PUBLIC

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Aqua Illinois, Inc. Proposed General Increase In Water Rates For the Kankakee Service Area	Docket No. 14-0419

INITIAL BRIEF OF
AQUA ILLINOIS, INC.

TABLE OF CONTENTS

Page

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Aqua Illinois, Inc.

Proposed General Increase In Water Rates For the Kankakee Service Area	Docket No. 14-0419

INITIAL BRIEF OF AQUA ILLINOIS, INC.

Aqua Illinois, Inc. ("Aqua Illinois" or the "Company"), by its counsel, in accordance with the Rules of Practice of the Illinois Commerce Commission (the "Commission" or "ICC") and the Administrative Law Judge's ("ALJ") schedule, submits this Initial Brief.

I. INTRODUCTION / STATEMENT OF THE CASE

The Company's Kankakee Water Division's ("Kankakee") current rates were established in December 2010, based on a future test year ending December 31, 2011. *See* ICC Docket No. 10-0194 (final Order Dec. 2, 2010). Aqua Illinois' current request for an adjustment to Kankakee's rates is driven by the need to recover the costs of its capital investments in the system. The Company has invested in various water treatment plant improvements to increase reliability and redundancy, in water meter replacements, and in the replacement of aged infrastructure in the distribution system. Meanwhile, since the last Kankakee rate case, Aqua Illinois has managed its operating expenses carefully and has controlled its costs. Indeed, in the instant proceeding, the Company is requesting test year operating expenses that are less than what the Company proposed in its last Kankakee rate case. Operating and maintenance expenses have *decreased* overall due to the installation of energy efficient equipment and a continual decrease in consumption, both of which have resulted in savings in power and chemical costs. Additionally, bad debt, benefits, and supply costs have decreased.

Kankakee is comprised primarily of 26,090 residential customers, 1,896 commercial customers, and 576 other water customers. Within this service area, Aqua Illinois serves a variety of metropolitan areas, including the City of Kankakee. In addition, Aqua Illinois serves various unincorporated areas around the periphery of these municipalities. Kankakee's distribution and storage facilities include more than 2,640,000 feet of distribution mains, approximately 3,900 public fire protection hydrants, 16 million gallons of combined elevated and ground storage, and four booster pumping stations.

Aqua Illinois has presented substantial and compelling evidence to support a revenue requirement increase of 10.04% for Kankakee.[1] *See* Hanley Sur., Aqua Exhibit ("Ex.") 11.0, 2:24-35. This proposal is based upon a forecasted 2015 test year. In seeking this adjustment to rates, the Company has recognized that an increase of this level may have a significant impact on its customers. Accordingly, the Company has chosen to limit its rate increase request to 9.95% over pro forma present operating revenues. Hanley Dir., Aqua Ex. 2.0, 2:36-42. This limitation balances the interests of customers, i.e., mitigating the impact of a rate increase, with the need for the Company to recover its just and reasonable costs to serve its customers, which includes a reasonable return on investment. Thus, consistent with its initial proposal, the Company maintains that its capped revenue requirement increase of 9.95%, or $2,190,737, is just and reasonable. *Id*.[2] In light of the Company's desire to recover its capital investments and earn a

[1] Aqua Illinois' updated figures reflect adjustments accepted by the Company in the interest of narrowing the issues in the instant proceeding.

[2] Aqua Illinois and Staff agree that certain figures may change based on the final rate case expense and Return on Equity ("ROE") determination.

fair return on its investment in utility plant, the Company is seeking a revenue increase of 9.95% that will enable it to maintain and improve service quality for its Kankakee customers.

Aqua Illinois has worked with Staff throughout the course of this proceeding to resolve as many issues as possible in the interest of narrowing the issues. Currently, based upon Aqua Illinois' surrebuttal testimony and Staff's rebuttal testimony, all Rate Base issues, all Operating Expense issues (other than rate case expense), and all Rate Design issues have been resolved. Just four contested issues remain: 1) rate case expense; 2) Staff witness Sackett's proposed adjustment to "Other Revenues" related to HomeServe USA ("HomeServe"); 3) establishing a reasonable ROE; and 4) Staff witness Sackett's proposal to initiate an investigation into the Company's Commission-approved Affiliated Interest Agreements ("AIA") and the Company's historical affiliate transactions. The evidentiary record and arguments below demonstrate that Aqua Illinois' positions should be adopted, and that its proposed revenue requirement is prudent and reasonable, and should be approved.

II. TEST YEAR

Aqua Illinois has proposed the use of a 2015 future test year, which no parties contest. Kahoun Dir., Aqua Ex. 1.0, 3:37.

III. RATE BASE

A. Uncontested Issues

1. Corporate Office Plant in Service

Staff initially proposed an adjustment to remove Corporate Office Plant in Service retirements and to remove a line item included in the 2015 budget for the corporate office. Jones Dir., Staff Ex. 1.0, 12:243-245. Although Aqua Illinois accepted the concept and intent of the adjustments, Staff based its adjustments to the Utility Plant and Reserve for Accumulated

Depreciation on year-end rather than average 2015 test year balances, which resulted in an incorrect adjustment to the entire 100% of the capital additions. Hanley Reb., Aqua Ex. 7.0, 7:147-150. Aqua Illinois witness Hanley explained that the capital additions spending will occur in 2015; thus, Aqua Illinois only will be permitted to recover 50% of those projects. *Id.* at 7:150-152. As a result, Staff's adjustment, which reduced the rate base by the full amount, is incorrect. *Id.* at 7:152-153. Further, Mr. Hanley explained that the Kankakee allocation percentage of 45.56% was not applied to the Illinois Corporate assets that are the basis of Staff's adjustment, and that the proper allocation to the Kankakee area customers must be applied. *Id.* at 7:153-8:156. In rebuttal, Staff agreed with Mr. Hanley's correction to the calculation of the adjustment, as reflected in Aqua Ex. 7.4. Jones Reb., Staff Ex. 6.0, 5:88-97. This issue is not contested.

2. <u>Derivative Impacts</u>

Staff initially proposed to disallow $6,486 related to depreciation expense in conjunction with the Corporate Office Plant in Service adjustment. Jones Dir., Staff Ex. 1.0, 12:241-13:263; Staff Schedule ("Sch.") 1.12. Further, Staff proposed to reduce Accumulated Deferred Income Tax ("ADIT") by $21,169 in conjunction with the Corporate Office Plant in Service adjustment. Staff Sch. 1.12. In the interest of limiting the issues in this docket, Aqua Illinois did not contest these adjustments. Hanley Reb., Aqua Ex. 7.0, 3:55-57. However, Aqua witness Mr. Hanley noted that Staff's adjustment to the Corporate Office Plant in Service should be revised based upon the average 2015 test year balances and corrected allocation percentage. *Id.* at 7:145-8:158. As noted above, Staff accepted Mr. Hanley's adjustments, and, as a result, modified its adjustment to depreciation expense and to ADIT to reflect a reduction of $1,701 and an increase of $15,082, respectively, in alignment with the corrected plant adjustments provided by the

Company. Jones Reb., Staff Ex. 6.0, 5:99-6:110; Staff Schs. 6.09, 6.10. Aqua Illinois accepted Staff's corrected adjustments. Hanley Sur., Aqua Ex. 11.0, 3:53-54. This issue is not contested.

3. Working Capital

Staff proposed an adjustment to calculate the Working Capital component of rate base following the resolution of contested adjustments to the 2015 test year revenue requirement. Jones Dir., Staff Ex. 1.0, 7:128-133. Aqua Illinois does not dispute Staff's calculation methodology, which was based upon the methodology reflected in the Company's Schedules B-2.3 and B-8. *Id.* at 7:130-131; Hanley Reb., Aqua Ex. 7.0, 8:167-169. The Company and Staff agree that the final working capital allowed will be calculated based upon the final operating expenses allowed. Hanley Reb., Aqua Ex. 7.0, 8:169-170. This issue is not contested.

IV. OPERATING EXPENSES

A. Uncontested Issues

1. Industry Association Dues

Staff proposed to disallow $2,332 related to Industry Association Dues. Jones Dir., Staff Ex. 1.0, 7:135-8:165. In the interest of limiting the issues in this docket, Aqua Illinois did not contest this adjustment.[3] Hanley Reb., Aqua Ex. 7.0, 3:51-52. This issue is not contested.

2. Charitable Contributions

Staff proposed to disallow $3,090 related to miscellaneous expenses for Charitable Contributions. Jones Dir., Staff Ex. 1.0, 9:167-10:196. In the interest of limiting the issues in this docket, Aqua Illinois did not contest this adjustment. Hanley Reb., Aqua Ex. 7.0, 3:53-54. This issue is not contested.

[3] For purposes of this brief, where it is noted that the Company is declining to contest the particular proposed adjustment, it retains its right to object to a similar adjustment in future proceedings.

3. Advertising Costs

Staff proposed to disallow $11,241 of Advertising Costs. Jones Dir., Staff Ex. 1.0, 10:199 – 12:238. In rebuttal, Aqua Illinois accepted $7,451 of Staff's proposed disallowance and provided additional evidence rebutting the remainder of Staff's proposed adjustment, which amounted to $3,790. Kahoun Reb., Aqua Ex. 6.0, 2:40-3:57; Aqua Ex. 6.1, p. 1, col. (d), line 9. In rebuttal, Staff withdrew the remaining $3,790 of its proposed adjustment. Jones Reb., Staff Ex. 6.0, 4:78-83. This issue is not contested.

4. Incentive Compensation

Staff proposed an adjustment to reduce incentive compensation expense that results in the issuance of stock-based incentive compensation to employees by $76,884. Pearce Dir., Staff Ex. 2.0, 5:108 – 6:110; Staff Sch. 2.03. Staff's proposed disallowance related to Aqua Illinois' Performance Share Unit costs and Restricted Share Unit costs. Pearce Dir., Staff Ex. 2.0, 6:112-117. In the interest of limiting the issues in this docket, Aqua Illinois did not contest this adjustment, but noted that the Management Incentive Program provides the Company with an advantage in attracting and retaining qualified individuals in the water industry who are confident in their abilities and who are willing to stake their compensation on performance. Kahoun Reb., Aqua Ex. 6.0, 4:90 – 5:96. This issue is not contested.

5. Accumulated Deferred Income Taxes

Staff proposed an adjustment to reduce ADIT by $19,728 in order to reflect the impact on ADIT of the decrease in the Illinois state income tax rate from 9.5% to 7.75% due to Public Act 98-496, effective January 1, 2015. Pearce Dir., Staff Ex. 2.0, 3:50-52. In the interest of limiting the issues in this docket, Aqua Illinois did not contest this adjustment. Hanley Reb., Aqua Ex. 7.0, 3:58-61. However, Company witness Hanley noted that the state income tax rate is currently set at 9.5%, and requested that if the state income tax rate is changed to anything other than 7.75% throughout this proceeding, that Staff, the ALJ, and the Commission update the revenue requirement and tariffs accordingly. *Id.* at 3:66 – 4:70. Staff accepted this recommendation. Pearce Reb., Staff Ex. 7.0, 3:48. This issue is not contested.

6. <u>Income Tax Expense</u>

Staff proposed an adjustment to reduce the state income tax expense by $62,129, to reflect the change in the state income tax rate from 9.5% to 7.75%. In the interest of limiting the issues in this docket, Aqua Illinois did not contest this adjustment, subject to the same conditions related to the adjustment of the state income tax rate as applied to Staff's proposed adjustment to ADIT. Hanley Reb., Aqua Ex. 7.0, 3:64 – 4:70. This issue is not contested.

7. <u>Wages and Salaries Expense</u>

Staff proposed an adjustment to reduce wages and salaries expense based upon the actual information available at that time. Pearce Dir., Staff Ex. 2.0, 4:77 – 5:96. In response, Company witness Hanley presented the most recent actual costs for salaries and wages up to and including the latest full month of activity as of August, 2014. Hanley Reb., Aqua Ex. 7.0, 8:172 – 9:186. Based on the updated wages and salaries expense information, the Company proposed to revise Staff's proposed adjustment by $31,187, from $60,397 to $29,210. *Id.* at 9:184-186. Staff accepted the Company's revised adjustment. Pearce Reb., Staff Ex. 7.0, 3:58 – 4:63. This issue is not contested.

8. <u>Contractual Services, Other</u>

Staff proposed an adjustment to reduce Contractual Services, Other by $62,598. Pearce Dir., Staff Ex. 2.0, 12:254 – 13:258; Staff Sch. 2.05. In response, Company witness Hanley provided additional information regarding the 2014 actual expenses as they relate to the customer service manager and the costs originally budgeted for 2014 and subsequently projected for the 2015 test year. Hanley Reb., Aqua Ex. 7.0, 11:236 – 12:250. As a result of this information, Staff stated that it found the Company's explanation persuasive, and withdrew its adjustment. Pearce Reb., Staff Ex. 7.0, 4:68-80. This issue is not contested.

9. <u>Parent Company Service Charges</u>

Staff proposed an adjustment to reduce Parent Company Service Charges by $412,304. Staff Sch. 2.07. This proposal reflected the disallowance of certain intercompany charges as well as the "correction of the allocation percentage (based on number of customers) from 48% to 45.56%." Pearce Dir., Staff Ex. 2.0, 16:331-335. Staff further requested that the Company provide additional information addressing the intercompany charges at issue. *Id.* at 17:349-353. In rebuttal testimony, Company witness Hanley provided the requested information, including details regarding the business purposes of the services identified in Staff's Schedule 2.07 as well as other supporting information. Hanley Reb., Aqua Ex. 7.0, 12:260 – 20:439. In particular, Mr. Hanley noted that many of the sundry costs at issue support services that the Company provides to ratepayers, including accounting, finance, human resources, information services, legal, engineering, and water quality-related costs. *Id.* at 19:405-408. Further, Mr. Hanley noted the Company's agreement with Ms. Pearce's correction of the allocation percentage to 45.56%. *Id.* at 20:443-21:447. In rebuttal Staff reduced its proposed adjustment to $51,408 based on the information provided by the Company. Pearce Reb., Staff Ex. 7.0, 11:231-12:237; Staff Sch. 7.02. In surrebuttal testimony, the Company accepted Staff's revised adjustment. Hanley Sur., Aqua Ex. 11.0, 3:57-58. This issue is not contested.

10. Employee Benefits Expense

In rebuttal testimony, Staff witness Ms. Pearce proposed an adjustment to reduce the projected 2015 balance of employee benefits expense by $48,990. Staff Sch. 7.03. Ms. Pearce noted that the proposed adjustment consists of two components, namely a reduction of projected pension expense and a reduction of projected Other Post-Employment Benefits ("OPEB") expense. Pearce Reb., Staff Ex. 7.0, 13:263-266. In the interest of limiting the issues in this docket, Aqua Illinois did not contest this adjustment. Hanley Sur., Aqua Ex. 11.0, 3:59-60. This issue is not contested.

B. Contested Issues

1. Rate Case Expense

As an initial matter, the question before the Commission on this issue of rate case expense concerns what level expense is just and reasonable. Staff has reviewed all of the Company's actual expenses incurred and has no objection to recovery. *See, e.g.,* Pearce Dir., Staff Ex. 2.0, 11:215-219; Pearce Reb., Staff Ex. 7.0, 8:157-162. The question, rather, is what level of projected rate case expense is appropriate. In this regard, Aqua Illinois submits that the evidence fully supports the recovery of $351,550 in rate case expense.

In direct testimony, Aqua Illinois presented evidence supporting its estimated rate case expense for this proceeding. In particular, the Company examined estimates for legal support, the cost of capital and cost of service/rate design witnesses, the required external audit, and other related expenses to support the filing of this case: the projected rate case expense totaled $351,550. Hanley Dir., Aqua Ex. 2.0, 12:261-264; Sch. C-10. With respect to these expenses, Aqua Illinois requested a three-year amortization period, which would equate to an increase per customer of $0.34 per month. Hanley Dir., Aqua Ex. 2.0, 12:269-270. Aqua Illinois has provided substantial evidence in this proceeding supporting these costs as reasonable and justified, as required by Section 9-229 of the Act, 220 ILCS 5/9-229. The Commission should approve Aqua Illinois' proposed rate case expenses as just and reasonable.

It is well-established under Illinois law that a utility is entitled to recover rate case expenses because "the costs incurred by a utility to prepare and present a rate case are properly recoverable as an ordinary and reasonable cost of doing business." *People ex rel. Lisa Madigan v. Illinois Commerce Comm'n*, 2011 IL App (1st) 101776, ¶ 13 (1st Dist. Dec. 9, 2011) ("*Illinois-American Water*"), *appeal denied* (Ill. S. Ct. Sept. 26, 2012). The Illinois Supreme Court has expressly recognized that "rate-case expense is ordinarily properly and fairly allowed as an operating expense"). *DuPage Util. Co. v. Illinois Commerce Comm'n*, 47 Ill. 2d 550, 553, 561, 267 N.E.2d 662, 664, 668 (1971). In addition, Section 9-229 of the Act establishes that the Commission shall "specifically assess 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." Pursuant to Illinois law, in order to satisfy Section 9-229, a utility seeking recovery of attorney's fees and expert witness fees must "provide evidence that specifies: (1) the services performed; (2) by whom they were performed; (3) the time expended; and (4) the hourly rate charged." *Commonwealth Edison Co. v. Illinois Commerce Commission*, 2014 IL App (1st) 130302, ¶ 87 (1st Dist. June 30, 2014).

The evidentiary record demonstrates that Aqua Illinois has satisfied these standards, and has provided ample evidence to demonstrate the justness and reasonableness of its rate case expenses. In fact, Staff does not contest the justness and reasonableness of the projected expenses – instead, Staff's proposed adjustment is based solely on its contention that "the Company's projection appears unreasonably high" and that the Company has "over-estimated its rate case expense." Pearce Reb., Staff Ex. 7.0, 9:173-174, 178. Notably, Staff does not contest the reasonableness of the specific rate case expenses presented by the Company. *See, e.g.,* Pearce Dir., Staff Ex. 2.0, 11:215-219; Pearce Reb., Staff Ex. 7.0, 8:157-162; Kight-Garlisch Reb., Staff Ex. 8.0, 20:359-361; Harden Reb., Staff Ex. 9.0, 7:135-137. Instead, Staff offers two criticisms of the Company's proposed rate case expenses: 1) "there are no intervening parties in this proceeding;" and 2) that "the estimated rate case expenses are based on proposals from third parties, which may be higher than actual expenses." Pearce Dir., Staff Ex. 2.0, 9:179-182. Staff offers limited support for its second point, arguing that the Company's estimate is overstated based on the actual expenses incurred in the Kankakee Water Division's last rate case proceeding, noting: "the Company's 2015 projection reflects a 39% increase over the most recent Kankakee rate case [ICC Docket No. 10-0194]." Pearce Reb., Staff Ex. 7.0, 6:104-108. Staff's criticisms of Aqua Illinois' projected expenses are unfounded and ignore the substantial evidence that the Company has provided.

Aqua Illinois' projected rate case expenses are reasonable based upon actual expenses incurred by the Company through the filing of the Company's surrebuttal testimony, in addition to the anticipated expenses that will be incurred through the resolution of this proceeding. The Company demonstrated that its actual rate case expense, based on invoices received at the time of the filing of Company surrebuttal testimony on November 12, 2014, was [redacted] Hanley Sur., Aqua Ex. 11.0, 6:114-117. There is no dispute that the Company has, and will, incur rate case expenses for a variety of legitimate rate case activities that have and will continue to occur to complete this proceeding. For example, the actual figure did not account for additional expenses that were incurred to finalize the Company's surrebuttal testimony, nor does it include costs related to: 1) preparing the Company's Pre-Trial Memorandum, filed on November 14, 2014; 2) preparing for and participating in the evidentiary hearing, which took place on November 20, 2014; 3) preparing four rounds of briefs addressing the contested and uncontested issues in this proceeding and the Administrative Law Judge's Proposed Order; 4) preparing a draft Order; 5) analyzing the Commission's final Order in this proceeding and preparing and filing the compliance filing; and 6) preparing any post-Order pleadings that may be required. *Id.* at 6:118-127. Notably, the Company's actual expenses as of November 12, 2014 nearly meet the level of expenses incurred throughout the entire 2010 rate case proceeding for Kankakee. Staff's adjustment not only fails to recognize the actual expenses incurred thus far, the reasonableness of which is not disputed, but also fails to take into account the significant added expenses that the Company will incur throughout the pendency of this proceeding.

Staff's argument that its adjustment is justified based on the fact that there are no intervening parties in this proceeding is similarly unfounded. This contention fails to consider the significant increase in discovery propounded on the Company in the instant proceeding, as well as the litigation of new and complicated issues. As of the time of the filing of the Company's rebuttal testimony on October 2, 2014, Aqua Illinois had received and responded to 703 Staff data requests. Hanley Reb., Aqua Ex. 7.0, 10:211. In addition, Aqua Illinois received and responded to additional Staff data requests up until the date of the evidentiary hearing on November 20, 2014. This volume of data requests, which does not take into account the additional discovery served and responded to following the date of rebuttal testimony, is significantly larger than the volume of data requests received and responded to in any prior Aqua Illinois rate case proceeding, especially the last Kankakee rate case, Docket No. 10-0194. Hanley Sur., Aqua Ex. 11.0, 5:95-96. Moreover, Staff has issued multiple data requests focusing on historical information and has raised new issues that Aqua Illinois has not previously litigated in rate case proceedings. *Id.* at 5:96-98.

Staff's proposed adjustment is unreasonable in light of the actual expenses incurred by the Company in its historical rate case proceedings. In support of its adjustment, Staff points to the actual rate case costs from the last Kankakee rate case, wherein the Company incurred $252,172 of rate case expense and responded to 355 data requests. Pearce Reb., Staff Ex. 7.0, 6:120-121; Hanley Sur., Aqua Ex. 11.0, 5:98-100. A comparison of these costs to those incurred in Aqua Illinois' historical rate case proceedings filed since 2006 demonstrate that the level of rate case expenses incurred in Docket No. 10-0194 are anomalous, and the Company's estimate in this docket are reasonable. Although no parties have intervened in this docket, the volume of discovery propounded on the Company in this docket compared to historical discovery levels and resulting actual expenses in Aqua Illinois' previous rate case proceedings demonstrate that the Company's estimated rate case expenses are accurate. For example, in the 2006 Kankakee Water Division rate case, Docket No. 06-0285, the Company answered 380 data requests and incurred rate case expense totaling $430,439. In the 2007/2008 Willowbrook Water & Sewer, Hawthorn Woods Water & Sewer and the Vermilion Water rate case, consolidated Docket Nos. 07-0620, 07-0621, 08-0067, the Company answered 661 data requests and incurred rate case expense of $383,560. In the 2011 Consolidated Water & Sewer rate case, Docket No. 11-0436, the Company answered 374 data requests and incurred rate case expense of $664,429. Hanley Sur., Aqua Ex. 11.0, 5:98-109.

Staff has failed to present any compelling reason to adjust the projected rate case expenses in this proceeding. The Company has demonstrated that it has incurred substantial expenses thus far, the justness and reasonableness of which are not contested by Staff. In addition, it is undisputed that the Company will incur additional expenses throughout the course and to the conclusion of this proceeding. Lastly, Staff's criticism of the Company's projected rate case expenses in light of the actual expenses incurred in Docket No. 10-0194 is unfounded – an examination of the actual expenses historically incurred in Aqua Illinois rate cases, in comparison to the number of discovery requests propounded thus far, demonstrates that the Company's estimate in the instant proceeding is reasonable. In light of the foregoing, the Company's estimated rate case expenses of $351,550 in this proceeding are just and reasonable and should be approved.

V. OTHER REVENUES

A. Uncontested Issues

1. Late Payment Fees

In rebuttal testimony, Company witness Mr. Hanley noted that Staff presented an adjustment of $10,246 related to a Late Payment Fee component of Staff's Pro Forma Proposed Other Revenues, reflected in Staff Sch. 1.01. Hanley Reb., Aqua Ex. 7.0, 6:118-120. Mr. Hanley contested this adjustment, and explained that Staff's figure represents the "Company-calculated amount of increased late payment fees associated with its originally calculated and supported revenue increase of $2,579,478." *Id.* at 6:120-121. As a result, Mr. Hanley stated that to the extent that Aqua Illinois' final overall revenue increase is decreased, the associated increase in late payment fees must be decreased as well. *Id.* at 6:122-124. Because Staff did not appropriately adjust the late payment fees in light of Staff's adjustment to Aqua Illinois' overall revenue increase, Mr. Hanley explained that the amount of Staff's pro forma proposed tariff revenues were understated, and Staff's other revenues were overstated by the same amount. *Id.* at 6:127-130. Staff witness Ms. Jones accepted with Mr. Hanley's correction, noting that "there is a nexus between tariffed revenues and late payment fees." Jones Reb., Staff Ex. 6.0, 7:128-129. Staff agrees that "the late payment fees included in Other Revenues in the ordered revenue requirement should be reflective of the revenue change approved by the Commission." *Id.* at 7:132-135. This issue is not contested.

B. Contested Issues

1. Adjustment to "Other" Revenues

Staff seeks to impute $79,732 of revenue to offset the Kankakee 2015 test year revenue requirement principally based on assumptions that are both factually incorrect and contrary to test year ratemaking principles. Sackett Reb., Staff Ex. 10.0, 2:37-40. In particular, Staff's claim centers on a 22-month period (September 2010 – June 2012) wherein certain, limited Aqua Illinois customer information was provided to an entity that was unaffiliated with Aqua Illinois, HomeServe, and the Company was compensated accordingly. HomeServe used that information for marketing purposes and, pursuant to contract, destroyed or returned such information subsequent to its use. Staff Cross-Ex. 1, p. 19; Tr. at 53:21-54:8. Thus, since June 2012, Aqua Illinois customer information has not been provided to HomeServe, or any other entity, for marketing purposes. In fact, the uncontroverted evidence shows that HomeServe has not marketed its product(s) to any new customers in the Aqua Illinois service territory since June 2012. Kahoun Sur., Aqua Ex. 10.0, 4:84-89.

Notwithstanding these facts, Staff seeks to impute $79,732 in alleged HomeServe-related revenues towards Kankakee's 2015 test year revenue requirement. There are multiple reasons why Staff's claim is improper and should be rejected. First, the evidence demonstrates that at no time did Aqua Illinois receive, nor was it entitled to receive, the amount Staff claims: there is no evidence that the Company will receive any such amount in the test year or thereafter. Rather, that figure relates to a contractual relationship to which Aqua Illinois is not a party – an agreement between HomeServe and Aqua Resources. Staff pointed to no credible evidence, and there is none, to link the $79,732 figure – or any HomeServe-related figure – to the Kankakee 2015 test year, the two years preceding the test year, or any year after 2015. Moreover, as detailed further below, the $79,732 figure is based on assumption, not facts, and is entirely unreliable.

Second, Staff's hypothesis for imputing this revenue figure hinges on the flawed assumption that, but for the provision of Aqua Illinois customer information to HomeServe, no customer would have purchased HomeServe's warranty product. *See, e.g.,* Sackett Dir., Staff Ex. 5.0 CORR, 23:561-563; Sackett Reb., Staff Ex. 10.0, 12:274-277. Of course, such a conclusion is nothing more than rank speculation. HomeServe is not regulated by the Commission and it could have engaged in any manner of marketing in Illinois. Additionally, Staff's conclusion assumes that customers would not engage in their own assessment of the product to determine whether the product, and its price-point, provided a value to that customer. Indeed, HomeServe is not the only entity offering warranty products to customers. Furthermore, Staff's position fails to consider that HomeServe contracts only are for one year in duration. Thus, customers who still retain the product today have chosen to renew purchasing the HomeServe product (possibly on multiple occasions) clearly because they like the product. Tr. at 52:18-53:11. To assume, as Staff does, that Aqua Illinois is somehow linked to a customer's decision to renew their purchase of that product has no foundation in fact.

Third, Staff's proposed adjustment contravenes fundamental test year principles in at least two ways. For example, Staff seeks to include in Kankakee's 2015 test year revenues that are unrelated to the Company's actual activities for 2015. Aqua Illinois customer information was last provided to HomeServe in June 2012. The Company did not receive, nor was entitled to, any revenues related to HomeServe in 2013 and 2014, and it will not receive any such revenues in the 2015 test year or thereafter. Kahoun Reb., Aqua Ex. 6.0, 7:143-145. Indeed, if HomeServe wishes to market its product to Aqua Illinois customers in the future, Aqua Illinois has committed to meeting with Staff and to obtaining Commission approval on a mutually agreed-upon approach to do so. Kahoun Sur., Aqua Ex. 10.0, 2:32-35. Consequently, there is no basis to impute phantom revenues into the 2015 test year: revenues that will unreasonably reduce the recovery of its actual operating costs not only for one year, but in succeeding years as well. Such a result not only violates test year principles, it is punitive.

Staff's proposal also violates test year principles in another way. In particular, Staff seeks to impute an alleged level of revenues that is not limited to Kankakee. Instead, Staff proposes a level of revenues into the Kankakee revenue requirement that relates to *all* of Aqua Illinois' customers. Sackett Reb., Staff Ex. 10.0, 12:287-298. The Company pointed out this flaw in rebuttal testimony, noting that the appropriate allocation for Kankakee is 45.56% (Kahoun Reb., Aqua Ex. 6.0, 8:170-174), but Staff did not modify its position when confronted with this uncontroverted fact (Sackett Reb., Staff Ex. 10.0, 12:287-298). While the imputation of any alleged HomeServe revenues into the 2015 test year is baseless, at a minimum, test year principles do not support imputing revenues that are entirely unrelated to the Company's Kankakee service territory.

Fourth, assuming, *arguendo*, that the Commission were to impute to Aqua Illinois revenues received by Aqua Resources, Staff's calculation of that adjustment is incorrect. Staff's revised adjustment, as reflected in Staff Sch. 10.01 CORR, is based on outdated pricing information and assumes revenues that the Company will not receive. Staff's adjustment, as reflected in Staff Schedules 5.01 and 10.01 CORR, incorporate certain assumptions and financial rates that are inaccurate. Company witness Mr. Hanley identified and corrected these assumptions, noting that Staff's cost information reflects pricing from 2014, instead of 2012, the time when HomeServe ceased marketing its products in the Aqua Illinois territory. Hanley Sur., Aqua Ex. 11.0, 10:202-203; Tr. at 88:5-20. Mr. Hanley noted additional errors in Staff's calculations, namely that the net commission rate in effect during the time of HomeServe's program in the Aqua Illinois territory was [redacted] instead of [redacted] and that the actual sign-up rate from 2012 was [redacted] not [redacted] *Id.* at 10:200-201, 204-206; Tr. at 88:21-89:7. In addition, and as discussed above, Staff improperly allocates 100% of the revenues received by Aqua Resources to Kankakee. Sackett Reb., Staff Ex. 10.0, 12:287-298. This allocation is improper – using the Kankakee allocation factor for 2014, Aqua Resources' revenues would be 45.56% of the corrected adjustment, totaling [redacted]. Kahoun Reb., Aqua Ex. 6.0, 8:170-174; Hanley Sur., Aqua Ex. 11.0, 8:173-175, Aqua Ex. 11.1 CONF.

Finally, and contrary to Staff's assumption, Aqua Illinois did not receive a [redacted] As a result, the value assigned in Staff's schedules should reflect [redacted], not [redacted] Hanley Sur., Aqua Ex. 11.0, 9:184-189, 10:207-209; Tr. at 89:8-16. Similarly, the [redacted]

[redacted] Hanley Sur., Aqua Ex. 11.0, 10:211-213; Tr. at 89:17-90:4. In light of these corrections, and utilizing Staff's calculation as provided in Staff Schedule 10.01 CORR, if the Commission were to somehow adjust Aqua Illinois' revenues in any way related to the HomeServe activities that ceased in 2012, such adjustment to revenues related to Aqua Illinois should be limited to [redacted], the amount properly allocated to Kankakee.

VI. RATE OF RETURN

A. Uncontested Issues

1. Capital Structure and Cost of Debt

Aqua Illinois proposes a future test year average 2015 capital structure consisting of 0.51% short-term debt, 46.23% long-term debt and 53.26% common equity. Aqua Ex. 5.0, Sch. D-1. Further, for the future test year 2015, Aqua Illinois presents an embedded cost of short-term debt of 2.14%, an embedded cost of long-term debt of 6.17%, and of common equity of 10.25%. Staff recommends that the Commission adopt Aqua Illinois' proposed capital structure and the Company's proposed embedded cost of short-term or long-term debt. Kight-Garlisch Dir., Staff Ex. 3.0, 3:55-62, 26:485-491. These issues are not contested.

B. Contested Issues

1. Return on Equity

It is well-established that the Commission "is charged by the legislature with setting rates which are 'just and reasonable' not only to the ratepayers but [also] to the utility and stockholders." *Bus. and Prof. People for the Pub. Interest v. Illinois Commerce Comm'n*, 146

Ill. 2d 175, 208-209 (1991). To do so, the Commission must ensure a "balancing of the investor and consumer interests." *Citizens Utility Board, et al. v. Illinois Commerce Comm'n,* 276 Ill. App. 3d 730, 736 (1994) (*quoting Illinois Bell Tel. Co. v. Illinois Commerce Comm'n,* 414 Ill. 275, 287, 111 N.E. 2d 329 (1953)).

Establishing a just and reasonable ROE percentage is important in every rate case, but it is of critical importance to smaller utilities such as Aqua Illinois. For example, the Company must compete in capital markets to obtain the funding necessary to invest in infrastructure improvements that will benefit customers. Walker Reb., Aqua Ex. 8.0, 3:52-54. All else being equal, investors will go where they can get the best return on their investment. Therefore, authorizing a low ROE percentage will make it more difficult for Aqua Illinois to access the capital necessary to continue investing in infrastructure. *Id.*

Another important reason for establishing a reasonable ROE percentage is to incentivize water/sewer utilities such as Aqua Illinois to invest in troubled water or sewer systems. The evidence shows that there are water and sewer utilities in the State that do not have the financial wherewithal or technical expertise to operate such utilities effectively. Indeed, the General Assembly has recognized the public interest value and customer benefits associated with having financially stable and experienced operators at the helm of such systems. To this end, legislation was recently enacted to encourage the acquisition of such systems. *See* Section 9-210.5 of the Act, 220 ILCS 5/9-210.5. Historically, the Company has been active in acquiring smaller or troubled systems. However, as Company witness Ms. Kahoun explained, establishing a low ROE percentage will not encourage Aqua Illinois or other similarly situated utilities from continuing to invest in Illinois. Kahoun Sur., Aqua Ex. 10.0, 3:66-68. Instead, the Company will look to invest where it has the opportunity to earn a reasonable return.

In this proceeding, the Company proposes a ROE of 10.25%, using methodologies that the Commission regularly employs in its assessment of a reasonable ROE. Aqua Illinois' ROE proposal takes into account the Company's unique risk characteristics, regulatory policy, and the ROE required to provide Aqua Illinois with a fair rate of return. Aqua Illinois' proposed ROE is reasonable, is designed to provide the Company with a fair rate of return, and should be approved.

In contrast, Staff proposes an ROE of 9.07%: an ROE that is neither just nor reasonable. Staff's proposal would reduce the Company's proposed revenue requirement increase by $921,798. Staff Ex. 6.0, Sch. 6.05, line 6. Put another way, this adjustment alone reduces the Company's proposed rate increase by approximately 42%. The methodology Staff employs to arrive at its ROE proposal represents a significant departure from Staff's approach in previous rate cases. In doing so, Staff's proposal undermines the notion of regulatory stability, and negatively penalizes Aqua Illinois as compared to other utilities. Additionally, Staff's methodology contains errors and inconsistencies. Combined, these problems result in an unreasonably low ROE recommendation. All of these flaws are described below.

a. Description of the Company's ROE Methodology

Company witness Walker presented a detailed discussion of his ROE methodology in his direct testimony. In order to formulate the recommended ROE of 10.25%, Mr. Walker relied upon several models, including Discounted Cash Flow ("DCF"), Capital Asset Pricing Model ("CAPM"), and Risk Premium ("RP") – models that the Commission regularly relies upon. Walker Dir., Aqua Ex. 3.0 CORR, 2:26-28. Because Aqua Illinois' shares of common stock are not publicly traded, Mr. Walker relied upon two comparable groups of publicly traded companies to estimate the common equity rate and reach a proposed ROE of 10.25%. *Id.* at

2:38-42. These comparable groups were made up of two carefully selected groups: the Water Group and the Gas Group, which were selected by Aqua Illinois based on certain general criteria. *Id.* at 8:171-9:191. Based on his analysis, the current range of common equity cost for Aqua Illinois is 10.70% (DCF), 10.40% (CAPM), and 9.70% (RP). *Id.* at 2:42-44. Further, in order to check the reasonableness of the ROE recommendation, the Company reviewed Value Line Investment Survey's ("Value Line") projected returns on comparable utilities, which ranged from 10.0% to 10.40%. *Id.* at 2:45-3:50.

b. Staff's ROE Methodology is Flawed and Should Not Be Adopted

Staff's approach to determining the Company's ROE represents a significant departure from Staff's approach in previous rate cases, undermines the notion of regulatory stability, and negatively penalizes Aqua Illinois as compared to other utilities. Further, Staff's ROE analysis contains numerous errors and inconsistencies, fails a comparison test of alternative investment opportunities when compared to the common equity cost rate estimated for large companies, fails a comparison test of projected ROE, and fails to consider the fact that if authorized, Staff's proposed 9.07% ROE will not likely be earned due to Staff's proposed adjustments, discussed further in this Initial Brief.

i. Staff's Sample Group is Flawed and is Inconsistent With Sample Groups From Prior Rate Cases.

In developing a proposed ROE for Aqua Illinois, Staff relied upon two groups of companies (the "Water Sample" and the "Gas Sample") as well as on a constant growth DCF model, a non-constant growth discounted cash flow ("NCDCF model"), and the CAPM. Kight-Garlisch Dir., Staff Ex. 3.0, 23:424-427. Notably, Staff recommends giving 100% weight to the results of the Gas Sample. Aqua Ex. 8.1, Sch. 1. As a result of this analysis, Staff recommends an 8.36% to 9.77% range of return on common equity. Staff's proposed ROE of 9.07% is based on the average or mid-point of this recommended range. Kight-Garlisch Dir., Staff Ex. 3.0, 26:480-483.

Staff's allocation of 100% weight to the Gas Sample is inappropriate in light of Staff's approach to the determination of ROE in other related cases. For example, in Docket No. 13-0079, Mt. Carmel Public Utility Company's proposed general rate increase proceeding ("GAS2013"), Staff determined a cost of common equity of 10.97% for electric delivery service operations based on a sample of electric companies and a cost of common equity of 10.15% for natural gas distribution operations based on a sample of gas companies ("Gas Group"). *See* ICC Docket No. 13-0079, Kight-Garlisch Dir., Staff Ex. 3.0, 6:104-106. The Commission subsequently authorized an ROE in GAS2013 based on Staff's recommendations. *See Mt. Carmel Public Utility*, ICC Docket No. 13-0079 (final Order Nov. 6, 2013) at 10. Notably, in GAS2013, Staff originally determined a cost of common equity of 8.65% for the Gas Group. However, Staff's recommendation of an ROE of 10.15% was based on Staff's addition of a liquidity premium of 150-basis points to the cost of equity for the Gas Sample. Walker Reb., Aqua Ex. 8.0, 6:130-7:139; *see* ICC Docket No. 13-0079, Kight-Garlisch Dir., Staff Ex. 3.0, 28:546-548, 30:588-590. In doing so, Staff noted that "a fair rate of return on common equity for Mt. Carmel's natural gas distribution operations equals the cost of common equity for the Gas Sample, 8.65%, plus 150 basis points, or 10.15%." ICC Docket No. 13-0079, Kight-Garlisch Dir., Staff Ex. 3.0, 28:546-548, 30:593-595.

Staff's ROE analysis in the instant proceeding deviates from its approach in the GAS2013 rate case. Staff utilized a similar Gas Sample to determine Aqua Illinois' ROE – in fact, in the instant proceeding, Staff's Gas Sample is comprised of ten gas companies, eight of which were used by Staff in GAS2013. Walker Reb., Aqua Ex. 8.0, 6:121-127. Staff did not, however, recommend a liquidity premium for Aqua Illinois, despite noting that such a factor may exist: "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." Kight-Garlisch Dir., Staff Ex. 3.0, 33:604-607. Staff's failure to add a liquidity premium to its derived cost of equity is improper. A comparison of Aqua Illinois' average debt cost rate and the average debt cost rate for the Water Sample and the Gas Sample for the three-year period from 2011 to 2013 demonstrates that Aqua Illinois' 2013 average debt cost rate of 6.69% is 146-basis points higher than the Water Sample's 5.23% rate and 249-basis points higher than the Gas Sample's 4.21% rate. Similarly, Aqua Illinois' 6.50% average debt cost rate for the three-year period 2011 to 2013 is 110-basis points more than the Water Sample's 5.40% rate and 182-basis points greater than the Gas Sample's 4.68% rate. Walker Reb., Aqua Ex. 8.0, 8:159-166; Aqua Ex. 8.1, Sch. 2. Aqua Illinois notes that although the entire difference in average debt cost rate may not be exclusively comprised of the liquidity premium, it does provide a measurable difference in the capital markets assessment of risk and required return. *Id.* at 8:167-169. In addition, Staff used essentially the same Gas Sample group for Aqua Illinois as in GAS2013 – had Staff recommended a 150-basis point liquidity premium for Aqua Illinois, as it did in GAS2013, the recommended cost of equity in this proceeding would be 10.57% (9.07% + 1.50%). *Id.* at 11:210-212. As noted above, Staff recommends an 8.36% to 9.77% range of return on common equity in the instant proceeding. If Staff had recommended the upper end of this range, this would have been consistent with Staff's recommendation in GAS2013, wherein Staff justified the use of a liquidity premium by noting that the Gas Sample group was comprised of market-traded companies whose security prices did not reflect substantial liquidity costs. *Id.* at 11:213-

12:220. Staff's failure to recommend a liquidity premium of any size is improper, and fails to provide Aqua Illinois with a fair cost of common equity.

Staff's ROE recommendation is also inconsistent with Staff's testimony in Aqua Illinois' last rate case, Docket No. 11-0436 ("AQUA2012"). In AQUA2012, Staff relied upon different cost models in order to reach its recommended ROE. For example, in AQUA2012, Staff solely relied upon the DCF model, but in the instant proceeding, Staff relies on both the DCF and the NCDCF models. *Id.* at 14:267-269. If Staff had solely relied upon the DCF model in formulating its recommended ROE in the instant proceeding, Staff's calculation would produce a DCF based cost of common equity of 8.62% for the Water Sample and 8.46% for the Gas Sample, as compared to Staff's current recommendation of a DCF based cost of common equity was 8.15% for the Water Sample and 8.36% for the Gas Sample. *Id.* at 15:276-279. An ROE based on a DCF model would result in a recommended ROE of 9.12%, based on an 8.46% to 9.77% range of return on common equity. *Id.* at 15:279-280. In addition, Staff's DCF calculations reflect a different type of growth rate between AQUA2012. If Staff had relied upon the growth rate utilized in AQUA2012, it would have resulted in an adjustment to the DCF based cost of common equity to 9.16% for the Water Sample and 8.99% for the Gas Sample, compared to the DCF based cost of common equity of 8.15% for the Water Sample and 8.36% for the Gas Sample. *Id.* at 16:293-297. In the instant proceeding, an ROE based on a DCF model that uses projected five-year growth rates in earnings per share, as utilized in AQUA2012, would result in a recommended ROE of 9.38%. *Id.* at 16:297-299.

ii. Staff's Recommended Growth Rate is Wrong

Staff's recommended ROE also suffers from an unreasonable recommended Nominal-GDP growth rate of 4.5%. Kight-Garlisch Dir., Staff Ex. 3.0, 9:174-10:206. Staff's rate based on 15-year and 20-year projections, as compared to actual 15-year and 20-year periods based on data published by the Federal Bureau of Economic Analysis dating back to 1929, reflect average growth rates significantly higher than those recommended by Staff. Walker Reb., Aqua Ex. 8.0, 19:365-20:388; Aqua Ex. 8.1, Schs. 6-7. In contrast, a calculation of the Nominal-GDP growth rate and the Real-GDP growth rate based upon the compound growth of the value of the economic output since 1929, as published by the Federal Bureau of Economic Analysis, shows that the long-term Nominal-GDP growth rate has been 6.2% since 1929. Walker Reb., Aqua Ex. 8.0, 20:394-397. In addition, a calculation of the growth in the Real-GDP to a projected nominal growth by adding the implied forward rate of inflation recently reflected in comparable long-term treasury securities results in a long-term Nominal-GDP growth rate of 5.7%. *Id.* at 20:398-21:401. The Commission has noted these trends, and, importantly, has rejected Staff's methodology, finding:

> 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 Company, ICC Docket No. 10-0467 (final Order May 24, 2011) at 153. Based upon these figures, a practical estimate of the long-term Nominal-GDP growth rate is in the range of 5.7% to 6.2%. In light of actual data, Staff's recommended Nominal-GDP growth rate of 4.5% is unreasonably low and Aqua Illinois' recommended long-term Nominal-GDP growth rate of 5.9% is a reasonable rate. Walker Reb., Aqua Ex. 8.0, 21:402-404.

In light of the inconsistencies discussed above, Staff's NCDCF study, revised to utilize projected five-year growth rates reflects an increase in the NCDCF for the Water Sample from 7.67% to 7.96% and from 8.26% to 8.62% for the Gas Sample. *Id.* at 21:407-413; Aqua Ex. 8.1, Sch. 8. In addition, Staff's NCDCF study, revised to utilize a more realistic Nominal-GDP growth rate of 5.9%, reflects an increase in the NCDCF for the Water Sample to 9.11% and for the Gas Sample to 9.68%. *Id.* at 21:414-417; Aqua Ex. 8.1, Sch. 8. Based on these adjustments, the DCF based cost of common equity increases from 8.15% to 9.14% for the Water Sample and from 8.36% to 9.34% for the Gas Sample. *Id.* at 21:421-22:425; Aqua Ex. 8.1, Sch. 9. These modifications would result in a significant change to Staff's recommended ROE, resulting in a recommended ROE of 9.56% based on a 9.34% to 9.77% range of return on common equity. Walker Reb., Aqua Ex. 8.0, 22:425-428.

Staff's calculation of a CAPM estimate suffers from similar inaccuracies. Because Staff calculated a CAPM after determining the return on the market based on a DCF, Staff's CAPM suffers from the same errors as its DCF calculations do. *Id.* at 22:431-432. It is indisputable that size plays a role in the composition of investors, and hence, liquidity. *Id.* at 10:192-193. The small size of a company creates an additional element of risk for which investors should be compensated. *Id.* at 23:446-447. Hence, the CAPM size premium impacts the value of Aqua Illinois and reflects the risks associated with Staff's Samples' small size and its impact on the determination of their beta (or, systematic risk). *Id.* at 22:443-23:445. Staff's recommended ROE does not recognize the additional risk associated with Aqua Illinois' smaller size. Because the beta does not capture or reflect the Staff's Samples' small size, Staff's CAPM must be adjusted to account for size premium. *Id.* at 23:447-449; Aqua Ex. 8.1, Sch. 10. These modifications would result in an increased CAPM based cost of common equity from 9.41% to 10.71% for the Water Sample and from 9.77% to 10.67% for the Gas Sample. Walker Reb., Aqua Ex. 8.0, 23:450-452. These modifications, in addition to the adjustments related to the projected five-year growth rates and Nominal-GDP growth rate, would result in a significant change to Staff's recommended ROE, resulting in a recommended ROE of 10.01% based on a 9.34% to 10.67% range of return on common equity. *Id.* at 23:452-455.

Lastly, the companies included in Staff's Market Portfolio are riskier investments than those included in Staff's Water and Gas Sample. *See* Kight-Garlisch Dir., Staff Ex. 3.0, 16:321-17:333. However, Staff's DCF estimates wrongly assume that the Water Sample is 428-basis points less risky and that the Gas Sample is 416-basis points less risky than Staff's Market Portfolio. Walker Reb., Aqua Ex. 8.0, 24:470-474. This assumption is unreasonable and should be rejected. Staff's recommended DCF based common equity cost rate of 8.15% for the Water Sample is 225-basis points below Staff's 10.4% projected return on equity, and Staff's recommended DCF based common equity cost rate of 8.37% for the Gas Sample is 353-basis points below their 11.9% projected return on equity. *Id.* at 24:480-485. These results utterly disregard actual measurable, alternative investment opportunities. As a result, no weight should be given to Staff's DCF based common equity cost rate estimate for Staff's Samples.

iii. Staff's Proposed ROE Would Place Aqua Illinois at a Competitive Disadvantage to Attract Capital

Staff's recommended ROE would place Aqua Illinois at a competitive disadvantage in the capital markets, making it more difficult and costly to obtain the capital necessary to finance future infrastructure improvements. If Aqua Illinois is unable to compete to obtain capital at competitive rates, or is unable to obtain capital through the market, Aqua Illinois' ability to continue to offer reliable service at a reasonable cost will be put at risk. *Id.* at 3:52-56. Moreover, an unreasonably low ROE would impair Aqua Illinois' ability to maintain its dividend and would impair its ability to maintain its credit rating. *Id.* at 27:532-533. Notably, the ROE recommended by Staff is significantly below the authorized returns on equity for Aqua Illinois' sister companies, Aqua Ohio and Aqua Pennsylvania, companies with which Aqua Illinois must compete for equity capital. Walker Sur., Aqua Ex. 12.0, 9:199-201.

Aqua Illinois' request for a rate increase is driven by the need to recover the costs of its capital investments in the system. These costs are driven by the Company's investment in infrastructure, in various water treatment plant improvements to increase reliability and redundancy, in water meter replacements, and in the replacement of aged and deteriorating infrastructure in the distribution system for reliability. Between 2002 and 2013, Aqua Illinois has replaced 96,000 feet of main – an average of 9,100 feet of main replacements per year – in order to improve reliability, fire protection, and water quality. Kahoun Dir., Aqua Ex. 1.0, 7:137-139.

iv. Staff's ROE Proposal Serves as a Disincentive to Acquire Troubled Water and Sewer Systems

Over the past several years, the Company has worked cooperatively with agencies such as the Illinois Environmental Protection Agency ("IEPA"), the Commission, and local communities to acquire financially and/or operationally troubled water and wastewater systems in Illinois. Kahoun Sur., Aqua Ex. 10.0, 3:52-54. Staff's proposed ROE fails to incentivize the Company to continue to invest in troubled water or sewer systems – Staff's recommended ROE fails to reflect Aqua Illinois' consistent actions that have improved the provision of water and/or sewer service to communities previously served by troubled utilities, and would prevent Aqua Illinois from continuing to do so going forward. *Id.* at 3:48-50. Over the last three years, Aqua Illinois has acquired Moecherville Water and Tri Star Estates Sewer in 2012; Woodlawn Water, Woodlawn Sewer, Nordic Park Water, Sheridan Grove Water and Sun River Terrace Sewer in 2013; and McHenry Shores Water in 2014. *Id.* at 3:54-57. These acquisitions have brought the customers of these utilities a company that is financially sound, with a demonstrated ability to operate water and sewer facilities efficiently and effectively, and in compliance with IEPA standards. *Id.* at 3:57-60. Notably, the Commission has expressed its appreciation with regards to Aqua Illinois' commitment to solving problems that often befall water systems with poor maintenance and oversight. In light of these actions, Staff's proposed ROE would likely have a significant negative impact on the Company's plans for investing in other troubled systems. Capital is limited, and if the Company cannot generate investor capital given the opportunity to earn a better return elsewhere, there is no incentive to invest here and obtain a lower return. *Id.* at 3:66-68. Such a result does not benefit those customers currently taking service from troubled systems. An ROE of 9.07% would send a signal contrary to supporting regulatory stability and would indicate that a company's continued provision of safe and reliable service is of no consequence. Without the approval of a reasonable and adequate ROE, the Company may struggle to address the formidable tasks of rehabilitating infrastructure, acquiring and repairing troubled systems, and maintaining quality service. Thus, awarding an appropriate ROE is essential to Aqua Illinois' on-going ability to maintain and improve service quality for its customers.

v. Should the Commission Adopt Staff's ROE Methodology, Certain Adjustments Are Necessary to Develop A Reasonable ROE.

In the event the Commission applies Staff's methodology, then it should:

1. recognize that Staff deviated from the evidence supporting their own liquidity premium, which supports a ROE of 9.42% to 9.77% (Walker Reb., Aqua Ex. 8.0, 11:214, 12:227);

2. give the upper end of Staff's recommended range of cost rate a majority of weighting, or 9.77% (*Id.* at 11:214);

3. recognize that Staff's types of growth rate used is not consistent with the types of growth rates utilized in similar cases, and if Staff were consistent their ROE would be 9.38% (*Id.* at 16:299);

4. recognize that Staff's DCF methodology is not consistent with the DCF model utilized in other cases, and that if Staff were consistent their ROE would be 9.12% (*Id.* at 15:279);

5. recognize that Staff used an unrealistic estimate of economic growth, and that a realistic estimate of growth would produce a ROE of 9.56% (*Id.* at 22:428); and

6. recognize that Staff's CAPM methodology is not consistent with the financial theory underlying CAPM analyses, and that a CAPM methodology consistent with financial theory would produce a ROE of 10.01% (*Id.* at 23:454).

Adopting these adjustments would result in an ROE of 10.01%. This result is reasonable and appropriate, especially in light of ROEs issued for like utilities. However, if the Commission is going to give any weight to the results of Staff's cost of common equity estimate, the Commission should give 100% weight to the upper end of Staff's range of return on common equity. *Id.* at 4:82-89. Doing so would suggest a 9.77% ROE for Aqua Illinois.

VII. <u>RATE DESIGN</u>

A. <u>Cost of Service Study</u>

Aqua Illinois prepared and presented a Cost of Service ("COS") study ("COSS") to determine the relative cost of providing water service to the various Kankakee customer classes, which was used to prepare the Company's recommended tariff design. Monie Dir., Aqua Ex. 4.0, 4:67-70. Aqua Illinois and Staff agree that the COSS appropriately utilized the base-extra capacity method of allocating costs between the various customer classes, the basis for which originated in the Water Rates Manual M1 ("M1 Manual") of the American Water Works Association ("AWWA"), Sixth Edition. *Id.* at 4:75-77; Monie Reb., Aqua Ex. 9.0, 2:32-35; Harden Dir., Staff Ex. 4.0, 8:127-9:147. The M1 Manual is widely recognized in the water industry as the best authority that details the correct procedures to follow for preparing COS studies, and is relied upon regularly by the Company and by Staff. Monie Reb., Aqua Ex. 9.0 at 2, fn. 1.

Pursuant to the base-extra capacity method of allocating costs, costs are allocated among the various customer classes "based on the relative amount of demand that each customer class places on the water system." Monie Reb., Aqua Ex. 9.0, 2:35-38. This allocation method will ensure that the peaking demands (which reflect water use over and above the average demand) will be further allocated to the maximum day and maximum hour demands by use of extra capacity factors. *Id.* at 2:38-40. Thus, the design of the water supply, storage, pumping and distribution systems will reflect the fact that different customer classes place different peaking demands on the water system. *Id.* at 2:40-42. Staff agrees with the Company's proposed COSS, including the use of base-extra capacity factors.

The Company also proposed the use of non-coincident peak ("NCP") extra capacity factors for allocating costs between the various customer classes in its COSS, based upon the recommendation of the M1 Manual that NCP extra capacity factors should be used for diverse systems such as Aqua Illinois. *Id.* at 3:56-60. The use of NCP demand factors is essential for a system like Aqua Illinois that is capable of meeting not only actual system demands but also higher, noncoincident demands, such as fire protection. *Id.* at 5:108-110. Mr. Monie explained that although it is unlikely that a fire will occur during a high demand period, such as a maximum day or during a maximum hour system-wide, the water system must be able to provide fire demands during a high demand period. *Id.* at 5:111-113. Furthermore, if a major downtown fire were to occur during peak flow times for the rest of the customer classes in a large system like Aqua Illinois, the fire could trigger a maximum hour or maximum day event. *Id.* at 5:115-6:118. However, because such large fires do not occur regularly, the use of Coincident Peak ("CP") extra capacity factors in a COSS would significantly reduce the allocation of costs to the fire protection customer classes, both public and private. *Id.* at 6:119-123.

Staff agreed with the Company's proposed COSS, including the use of the base-extra capacity method of allocating costs, with one exception. Harden Dir., Staff Ex. 4.0, 12:202-204. Although Staff originally recommended the use of CP extra capacity factors to allocate the excess portion of system costs in the COSS, in rebuttal testimony Staff witness Ms. Harden agreed with the Company's COSS and the use of NCP demand factors and noted that "switching to an NCP demand factor in this case, as the Company proposes, will avoid a decrease in fire protection rates which would require a 1% increase in the usage charges." Harden Reb., Staff Ex. 9.0, 5:104-106. Staff agrees with the Company that "a significant part of a water system is designed to meet fire protection requirements," and that the use of CP demand factors in this case "would lower the fire protection rates from their current levels." *Id.* at 5:106-6:110.

Lastly, while maintaining its position that NCP demand factors should continue to be used in designing rates for Aqua Illinois, the Company agrees to comply with Staff's recommendation that the Company prepare and provide rates using a base-extra capacity method COSS using CP demand factors to allocate system costs in addition to a rate design and COSS using NCP demand factors in all future rate cases until this matter is ultimately decided. Harden Reb., Staff Ex. 9.0, 6:121-125.

B. <u>Rate Design</u>

Aqua Illinois presented a tariff design for the Company's proposed rates, as reflected in the Company's Part 285 schedules. *See* Monie Dir., Aqua Ex. 4.0, 7:160-8:181; Schs. E-1 – E-7. This proposal provides revenues for all customer classes that closely reflects the respective costs of service for each class, with the exception of Private Fire Protection. Monie Dir., Aqua Ex. 4.0 6:129-130. To create the tariff design, the Company developed Public Fire Service rates, which were set close to the cost of service. Then, in order to move the revenues provided by Private

Fire Service class closer to its cost of service, the Company increased Private Fire Service rates by 15% after taking into account the current level of the Qualifying Infrastructure Plant Surcharge ("QIPS"). *Id.* at 6:131-135. The metered revenues were then increased by the 10.3% required to provide the total requested revenue at proposed rates, after taking into account QIPS. In addition, Customer Charges were increased by 3.5% over the current level, including QIPS. *Id.* at 7:137-139. The Company's tariff design proposal recommends increasing the charges in the Standby Water Service rates and Large Industrial by the average overall increase of 9.95% after allowing for the current level of QIPS. *Id.* at 8:177-178.

Staff recommends that the Commission adopt the Company's proposed rate design using the NCP factors in the Company's original COSS to be applied to the revenue requirement as approved in the final Order. Harden Reb., Staff Ex. 9.0, 5:102-104, 6:117-118. This issue is not contested.

VIII. OTHER

A. Uncontested Issues

1. Affiliate Interest Agreements Update

The Company has agreed to update its current Commission-approved affiliated interest agreements that are on filed with the Commission. These agreements include: (1) the Service Agreement between Consumers Illinois Water Company ("CIWC") and Consumers Water Company ("CWC"), approved by the Commission in Docket No. 85-0491 and assumed by acquisition to remain in place following the merger of CWC and Philadelphia Suburban that was approved in Docket No. 98-0602; and (2) the Service Agreement between CIWC and CWC approved by the Commission on March 19, 1985 in Docket No. 85-0492. Hanley Reb., Aqua Ex. 7.0, 21:451-466. The Company's update will serve to clarify and update what was previously approved by the Commission. *Id.*; Hanley Sur., Aqua Ex. 11.0, 16:338-340. Pursuant to Staff's recommendation, the Company will file its updated Service Agreement within 90 days of the entry of a final Order in this proceeding. Pearce Reb., Staff Ex. 7.0, 16:330-334.

B. Contested Issues

1. Request to Initiate Investigation

Staff witness Sackett argues that Aqua Illinois' Commission-approved AIAs that are currently in place "[do] not cover many of the services that Aqua America and its subsidiary, Aqua Services Inc. provide to Aqua Illinois," in contravention of the Act and contrary to public interest. Sackett Dir., Staff Ex. 5.0 CORR, 4:71-75, 4:78-79. As a result, he recommends that the Commission initiate a historical investigation into the Company's prior Commission-approved AIAs. *Id.* at 4:78-79, 5:91-117. The Commission should reject Staff's recommendation. The Company's interactions with its affiliates is, and has been, consistent with its Commission-approved affiliate interest agreements. While this is Mr. Sackett's first involvement in an Aqua Illinois rate case, his claim disregards the fact that the Company's affiliate transactions have been the subject of Commission and Staff review for more than a decade (in 2003, 2004, 2005, 2006, 2007, 2008, 2010 and 2011), as part of regular rate case proceedings. Indeed, the costs associated with the affiliate services that Staff witness Sackett now calls into question have been reviewed and allowed to be recovered in multiple Aqua Illinois rate cases.

A historical review of Aqua Illinois' transactions pursuant to its Commission-approved AIAs is inappropriate and unwarranted. The Commission-approved agreements are still valid and cover services that are provided by the service company. Staff acknowledges that Aqua Illinois is a party to the three Service Agreements at issue, and does not challenge the validity of or the review process that occurred regarding these agreements. Hanley Sur., Aqua Ex. 11.0, 12:244-248; Sackett Dir., Staff Ex. 5.0 CORR, 11:251-12:267. In fact, Staff has confirmed that the specific services that Aqua Illinois has received are necessary and would have to be provided by "some party" to the Company. Sackett Dir., Staff Ex. 5.0 CORR, 22:542-543. Staff notes that "if such services were not provided by Aqua America, then they would have to be provided in-house or contracted out to a third party." *Id.* at 22:543-545. Nonetheless, Mr. Sackett claims that the Commission-approved Services Agreements on file do not address "many of the services" provided to Aqua Illinois, "including, without limitation, customer services." *Id.* at 12:276-279. He argues that "Aqua Illinois has overreached its authority by providing customer services under the AIA, and may have been doing so for some time." Sackett Reb., Staff Ex. 10.0, 8:179-181. Notably, Staff does not provide any evidence in support of this contention, save the subjective interpretation of a single Staff witness. Further, Staff seeks to initiate an investigation into decades of activity under valid Service Agreements based upon the unsupported conclusion that the Service Agreements "[do] not approve the provision of customer services and billing among other things." Sackett Dir., Staff Ex. 5.0 CORR, 20:501-502.

Aqua Illinois is in compliance with Section 7-101 of the Act and has, at all times, acted in good faith to comply with this Section. Aqua Illinois' Service Agreements were appropriately and lawfully submitted to the Commission, reviewed by the Commission, and the terms of the Service Agreements were approved. Moreover, Aqua Illinois' actions have been compliant with the terms of its Service Agreements, which have been the subject of Commission review in numerous rate cases over the past 15 years. Company witness Mr. Hanley explained that Aqua Illinois has brought a rate case in front of the Commission nearly annually for over a decade.[4]

---

[4] Please see rate case proceedings in Docket No. 03-0403 (final Order 4/13/2004); Docket No. 04-0442 (final Order 4/20/2005); Docket Nos. 05-0071 & 05-0072 (Cons.) (final Order 11/08/2004); Docket No. 06-0285 (final Order

Hanley Sur., Aqua Ex. 11.0 at 14, fn. 2. During these proceedings, the Commission and any intervenor had every opportunity to review the services provided to Aqua Illinois, as well as the cost of such services. *Id.* at 14:288-291. Staff, the Commission, and any other intervening party had multiple opportunities and all of the necessary information to determine whether Aqua Illinois' customer service and billing operations were conducted properly and in compliance with the law. At no point has any party, including Staff, challenged those services or the costs associated with them. In this regard, Mr. Sackett's conclusion that the Commission has never considered this issue is plainly wrong. *See* Sackett Reb., Staff Ex. 10.0, 8:183-184. These services and costs have been clearly identified in each rate case proceeding before the Commission. The fact that no party, whether Staff or intervenor, has found cause to contest these issues does not mean that it has gone unnoticed by the Commission. If parties were required to identify every distinct uncontested issue throughout every rate case proceeding, the burden would be overwhelming.

For all of these reasons, it would be unreasonable and inappropriate to adopt Staff witness Sackett's proposal. The affiliate services he now takes issue with were subject to Commission review through a multitude of Aqua Illinois rate case dockets, and the Company was allowed to recover the costs of such services through Commission-approved rates. Instead, any review of the Company's affiliate agreements should be focused on the updated AIA that the Company has agreed to file with the Commission: a filing that will be made within 90 days of the entry of a final Order in this proceeding.

12/20/2006); Docket Nos. 07-0620, 07-0621, & 08-0067 (Cons.) (final Order 11/13/2008); Docket No. 10-0194 (final Order 12/02/2010); Docket No. 11-0436 (final Order 2/16/2012) (final Order on Rehearing 8/21/2012).

IX. CONCLUSION

For all reasons set forth above, Aqua Illinois respectfully requests that the Commission enter findings and make conclusions on all uncontested and contested issues consistent with the Company's positions taken in testimony and/or stated herein regarding the evidence in the record and the applicable law.

Dated: December 10, 2014

Respectfully submitted,

AQUA ILLINOIS, INC.

By: /s/ John E. Rooney
One of the attorneys for
Aqua Illinois, Inc.

John E. Rooney
Maris J. Jager
ROONEY RIPPIE & RATNASWAMY LLP
350 West Hubbard Street, Suite 600
Chicago, Illinois 60654
(312) 447-2800
john.rooney@r3law.com
maris.jager@r3law.com