, 0.24% preferred stock, and 53.31% common equity, which Staff witness Sheena Kight-Garlisch recommended that the Commission accept. (Staff Ex. 3.0, p. 3.)

The above suggests that Aqua's capital structure is commensurate with a strong degree of financial strength, but not excessive degree of financial strength. Thus, Ms. Kight-Garlisch concluded that the proposed capital structure for Aqua is reasonable for rate-making purposes. (Staff Ex. 3.0, pp. 7-8.)

B. Cost of Debt

1. Cost of Short-Term Debt (Uncontested)

Staff witness Sheena Kight-Garlisch testified that the cost of short-term debt is 2.00% for Aqua. (Staff Ex. 3.0, p. 8 and Schedule 3.01.)

2. Cost of Long-Term Debt (Uncontested)

Staff witness Sheena Kight-Garlisch testified that the average embedded cost of long-term debt for the average 2012 measurement period equals 6.71% for Aqua. (Staff Ex. 3.0, p. 9 and Schedule 3.01.)

3. Cost of Preferred Stock (Uncontested)

Staff witness Sheena Kight-Garlisch testified that the average cost of preferred

stock equals 5.47% for Aqua. (Staff Ex. 3.0, p. 9 and Schedule 3.01.)

C. Cost of Common Equity

Staff estimated the investor-required rate of return of common equity for Aqua at 9.43%. Aqua recommended a return on common equity of 10.90%.

1. Staff's Analysis of Cost of Common Equity

Staff witness Sheena Kight-Garlisch estimated the investor-required rate of return on common equity to be 9.43% for Aqua. (Staff Ex. 3.0, p. 9.) In her direct testimony, Ms. Kight-Garlisch measured the investor-required rate of return on common equity with the constant growth Discounted Cash Flow ("DCF") and Capital Asset Pricing Model ("CAPM") analyses. She applied those models to a sample of water companies ("Water Sample") and utility companies ("Utility Sample"). (Staff Ex. 3.0, p. 9.)

2. Staff's DCF Analysis

DCF analysis assumes that the market value of common stock equals the present value of the expected stream of future dividend payments to the holders of that stock. Since a DCF model incorporates time-sensitive valuation factors, it must correctly reflect the timing of the dividend payments that a stock price embodies. The companies in Ms. Kight-Garlisch's samples pay dividends quarterly. Therefore, Ms. Kight-Garlisch applied a quarterly DCF model. (Staff Ex. 3.0., pp. 12-13.)

DCF methodology requires a growth rate that reflects the expectations of investors. A non-constant growth DCF ("NCDCF") model is appropriate when the growth rate estimates are not sustainable over the long-term. A NCDCF model employs more than one growth rate estimate, including a near-term growth rate covering the first

five years and a sustainable growth rate into perpetuity. In contrast, a single-stage, constant growth DCF model employs a single growth rate estimate, which is assumed to be sustainable to infinity. Thus, the cost of common equity calculation derived from a constant growth estimate DCF is correct only if the near-term growth rate forecast for the sample as a group is expected to approximate its average long-term dividend growth. Ms. Kight-Garlisch concluded that the estimated average 3-5 year growth rate of 4.62% for her Water Sample and 4.88% for her Utility Sample are sustainable over the long-term. Therefore, she implemented a single-stage, constant growth model. (Staff Ex. 3.0, pp. 14-15.) Ms. Kight-Garlisch used the Zacks growth rate estimates as of July 6, 2011. (Staff Ex. 3.0, p. 14.)

The growth rate estimates were combined with the closing stock prices and dividend data as of July 6, 2011. Based on the growth rate, stock price, and dividend data, Ms. Kight-Garlisch's DCF estimates of the cost of common equity were 8.36% for the Water Sample and 9.65% for Utility Sample. (Staff Ex. 3.0, pp. 14-16.)

3. Staff's Risk Premium Analysis

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' aversion to risk. That is, investors require higher returns to accept greater exposure to risk. In equilibrium, two securities with equal quantities of risk have equal required rates of return. Ms. Kight-Garlisch used 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 cannot be eliminated through portfolio diversification. (Staff Ex. 3.0,

pp. 17-18.)

The CAPM requires the estimation of three parameters: beta, the risk-free rate, and the required rate of return on the market. For the beta parameter, Ms. Kight-Garlisch combined adjusted betas from Value Line, Zacks, and a regression analysis. (Staff Ex. 3.0, pp. 18-28.) The Water Sample's average Value Line, Zacks, and regression beta estimates were 0.68, 0.60, and 0.57, respectively. The Utility Sample's average Value Line, Zacks, and regression beta estimates were 0.73, 0.74, and 0.69, respectively. The Value Line regression employs 259 weekly observations of stock return data regressed against the New York Stock Exchange ("NYSE") Composite Index. Both the regression beta and Zacks betas employ sixty monthly observations; however, while Zacks betas regress stock returns against the S&P 500 Index, the regression beta regresses stock returns against the NYSE Index. Since the Zacks beta estimate and the regression beta estimate are calculated using monthly data rather than weekly data (as Value Line uses), Ms. Kight-Garlisch averaged the Zacks and regression results to avoid over-weighting monthly return betas. She then averaged that result with the Value Line beta, which produced a beta for the Water Sample of 0.64 and for the Utility Sample of 0.73. (Staff Ex. 3.0, pp. 23-28.) For the risk-free rate parameter, Ms. Kight-Garlisch considered the 0.01% yield on four-week U.S. Treasury bills and the 4.40% yield on thirty-year U.S. Treasury bonds. Both estimates were measured as of July 6, 2011. Forecasts of long-term inflation and the real risk-free rate imply that the long-term risk-free rate is between 4.5% and 5.4%. Thus, Ms. Kight-Garlisch concluded that the U.S. Treasury bond yield is currently the superior proxy for the long-term risk-free rate. (Staff Ex. 3.0, pp. 18-22.) Finally, for the expected rate of

return on the market parameter, Ms. Kight-Garlisch conducted a DCF analysis on the firms composing the S&P 500 Index. That analysis estimated that the expected rate of return on the market equals 12.86%. (Staff Ex. 3.0, pp. 22-23.) Inputting those three parameters into the CAPM, Ms. Kight-Garlisch calculated a cost of common equity estimate of 9.81% for the Water Sample and 10.58% for the Utility Sample. (Staff Ex. 3.0, p. 28.)

4. Staff's Cost of Common Equity Recommendation

First, Ms. Kight-Garlisch estimated the investor-required rate of return on common equity for the two Samples from the results of the DCF and risk premium analyses for the Samples. The average investor-required rate of return on common equity for her Water Sample, 9.09%, is based on the average of the DCF-derived results (8.36%) and the risk premium-derived results (9.81%). The average investor-required rate of return on common equity for her Utility Sample, 10.12%, is based on the average DCF-derived results (9.65%) and the risk premium-derived results (10.58%). (Staff Ex. 3.0, pp. 29-30.)

Next, Ms. Kight-Garlisch compared the risk of the two Samples to Aqua to determine the relative weighting that should be applied to each. The average S&P credit rating for the companies in her Water Sample is A. The average S&P credit rating for the companies in her Utility Sample is BBB. This indicates that the Water Sample is less risky than the Utility Sample. (Staff Ex. 3.0, p. 30.)

S&P does not present a credit rating specifically for Aqua; therefore, Ms. Kight-Garlisch estimated the credit rating that Aqua's financial ratios imply using the S&P risk matrix. S&P publishes a business risk and financial risk matrix to evaluate a company's

total risk.

The Water Sample and the Utility Sample both have “Excellent” business risk profiles. Further, all water companies rated by S&P have an “Excellent” business risk profile. Therefore, Ms. Kight-Garlisch assumed an “Excellent” business risk profile for both Aqua and Aqua America for evaluating their overall risk. The financial risk matrix implies a credit rating of A- for Aqua, A-/BBB for Aqua America, and BBB for both the Water Sample and the Utility Sample. The average S&P credit rating for the Utility Samples is BBB, which is consistent with that implied by the matrix. However, the average S&P credit rating for the Water Sample is A, which is higher than its financial ratios imply. Although S&P does not present a credit rating specifically for Aqua or its parent Aqua America, Inc., Aqua’s affiliate for which S&P does present a credit rating, Aqua Pennsylvania, Inc, Aqua’s regulated sister subsidiary is rated A+. The rating for Aqua Pennsylvania reflects Aqua America’s consolidated credit strength. Aqua has similar if not better cash flow ratios and lower debt ratios than Aqua America and both Samples. Thus, Ms. Kight-Garlisch concluded the Company’s implied credit rating is A+, the same as Aqua Pennsylvania. Thus, S&P implied credit ratings for Aqua’s suggest that Aqua may be slightly less risky than her Water Sample, and less risky than her Utility Sample. (Staff Ex. 3.0, p. 30.)

Ms. Kight-Garlisch also performed a principal components analysis for Aqua and her samples, using the same approach she used to select her Utility Sample. She compared four principal components factor scores for Aqua, her Water Sample, and her Utility Sample to assess their relative risk. Each utility’s principal components factor score represents the number of standard deviations (σ) that utility falls from the industry

average in terms of that specific risk factor. The standard deviation is a statistic that explains how tightly the observations are clustered around the mean in a set of data. Under a normal distribution, approximately 68% of all observations will fall within one standard deviation of the average; approximately 95% will fall within two standard deviations. (Staff Ex. 3.0, p. 30-31.)

Factor 1 measures financial strength, with a higher score indicating less risk. Aqua's score on factor 1 is -0.996σ, while her Water Sample's factor 1 score is -0.673σ and the Utility Sample's factor 1 score is -0.506σ. Thus, Aqua is slightly riskier than both Ms Kight-Garlisch's Water Sample and Utility Sample in terms of financial risk. Factor 2 measures revenue and earnings stability, indicators of sales and cost variability. A higher factor 2 score indicates greater revenue and earnings stability and, thus, lower risk. Aqua's factor 2 score of 0.296σ is lower than her Water Sample's score of 1.245σ, but very similar to her Utility Sample's factor score of 0.324σ. This indicates that Aqua has less stable revenues and earnings, and consequently, more risk, than her Water Sample, but very similar sales risk to her Utility Sample. Factor 3 measures construction risk, with a higher score again indicating less risk. Aqua's score on factor 3 is 1.126σ is higher than both her Water Sample's -0.036σ and her Utility Sample's 0.227σ. This indicates that Aqua's level of construction risk is lower than both her Water Sample and Utility Sample. Factor 4 measures capital intensity. Capital intensity can insulate a company from competition and, thus, reduce risk. However, capital intensity can also indicate higher operating leverage (i.e., fixed costs), which can increase risk through lower earnings stability. Aqua's factor 4 score of 1.488σ is slightly higher than her Water Sample's factor score of 1.237σ and higher than the Utility

Sample's factor score of 0.093σ. Given the minor difference between the factor 4 scores for Aqua and her Water Sample and the imprecise nature of interpreting the risk associated with that factor, it is not clear what effect Aqua's slightly higher capital intensity has on its risk relative to that of the Water Sample. However, it is clear that the effect is small. Moreover, Aqua's factor 4 score is higher than her Utility Sample's factor 4 score of 0.093σ, which indicates that Aqua has more operating leverage, but is exposed to less competitive risk. Since Aqua's earnings stability is about the same as that of her Utility Sample, Aqua's operating leverage has not led to greater relative operating risk. Thus, Ms. Kight-Garlisch concluded that Aqua's capital intensity lowers its operating risk relative to her Utility Sample. Overall, Ms. Kight-Garlisch's analysis indicated that Aqua has slightly higher risk than her Water Sample and has less risk than her Utility Sample. (Staff Ex. 3.0, pp. 31-33.)

Both Ms. Kight-Garlisch's review of credit ratings and her principal components analysis suggest that the Utility Sample is more risky than either Aqua or the Water Sample. While the S&P implied credit rating and financial ratios suggest that Aqua may be slightly less risky than the Water Sample, the principal components scores suggest that it may be more risky. Given the split results of those risk measures, the minor difference in risk each suggests, and the inexact nature of risk assessment, it is reasonable to conclude that the Water Sample's risk level is representative of that of Aqua. Thus, she concluded that Aqua is closer in risk to the Water Sample than the Utility Sample. However, the small size of the Water Sample increases measurement error. Due to the increased measurement error for the Water Sample, she applied two-thirds weight to the Water Sample average investor-required rate of return on

common equity, and one-third weight to the Utility Sample average investor-required rate of return on common equity instead of relying solely on the Water Sample. Her recommended cost of equity for Aqua, 9.43%, is the result of that calculation. (Staff Ex. 3.0, p. 33.)

6. Weighted Average Cost of Capital

Staff recommends an 8.13% rate of return on Aqua's rate base. (Staff Ex. 3.0, Schedule 3.01) This rate of return incorporates the 2.00% cost of short-term debt and the 6.71% embedded cost of long-term debt and 5.47% cost of preferred stock agreed on by Aqua and Staff and the 9.43% rate of return Staff witness Sheena Kight-Garlisch recommends for Aqua's common equity. (Staff Ex. 3.0, p. 34 and Schedule 3.01; Aqua Ex. 11.0, p. 27-28.)

D. Staff's Criticism of the Company's Cost of Equity Analysis

Staff noted that Company Witness Walker's analysis contains several errors that lead him to over-estimate Aqua's cost of common equity. The most significant flaws in Mr. Walker's analysis of Aqua's cost of common equity are the: (1) use of historical data in each of his models; (2) the analyst growth rates he applied in his DCF analysis are unsustainably high, based on current expectations of overall economic growth; (3) his CAPM analysis suffers from a number of errors, the most critical of which are his flawed derivation of the overall market return ("R_m") and an inappropriate size premium and missing data which undermines the integrity of his beta estimate for the Water Group, since he only relied on the beta estimate of three of his six companies in the Water Group; and (4) the leverage adjustment he adds to the results of each of his DCF, CAPM and Risk Premium models is inappropriate. (Staff Ex. 3.0, p. 35.)

1. Historical Data

Mr. Walker used historical data to estimate the current dividend yield in his DCF analysis, the terminal growth rate in his 3-stage DCF analysis, and the equity risk premium in his RPM analysis and in his CAPM analysis. (Staff Ex. 3.0, p. 36.)

Mr. Walker's use of historical data is problematic. First, historical data favors outdated information that the market no longer considers relevant over the most-recently available information. Second, historical data reflects conditions that may not continue in the future. In other words, use of average historical data implies that securities data will revert to a mean. That implication is even more questionable for security returns since they approximate a random walk, which suggests no tendency of mean reversion. That is, in a random walk, the "future steps or directions cannot be predicted on the basis of past actions."[2] Finally, even if securities data were mean reverting, there is no method for determining the true value of that mean. Consequently, sample means, which depend upon the measurement period used, are substituted. Thus, any measurement period chosen is arbitrary, rendering the results uninformative. (Staff Ex. 3.0, pp. 35-36.)

2. Growth Rates

Mr. Walker's near-term growth rates are not sustainable over the long term. As Ms. Kight-Garlisch noted, the expectations of long-term growth in the overall economy ranges from 4.5% to 5.4%, with a midpoint of 4.9%. In contrast, the average near-term growth rate for Mr. Walker's Water Group is 47% greater than the midpoint of the expected long-term growth in the overall economy, at 7.2%, and the growth rate Mr. Walker utilized for his Gas Group is 20% greater, at 5.9%. Since utilities are generally

[2] *Id.*, at 16, *emphasis added*.

below average growth companies, it is unlikely investors expect the companies in Mr. Walker's samples to be able to sustain above average growth. Also, Mr. Walker relied on historical information to determine the terminal growth rate in his 3-stage DCF analysis, the shortcomings of which have been discussed above. (Staff Ex. 3.0, pp. 36-37.)

3. CAPM Analysis

Market Return

Mr. Walker utilized two estimates of R_m to derive his CAPM estimate. One estimate is the long-term historical total equity earned return rate of 11.85%, as reported by Ibbotson Associates.[3] The other estimate is based on projections reported in *The Value Line Investment Survey*. (Staff Ex. 3.0, p. 37.)

For the Value Line estimate, Mr. Walker added together median dividend yield and median price appreciation projections to estimate R_m. As a proxy for the market portfolio's dividend yield, Mr. Walker adopted the median of estimated dividend yields (for the next 12 months) of all dividend paying stocks under review in *The Value Line Investment Survey*. For the proxy of expected growth in the market portfolio, Mr. Walker adopted the 3-5 year estimated median price appreciation potential of all 1700 stocks in the hypothesized economic environment three to five years hence. He then calculated twelve months of annual total returns from the monthly dividend yields and price appreciations. Finally, he then determined the midpoint (14.4%) and the average (14.3%) of the annual total returns for the twelve months ending February 2011. Those two rates were averaged together for an R_m of 14.4%.[4] (Staff Ex. 3.0, pp. 37-38.)

[3] Aqua Ex. 5.0, Schedule 20, p. 3, note 5.
[4] Aqua Ex. 5.0, Schedule 20, pp. 2-3.

The two approaches used by Mr. Walker contain errors that corrupt his CAPM results. First, Mr. Walker's Ibbotson-based estimate is based entirely on historical data, the use of which has several shortcomings noted above.

Second, Mr. Walker's Value Line-based estimate of the required rate of return on the market contains several errors. First, the median is a biased measure of the aggregate market dividend yield and growth rate. The median of a sample is its middle value; that is, the sample contains as many values above the median as it contains below it. The magnitude of the difference between those other values and the median is not considered. For example, the median of a set comprising 1, 3 and 5 equals 3. The median of a set comprising 1, 3 and 10 also equals 3; although, the highest value in the latter set is double that in the former set. (Staff Ex. 3.0, p. 38.)

In particular, the median fails to properly weight the relative value of the securities composing the market portfolio. The common stocks of larger companies have a greater effect on market returns because they constitute a greater proportion of the market than those of smaller companies. Nevertheless, the median growth estimate does not afford higher weights to larger companies, and thus over-weights the contributions of smaller companies, which tend to have greater growth potential. (Staff Ex. 3.0, pp. 38-39.)

Mr. Walker's Value Line-based estimate compounds that problem by improperly drawing the median dividend yield and growth rates from two different samples. The median of estimated dividend yields is derived from dividend paying stocks only. That is, common stocks that do not pay dividends were excluded from the sample from which the median dividend yield was derived. Conversely, the median appreciation projection

is an estimate of all stocks in the hypothesized economic environment, dividend paying or not. Obviously the dividend yield of non-dividend paying stocks is 0%. Therefore, the median dividend yield for all common stocks included in *The Value Line Investment Survey* would be lower than that for the subset of common stocks paying dividends. Thus, by adding the higher dividend yield of dividend paying stocks alone to the estimated price appreciation of all stocks, Mr. Walker over-estimates the overall return on the market. (Staff Ex. 3.0, p. 39.)

Size Premium

Mr. Walker also claims that the beta, which is used to measure systematic risk in the CAPM, does not reflect the risk associated with the relatively small size of the companies in his Water Group and Gas Group. Thus, he adds 100 basis points to his Water Group's CAPM results and 70 basis points to his Gas Group's CAPM results. However, it is not appropriate to apply a size premium to Mr. Walker's CAPM results. (Staff Ex. 3.0, pp. 39-40.)

There are two fundamental flaws that render it unsuitable from a conceptual standpoint. First, Mr. Walker's size premium has no theoretical basis. Second, the empirical study of beta on which his adjustment is based is not applicable to Aqua.

Since a size premium has no theoretical basis, to the extent that a correlation between firm size and return exists, that relationship is likely the result of some other factor or factors that are related to both size and return, such as liquidity or information costs, rather than size, *per se*.

In fact, evidence of the existence of a size premium is not very strong. Fernholz found that a statistical property he termed the "crossover effect" was the primary cause

of the difference between large and small company stock returns. The "crossover effect" measures the effect on rate of return of those stocks that switch from one size portfolio to another.[5] Fernholz states that as random price changes affect the size of stocks, some stocks cross over from one size portfolio to another. When a stock that starts in the large stock portfolio experiences a random negative price change that moves it into the small stock portfolio, its resulting negative return is assigned to, and therefore reduces, the return on the large stock portfolio. Conversely, when that same stock experiences a random positive price change that moves it back into the large stock portfolio, its resulting positive return is assigned to, and therefore increases, the return on the small stock portfolio.[6] The combination of portfolio construction and random (i.e., non-systematic) price movements creates a biased source of measurement error. Thus, the size premium may be less a market return phenomenon than a modeling problem. That is, the size premium may be nothing more than a statistical anomaly.

In another study of domestic stocks listed on the NYSE and AMEX, Jensen, Johnson, and Mercer ("Jensen") found that size premiums appear to be related to monetary policy. Specifically, changes in monetary policy play a prominent role in determining the magnitude of size premiums. During expansive monetary periods, defined as months following a reduction in the Federal Reserve discount rate, Jensen found that small stock returns were significantly greater than large stock returns. Conversely, during restrictive monetary periods, defined as months following an

[5] Fernholz, "Crossovers, Dividends and the Size Effect," *Financial Analysts Journal,* May/June 1998, pp. 73-75.

[6] Fernholz, "Crossovers, Dividends and the Size Effect," *Financial Analysts Journal,* May/June 1998, p. 73.

increase in the discount rate, Jensen found that small stock returns were not significantly greater than large stock returns.[7] Nevertheless, the applicability of the Jensen results to small *utility* stocks is doubtful. First, since the Jensen study was based on largely non-utility companies, its findings that small stocks outperformed large stocks during "expansionary" monetary periods is not surprising. During monetary expansions, as the supply of loanable funds increases, investors are more likely to invest in speculative, small company stocks. However, during monetary contractions, as the supply of loanable funds decreases, investors are more likely to switch from speculative investments to safer ones – a phenomenon known as the "flight to quality." It is counter-intuitive to claim that investors would consider the smaller firms in the *regulated utility sector* to be speculative investments. Moreover, the Jensen study did not control its measurement of the size premium for risk as measured by beta or other means.[8] Therefore, the study does not support Mr. Walker's size premium adjustment. (Staff Ex. 3.0, pp. 40-42.)

Moreover, Mr. Walker's risk premium is not applicable to Aqua. Even if one were to accept the existence of a size premium for small companies generally, Mr. Walker provided no evidence to demonstrate a size premium is warranted for utilities specifically. The study reported in Ibbotson Associates, which forms the basis for Mr. Walker's size premium adjustment, is not restricted to utilities. Rather, it is based on the stocks listed on the New York Stock Exchange ("NYSE"), American Stock Exchange ("AMEX") and National Association of Security Dealers Automated Quotation System

[7] Jensen, Johnson and Mercer, "The Inconsistency of Small-Firm and Value Stock Premiums," *Journal of Portfolio Management,* p. 35.
[8] Jensen, Johnson and Mercer, "The Inconsistency of Small-Firm and Value Stock Premiums," *Journal of Portfolio Management,* pp. 30 and 34.

("NASDAQ"). Utilities, unlike most stocks listed on the NYSE, AMEX, or NASDAQ, are subject to uniform reporting requirements. Furthermore, their rates and conditions of service are publicly reported. Therefore, the cost of obtaining information regarding smaller utilities in general, and Aqua in particular, is unlikely to be as high as that of unregulated companies that are similar in size; hence, the application of a size premium to a utility is highly questionable. In fact, contrary to Mr. Walker's claims, a study by Annie Wong, reported in the Journal of the Midwest Finance Association, specifically found that there is no justification for a size premium for utilities.[9] Thus, the entire basis of Mr. Walker's size premium is questionable at best. (Staff Ex. 3.0, pp. 42-43.)

Beta

Mr. Walker's beta estimate is questionable because missing data undermines the integrity of Mr. Walker's Water Group's beta estimate. Mr. Walker's Water Group's beta estimate is uninformative because it is based on the beta estimates of only three of the six companies in his Water Group. (Staff Ex. 3.0, p. 43.)

4. Leverage Adjustment

Mr. Walker adjusted his DCF, CAPM and RP results upward by 55 basis points each because, he claims, there is a large difference in leverage as a result of the difference between the average market value of common equity for his samples and their average book values (i.e., market value > book value). To derive his leverage adjustment, he averaged the results of two approaches. In the first approach, he used the "Hamada Formula" to "unlever" the Value Line sample beta using market value capital structure ratios, and then "re-levered" the unlevered beta using book value

[9] Wong, "Utility Stock and the Size Effect: an Empirical Analysis," *Journal of the Midwest Finance Association,* 1993.

capital structure ratios. He then multiplied the difference between the unlevered and levered betas by the samples' risk premium to obtain a leverage adjustment estimate. In the second approach, Mr. Walker estimated that, based on market value debt ratios, the companies in his sample would command a AAA rating, in contrast to their current book-value based A rating. Thus, he used the spread between AAA-rated debt and A-rated debt to estimate the implied leverage adjustment. The average leverage adjustment estimate for those two approaches was 0.60% for the Water Group and 0.50% for the Gas Group. He averaged those two to get the 0.55% leverage adjustment he added to the results of his models. (Staff Ex. 3.0, pp. 43-44.)

Both of Mr. Walker's "leverage" adjustment approaches are based on the incorrect notion that utilities should be authorized rates of return on common equity in excess of the investor-required return whenever their market values of common equity exceed book values. However, to address this issue, one must first explore why the market value of utility common equity exceeds book value, which Mr. Walker has failed to do. (Staff Ex. 3.0, p. 44.)

There are two possible explanations for how utility stock prices have come to exceed their respective book values: (1) the investor-required rate of return has fallen, or (2) expectations of future earnings have risen. The investor-required rate of return on an investment in a utility would fall if either the price of risk (i.e., the risk premium) has fallen or if investors' perceived level of risk in that utility has fallen. Either way, if a utility's stock price grows to exceed its book value due to a decline in investors' required rate of return for that utility, then it obviously follows that the Commission should authorize a lower rate of return, not a higher one. (Staff Ex. 3.0, p. 45.)

An increase in investors' expectations of future returns could also cause a rise in market values over book values. Such an increase in expectations may be due to positive deviations from the test year amounts upon which the company's rates are set. Clearly, the Commission should not approve higher rates today based on such deviations (e.g., higher than projected sales) from past rate case estimates. Increased expectations of future returns may also be a function of earned returns from sources other than the revenue requirements formula component (R_{Other}), the product of rate base and rate of return. Earnings from these sources could allow a utility to earn returns beyond the level needed to meet investors' required rate of return on rate base investment. (Staff Ex. 3.0, p. 45.)

R_{Other} can come from a number of sources. First, many utilities have unregulated sources of income that would contribute to earnings beyond the level needed to meet the required rate of return. Second, the normalization of deferred income taxes and income tax credits might also contribute to the divergence between utility market and book equity values since that practice compensates utilities for taxes they do not yet owe. Finally, investors do not value utilities on the basis of accounting earnings, as Mr. Walker suggests, but on economic earnings and cash flow. In utility revenue requirements, part of cash flow comes from operating income (i.e., rate base $\times$ rate of return). The larger share of the remainder comes from operating expenses in the form of depreciation and deferred taxes. Clearly, the Commission should not increase a utility's rate of return due to expectations of additional earnings from these other sources. (Staff Ex. 3.0, pp. 45-46.)

Mr. Walker incorrectly argues that "the market value derived cost rate reflects the

financial risk or leverage associated with capitalization ratios based on market value, not book value. Mr. Walker is confusing a measurement tool, common equity ratio, with the phenomenon to be measured, financial risk. Switching measurement tools (i.e., market value or book value based ratios) does not affect the phenomenon to be measured. The ambient temperature does not change when the measurement tool is switched from a Fahrenheit thermometer to a Celsius thermometer. Similarly, the intrinsic financial risk level of a given company does not change simply because the manner in which it is measured has changed. To be clear, capital structure ratios are merely indicators of financial risk; they are not sources of financial risk. In fact, several other measures of financial risk, such as the pre-tax interest coverage ratio, funds flow interest coverage ratio, and funds flow debt coverage ratio, reflect neither book nor market common equity values. Financial risk arises from contractually required debt service payments. Changing the measure of capital structure ratios from a market to book value basis does not affect a company's debt service requirements. (Staff Ex. 3.0, pp. 46-47.)

For all of these reasons, Staff recommends that the Commission reject the Company's proposed cost of equity of 10.90% and adopt Staff's proposal of 9.43%.

V. RATE DESIGN

A. Separate Books for Each Tariff Group

The Company incorrectly infers that Staff recommends that Aqua keep separate books for each of its tariff groups. (Aqua Ex. 16.0, p. 9.) Staff makes no such recommendation. It was not clear to Staff until Company surrebuttal that the

Company's request to move to one revenue requirement was also a request for a determination regarding how it keeps its books; therefore, Staff did not address the technical merits of how many sets of books the Company should keep. Presumably, the Company is aware that it should keep its books such that it can comply with the filing requirements of 83 Ill. Adm. Code Part 285.

Section 285.2000 contains the instructions for submitting rate base schedules and provides in part:

> b) Separate rate base schedules must be provided for each applicable service and for each service area for which separate tariffs exist (e.g., district, division, etc.) where a requested change in rates is being proposed.

Section 285.3000 contains the instructions for submitting operating income schedules and provides in part:

> b) Schedules shall present information on a total company basis and on an applicable service basis, unless otherwise specified. If the utility maintains separate books for each service area for which separate tariffs exist (e.g., district, division, etc.), the schedules shall present information for each service area for which a change in rates is requested. In addition, if common rates are requested for a service area for which separate tariffs currently exist, the utility shall present information for each service area requesting common rates and the combined service areas requesting common rates.
>
> c) Separate operating income schedules must be provided for each applicable service and for each service area for which separate tariffs exist (e.g., district, division, etc.) where a requested increase in rates is being proposed for each, or separate service area.

The need to comport with the requirements of Part 285 was recently affirmed by the Commission in its Order in Docket No. 10-0517.

B. Rules, Regulations, and Conditions of Service Tariffs For Water and Sewer Service ("Rules")

Aqua was in contact with Staff prior to filing its current rate case and Staff

proposed some minor changes to the Company's Rules. In response to Staff data requests, the Company stated that there are no changes in the text of the Rules other than some minor typographical changes. The Company stated that the changes made to the Rules included: changes to the ILL. C. C. Nos.; all tariff sheets were labeled Original Sheet Nos.; and some of the tariff sheets' titles were changed from Consumers Illinois Water Company to Aqua Illinois, Inc. (ICC Staff Ex. 5.0, p. 11.) Staff witness Johnson stated that the proposed changes are minor typographical changes that promote clarity and do not change the substance of the Company's Rules and therefore should be approved. (*Id.*, p. 12.)

VI. RATES ISSUES

A. Uncontested issues

1. Public Fire Protection Charges

Staff recommends that the Commission approve the Company's method and resulting rate design for recovering the Public Fire Protection cost of service. (Staff Ex. 9.0R-C, pp. 33-34.) The two tier method for setting Public Fire Protection costs that the Company employed has been approved in previous rate cases. (Docket Nos. 00-0337, 00-0338, 00-0339, Cons. Final Order, January 31, 2001, p. 9; Docket No. 06-0285, Final Order, December 20, 2006, p. 18 and Docket No. 10-0194, Final Order, December 2, 2010, p. 25.) Additionally, the Company's proposed rate design recovers the full cost of Public Fire Protection service which is consistent with the Commission's decision in the most recent Illinois American Water Corp. rate case "that the Public Utilities Act

requires public fire protection charges to be set no higher than the cost of service." (Docket No. 09-0319, Final Order, p. 184.)

2. Private Fire Protection Charges

The Company is proposing a 100% increase in revenue recovery from this class (Aqua Ex. 6.0, p. 7), which will move the recovery of cost to serve this class to 55.12%. The proposal is a reasonable step closer to full cost recovery, which is the eventual goal for this service. Staff witness Boggs agrees with the Company's proposal (Staff Ex. 4.0 p. 43).

B. Contested issues

1. Water Division Consolidation

The Company's proposal to consolidate eight of its nine water divisions involved in this rate case (Candlewick Water, Fairhaven Water, Hawthorn Woods Water, Ivanhoe Water, Oak Run Water, Ravenna Water, Vermilion Water Division and Willowbrook Water) should be rejected. (Aqua Ex. 6.0, p. 4.) Under the Company's proposed revenue requirements and rate design, many customers would face sizeable increases in their monthly water bills if the Commission approves the proposed consolidation. Specifically, for a 5,000 gallon/month residential customer, Staff noted that such customers in the Candlewick, Fairhaven, Ivanhoe, Willowbrook and Vermilion Divisions would face larger monthly bill percentage increases under the Company's proposed Consolidated Tariff Group than if each of these divisions remained as stand alone divisions. (Staff Ex. 9.0R-C, p. 7.)

Instead, Staff recommends a Consolidated Tariff Group that includes the six water divisions of Oak Run, Ravenna, Hawthorn Woods, Willowbrook, Ivanhoe and

Vermilion. (*Id.*) Staff also recommends that the Fairhaven and Candlewick water divisions should be separately consolidated. Staff, however, supports the Company's proposal to maintain University Park as a stand alone division. (*Id.*)

Staff's Consolidated Tariff Group recommendation consisting of six water divisions is based on its finding that: (1) the water customers of Ravenna and Hawthorn Woods would have larger monthly bill increases if they remained as stand alone divisions than if they were included in the Consolidated Tariff Group; (2) although Vermilion water customers would have a slightly larger monthly bill increase if it was included in the Consolidated Tariff Group than if it remained a stand alone division, its water revenue increase in either scenario would be less than the overall increase that the Company proposes; (3) the benefits of adding Vermilion water's large customer base to the Consolidated Tariff Group provides an economies of scale benefit that allows the Company to spread out the recovery of costs of service to a larger group; and (4) Willowbrook and Ivanhoe water customers would face only a slightly larger increase in their monthly bills in the Consolidated Tariff Group than if they stood alone, but their small customer bases would benefit more from their costs being spread out over a larger group in the event a major water system improvement is needed in the future. (*Id.*, p. 9.)

Staff's recommendation that the Fairhaven and Candlewick Water divisions be consolidated to form their own water division is based on its finding that: (1) Candlewick customers would realize a reduction in their current monthly customer charges if they stood alone; and (2) Candlewick water customers would realize a lower Customer Charge than they currently pay if they consolidated with the Fairhaven customer base.

It is not typical for Staff to propose a reduction in Customer Charges in a rate case where the cost to serve the customer base has increased. In this rate case, however, a lower Candlewick Customer Charge was necessary to mitigate rate shock to Fairhaven customers under Staff's proposed consolidation of Fairhaven and Candlewick's water divisions. Consolidating Candlewick with Fairhaven provides each with the benefit of having a larger customer base over which to spread out costs and mitigates the rate shock that would occur if these divisions were included in the Consolidated Tariff Group. (*Id.*)

2. Sewer Division Consolidation

The Company's proposal to consolidate all six sewer divisions involved in this rate case (Candlewick Sewer, Ellwood Greens Sewer, Hawthorn Woods Sewer, Ivanhoe Sewer, University Park Sewer and Willowbrook Sewer) should be rejected. (Aqua Ex. 6.0, p. 4.) Under the Company's proposed revenue requirements and rate design many customers would face sizeable increases in their monthly waste water bills if the Commission approves the proposed consolidation.

Staff's analysis showed that all sewer divisions would require a higher revenue increase at the Company's proposed revenue requirement as a stand alone division than if they were all consolidated, except the Ellwood Greens and the University Park sewer divisions (Staff Ex. 9.0R-C, p. 22).

Staff recommends that the Commission reject the Company's proposal to include Ellwood Greens in the Consolidated Sewer Division. (*Id.* p. 23.) Staff noted that a 5,000 gallon/month Ellwood Greens waste water customer would see the percentage increase in his/her monthly bill nearly double if Ellwood Greens was included in the

Company's proposed consolidation. Likewise, the revenues that have been proposed by the Company to be recovered from the Ellwood Greens customers would also double if Ellwood Greens was included in the consolidation. Furthermore, according to the Company's response to Staff DR CB-5.03, if Ellwood Greens was not in the Consolidated Sewer Division, the monthly Customer Charge for the remainder of the customers in the Company's proposed Consolidated Sewer Division would need to be increased from the Company's proposed $36 to $36.35 and the Usage Charge would need to be increased from the Company's proposed $5.306 per 1,000 gallons used to $5.35 per 1,000 gallons used. Staff concludes that these slight increases to the tariff charges would not significantly affect the monthly bills of the remaining customers of the Consolidated Sewer Division.

Staff also recommends that the Commission reject the Company's proposal to include University Park in the Consolidated Sewer Division. (*Id.*, p. 25.) Table 9.6 in Staff Ex. 9.0R-C p. 22 and the Company's Schedule A-3 for University Park showed that University Park sewer customers would require a 19.92% increase in revenues at the Company's proposed rates if the division remained a stand alone and a 38.21% revenue increase if they were included in the Consolidated Sewer Division. Currently, University Park customers have a flat monthly Customer Charge ($45.55) and are not subject to a monthly Usage Charge. (*Id.*, p. 24.) Under the Company's proposed consolidation, University Park customers would be subject to both a monthly Customer Charge and a Usage Charge. The Customer Charge for these customers would actually decrease by 26.5% ($45.55 to $36) based on the Company's proposed rates. However, the inclusion of a uniform Usage Charge would cause the overall bill of any

customer using more than 2,000 gallons of waste water to exceed the current stand alone flat monthly Customer Charge. (*Id.*)

In addition, under the Company's consolidation proposal, a University Park residential customer that uses 5,000 gallons of waste water/month would have a monthly bill of $62.53. This would represent a 37% increase from the current monthly bill of $45.55. If University Park remained a stand alone division, the same customer will experience a 20% increase in his/her monthly bill ($54.68 flat stand alone rate vs. $45.55 current flat stand alone rate). (Staff Ex. 9.0R-C, p. 25) Therefore, Staff recommends leaving University Park Sewer as a stand alone division. (*Id.*)

Instead of the Company's proposal to consolidate all sewer divisions in this rate case, Staff recommends that the Commission approve a Consolidated Sewer Division that only includes Candlewick, Hawthorn Woods, Ivanhoe and Willowbrook. Each of these sewer divisions would experience smaller revenue increases and smaller monthly bills upon being consolidated than they would if each of these divisions remained on a stand alone basis. (*Id.,* p. 26.)

Staff also recommends that the Ellwood Greens and University Park sewer divisions remain on a stand alone basis. The basis of this recommendation is Staff's finding that including Ellwood Greens and University Park in the Company's proposed Consolidated Sewer Division would require larger revenue increases and monthly sewer bills for customers than if these two sewer divisions remained independent. Staff notes that in this rate case, the sewer customers of University Park and Ellwood Greens would experience no additional advantages by being consolidated with the Company's recommended Consolidated Sewer Division. (*Id.*)

3. Viscofan

Viscofan is Aqua's largest water customer and Aqua is devoted to keeping it on the water system due to the large amount of revenue Viscofan contributes to the system. In the past, Aqua has proposed moderate rate increases that were intentionally kept low to encourage Viscofan to remain on the water system. Viscofan has indicated that it has explored the possibility of building and managing its own water plant to try to control costs of its water usage. (Viscofan Ex. 1.0, pp. 4-5.)

The AG asserts that it does not believe there is adequate information to develop a competitive rate option for this customer (Viscofan) (AG Ex. 2.0, p.5). The AG also asserts that this type of competitive rate should be embodied in a contract that remains in effect for a period of years equivalent to the payback period of the competitive option. In other words, a utility's response to an alleged competitive supply option should focus not only on the price, but also on the length of the commitment the customer must make. (*Id*.)

In Docket No. 04-0442, the Commission agreed with Staff that Teepak (now known as Viscofan), at a minimum, should continue to pay at least 48.7% of its cost of service. (Docket No. 04-0442, Final Order, April 20, 2005, p. 54.) The Commission also agreed with Staff; however, that Viscofan should begin to pay a greater portion of its cost of service to address Viscofan's declining contribution toward its cost of service, while not being so large as to induce rate shock. The Commission concluded "that Teepak [Viscofan] should assume responsibility for an additional 1.0%, or a total of 49.7%, of its cost of service." (*Id.*)

Staff's rate proposal for Aqua's Large Industrial class (Viscofan) increases the

revenue percentage that Aqua would recover from Viscofan to 52.95% (up from 49.7% approved in Docket No. 04-0442). (Staff Ex. 9.0R-C, p. 38.) This proposed increase would represent a gradual increase in the percentage of the cost to serve this customer while slightly reducing the subsidy that other rate classes provide to Viscofan. Staff's proposal also seeks to minimize any potential rate shock that could induce Viscofan to consider building its own water plant. (*Id.*)

VII. CONCLUSION

For the reasons set forth *supra*, Staff respectfully requests that the Commission's Final Order in the instant proceeding reflect Staff's recommendations consistent with this Initial Brief.

Respectfully submitted,

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