STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Aqua Illinois, Inc.	:	
	:	Docket No. 11-0436
Proposed general increase in water and sewer rates.	:	

REPLY BRIEF OF AQUA ILLINOIS, INC.

Dated: December 8, 2011

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REPLY BRIEF OF AQUA ILLINOIS, INC.

Aqua Illinois, Inc. ("Aqua" or "the Company") hereby files with the Illinois Commerce Commission ("Commission") its Reply Brief in accordance with the Administrative Law Judge's established schedule.

I. EXECUTIVE SUMMARY

The Commission is required by law to approve rates that reflect the prudent and reasonable costs of serving Aqua's customers. 220 ILCS 5/9-201(c). As the Commission recently recognized:

> A public utility has a constitutional right to a return that is 'reasonably sufficient to assure confidence in the financial soundness of the utility and [is] adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.' The authorized return on equity 'should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.'

North Shore Gas Co., et al., ICC Docket Nos. 09-0166/09-0167 Cons., Order at 89-90 (Jan. 21. 2010) (citing *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944); *Bluefield Water Works & Improvement Co. v. Public Service Comm'n of West Virginia*, 262 U.S. 679, 693 (1923)).

Under these governing principles, Aqua showed that its 2012 test year costs are prudent and reasonable, and that its current rates will not recover these costs. *See, e.g.*, Aqua Init. Br. at 6-20. Specifically, the evidence supports the Commission's approval of a revenue requirement of $22,238,809 for Aqua's consolidated water divisions and $7,127,744 for its consolidated sewer divisions. *Id*. at 6. Thus, based on the evidentiary record, the Commission should approve a revenue increase of $4,120,259 for Aqua's consolidated water divisions and a revenue increase of $1,245,586 for its consolidated sewer divisions as just and reasonable. *Id*. at 3, 20.

The evidentiary record also supports the Commission's approval to consolidate Aqua into one water revenue requirement and one sewer revenue requirement, which is critical for realizing the benefits of operating as one company. *Id*. at 2, 20. Further, the evidence supports Aqua's proposed consolidated rate structure for the divisions in this proceeding into three tariff groups—consolidated water, University Park water, and consolidated sewer—because this consolidation will create increased efficiencies that will bring about numerous benefits for Aqua's customers. *Id*. at 2-3, 21.

Importantly, the Initial Briefs of the Staff of the Commission and the Illinois Attorney General's office ("AG") do not contest the soundness of Aqua's investments, the management of Aqua's operations and maintenance expenses, or the quality of Aqua's water or sewer services. Instead, they focus on the only remaining disputed issues: (i) Staff's unsupported disallowance of incentive compensation expenses; (ii) Staff's unreasonable proposed return on equity ("ROE") that represents a break from past proposals and is now supported by the AG; and (iii) the piecemeal counter-proposals of Staff and the AG regarding consolidation of Aqua's divisions for ratemaking and rate design purposes that would be cumbersome to implement and would delay the economy of scale benefits afforded under Aqua's proposal. The evidentiary record supports the Commission's rejection of each of these proposals by Staff and the AG.

The largest of the remaining disputes concerns a reasonable ROE. Although Aqua presented evidence supporting an even higher ROE, Aqua capped its ROE request at 10.9% and asks that the Commission adopt that figure as it is more than amply supported by the record and is just and reasonable. Meanwhile, Staff's unreasonably low 9.43% ROE recommendation is flawed in numerous respects, including:

- Staff's inappropriate use of a spot date as part of its DCF analysis, contrary to the Commission's recent decision in Docket No. 10-0467;

- Staff's significant departure from decades of Commission decisions adopting a higher ROE for water and sewer utilities; and

- Staff's unexplained departure from its recent recommendation of a methodology in Aqua's 2010 rate case, which supported an ROE of 10.03% and that the Commission approved just one year ago in Docket No. 10-0194.

Indeed, Staff has flip-flopped on its own ROE analysis in this proceeding and has apparently abandoned its ROE rebuttal testimony in its entirety, as there is no reliance on such testimony in Staff's Initial Brief. The Commission should reject Staff's proposed ROE for numerous reasons detailed below, not the least of which is that any endorsement of Staff's flip-flopping to support lower ROE recommendations would run counter to a message of regulatory certainty.

II. REVENUE REQUIREMENT

A. Overview

The evidentiary record demonstrates as follows:

- For its consolidated water divisions, Aqua's rate base is $60,070,203, and revenue increase is $3,186,356, with a resulting revenue requirement of $20,170,524.

- For its University Park water division, Aqua's rate base is $4,964,139, and revenue increase is $933,903, with a resulting revenue requirement of $2,068,285.

- For its consolidated sewer divisions, Aqua's rate base is $22,014,072, and revenue increase of $1,245,586, with a resulting revenue requirement of $7,127,744.

Hanley Sur., Aqua Ex. 14.0, 4:82-87; Aqua Ex. 14.1, pp. 1-4; Staff Ex. 6.0 Sch. 6.01 UPW; Staff Ex. 6.0 Sch. 6.03 UPW. Thus, an increase in Aqua's revenue requirements to $20,170,524, $2,068,285 and $7,127,744 for its consolidated water, University Park water and consolidated sewer divisions, respectively, is just and reasonable. Importantly, these revenue requirements, based upon 2012 costs, reflect nearly all of the Staff adjustments to rate base and operating expenses, as set forth in the testimony of Staff and the Company.

For the sake of clarity, Aqua notes that Staff's Initial Brief may be unintentionally misleading as to the final rate base and revenue requirement figures proposed by Staff.[1] Aqua noted in its Initial Brief that Staff proposed several adjustments to Aqua's rate base, which Aqua did not oppose in the interest of limiting the issues in this proceeding. Aqua Init. Br. at 7. Included among these adjustments was Staff's revised adjustment to forecast plant additions, which was originally submitted as Schedule 7.04 to Staff witness Bridal's rebuttal testimony and in its revised form as Aqua Exhibit 14.2 with Aqua witness Hanley's surrebuttal testimony. Mr. Hanley testified that Mr. Bridal submitted a revised Schedule 7.04 in response to a data request served by Aqua to clarify some formulas noted in the original Schedule 7.04. Hanley Sur., Aqua Ex. 14.0, 1:23-2:25. Mr. Hanley further testified that he accepted the adjustments as revised by Mr. Bridal and he attached the revised schedule to his testimony as Aqua Exhibit 14.2. *Id.* at 2:25-29. Aqua's rate base and revenue requirement figures as last presented in surrebuttal testimony and referenced in its Initial Brief reflect Schedule 7.04 Revised whereas Staff's rebuttal testimony cited in its Initial Brief does not. Thus, the Commission should reference Schedule 7.04 Revised, which is reflected in Aqua Exhibit 14.2, in arriving at the final rate base and revenue requirement figures in this proceeding.

B. The Commission Should Reject Staff's Proposed Disallowance Of Certain Incentive Compensation Costs

In light of Aqua's concession on most of Staff's proposed adjustments, the only contested operating expenses issue is Staff's proposal to disallow certain incentive compensation expenses.

[1] Aqua similarly notes for the sake of clarity that Staff's Initial Brief (at 9-11) lists the following adjustments under its "Contested Adjustments" heading, even though Staff acknowledges, as did Aqua in its Initial Brief (at 7-8), that these issues are, in fact, uncontested: (a) depreciation rates; (b) miscellaneous expenses; (c) charitable contributions; and (d) industry association dues.

Aqua Init. Br. at 8-11; Staff Init. Br. at 3-5. Specifically, Staff recommends a disallowance of $150,695 across Aqua's water and sewer divisions, which is comprised of three parts: (1) disallowance of 2009 Omnibus Equity Compensation Plan costs; (2) disallowance of the increase in test year Management Improvement and Employee Recognition Plan costs for Dividend Equivalents; and (3) disallowance of Management Improvement Program costs. Jones Dir., Staff Ex. 1.0, 9:170-80, Sch. 1.09; Staff Init. Br. at 5. Aqua respectfully submits that the Commission should reject Staff's proposed disallowance. At a minimum, Aqua's incentive compensation costs should be allowed to be recovered consistent with the Company's historical experience at 93% of the budgeted test year amount – a figure that Staff does not, and cannot, dispute.

Aqua's Annual Cash Incentive Plan ("ACIP") has two components: (i) the Management Improvement Program and (ii) the Employee Recognition Program, which is to reward non-union employees who are not eligible for the Management Improvement Program. Aqua Init. Br. at 9. Aqua presented evidence demonstrating that its 2011ACIP satisfies the Commission's requirement that the incentive compensation provide tangible benefits to ratepayers, including (i) improving customer service, (ii) enhancing environmental compliance, (iii) controlling costs, and (iv) improving efficiencies and productivity. Blanchette Sur., Aqua Ex. 13.0, 1:14-2:24. Aqua also removed all financial, affiliate, or shareholder based objectives from the ACIP. *Id*. at 2:25-26. Moreover, Aqua demonstrated that recovery of incentive compensation expense is important in Aqua's quest toward improving service and reliability to our customers while at the same time attracting and retaining quality industry professionals. *Id*. at 2:40-42. Based upon Aqua's evidentiary presentation, the Commission should approve the test year operating expenses for Aqua's consolidated water divisions and consolidated sewer divisions of $16,444,987 and $5,166,541, respectively.

While Staff concedes that Aqua removed language regarding financial goals that must be met in order for employees to receive incentive compensation payments, Staff argues that Aqua's ability to decrease a participant's award based on "other factors" achieves the same result. Staff Init. Br. at 7. This claim, however, is based on nothing more than speculation. The unrebutted evidence demonstrates that an individual participant's award could increase or decrease based on "other factors" under the 2011ACIP, but these "other factors" are based solely on tangible benefit to the customer and not related to undefined financial, affiliate, or shareholder objectives. Blanchette Sur., Aqua Ex. 13.0, 2:30-33. Any additional objectives or "other factors" used in calculating an award under the ACIP are specifically listed in each participant's performance objectives before an award is made. *Id*. at 2:33-35.

Although Staff states that it has no recommendation to make regarding Aqua's incentive compensation package other than its disallowance, Staff argues that in the event the Commission approves Aqua's recovery of its incentive compensation costs, only 93% of the Company's budgeted test year amount should be included in the revenue requirements. Staff Init. Br. at 8-9. In this respect, Staff relies upon Aqua's rebuttal testimony that its incentive compensation awards have averaged 93% of the annual budgeted amount over the past six years. *Id*. at 9. Aqua does have a proven track record of consistent payments under its incentive compensation program to employees that participate in and meet the identified incentive compensation program objectives, averaging 93% of budgeted expenses over the past six years. Blanchette Sur., Aqua Ex. 13.0, 2:38-39; Blanchette Reb., Aqua Ex. 9.0, 1:18-22. Accordingly, in the event the Commission determines that a disallowance is warranted related to Aqua's ACIP, which should not be the case in light of the evidentiary record, such a disallowance should be no more than 7% of the budgeted test year amount. Aqua incurs incentive compensation costs every year and, just like any other cost included in Aqua's 2012 Test Year, actual incentive compensation costs may fluctuate after the Commission enters an Order in this proceeding. *Id*. at 1:23-2:27. Thus, at a minimum and in light of Staff's alternative proposal, Aqua's incentive compensation costs should be allowed to be recovered consistent with the Company's historical experience at 93% of the budgeted test year amount.

C. Rate of Return

1. Staff's Position On ROE Is A Moving Target

Staff broke from its own past recommendations and past Commission decisions to propose an unreasonably low return on equity ("ROE") of 9.43%. Staff Init. Br. at 13. Indeed, Staff has apparently broken from its own ROE rebuttal testimony in this proceeding—other than one non-substantive citation (at 12), Staff's Initial Brief is completely devoid of any reference to the rebuttal testimony of Ms. Kight-Garlisch, in which she updated her common equity cost estimates, changed the companies contained in her sample groups, and changed her DCF methodology. Walker Sur. Aqua Ex. 15.0, 6:118-20. Staff's unexplained abandonment of its rebuttal testimony appears to be an effort to rehabilitate support for its unreasonably low ROE position; however, Staff's reversion to its direct testimony only serves to underscore the unreasonableness of its shifting position in this proceeding.[2] Aqua fully addressed the shortcomings of Staff's apparently abandoned ROE rebuttal testimony in the surrebuttal testimony of its witness Harold Walker (Aqua Ex. 15.0), as summarized in Aqua's Initial Brief. Aqua Init. Br. at 15-19.

In addition to its demonstrated variances in testimony in this proceeding, Staff waivered from its own past recommendations on ROE. In particular, Staff supported an ROE of 10.03%

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[2] Even when Staff witness Kight-Garlisch updated certain figures in her rebuttal testimony (Staff Ex. 8.0C, 13:227), she remained silent on whether she was updating her ROE recommendation accordingly, leaving Aqua to speculate about Staff's rebuttal position.

in Aqua's 2010 Kankakee Rate Case ("2010 Rate Case"), which was ultimately approved by the Commission. *Aqua Illinois, Inc.*, ICC Docket No. 10-0194, Order at 22, 24 (Dec. 2, 2010). In the 2010 Rate Case, Staff and the Company agreed that the evidence demonstrated the sample group of water utilities was small and, thus, prone to measurement errors. Walker Sur., Aqua Ex. 15.0, 6:137-39. Consequently, Aqua and Staff agreed that the evidence showed a revised weighting to 1/3 weighting to Staff's Water Sample Group and 2/3 weighting to Staff's Utility Sample Group because "Aqua and Staff agree and stipulate that the cost of common equity estimates for smaller samples are prone to more measurement error." *Aqua Illinois, Inc.*, ICC Docket No. 10-0194, Order at 20. Despite agreement in the 2010 Rate Case, Staff fails to explain its departure to a different, admittedly flawed weighting proposal, which further undermines the Commission's notions of regulatory certainty. *Peoples Gas Light & Coke Co., et al.*, ICC Docket Nos. 07-0241/07-0242 Cons., Order at 16 (Feb. 5, 2008) ("All parties should agree that Commission action brings certainty to a situation and settles expectations. This is another way of saying that unless there are clear and distinguishable reasons for deciding a case differently, the Commission will follow in line with precedent.").

2. Staff's ROE Calculation Has Numerous Flaws And Inconsistencies

Aqua's Initial Brief summarized the evidence supporting the Commission's rejection of Staff's proposed ROE of 9.43% because it is fundamentally flawed and represents an unexplained and unsubstantiated departure from historical, Commission-approved ROEs of 10.40% to 10.71% for other water and sewer utilities. Aqua Init. Br. at 15-19; *see also* Walker Sur., Aqua Ex. 15.0, 2:30-3:63. The record is replete with evidence demonstrating the numerous flaws and inconsistencies in Staff's ROE proposal, including:

- Undue reliance on Zacks projected growth rates;

- Inconsistent weighting of Staff's Comparison Groups' cost of equity based on risk analysis;
- Observable changes in stock prices, dividend yields, and growth rates that are inconsistent with Staff's recommendation;
- A dramatic change in the DCF model utilized by Staff;
- Untested end-result of Staff's Water Group DCF relative to comparative benchmarks;
- Sole reliance on one model to estimate the cost of equity; and
- Cost rate estimate inconsistent with risk analysis.

Walker Reb., Aqua Ex. 11.0, 2:29-41.

Significant among the flaws in Staff's ROE calculation is the DCF analysis utilized by Staff witness Kight-Garlisch. In the first instance, Staff switched to a single-stage or constant growth DCF in this proceeding even though Staff has used a multi-stage DCF model in numerous past proceedings, including the 2010 Rate Case. Staff Init. Br. at 13-14; Walker Reb., Aqua Ex. 11.0, 6:122-27, 20:425-26. Aqua witness Walker testified that it his understanding that the Commission's Financial Analysis Division uses a multi-stage growth or three-stage growth model in most instances. Walker Reb., Aqua Ex. 11.0, 20:422-25. Staff's justification for using a single-stage DCF in this proceeding is that the near term growth rate estimates fall within the range of 4.50% to 5.40% for expected long-term overall economic growth. Kight-Garlisch Dir., Staff Ex. 3.0, 14:272-15:277. However, as Mr. Walker testified, Staff's assumed range for long-term economic growth is not correct. Walker Reb., Aqua Ex. 11.0, 20:436-21:438. Instead, investors believe the long-term growth of the economy is between 6.08% and 6.34%. Walker Dir., Aqua Ex. 5.0, Sch. 17, p. 2 Corr. Further, the Commission recently rejected the methodology utilized by Staff in estimating the expected long-term overall rate of growth for the economy:

> The Commission finds problems with how . . . GDP growth rate forecast is calculated because it is based on assumptions that are inconsistent with actual historical growth for the U.S. economy. . . It is reasonable to believe that future real growth and inflation will both be 3% and therefore a 6% growth rate is a more reasonable proxy for investor's long-term expectations.

Commonwealth Edison Co., ICC Docket No. 10-0467, Order at 153 (May 24, 2011).

In addition, Staff's DCF recommendation is well below the zone of reasonableness for Aqua as demonstrated by past rate cases before the Commission. Aqua witness Walker testified that, according to a March 2011 rate case histories report published by the Commission's Financial Analysis Division, since 1975, the Commission only has authorized one return on common equity lower than Staff's single-stage DCF common equity cost rate recommendation of 8.36% recommended by Ms. Kight-Garlisch for the Water Group. Walker Reb., Aqua Ex. 11.0, 12:253-61. Specifically, Nordic Park Water in Docket No. 95-SF was authorized a ROE of 5.63% and an overall rate of return ("ROR") of 9.71% in November 1996. *Id*. at 12:261-13:263. Therefore, even though Nordic Park Water was authorized a ROE lower than Staff's recommendation for Aqua, Nordic Park Water was authorized an overall ROR that was higher than the ROE Staff recommends here. *Id*. at 13:263-65. Additionally, Staff's DCF based common equity cost rate estimate is 235 basis points below the Commission's 10.71% average authorized return on equity for other water and sewer utilities over the last 30 months and is 204 basis points below the Commission's 10.40% average authorized return on equity for other water and sewer utilities for the year 2010. *Id*. at 13:266-69.

Meanwhile, Staff's use of a spot date as part of its DCF analysis is flawed and contrary to a recent Commission decision. Specifically, the Commission recently rejected Staff's use of a spot date in favor of a longer approach to measuring cost rates in its Order in the Commonwealth Edison Company rate case. There, the Commission stated:

> The Commission has recently rejected use of such a pure "spot date" approach in its North Shore decision (Tr. at 1783) and notes the problems that can result from using such data. (*Id*.; North Shore Gas Co., et al, Docket Nos. 07-0241/07-0242 (Cons.), Final Order (Feb. 5, 2008) at 92, 125-126).

Commonwealth Edison Co., ICC Docket No. 10-0467, Order at 126 (May 24, 2011).

Aqua also presented evidence demonstrating that Staff inappropriately used a spot date of July 6, 2011 as part of its DCF analysis. Staff Init. Br. at 14; Kight-Garlisch Dir., Staff Ex. 3.0, 14:260-62. For example, the conditions of the financial markets changed a great deal after the date selected by Ms. Kight-Garlisch. Walker Reb., Aqua Ex. 11.0, 17:352-55 and Sch. 4. As shown on Schedule 4 to Mr. Walker's rebuttal testimony, Staff's Utility Group experienced an average decline in stock price from July 6 to August 18 of 6.2% and Staff's Water Group experienced an average decline of 3.9%. *Id*. at 17:357-60. These declines in stock prices produce increases in dividend yield and an increase in common equity cost rate, all other things being equal. *Id*. at 17:360-61. Further, the rapid decline in stock prices reflects the extraordinary chaos that has existed in the financial markets since late 2008. *Id*. at 17:352-63. When there is a crisis in the markets, market participants usually sell off and move their money to a safer place; fleeing from illiquid, low quality investments to liquid, high quality investments. *Id*. at 17:363-65. This flight to quality reflects a collapse of confidence in the financial system and is most evident in short-term interest rates and Treasury bond yields, both of which are used by the Federal Reserve to stabilize the capital markets. *Id*. at 17:366-68. For the years 2011-2013, the capital markets are and will continue to be affected by the upcoming large real estate refinancings, the unprecedented Treasury financings, the downgrading of US credit, and large federal government budget deficits. *Id*. at 17:368-18:372. Additionally, extremely high debt levels in certain European countries could trigger a wave of national defaults, undermining a revival in the credit markets. *Id*. at 18:372-74. The results of upcoming real estate refinancings, Treasury financings, and sovereign debt defaults will have an impact on Aqua's cost of capital. *Id*. at 18:74-76. In this context, the spot dividend yields on July 6, 2011 utilized by Staff were generally the lowest yields the Water Group and the Utility Group have had over the last 12 months. *Id*. at 18:377-78.

At the evidentiary hearing, Aqua witness Walker testified further about the problems inherent in using daily data such as the spot date adopted by Staff:

> I traditionally have shied away from using daily data simply because daily data is extremely volatile. You might have a change of 40 bas[i]s points over a short period of time. Traditionally I have relied upon … monthly yield information.
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> * * *
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> …I use [monthly data from the Fed] to eliminate the volatility that may occur from day-to-day. Essentially, by comparing daily or a spot yield to a monthly yield, you can determine whether or not the spot yield is representative of interest rates. And this is done by comparing the spot date to the monthly date. And if there is a large variation between the two, you know that the spot date is not reflective of the trend in interest rate.
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> In this proceeding I looked at – I compared the single spot date relied upon by Staff to monthly data to determine whether or not it was representative of money cost rates, and clearly it was not and is not representative of money cost rates.... Even using daily interest rates, the only time the daily interest rates were lower than the spot rate used by Staff in this proceeding in their updated proceeding was December of 2008 and some portion of January 2009, right in the heart of the financial crisis.

Oct. 25, 2011 Tr. at 120-22.

In conclusion, both a recent Commission Order and the facts in this proceeding demonstrate convincingly that it is inappropriate to use a spot date in estimating the cost of common equity, as Staff did here.

Given the demonstrated flaws and inconsistencies described in Aqua's Initial Brief and herein, the Commission should reject Staff's ROE recommendation.

3. Approval of Staff's Proposed ROE Would Harm Customers And Contradict Long-Standing Notions Of Regulatory Policy

Aqua also demonstrated that adoption of Staff's proposed ROE will have a significant negative impact on Aqua's customers and contradict sound regulatory policy. First, it would place Aqua at a competitive disadvantage in the capital markets, making it more difficult and costly to obtain the capital necessary to finance future infrastructure improvements. Walker Sur., Aqua Ex. 15.0, 3:70-72. If Aqua is unable to obtain capital at competitive rates or through the market, Aqua's ability to continue to offer reliable service will be put at risk, which will not benefit customers or Aqua's regional economy. *Id*. at 3:72-75.

In this respect, Staff fails entirely to address the Company's history of under-earning its authorized ROE, which, combined with a low authorized rate of return such as that advocated by Staff, will significantly impact Aqua's ability to attract capital and maintain its credit. Walker Sur., Aqua Ex. 15.0, 23:526-24:529. This may be because Staff is not aware of the likelihood that Aqua will under-earn its authorized ROE, or, if it is, Staff does not think the Company's likelihood of under-earning is significant. *Id*. at 23:511-12 and Sch. 5. The *Hope* and *Bluefield* decisions establish that utilities are entitled to the opportunity to earn a fair return on their investment that is commensurate with the returns earned by other firms of comparable risk. Aqua presented evidence showing that it has experienced the lowest ROE when compared to the companies in Staff's sample groups over the last several years. Walker Sur., Aqua Ex. 15.0, Sch. 6. Clearly if two identically risky companies were authorized the same ROE but one operated in a regulatory environment where the likelihood of under earning is significant, then that company would find it harder to attract capital as compared to the entity with less regulatory lag and attrition. *Id*. at 23:520-23. For these reasons, the Commission should consider the likelihood of under-earning when determining Aqua's cost of capital.

Second, Staff's proposal disregards recent Commission decisions, thereby also ignoring the benefits to be obtained from a review of past decisions. Aqua demonstrated that it is useful to consider recent Commission-authorized ROE for other water utilities. Capital markets do not operate in a vacuum, and neither should the Commission when evaluating a reasonable cost of equity for a utility. Walker Sur., Aqua Ex. 15.0, 24:533-34. While the cost of equity analysis should focus on financial merits of Aqua, the Commission should, and does, realize that Aqua competes for capital with other regulated and unregulated entities. *Id*. at 24:534-37. Consideration of recent Commission-authorized ROEs for other water utilities is also a means of meeting the comparable standard, a precept of a fair rate of return and, ultimately, provides a test to measure the reasonableness of result. *Id*. at 24:539-41. Over the last 30 months, the Commission has authorized ROEs for 24 water and sewer utilities that average 10.71%. *Id*. at 24:541-43. Consideration here of other utilities' authorized ROEs is further buttressed by the fact that Wall Street and major credit rating agencies believe regulation and an adequate level of authorized ROE is critical to a company's ability to attract capital. *Id*. at 24:549-50 (citing Janney Montgomery Scott LLC, *Industry Report, Water Utility Sector*, February 24, 2009; Robert W. Baird & Co., *Utilities: Initial Publication of Bairds' Regulatory Toolkit*, September 20, 2011; Fitch Ratings Ltd., Fitch Evaluates Utility ROE Trends, August 17, 2011).

Here, Staff's water group DCF common equity cost rate estimate is 235 basis points below the Commission's average authorized return on equity for other water and sewer utilities over the last 30 months and is 204 basis points below the Commission's average authorized return on equity for other water and sewer utilities for the year 2010. Walker Reb., Aqua Ex.

11.0, 11:229-32. And, the Commission has historically approved ROEs of 10.40% to 10.71% for other water and sewer utilities. *Id*. at 11:225-26. Staff offers no basis, and there is none, to abandon the use of sample groups and weightings of their cost rates that the Commission historically has employed for water and sewer utilities.

Third, Commission adoption of Staff's proposed ROE would represent a departure from prior rulings without any rational support, which, in turn, would inject regulatory uncertainty into the marketplace. Walker Sur., Aqua Ex. 15.0, 22:499-501. Because financial capital is fluid and can flow from one company to another and from one region to another, a company can lose their investors, as well as make seemingly unrelated companies lose their investors, when there has been no real change in circumstances, yet a decision breaks from past rulings. *Id*. at 22:498-99, 501-03. Thus, the Commission must be cognizant of the results that may flow from approval of Staff's unreasonably low ROE in this proceeding.

Put simply, the Commission should reject Staff's proposed ROE because it will discourage investment, which will benefit no one, least of all Aqua's customers, and contradicts long-standing notions of sound regulatory policy.

4. The Commission Should Reject The AG's Criticisms Of Aqua's ROE Calculation As Wholly Unsubstantiated

Because it did not provide any witness to testify about the issue, the AG is left to argue in favor of Staff's proposed ROE with empty criticisms of Aqua witness Walker's testimony. AG Init. Br. at 1-4. The AG first argues that Mr. Walker's testimony should be disregarded because he gave similar testimony in the 2010 Rate Case. *Id*. at 2. While it is true that Mr. Walker's testimony in both cases is similar, this underscores the consistency in his position against Staff's unreasonably low ROE recommendations in both cases. Specifically, in the 2010 Rate Case, Staff originally recommended a 9.61%ROE, but the

Commission ultimately approved 10.03%. Oct. 25, 2011 Tr. at 116-17. Here, Staff recommends 9.43%, which is 60 basis points less than what it stipulated to and the Commission authorized in the 2010 Rate Case. *Id*.

The AG also argues that Mr. Walker's claim that Aqua will be unable to access capital if the Commission authorizes an unreasonably low ROE is undermined by the investment and dividend performance of Aqua America, the parent company of Aqua. AG Init. Br. at 2-4. Staff made a similar argument in its apparently abandoned ROE rebuttal testimony that access to common equity capital is based upon the resources of Aqua's parent company, Aqua America. Kight-Garlisch Corr. Reb., Staff Ex. 8.0C, 8:147-9:157. This argument, now resurrected by the AG, should be rejected for numerous reasons. Importantly, Mr. Walker testified that of the $327 million invested in capital by Aqua America in 2010 only $13-15 million was made by Aqua Illinois. Oct. 25, 2011 Tr. at 118-19. Similarly, while the dividends paid by Aqua America may have increased in 2010 (*see* AG Init. Br. at 3, citing AG Cross Ex. 1 at 4), there is absolutely no evidence that the dividends have anything to do with Aqua Illinois.

Moreover, the capital attraction standard, a precept of a fair rate of return, requires that the entity—Aqua—be able to attract capital at all times. Walker Sur., Aqua Ex. 15.0, 20:437-39. And the financial integrity standard, another precept of a fair rate of return, requires the return assures confidence in the financial soundness of the Aqua, not its parent company. *Id*. at 20:439-41. A sole shareholder like Aqua America prefers that a utility subsidiary must exhibit the ability to attract the capital it requires as a prerequisite to the initiation to warrant new common equity investment. *Id*. at 20:442-44. Aqua America is dedicated to providing the best possible water service at a reasonable cost consistent with adequate compensation for investors. *Id*. at 20:444-46. The ability to attract needed capital is dependent upon consistently achieving adequate earnings, which result from providing exceptional quality water and service for customers through the state operating companies. *Id*. at 20:446-48.

Finally, Mr. Walker explained at the evidentiary hearing why it is not reasonable to compare parent company data set forth in Aqua America's 2010 Annual Report with his testimony in this proceeding:

> …The parent company embedded debt cost rate is a reflection of the weighted cost of debt for every operating subsidiary. In other words, it includes the embedded debt cost rate for … Aqua Pennsylvania, for Aqua Indiana, etc. Whereas the cost of long-term debt that I recommend in this proceeding and is primarily adopted by the Staff -- and I say primarily, we changed -- when I say we, the Company agreed to the Staff's change, slight change, in the short-term debt cost rate which ultimately lowered the embedded cost of long-term debt slightly
>
> It reflects strictly the operations of Illinois. Illinois accesses the capital market on its own in terms of attracting long-term debt, and traditionally commissions have relied upon capital structure and embedded debt cost rates depending on where the long-term capital is raised.

Oct. 25, 2011 Tr. at 117-18.

For all these reasons, the Commission should reject the AG's arguments in support of Staff's proposed ROE.

5. The Commission Should Adopt Aqua's ROE Calculation

Although Aqua presented evidence supporting a higher ROE, the Company capped its ROE request at 10.9% and asks that the Commission adopt that figure as supported by the evidence. Aqua Init. Br. at 12 (citing Walker Dir., Aqua Ex. 5.0, 55:1120-56:1132; Walker Sur., Aqua Ex. 15.0, 4:86-88). As summarized in its Initial Brief, Aqua's recommended ROE is supported by the testimony of its expert witness, who provided a detailed quantitative analysis using Commission-recognized models, as well as financial market information from two comparable groups of publicly traded companies. Aqua Init. Br. at 14-15. The Commission should adopt the Company's proposed ROE, which appropriately reflects a fair and reasonable return sufficient to allow Aqua to attract equity capital.

Staff raises several criticisms of Aqua's ROE calculation, none of which have any merit as demonstrated in the rebuttal and surrebuttal testimony of Aqua witness Walker (Aqua Exs. 11.0 and 15.0). For example, Staff argues that Aqua's use of historical data is problematic. Staff Init. Br. at 21. Aqua witness Walker appropriately used historical data in his analysis because historical data is commonly used in making or formatting investment decision. Walker Reb., Aqua Ex. 11.0, 28:591-92. Further, Mr. Walker provided analysis confirming that his use of a size premium was appropriate, contrary to Staff's arguments in its Initial Brief (at 24-27). Mr. Walker analyzed the manner in which a company's size impacts the cost to issue long term debt. Walker Reb., Aqua Ex. 11.0, 28:594-95. The cost to issue long term debt is inversely related to the size of a debt offering; that is, the smaller the debt offering, the higher the issuance expenses. *Id*. at 28:595-96. Since issuance expenses are included as part of the cost of debt, a company's small size increases its cost of debt. *Id*. at 28:596-98. A company's size affects both the interest expense (yield or coupon) and the issuance expenses required to issue debt, as well as the terms of the issuance, which are usually more onerous for a smaller issue. *Id*. at 28:598-600. Finally, contrary to Staff's argument that leverage adjustment is inappropriate (Init. Br. at 27-30), Mr. Walker explained why a leverage adjustment should be used. Walker Dir., Aqua Ex. 5.0, 47:954-55; Walker Reb., Aqua Ex. 11.0, 29:608-09. Given that capital structure and firm value are related, a leverage adjustment is required when a cost of common equity model is based on market value and if its results are then applied to book value. Walker Reb., Aqua Ex. 11.0, 29:610-13. Thus, in order to be consistent with financial theory, Staff's ROE should be adjusted upwards by 55-basis points. *Id*. at 29:613-14.

6. In The Alternative, The Commission Should Adopt An ROE That Uses The Same Analysis Approved In The 2010 Rate Case

At a minimum, the Commission should determine that Aqua's ROE is no lower than 9.77%. Walker Sur., Aqua Ex. 15.0, 5:102-03 and Sch. 1. While the evidence overwhelmingly shows that Aqua's ROE should be even higher, the 9.77% figure represents the lowest end of the range for a reasonable ROE. *Id*. at 5:103-05. This result adopts Staff's overall approach as it is based on Staff's cost of common equity estimate contained in Ms. Kight-Garlisch's direct testimony, but adjusts the weighting of the sample groups consistent with what both Staff and Aqua determined was reasonable in the 2010 Rate Case, and which the Commission approved there. *Id*. at 5:105-08. Because Staff offers no reasonable explanation why it fails to employ such a weighting in this proceeding, the Commission should adopt no lower than a 9.77% ROE for Aqua. Indeed, even using the weighting from Ms. Kight-Garlisch's direct testimony in an analysis with a constant growth DCF, as Staff advocates for in its Initial Brief (at 14), indicates an ROE of 10.05%. Walker Sur., Aqua Ex. 15.1, Sch. 2, p. 2.

III. RATE DESIGN

A. Aqua's Proposed Consolidation Should Be Approved

Aqua proposes three separate, but related things. First, Aqua proposes to create a single revenue requirement for its water and sewer divisions. Hanley Dir., Aqua Ex. 4.0, 13:280-83. This will allow the Company to operate as one water company and one sewer company and, among other things, decrease rate case expense going forward. *Id*. at 14:308-15:322; *see also* Monie Reb., Aqua Ex. 12.0, 11:225-33. Second, the Company requests consolidation of its books and records. Hanley Dir., Aqua Ex. 4.0, 13:284-85; *see also* Monie Sur., Aqua Ex. 16.0, 9:193-10:205. The Company's third request relates to actual tariff design and the movement to a simpler tariff for ease of administration and understanding for customers. Specifically, Aqua proposes consolidating nine of its ten water divisions (all but the Kankakee Division, which is not subject to this proceeding) into one consolidated company with two tariff rate divisions – one for University Park and one for the other eight divisions. Hanley Dir., Aqua Ex. 4.0, 2:34-3:46 and Sch. 6.1. Aqua similarly proposes consolidating all six of its sewer operating divisions into one consolidated sewer division with one tariff applicable to all six divisions. *Id.*

Aqua's proposed consolidation plan balances the interests of all customers and the Company and should be approved. Staff and the AG generally support the reasoning and motives behind consolidation. However, their proposals, to varying extents, would significantly delay the realization of such benefits at the expense of indefinitely isolating Aqua's water and sewer divisions.

Arguing for "gradualism", Staff claims Aqua's proposal would subject customers to sizeable increases in their monthly water bills. Thus, Staff recommends a piecemeal approach to consolidation. Staff Init. Br. at 33-37. Although Staff's proposal is a move in the right direction, the Commission should reject it.

While Staff's plan may initially ease rate impacts for some customers, it would nonetheless delay the economy of scale benefits afforded under Aqua's proposal. Monie Sur., Aqua Ex. 16.0, 4:67-77. Aqua's evidence demonstrates that its proposal is unlikely to create an unbearable rate impact. Monie Reb., Aqua Ex. 12.0, 10:208-11:233. Moreover, despite Staff's ultimate support for full consolidation, its proposal fails to provide any certainty as to when or how future consolidations would occur under its plan, thus making full consolidation more difficult to achieve over time. *Id.* Under Aqua's proposal, customers will benefit more quickly from decreased capital improvement costs, while the Company can more efficiently streamline administrative and rate case costs. *Id.* Therefore, in order to begin realizing the full, undisputed benefits of consolidation, the Commission should reject Staff's partial consolidation plan in favor of Aqua's approach.

Conversely, the AG suggests an even more segmented approach that is clearly cumbersome and lacks long-term rate stability for customers. The AG argues that six water tariff divisions would "minimize rate impacts and avoid widely disparate results." AG Init. Br. at 10. Put another way, the AG's version of consolidation is to reduce the benefits of a consolidated rate structure that are simple and undisputed: by spreading the costs of capital projects over a larger base, customers are protected against significant rate increases, substantial improvements become more affordable to customers, and administrative costs decrease. Hanley Dir., Aqua Ex. 4.0, 14:310-316. However, the reality is that Aqua is an amalgamation of individual and distinct districts; thus, the realization of such benefits will inherently include some growing pains. While claiming a reduced customer impact, the AG's watered-down approach would indefinitely postpone customers from experiencing the long-term benefits of consolidation, while subjecting them to the cost and volatility of countless future consolidation efforts. *See* Aqua Init. Br. at 20-21; *see also* Monie Reb., Aqua Ex. 12.0, 10:208-11:233. That the AG's proposal "gradually" consolidates rates is an overstatement. The proposal is cumbersome and lacks long-term stability. Accordingly, the Commission should reject the AG's consolidation proposal.

B. If The Commission Seeks An Alternative Plan, It Should Adopt A Modified Version Of Staff's Proposal

Aqua's proposal balances everyone's interests and undoubtedly provides the most direct route to consolidation. Nevertheless, in the event the Commission is considering an alternative proposal, Aqua recommends the Commission adopt Staff's proposal with several minor modifications. Monie Sur., Aqua Ex. 16.0, 2:34-35. Regarding Staff's water consolidation plan, Aqua suggests several corrections to Mr. Boggs' calculations, as shown in Schedules 16.1-16.3, in order to bring the total water revenues in line with Aqua's surrebuttal water revenue position. Monie Sur., Aqua Ex. 16.0, 2:34-42 and Sch. 16.1-16.3. Aqua also corrected several significant, unexplained mistakes in the billing determinants Mr. Boggs used to calculate Staff's revised sewer calculations for University Park Sewer. Monie Sur., Aqua Ex. 16.0, 3:49-57 and Sch. 16.4-16.5. Using the corrected billing determinants offered by Mr. Monie, the rates for flat rate customers in Ellwood Greens and University Park would actually be much closer than Staff's calculations indicated. *Id*. at 7:149-155. Therefore, if the Commission rejects Aqua's preferred six division sewer consolidation, it should modify Staff's proposal to consolidate Ellwood Greens and University Park sewer divisions rather than leaving them as stand-alone divisions.

Although Staff's proposal does not achieve consolidation as swiftly and directly as Aqua believes is appropriate, it provides a far more workable framework than the AG's proposal. Accordingly, if the Commission disagrees with Aqua's proposal, it should adopt Staff's proposal subject to Aqua's proposed modifications.

C. The Commission Should Adopt Aqua's Proposed Large Industrial Customer Rate

Contrary to the AG's claims, Viscofan demonstrated that it may leave Aqua's water system if confronted with a dramatic increase in its water rates. *See* Niedenthal Dir., Viscofan Ex. 1.0; *see also* Viscofan Init. Br. It is in the best interests of all Aqua customers to maintain a rate design that keeps Viscofan an Aqua customer.

The AG's proposed 35.1% increase to Aqua's Large Industrial Customer Rate class is clearly unreasonable As Aqua witness Monie explained, the Large General Service Rate was purposely set below the fully allocated cost of service to encourage large users like Viscofan, who are capable of obtaining their own water supply, to become and remain Aqua customers. Monie Reb., Aqua Ex. 12.0, 8:164-74; Stephens Dir., Viscofan Ex. 2.0, 3:52-56. The AG's proposed rate goes too far and is precisely the type of increase that would drive Viscofan off the system. *See* Viscofan Init. Br. Both Staff and Aqua agree that a 35.1% increase would seriously jeopardize the likelihood of Viscofan remaining an Aqua customer, thus posing an unreasonable risk to customers that can and should be avoided. Aqua Init. Br. at 24.

On the other hand, Viscofan's proposed increase of 5% or less would unjustifiably burden other customers and should be rejected in favor of a middle ground. Given Aqua's acceptance of various Staff adjustments to the revenue requirement, the resulting impact to the Large Industrial Class, of which Viscofan is the only customer, provides such a reasonable middle ground. This proposal results in a just and reasonable rate, and strikes a balance between all interests: it incentivizes Viscofan to remain on the Aqua system with a below-allocated cost and yet gradually increases rates to recover its cost of service. Aqua Init. Br. at 24; Staff Init. Br. at 38-39. Accordingly, the Commission should approve Aqua's proposed Large Industrial Class Rate.

D. The Commission Should Reject Lake County's Proposed Changes To Aqua's Cost Of Service Study

Lake County's arguments are unfounded and should be rejected pursuant to Aqua's Motion to Strike filed November 29, 2011. If the Commission does not strike Lake County's Initial Brief, it should still reject Lake County's proposed Cost of Service ("COSS") adjustments. Lake County appears to take issue with Aqua's calculation of the Sales for Resale customer class in its proposed COSS. Lake County's recommendations are unsupported by the evidentiary record, thus equating to little more than conjecture. *See* Aqua Motion to Strike Lake Co. Init. Br.

Regardless, due to Lake County's failure to participate in this proceeding pursuant to the established procedural schedule, Lake County's arguments have not been subject to proper evidentiary safeguards, and Aqua has not had the opportunity to properly respond.

Aqua's proposed COSS, supported by Staff, is based on credible, well-vetted evidence and is therefore reasonable. As such, the Commission should reject Lake County's recommendations and adopt Aqua's proposed COSS.

IV. CONCLUSION

Aqua Illinois, Inc. respectfully requests that the Commission reject the claims of Staff and the Illinois Attorney General's office. Instead, the Commission should approve Aqua Illinois, Inc.'s proposed revenue requirement and related tariffs for its consolidated water and sewer divisions, which are based on information and analysis set forth in the evidentiary record.

Dated: December 8, 2011

Respectfully submitted,

AQUA ILLINOIS, INC.

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