BEFORE THE STATE OF NEW JERSEY
OFFICE OF ADMINISTRATIVE LAW

I/M/O THE PETITION OF AQUA NEW JERSEY,)	**BPU Docket No. WR05121022**
FOR APPROVAL OF AN INCREASE IN RATES)	**OAL Docket No: PUC 3338-06**
FOR WATER SERVICES AND OTHER TARIFF)	
CHANGES)	

INITIAL BRIEF OF THE NEW JERSEY DEPARTMENT OF THE PUBLIC ADVOCATE DIVISION OF RATE COUNSEL

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STATEMENT OF FACTS AND PROCEDURAL HISTORY

On December 8, 2005 Aqua New Jersey, Inc., ("Aqua" or the "Company") filed a petition requesting an increase and revision and charges for water service in the amount of $4,162,884 in annual revenues, or 18.73% over present revenues. Aqua New Jersey (hereafter referred to as "Aqua" or the "Company") is a utility that provides water service to more than 44,000 customers in the State of New Jersey. Aqua New Jersey is a subsidiary of Aqua America. The Company's water customers are located in various municipalities in Warren, Hunterdon, Mercer, Burlington, Monmouth, Camden, Ocean, Sussex and Gloucester Counties. Aqua also provides wastewater service to approximately 4,000 customers in New Jersey. Rates for wastewater service, however, are not the subject of the current petition.

With their petition the Company filed direct testimony from witnesses Sharon E. Schulman, Edward A. Rapciewicz, Jr., Jack Schreyer, William C. Packer, Jr., and Pauline M. Ahern. A Board order suspending increases, changes or alterations in rates for water service was issued by the Board of Public Utilities, ("BPU" or the "Board") on December 21, 2005 until May 9, 2006 and then further suspended to September 9, 2006. *I/M/O the Aqua New Jersey, Inc., for Approval of an Increase in Rates for Water Service and Other Tariff Charges*, BPU Docket No. WR05121022, Order dated April 27, 2006. The case was transmitted to the Office of Administrative Law ("OAL") on February 8, 2006. The parties in the case are the Department of the Public Advocate, Division of Rate Counsel ("Rate Counsel"), the Board of Public Utilities Staff, ("Staff"), and the Company.

The Parties conducted discovery during the next several months. A pre-hearing telephone conference was held on April 7, 2006. Public hearings were held on May 25,

2006 at 2:00 p.m. at the Berkeley Township Municipal Building and at 7:00 p.m. at the Hamilton Township Public Library in Hamilton. There were no members of the public in attendance at the Berkeley hearing, while several members of the public attended the Hamilton hearing.

On May 4, 2006 the Company filed supplemental direct testimony of witness Jack Shreyer and direct testimony of witness Richard Russo. The supplemental direct testimony related to the results of an original cost study of the Berkeley Water Company, the assets of which were acquired by Aqua New Jersey in late 2005. On June 2, 2006 direct testimonies were filed on behalf of the Rate Counsel by expert witnesses Robert Henkes, David C. Parcell and Brian Kalcic. On June 15, 2006 the Company filed rebuttal testimonies by witnesses William C. Packer, Jr., Sharon E. Schulman, Jack Schreyer and Pauline Ahern. In the rebuttal phase, the company provided an updated copy of their financial schedules decreasing the requested revenue increase to $4,054,783. On June 27, 2006, surrebuttal testimonies were filed on behalf of the Rate Counsel by expert witnesses Parcell and Henkes. Evidentiary hearings were held at the OAL on July 12 and 13, 2006 before the Honorable Barry N. Frank.

Argument

Point I.

YOUR HONOR SHOULD ADOPT RATE COUNSEL'S RECOMMENDED CAPITAL STRUCTURE AS OF APRIL 30, 2006, THE END OF THE TEST YEAR IN THIS CASE, AS WELL AS RATE COUNSEL'S RECOMMENDED 9.5% RETURN ON EQUITY, RESULTING IN AN OVERALL RATE OF RETURN OF 7.55%.

A. Statement of the Issues

On the issue of the appropriate cost of capital for Aqua, the Company offered the testimony of Ms. Pauline Ahern. Rate Counsel's position was presented through the testimony of Mr. David Parcell. Mr. Parcell has previously provided cost of capital testimony in over 350 utility proceedings before more than 30 regulatory agencies in the United States and Canada. RA-4 at 1.

Several issues related to cost of capital are in dispute between Rate Counsel and the Company. These issues include the appropriate capital structure for Aqua, the appropriate cost rate for Aqua's debt, as well as Aqua's cost of common equity. While all of these issues will be explained in greater detail below, the most complex dispute between Mr. Parcell and Ms. Ahern involves the determination of Aqua's cost of equity.

Mr. Parcell on behalf of Rate Counsel recommends a cost of equity rate for Aqua of 9.5%, based on the midpoint of his recommended range of 9.0% to 10.0%. RA-4 at 4. Mr. Parcell utilized the Discounted Cash Flow ("DCF") Method, the Capital Asset Pricing Model ("CAPM"), and a Comparable Earnings Model ("CEM"), as well as consideration of current financial conditions, in arriving at his recommendation.

Ms. Ahern, on behalf of Aqua, recommends a cost of equity range for Aqua between 10.75% and 11.25%, before her "business risk adjustment" of 0.25%. PT-5R,

Schedule PMA-26 at p. 2. Ms. Ahern's recommended range including the "business risk adjustment" was 11% to 11.50%. *Id.* Ms. Ahern quantified her recommended cost of equity through her version of the DCF, CAPM, CEM, as well as the Risk Premium Method ("RPM"). As will be explained more fully below, Ms. Ahern's cost of equity analyses are flawed in several respects, particularly in the extent of her reliance on analysts' forecasts of projected earnings-per-share ("EPS") in her DCF Model and her exclusive reliance on unregulated firms in her Comparable Earnings Model. Moreover, Ms. Ahern's implementation of a "business risk adjustment" for Aqua due to its alleged small size is improper and should be disallowed given that Aqua America is the largest U.S. based investor owned publicly traded water company, and indeed, represents as much to investors. RA-4 at 11.

B. Capital Structure

1. Your Honor Should Adopt Aqua's Actual Capital Structure as of the End of the Company's Test Year, Which is April 30, 2006.

Your Honor should adopt Rate Counsel's proposed April 30, 2006 actual test period capital structure of Aqua New Jersey. RA-5 at page 20 and Schedule DCP-12 Page 1 of 2, Updated. It is appropriate for the Company's capital structure to be based on the actual test year used by the Company in this case. An April 30, 2006 capital structure is also consistent with Rate Counsel witness Henkes' use of the actual April 30, 2006 test period figures for rate base and expense levels. RA-4 at Page 15.

The Company's proposed date of October 31, 2006 for its capital structure should be rejected by Your Honor. Any proposed rate increase recommended by Your Honor to the Board must be based on substantial credible evidence in the record.

Ensslin v. Township of N. Bergen, 275 *N.J. Super.* 352, 362 (App. Div. 1994). At the time of preparation of Rate Counsel testimony, Aqua's rebuttal testimony, and the evidentiary hearings, 12 months of actual test year data had become available for all components of the capital structure. Rate Counsel's proposed test year ending April 30, 2006 satisfies the criteria that Your Honor's recommendation must be based on substantial credible evidence in the record. In contrast, the Company's projected October 31, 2006 capital structure is speculative in nature, fails to satisfy the Company's burden of proof, and should be rejected by Your Honor.

2. Mr. Parcell's Recommended Capital Structure,Which Includes Short Term Debt, Should be Adopted by Your Honor.

Your Honor should adopt Rate Counsel witness Mr. Parcell's recommended April 30, 2006 actual capital structure for Aqua. Mr. Parcell's recommended capital structure consists of approximately 41.49% long-term debt, 14.69% short-term debt, and 43.83% common equity. RA-5 at Schedule DCP-12, page 1 (Updated).

Mr. Parcell's recommended capital structure best reflects Aqua's actual capital structure. As Mr. Parcell's undisputed testimony showed, both Aqua New Jersey and its parent Aqua America have consistently used short-term debt in their financings in recent years. RA-4 at 15. Indeed, as Mr. Parcell testified, there is no dispute that Aqua New Jersey consistently utilizes short-term debt as part of its financing. RA-5 at Page 2. Even the Company's witness Ms. Ahern admits that "over the last few years, Aqua has indeed used short term debt…." PT-5R at 2-3. Moreover, even though Ms. Ahern claims that Aqua's use of short-term debt "has mostly been eliminated," the reality is that Aqua

had a balance of $12.5 million in outstanding short-term debt on April 30, 2006. *Id.*; RA-5 at Schedule DCP-12, page 1.

Mr. Parcell also demonstrated that, from a financial perspective, the consistent use of short-term debt by Aqua New Jersey becomes a component of its financial risk, and thus, cost of capital. As testified by Mr. Parcell during the evidentiary hearings, "Aqua New Jersey, Aqua America, and virtually all the other proxy companies routinely use short-term debt. And since short-term debt is a factor of risk, it is also a factor in stock prices; and therefore, it's a factor in the cost of capital for these companies." 129T:L5-10 (7/12/06). This further provides support for use of short-term debt in capital structure. RA-5 at 2-3.

In sum, Rate Counsel's position on capital structure differs from that of the Company in two respects. First, the Company proposes use of a pro-forma October 31, 2006 capital structure. Second, unlike Rate Counsel, the Company does not include short-term debt in its capitalization. (PT-5R, Sch. PMA-26, Page 1). As noted above, the Rate Counsel believes that it is appropriate to use the actual test period capital structure ending April 30, 2006. In addition, Rate Counsel believes that the inclusion of short-term debt in Aqua's capital structure is appropriate since Aqua New Jersey has consistently used short-term debt over at least the past five years and, indeed, had a balance of $12.5 million short-term debt outstanding at April 30, 2006.

C. Cost of Debt

Rate counsel recommends use of Aqua New Jersey's actual cost rates of long-term debt and short-term debt as of April 30, 2006. These rates are 6.208% for long-term debt and 5.520% for short-term debt. RA-5 at Schedule DCP-12, page 1 (Updated). Rate Counsel believes that use of actual test period embedded cost rates is consistent with the use of the actual test period levels of long-term debt and short-term debt.

D. Return on Equity

1. Your Honor and the Board Should Approve a 9.50% ROE, Which is the Fair ROE in This Case.

Your Honor should adopt a 9.5% Return on Equity ("ROE") for Aqua as recommended by Rate Counsel witness Mr. Parcell. Mr. Parcell recommends a cost of common equity of 9.5% for Aqua New Jersey, the mid-point of a range of 9.0% to 10.0%. RA-4 at 30. In arriving at his recommendation, Mr. Parcell employed three widely-recognized methodologies for determining costs of equity - discounted cash flow, capital asset pricing model and comparable earnings. RA-4 at 7.

As Mr. Parcell testified, it is customary for rate of return analysts to use groups of comparison, otherwise known as "proxy" groups, to determine the cost of common equity for utilities such as Aqua New Jersey. RA-4 at 17. Both Mr. Parcell and Ms. Ahern use such proxy groups. Mr. Parcell used proxy groups in all three of the methodologies – DCF, CAPM, and CEM – in his cost of equity analysis. Specifically, Mr. Parcell used three proxy groups of water utilities: 1) six AUS Utility Report water utilities, which were used as one of two proxy groups by Aqua New Jersey witness Ms. Ahern; 2) four Value Line water utilities that were used as the second proxy group by Ms. Ahern; and 3)

the full set of ten water utilities included in AUS Utility Reports. RA-4 at 17. Through his choice of proxy groups, Mr. Parcell used not only the same proxy groups employed by Ms. Ahern, but also used an additional, more comprehensive group.

2. Your Honor and the Board Must Set a Rate of Return For Aqua New Jersey Which is Reasonable In Light of Current Capital Market Conditions.

The ratemaking process is designed to give a utility the opportunity to recover prudently-incurred costs of providing utility service to its customers, including a return on its used and useful utility property. The Board's regulation of a utility's ROR is intended to identify the fair and reasonable cost of capital invested in the utility's rate base and to approve rates that give a soundly managed utility an opportunity to recover those costs. A utility's ROR should be "reasonably sufficient to assure confidence in the financial soundness of the utility and should be 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." *Bluefield Waterworks and Imp't . Co. v. Public Svc. Comm.*, 262 *U.S.* 679, 693 (1923); *accord Public Svc. Coord'd v. Transport Co. v. State,* 5 *N.J.* 196, 225 (1950). In this process, the Board must balance the competing interests of the rate paying public and Aqua's investors to arrive at a figure "within the range of reasonableness, the zone between the lowest rate not confiscatory and the highest rate fair to the public." *In re N.J. Power & Light Co.*, 9 *N.J*. 498, 534 (1952).

The zone of reasonableness, which sets the bounds of a fair ROR, must be determined with regard to the general condition of the capital markets. That is, Your

Honor and the Board must set a ROR which provides investors with a yield similar to the return available from like investments of a comparable risk.

In turn, a fair return on equity for utility investors is the return investors require to hold or acquire that utility's common stock. Your Honor and the Board must be mindful that a higher return than this would not meet investor's requirements; rather it would provide them with an unexpected windfall achieved by overcharging ratepayers for utility service. The investor's return requirement would also normally be sufficient to permit the utility to maintain its financial integrity and to attract additional capital.

The minimum required return on common equity is the cost of common equity. The cost of common equity is difficult to identify as investors do not directly reveal the return they require on their common stock investments. Therefore, a utility's cost of common equity must be inferred through analyses of capital market behavior. Additionally, the cost of equity for water companies is generally lower than that for other types of utilities as water companies do not normally face the same competitive exposure as electric, telephone or gas utilities.

3 Discounted Cash Flow Method

a. Rate Counsel Analysis

As Mr. Parcell testified, the DCF method is one of the oldest and most widely used approaches to determining return on equity in utility rate cases. RA-4 at 18. This method equates the return expected by investors with the expected dividend yield plus expected future dividend growth. *Id.* at p. 19. In its simplified form, the DCF formula can be expressed as:

$$ROE = (D/P) + g$$

where D is the expected dividend, P is the current stock price, and g is the expected dividend growth.

The DCF method requires calculation of the dividend yield component. Mr. Parcell calculates the dividend yield by using a quarterly compounding of dividends. RA-4 at 19. The DCF method also requires estimation of dividend growth. As Mr. Parcell testified, "[t]he dividend growth rate component of the DCF model is usually the most crucial and controversial element involved in using this methodology." *Id.* The goal of estimating dividend growth is to reflect the growth expected by investors. *Id.* As Mr. Parcell testified, proper estimation of dividend growth requires recognition that investors have different expectations, and use different indicators in arriving at their varied expectations. *Id.* at 19-20. Mr. Parcell used the following five indicators of growth in his DCF analyses:

1. 2001-2005 (5 year) earnings retention growth,
2. 5-year average of historic growth in EPS, DPS, and BVPS,
3. 2006-2009 projections of earnings retention growth,
4. 2003-2009 projections of EPS, DPS, and BVPS, and
5. 5-year projections of EPS growth from First Call.

Mr. Parcell's DCF analyses resulted in average (mean and median) DCF cost rates of 7% to 8%, with the highest rates of about 9.5% to 10%. RA-4 at 20 and Schedule DCP-6, page 4. Through the examination of these proxy groups, Mr. Parcell concluded that a range of 8% to 10%, with a 9% midpoint, represents the current DCF cost of equity for Aqua New Jersey. It is notable that, in arriving at his recommended 9% midpoint,

Mr. Parcell actually focused on the upper portions of his DCF calculations since current financial conditions have driven down DCF results by historic standards. RA-4 at 21.

b. Rate Counsel Analysis of Ms. Ahern's DCF Analyses

Through Mr. Parcell's pre-filed testimony and testimony at the evidentiary hearings, as well as through cross-examination of Ms. Ahern, Rate Counsel has demonstrated that each of Ms. Ahern's ROE models produced excessive results. As explained by Mr. Parcell, Ms. Ahern's DCF results are flawed in that they are a product of her inordinate reliance on analysts' forecasts of earnings-per-share ("EPS") in determining growth rates.

Ms. Ahern performed two sets of DCF calculations. Her first set considered several growth rates, including historic and projected EPS and dividends per share ("DPS"), and historic and projected BR + SV (where BR is internal growth and SV is external growth). This analysis, which included these varied growth indicators, produced DCF results of 9.2% and 9.3%, similar to Mr. Parcell's results. PT-5, Schedule PMA-7. Ms. Ahern's second DCF analysis, however, relies exclusively on growth in EPS as projected by analysts, resulting in DCF results of 10.6% and 10.9%. Rate Counsel asserts that this exclusive reliance on analysts' projections of EPS growth is improper and has the effect of distorting Ms. Ahern's DCF results upward. Mr. Parcell testified extensively and persuasively as to the impropriety of the undue weight given by Ms. Ahern to analysts' forecasts of EPS. As Mr. Parcell testified, academic scholarship, the financial mainstream, and several recent events have given investors reason to question the accuracy of EPS projections. RA-4 at 34. For example, one prominent academic article

concluded that “analysts' forecasts of EPS and growth in EPS tend to be overly optimistic,” as evidenced by the fact that analysts' forecasts of EPS over the past 13 years have been more than twice the actual growth rate.[1] Indeed, as explained by then Federal Reserve Chairman Alan Greenspan, this trend of overly-optimistic forecasts may be attributable to the reality that analysts are often employed by the very same firms that are underwriting and selling the securities that the analysts are charged with evaluating. RA-4 at 34-35. Moreover, as Mr. Parcell testified, “investors are now very much aware of recent scandals involving security analysts, including the Enron and WorldCom debacles, conflicts of interest that have resulted in settlements, fines, and public admonishments, as well as other negative connotations related to the reliability of analysts' forecasts.” *Id.* at 35. In light of these recent public events, investors have extensive reason to question the reliability of such forecasts and likely do not rely on such forecasts exclusively in making investment decisions.

Accordingly, Your Honor should reject Ms. Ahern's DCF analysis due to its undue reliance on analysts' projections of EPS growth and adopt Mr. Parcell's DCF analysis, which gives proper weight to such projections.

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1 Vijay Kumer Chopra, “Why So Much Error in Analysts' Earnings Forecasts?”, F*inancial Analysts Journal*, Vol.. 54, No. 6, Nov./Dec., 1998, at 35-42.

4. Capital Asset Pricing Model ("CAPM")

a. Rate Counsel Analysis

Mr. Parcell's CAPM analyses result in a cost of equity for the proxy groups, and therefore Aqua New Jersey, of 10%, the midpoint of a range of 9.5% to 10.5%. Mr. Parcell testified that the CAPM, a version of the risk premium method, measures the relationship between a stock's investment risk and its market rate of return. RA-4 at 22. The CAPM determines a utility's ROE by taking a risk-free return and adding a market-adjusted risk premium. The CAPM formula can be expressed as follows:

ROE = Risk Free Rate + Beta (Market Return – Risk Free Rate)

The risk free rate reflects the level of return an investor can achieve without accepting risk; in a CAPM analysis, the risk free rate is generally defined by the return on U.S. Treasury securities. *Id.* at 22-23. Mr. Parcell's CAPM analysis used the three month average yield from February through April 2006 for 20 year U.S. Treasury bonds. *Id.* at 23.

Another component in the CAPM analysis is Beta. Beta is a measure of the relative volatility (and thus risk) of a particular stock in relation to the overall market. *Id.* Betas of less than 1 are considered less risky than the market, while Betas greater than 1 are considered more risky. Utility stocks generally have had Betas less than 1. *Id.*

Mr. Parcell testified that the market return component represents the expected return from holding an entire market portfolio. *Id.* Mr. Parcell also testified that in utility rate proceedings, the market return component traditionally focuses on return on common stocks. *Id.* Mr. Parcell focused his analysis on two measures of returns for the Standard & Poor's 500 composite group, a well-recognized stock market index, for the period

1978-2004. Based on this analysis, Mr. Parcell concluded that the expected market return component was 12.7%. Mr. Parcell's first CAPM analysis can be summarized as follows:

	Mean	Median
Ahern AUS Group	10.4%	10.8%
Value Line Group	10.7%	10.6%
AUS Group	10.4%	10.6%

Mr. Parcell also performed a second CAPM analysis using the historic risk premium from Ibbotson & Associates for the period 1926 - 2005. RA-4 at 24. These calculations can be summarized as follows:

	Mean	Median
Ahern AUS Group	9.5%	9.8%
Value Line Group	9.7%	9.7%
AUS Group	9.5%	9.7%

Based on these two CAPM calculations and using his expert judgment, Mr. Parcell concluded that the CAPM cost of equity for Aqua New Jersey is 10%, the midpoint of a cost range of 9.5% to 10.5%. RA-4 at 25.

b. Rate Counsel Analysis of Ms. Ahern's CAPM.

Ms. Ahern on behalf of the Company performed two CAPM analyses – a traditional CAPM analysis and an "empirical" CAPM analysis. Ms. Ahern's traditional CAPM produced a cost of equity range of 10.1% to 10.4%, consistent with Mr. Parcell's results. RA-4 at 36. Rate Counsel objects, however, to Ms. Ahern's use of the empirical CAPM. Ms. Ahern's empirical CAPM assigns only a 75% weight to the actual betas for the utilities in her proxy group, with a 25% weight going to an assumed beta of 1.0. *Id.* at 36-37. As Mr. Parcell testified, assigning a 25% weight to an assumed beta of 1.0, which is the market beta, overstates the cost of equity for companies with betas below 1.0. *Id.*

at 37. As discussed previously, most utilities have betas less than 1.0, meaning an investment in such a company is considered less risky than the overall market. Indeed, it is notable that all of the water utilities in Ms. Ahern's proxy groups have betas below 1.0. Exhibit PT-5, Schedule PMA-12, page 2. Ms. Ahern's empirical CAPM effectively assumes that one-fourth of the water utilities in her proxy group have a risk equivalent to the risk of the overall market. As Mr. Parcell testified, this is an inaccurate and inappropriate assumption, since betas are determined using actual stock price movements and reflect actual decisions by investors. RA-3 at 37; RA-5 at 13.

Accordingly, Rate Counsel urges Your Honor to reject Ms. Ahern's CAPM results.

5. Risk Premium Method

Rate Counsel witness Mr. Parcell did not perform a Risk Premium ("RPM") analysis as part of his overall cost of capital analysis since the CAPM is a variation of the RPM. Mr. Parcell believes the CAPM is superior to the RPM because the CAPM recognizes the risk of a particular company or industry, while the RPM does not. RA-4 at 22.

Mr. Parcell in his direct and surrebuttal testimonies disagreed with the equity risk premium level of 4.3% to 4.4% used by Ms. Ahern in her RPM analysis. RA-4 at 36; RA-5 at 19. Mr. Parcell demonstrated that Ms. Ahern's RPM was improper since it relied on a comparison of market returns for the S&P 500 and bond yields dating back to 1926, without any demonstration that such long-term relationships reflect current investor expectations. RA-4 at 36. Indeed, the 1926 - 2004 period was influenced by such major

events as the Great Depression, World War II, and the high inflation/high interest rate environment of the 1970's and 1980's. These factors, which are not currently prevalent, have the distorted effect of inflating risk premiums over those currently expected by investors. *Id.*

Rate Counsel respectfully recommends that Your Honor reject Ms. Ahern's RPM analysis.

6. Comparable Earnings Method ("CEM")

a. Rate Counsel Analysis

As Mr. Parcell testified, the CEM is based on the corresponding risk standard set forth in two seminal cases providing the standards for a fair rate of return, *Bluefield*, *supra*, and F*ederal Power Comm'n v. Hope Natural Gas Co.*, 320 *U.S.* 591 (1942). This method is based on the concept of opportunity cost, or the prospective return available to investors from alternative investments of similar risk. RA-4 at 26. A cornerstone of the CEM is the principal that in a free enterprise system, assuming comparable risk, available capital will shift to investments which yield the highest returns.

Mr. Parcell's CEM analysis examines realized returns on equity for several groups of companies, and evaluates investor acceptance of such returns by reference to the resulting market-to-book ratios. *Id.* Mr. Parcell testified that market-to-book ratios of greater than one (100%) represent situations where companies can attract new equity investments without dilution. *Id.* at 26-27. Mr. Parcell's CE analysis examined realized equity returns for his proxy group for the period 1992 – 2005. *Id.* at 27. This time period choice permitted Mr. Parcell to examine returns over one full business cycle, 1992 –

2001, plus five additional years. *Id.* Mr. Parcell's CEM analysis using the companies in his proxy group produced the following results:

Group	Historic ROE	M/B	Prospective ROE
Ahern AUS Group	10.0-11.3%	176-243%	10.2-12.0%
Value Line Group	9.5-10.5%	166-241%	9.3-11.8%
AUS Group	9.7-11.0%	175-236%	9.3-11.8%

Alternatively, Mr. Parcell also examined the Standard & Poor's 500 Composite Group, which is composed of mostly unregulated firms, for the period 1992 - 2004. The results of this second analysis indicated a range for this group's average earned returns of 12.3% to 14.7%, with market-to-book ratios between 334% to 341%. Unlike Ms. Ahern, Mr. Parcell properly accounted for the increased risk of this S&P 500 group compared to his proxy groups of water utilities in making his overall CEM evaluation. RA-4 at 28.

The results of Mr. Parcell's CEM analysis indicate a cost of equity for Aqua New Jersey of no more than 10%. RA-4 at 29.

b. Rate Counsel Analysis of Ms. Ahern's CEM Methodology

Ms. Ahern's CEM analysis examined historic and forecasted returns for two groups of non-utility companies which she perceives as having similar risk to her proxy groups of water utilities. It is worth repeating that Ms. Ahern exclusively utilized non-utility companies in her CEM analysis, which Rate Counsel asserts is an improper mechanism for evaluating the cost of equity for a regulated water utility such as Aqua New Jersey. Indeed, Ms. Ahern's CEM result of a 14.3% to 14.4% cost of equity range for Aqua New Jersey so greatly exceeds Mr. Parcell's cost of capital results, as well as even her own results using the DCF, CAPM, and CEM methodologies, that it should be wholly disregarded by Your Honor.

Ms. Ahern used groups of non-utility companies with beta values similar to those of the water utilities in her proxy groups. PT-5 at 51-52. However, as Mr. Parcell testified, equivalent beta values for utility and non-utility companies do not translate into equivalent costs of equity. RA-4 at 37. To illustrate his point, Mr. Parcell pointed to the fact that the water utilities in Ms. Ahern's proxy group have historic and projected earnings much lower than the non-utility companies she examines. From this fact, Mr. Parcell concluded that, in order for investors to perceive the non-utility companies as being of similar risk (equivalent betas) to the utility companies, greater earnings from the non-utilities were required. *Id.* Therefore, the non-utility companies' costs of capital generally exceed those of the utility companies, and form an improper basis for deriving Aqua New Jersey's cost of capital.

Ms. Ahern's improper use of non-regulated firms is evidenced by her incongruous CEM results of 14.3% to 14.4%. Compared to her CEM results, Ms. Ahern's next highest return on equity model, the RPM, produced a recommended range of 10.9% to 11.0%. RA-3. As Ms. Ahern acknowledged during cross-examination by Rate Counsel, her CEM results are over 300 basis points higher than even the upper range, 11.0%, of her RPM. 97T:L13-17 (7/12/06). Of the four ROE models she employs in her evaluation, the only model that produced results higher than Ms. Ahern's recommended ROE range of 10.75% to 11.25% was the CEM, a fact which Ms. Ahern acknowledged on cross-examination. *See* RA-3; 96T:L14-17 (7/12/06).

In other words, but for her CEM results, which have been improperly inflated due to her exclusive reliance on unregulated firms, Ms. Ahern's ROE results would be nowhere near as high as the 10.75% to 11.25% range she recommends. Rate Counsel

urges Your Honor to reject Ms. Ahern's CEM analysis, and accordingly, her inflated ROE recommendation.

7 Your Honor Should Reject Ms. Ahern's Recommended "Business Risk Adjustment" Since Such an Adjustment Would Be Inappropriate Given Aqua's Size.

Ms. Ahern recommends a "business risk adjustment" for Aqua New Jersey based on her mischaracterization of Aqua New Jersey as an allegedly small company. PT-5 at 57. However, Ms. Ahern's proposed business risk adjustment was thoroughly discredited by Rate Counsel witness Mr. Parcell. While Ms. Ahern cited the "small" size of Aqua New Jersey, Mr. Parcell showed that the parent company – Aqua America – is the largest U.S. based investor-owned water utility. RA-4 at 11. Mr. Parcell also noted that Aqua America portrays itself as a large company. RA-5 at 16, and further, focuses on the "economies of scale" resulting from its growth through acquisition strategy in recent years. RA-5 at 15. Significantly, as Mr. Parcell testified, "[w]hen Aqua needs additional equity capital, it cannot go directly to the equity markets, but must rather receive an equity infusion from Aqua America. When Aqua America goes to the equity markets, it does so on the consolidated financial strength of the entire company." RA-5 at 15.

Mr. Parcell further testified that, based on his experience, when other state commissions have used risk adjustments, they did so only "for the little mom-and-pop water companies that truly were small, not small subsidiaries of large companies." 132T:L24 – 133T:L1 (7/12/06). Aqua America is a "mid cap" stock with a market capitalization of $3.3 billion. The Petitioner, through Ms. Ahern, has offered no reason for why Aqua New Jersey should be rewarded for Aqua America's business decision to

maintain subsidiaries in different states. Instead, Ms. Ahern only offers a distorted portrayal of Aqua New Jersey as a small company. This portrayal is simply not true and should be rejected by Your Honor.

Point II

YOUR HONOR SHOULD RECOMMEND RATES BE SET FOR AQUA BASED ON AQUA'S ACTUAL TEST YEAR ENDING APRIL 30, 2006.

Aqua's proposed test year in this case is the 12 month period ending April 30, 2006. Aqua's initial filing including 5 months of actual data and 7 months of projected data. However, when Rate Counsel filed testimony in June 2006, and by the time of the evidentiary hearings in July 2006, most actual test year data had become available. Rate Counsel recommends Your Honor adopt this test period ending April 30, 2006.

Despite using an April 30, 2006 test year in its filing, the Company now proposes a revenue requirement in this case based on projected rate base balances as of October 31, 2006, the midpoint of its adjusted projected pro forma year ending April 30, 2007. The Company also annualized its revenues based on projected billing determinants as of October 31, 2006; reflected depreciation expenses based on the projected October 31, 2006 depreciable plant balances; and reflected adjusted annualized O&M expenses and taxes based on expense and tax projections for the Pro Forma year ending April 30, 2007.

As explained earlier in this brief, the Company's proposed projected test year should be rejected by Your Honor. The Company is inappropriately attempting to disavow the test year it proposed in its initial filing. As Rate Counsel expert witness Mr. Henkes testified, at the time of preparation of Rate Counsel testimony, Aqua's rebuttal testimony, and the evidentiary hearings, 12 months of actual test year data had become

available for all ratemaking components. RA-10 at 6. As Your Honor is aware, any proposed rate increase recommended by Your Honor to the Board must be based on substantial credible evidence in the record. *Ensslin v. Township of N. Bergen*, 275 *N.J. Super.* 352, 362 (App. Div. 1994). Given the immediate availability of actual test year data, Rate Counsel's proposed test year ending April 30, 2006 satisfies this criteria. In contrast, the Company's projected April 30, 2007 test year is speculative in nature, fails to satisfy the Company's burden of proof and should be rejected by Your Honor.

Point III

THE APPROPRIATE PRO FORMA RATE BASE AMOUNTS TO $71,773,088, WHICH IS $6,023,365 LOWER THAN THE PRO FORMA RATE BASE OF $77,796,453 PROPOSED BY AQUA NEW JERSEY.

Aqua's proposed rate base claim represents projected balances as of October 31, 2006. The only exception is the Company's proposed pro forma rate base balances for materials and supplies and prepayments, which represent the 13 month average balances for the 12 month period ended September 30, 2005. Rate Counsel witness Mr. Henkes recommends numerous adjustments to the Company's proposed rate base. Most of these rate base adjustments are due to Rate Counsel's recommendation to use test year-end April 30, 2006 for the Company's rate base, rather than October 31, 2006 rate base balances. RA-10 at 7. For materials and supplies and prepayments, Mr. Henkes recommends using 13 month average balances for the test year. *Id.* Mr. Henkes has updated his schedules as a result of information ascertained since the filing of his surrebuttal testimony. These updated schedules are attached to this brief as Exhibit A. It is apparent from the examination of Mr. Henkes' updated schedules that the Company

agrees with many of his adjustments. Each of Mr. Henkes' rate base adjustments will be discussed below.

1. Utility Plant in Service

a. Post-Test Year Additions

The Company is proposing to claim in its rate base the utility plant in service balance projected for October 31, 2006, which is six months beyond the test year in this case. To arrive at this projected utility plant in service balance, the Company used the actual plant balance as of September 30, 2005 as the starting point and then added 13-month's worth of projected plant additions through October 31, 2006. Again, since the test year in this case is the 12-month period ended April 30, 2006, the Company is inappropriately requesting rate recognition for projected plant additions extending 6 months beyond the end of the test year. One of the important tests that must be met in order to qualify for post-test year is that the capital additions must be "major in nature and consequence" in order to receive rate recognition. *In re Elizabethtown Water Company*, BPU Docket No. WR85040330 (5/23/85) ("Elizabethtown Water"). Unfortunately for the Company, its requested post-test year additions must be denied by Your Honor since they are routine in nature, and therefore fail to fall within the "major in nature and consequence" exception delineated in Elizabethtown Water.

Rate Counsel acknowledges that, in limited circumstances, the Board has permitted certain post-test year plant in service additions to be reflected in rate base. It is well settled that the Board has only allowed the inclusion of post test year expenditures in the rate base when the petitioner has shown that the post test year adjustments are

"known and measurable," "major in nature and consequence," and supported by "convincingly reliability data." *Id.* at 2. The Board, in Elizabethtown Water, *supra*, stated:

> With regard to the second issue, that is the appropriate time period and standard to apply to out of period adjustments, the standard that shall be applied and shall govern petitioner's filing and proofs is that which the Board has consistently applied, the "known and measurable" standard. Known and measurable changes to the test year must be (1) <u>prudent and major in nature and consequence</u>, (2) carefully quantified through proofs which (3) manifest convincingly reliable data. The Board recognizes that known and measurable changes to the test year, by definition, reflect future contingencies; but in order to prevail, petitioner must quantify such adjustments by reliable forecasting techniques reflected in the record.
>
> *Id.* at 2 (emphasis added).

If these criteria are satisfied, the Board has permitted changes to rate base for a six month period beyond the end of the test year. *Id.* However, following the precedent established by the Board, Aqua's post-test year plant in service additions must be disallowed. As Mr. Henkes testified, about $6 million of Aqua's requested $7.7 million in post-test year plant additions are for *routine, ongoing* construction of mains, meters, hydrants, etc, a fact which the Company acknowledged in response to Rate Counsel discovery. RA-10 at 9. Indeed, the Elizabethtown Water case does not grant a utility the unfettered discretion to include any and all capital expenditures in its rate base for six months beyond the chosen test year. Rather, the Elizabethtown Water decision is a carefully tailored exception to allow rate recognition for certain post-test year additions that are major in nature and consequence. *Id.*

As explained above, the Board has only permitted post-test year additions in the rate base when such additions are major and nature in consequence. A recently litigated Middlesex Water Company rate case confirmed the Board's position on this issue. As discussed on pages 4 – 7 of the Board's Order in that case, Middlesex had proposed rate recognition for projected post-test year plant additions totaling $3,816,558. *I/M/O Middlesex Water Co. For Approval of An Increase in Its Rates For Water Service and Other Tariff Changes*, BPU Docket No. WR00060362, Order dated 6/6/01. The BPU Staff determined in that case that $1,949,398 out of the total projected post-test year additions of $3,816,558 represented non-major *routine* construction projects. The Board's Order stated in this respect:

> With respect to the proposed routine capital budget items, amounting to $1,949,398, Staff was not persuaded that such expenditures, which the Company classified as routine, met the "major in nature and consequence" standard as set by the Board.
> *Id.* at 7.

The Board's Order goes on to state with regard to this issue:

> The ALJ also agreed with Staff's recommendation to reject the inclusion of $1,949,398 of proposed capital budget items, contending that these items are in fact routine, ongoing plant additions, and do not meet the "major in nature and consequence" test set by the Board.
> *Id.*

The Board adopted the above-referenced ALJ recommendation with regard to this post-test year plant addition issue. It is clear that Aqua's requested additions fail to satisfy the Board's narrowly tailored criteria for inclusion in the rate base and should be denied by Your Honor.

b. Transactions Costs Stemming From the Aqua/Berkeley Merger

Aqua New Jersey acquired the assets of the Berkeley Water Company ("Berkeley") sometime in late 2005. As part of the present case, Aqua New Jersey performed an Original Cost Study of the Berkeley assets. As a result of this Original cost study, Aqua identified Berkeley's plant balance to be $12,135,043. However, Aqua then inappropriately added $201,085 in capital transaction costs to this plant balance. Mr. Henkes on behalf of Rate Counsel removed these capitalized transaction costs from the Company's proposed test-year end balance for the Eastern Division. As Mr. Henkes testified during the evidentiary hearings, the Board has never permitted utilities to recover from ratepayers the costs associated with mergers or acquisitions:

> Q. (Juarez) Based on your 31 years of experience working on New Jersey utility cases, are you aware of any instance where the New Jersey Board of Public Utilities ever allowed recovery of transaction costs related to a utility merger?
>
> A. (Henkes) Not one single one.
>
> 123T:L1-6 (7/13/06).

The Board's long history of denying rate recovery for merger transaction costs is perhaps attributable to the fact that shareholders, not ratepayers, are often the main beneficiaries of such transactions, a fact which even Aqua America acknowledges. Indeed, Aqua America touts its "growth-through-acquisition" strategy to current and potential investors, claiming the Company's "aggressive growth-through-acquisition strategy has resulted in more than 100 acquisitions and growth ventures in the last ten years. These growth ventures have allowed [Aqua America] to achieve its growth goals and [sic] has had a favorable impact on its financial performance." *See* http://wtr.client.shareholder.com/, Aqua America's Investor Relations website, dated July 25, 2006 and attached as Exhibit B. This is yet another reason why ratepayers should

not be forced to pay Aqua's transaction costs associated with the Berkeley merger. Rate Counsel urges Your Honor to adopt Mr. Henkes position and deny the Company recovery of these transaction costs.

2. Materials & Supplies and Prepayments

The Company proposed 13 month average balances based on the 12 month period ended September 30, 2005 for the materials and supplies and prepayments components of the rate base. RA-10 at 12. Consistent with his and Rate Counsel's use of the actual test year, Mr. Henkes recommended rate base balances based on the 13 month averages for the test year ending April 30, 2006. The Company accepted Mr. Henkes' adjustments, so this issue appears to not be in dispute. *See* P-44.

3. Unamortized Acquisition Adjustment

The Company requests acquisition adjustments relating to its acquisition of five small water companies, two of which are recent acquisitions of the Berkeley Water Company and Bear Brook Village. Mr. Henkes adopted the Company's unamortized acquisition adjustment that was revised on May 4, 2006 as a result of the Original Cost Study of the Berkeley Water Company. Mr. Henkes on behalf of Rate Counsel took no exception to the Company's proposed ratemaking treatment for the acquisition adjustments associated with these two acquisitions. RA-10 at 13 and Schedule RJH-3 (Updated). Therefore, the issue of the acquisition adjustments is not in dispute between the Company and Rate Counsel.

4. Unamortized Deferred Rate Case Expenses

Consistent with prior Board decisions, Mr. Henkes removed from rate base the Company's claim for $94,762 in unamortized deferred rate case expenses. RA-10 at 14; Schedule RJH-3 (Updated). As Mr. Henkes testified, to his knowledge the Board has never allowed rate base inclusion of these expenses for Aqua or other large New Jersey utilities. RA-10 at 14. The effect of the Company's proposal would not only force ratepayers to pay for the annual amortization of rate case expenses, but would allow the Company to receive a return on the unamortized balance it seeks to put in the rate base. The BPU has consistently denied this proposed rate base treatment, as should Your Honor. Accordingly, Your Honor should deny the Company's claim and recommend exclusion of these expenses from the rate base.

5. Reserve for Depreciation

Mr. Henkes' adjustment regarding the Company's proposed depreciation reserve relates to the timing dispute in this case between Aqua and Rate Counsel. Consistent with Rate Counsel's position that Your Honor should adopt an April 30, 2006 rate base, Mr. Henkes recommends that the depreciation reserve balance be the actual balance at the end of the test year, April 30, 2006. Mr. Henkes' adjustment to the depreciation reserve increases the Company's proposed rate base by $1,897,499. Schedule RJH-3, Line 7 (Updated).

6. Customer Advances ("CA") and Contributions in Aid of Construction ("CIAC")

Aqua proposes to reflect the projected CA and CIAC balances as of October 31, 2006. PT-4-R at 6. Mr. Henkes recommends actual CA and CIAC balances as of April 30, 2006. In his rebuttal testimony, Mr. Packer on behalf of Aqua projects the Company's October 31, 2006 CIAC balance to be the actual balance as of April 30, 2006.

Mr. Packer also recommends a CA balance as of October 31, 2006. Mr. Packer asserts that the projected October 31, 2006 CA balance should be the actual $10,442,924 balance as of April 30, 2006, less an amount of $763,745 projected to be refunded from May 1 to October 31, 2006. PT-4-R at 6. Rate Counsel objects to this proposed treatment. As Mr. Henkes testified, it is unrealistic for Mr. Packer to assume that the Company's CIAC and CA balances will not grow during the 6 month period from May through October 31, 2006. RA-11 at 6. It is even more unrealistic to assume, as Mr. Packer does and proposes, that the CIAC/CA balance will decrease by $763,745. *Id.* For this reason, the Company's proposal should be rejected.

7. Accumulated Deferred Income Taxes ("ADIT")

Mr. Henkes on behalf of Rate Counsel proposes three adjustments to the Company's ADIT balance. First, instead of Aqua's projected October 31, 2006 balance, Mr. Henkes' recommended balance reflects the actual balance as of April 30, 2006. RA-10 at 15. Second, consistent with Mr. Henkes' proposal to remove from rate base the Company's unamortized rate case expenses, Mr. Henkes made a corresponding adjustment of $52,730 to remove the ADIT associated with these expenses from the rate base. *Id.* Third, Mr. Henkes removed $95,580 in prepaid ADIT associated with the merger transaction costs incurred when Consumers Water Company and Philadelphia

Suburban (now Aqua New Jersey) merged. In its Decision and Order approving this merger, the Board ruled that transaction costs associated with the merger should never be charged to the ratepayers of New Jersey. *I/M/O Consumers New Jersey Water Co. and Philadelphia Suburban Corp. For Approval of a Change In Ownership and Control*, at p. 6, BPU Docket No. WM98080706, Order dated 1/14/99. Consistent with the BPU's directive, Mr. Henkes eliminated the merger related ADIT from rate base. It should also be noted that Mr. Packer in his rebuttal testimony accepted the two ADIT adjustments of $52,730 and $85,580 recommended by Mr. Henkes. PT-4-R at 7.

The collective effect of Mr. Henkes' adjustments for ADIT actually increases the Company's rate base by $402,600. Schedule RJH-3, Line 9 (Updated).

8. Customer Deposits

Mr. Henkes' adjustment for customer deposits is once again based on the timing issue. Instead of the Company's projected October 31, 2006 balance, Mr. Henkes recommends Your Honor adopt an actual customer deposit balance as of April 30, 2006. RA-10 at 16. This adjustment decreases the Company's proposed rate base by $81,672. Schedule RJH-3, Line 10 (Updated).

9. Reserve Balances

This adjustment involves reserve balances associated with pension & FAS 106 and tank maintenance. Again a timing difference, Mr. Henkes' adjustment reflects actual reserve balances as of April 30, 2006, the end of the test year, as opposed to Aqua's projected October 31, 2006 balances. RA-10 at 16-17. Mr. Henkes' adjustment actually

increases the Company's rate base by $292,774. Schedule RJH-3, Lines 11-12 (Updated).

Point IV

THE APPROPRIATE PRO FORMA OPERATING INCOME AMOUNTS TO $5,148,624, WHICH IS $484,468 MORE THAN AQUA'S PROPOSED PRO FORMA OPERATING INCOME OF $4,664,156.

Aqua proposes a pro forma operating income for the Company of $4,664,156. Schedule RJH-7, line 18 (Updated). Rate Counsel witness Mr. Henkes recommended numerous adjustments to the Company's operating income. The effect of Rate Counsel's adjustments increases Aqua's proposed pro forma operating income by a total amount of $484,468. *Id.* This brief will discuss each of Mr. Henkes' adjustments.

1. Metered Sales Revenues

Aqua's proposed metered sales revenues were normalized based on normal customer usage levels assumed by the Company, then annualized based on projected number of customers, hydrants, inch-feet, and sprinklers as of October 31, 2006. RA-10 at 17. Consistent with Rate Counsel's recommended actual test year ending April 30, 2006 for the Company's rate base, Rate Counsel witness Mr. Henkes recommended that the Company's metered sales revenues should be annualized based on billing determinants as of April 30, 2006. *Id.* at 18. Mr. Henkes used the same method in calculating the annual metered sales revenues as of April 30, 2006, as used by Aqua to determined projected annualized metered sales revenues as of October 31, 2006. *Id.* The

details of Mr. Henkes' calculations were explained extensively in his direct testimony, RA-10 at 18-21, and won't be repeated here.

As a result of Mr. Henkes' use of the April 30, 2006 test year, he recommends a decrease in Aqua's pro forma operating revenues for metered sales of $290,412. Schedule RJH-7, line 2 (Updated). Rate Counsel respectfully recommends Your Honor adopt Mr. Henkes' adjustment.

2. Public and Private Fire Revenues

Again a timing issue, Mr. Henkes recommends the Company's fire protection revenues be annualized based on the number of hydrants, sprinklers and inch-feet as of April 30, 2006. RA-10 at 21. Mr. Henkes' recommendation lowers the Company's operating revenues by $12,617 for public fire and $14,615 for private fire. Schedule RJH-7, lines 3 and 4.

3. Miscellaneous and Golf Course Revenues

The Company's actual miscellaneous and golf course revenues for the last five years are shown below:

	Miscellaneous	Golf Course
2001	$ 26,878	$ 43,962
2002	38,519	27,850
2003	34,447	14,696
2004	37,428	14,937
2005	38,596	29,234
5-Yr. Avg.	$ 35,000	$ 26,000

As this table illustrates, Aqua's annual miscellaneous and golf course revenues vary significantly for year to year. For this reason, Mr. Henkes recommended that a five year average of these revenues would be most appropriate for ratemaking purposes. RA-10 at 22. During cross-examination at the evidentiary hearings, Mr. Packer on behalf of the Company testified that he has accepted Mr. Henkes' five year averaging for these revenues. 105T:L1-8 (7/13/06). Therefore there appears to be no dispute on this issue between Rate Counsel and the Company. The effect of Mr. Henkes' adjustment increases Aqua's miscellaneous revenues by $19,000 and decreases the golf course revenues by $9,000. Schedule RJH-7, lines 5 and 6 (Updated).

4. Sale for Resale Revenues

Aqua has booked a small amount of sale for resale revenues in the last five years:

	Sale for Resale
2001	$ 8,333
2002	9,326
2003	9,036
2004	6,360
2005	7,168
5-Yr. Avg.	$ 7,500

As illustrated above, Mr. Henkes proposed a five year average as most appropriately reflecting the proper ratemaking treatment for such revenues. Aqua has accepted Rate Counsel's five year average of $7,500, so this issue is no longer disputed between Rate Counsel and the Company. P-44.

5. Antenna Revenues

Antenna revenues represent rent revenues collected by the Company for the use of its utility property as a mounting device for cellular antennas owned by telecommunications companies. For the test year ending April 30, 2006, Aqua's annualized antenna revenues based on the current antenna lease contracts amount to $222,900. Aqua proposes to reflect only approximately half of the revenues for ratemaking purposes, and to retain the other half to benefit stockholders. Rate Counsel asserts that the entirety of the Company's antenna revenues for the test year should be reflected for ratepayers' benefit.

Rate Counsel's position, which is consistent with current Board policy, is based on the fact that cellular antenna revenues can only be realized by the Company by virtue of the existing utility property - the water tanks - upon which the cellular antennas are mounted. The water tanks are included in rate base and the Company's ratepayers pay a return to shareholders for water tanks, as well as the O&M expenses, depreciation expenses and property taxes associated with the operation of the tanks. All of these costs create a revenue requirement, which falls solely on the shoulders of ratepayers. If rent revenues can be realized from these water tanks, these revenues should be used to partly offset this revenue requirement. The Company cannot be allowed to use its regulated property to engage in unregulated activities without providing appropriate compensation to its customers.

Accordingly, Rate Counsel recommends reflecting an additional $113,352 in antenna revenues, which increases the Company's total operating revenues by this same amount. Schedule RJH-7, line 8 (Updated).

6. O&M Contract Revenue Margins

Aqua New Jersey maintains contracts with a number of municipalities and Townships to provide various components of water service on behalf of those municipalities. The proper ratemaking treatment of revenues realized by the Company pursuant to those contract are at issue here. Aqua has failed to reflect the revenues from these contracts for ratemaking purposes in this case. Rate Counsel asserts that, due to the Company's failure to establish a non-regulated subsidiary for these contracts, in violation of their representation of 6 years ago to do so, these revenues must be reflected for ratemaking purposes.

As detailed in Mr. Henkes' testimony, the Company represented six years ago that the Company was in the process of creating the appropriate unregulated subsidiary. RA-10 at 25. By the time of the Company's 2002 base rate case, the Company had still not created this subsidiary. However, in that case, the Company reiterated its intention to form the subsidiary, and in fact represented that it would do so prior to the conclusion of that proceeding. *Id.* Once again, the Company never formed the necessary subsidiary.

Yet, in the present case, the Company has not reflected these contract revenues for ratemaking purposes. Aqua's only justification for this position is that "the Company has not proposed to include these revenues for ratemaking purposes because the Company has also not included the associated expenses for ratemaking purposes." *Id.* at 26 (quoting RAR-A-54(b)). Rate Counsel agrees with the Company that if one reflects the revenues for ratemaking purposes in this case, one should also reflect the associated expenses. *Id.* Mr. Henkes' adjustment reflects both the revenues and associated expenses associated with these contracts, resulting in net margins of $101,352. Schedule

RJH-7, line 9 (Updated). It is clear that, in light of the Company's failure to establish an unregulated subsidiary, and the fact that Rate Counsel's recommendation includes both revenues and expenses associated with these contracts, Your Honor should adopt Rate Counsel's recommended adjustment.

7. Labor Expenses

Mr. Henkes recommends two adjustments to the Company's projected labor expenses: removal of the proposed general inflation factor, which the Board has never given recognition to; and removal of all incentive compensation expenses, also consistent with prior Board decisions.

Mr. Henkes' removal of the Company's proposed general inflation factor is consistent with prior Board action. As Mr. Henkes testified during the evidentiary hearings, "[t]he 1.5 percent general inflation factor is an unspecified general labor or general inflation factor that the Board, as long as I have testified in this jurisdiction, has never…allowed for ratemaking purposes." 120T:L16-20 (7/13/06). Rate Counsel respectfully recommends Your Honor deny Aqua this inflation factor.

Regarding incentive compensation, Mr. Henkes offers several reasons why ratemaking treatment for these expenses should be denied. First, incentive compensation expenses are disallowed for ratemaking purposes under current Board policy. RA-10 at 29. As Mr. Henkes testified, the Board has a long-established position that incentive compensation expenses that are significantly influenced by the achievement of financial performance targets, such as is the case with Aqua's incentive compensation, should not be recovered from ratepayers. *Id.* Citing the fact that incentive compensation was

significantly affected by achievement of financial performance, the Board reaffirmed its position in a recent Middlesex Water Case. *I/M/O Petition of Middlesex Water Company for Approval of an Increase in Its Rates for Water Service and Other Tariff Changes*, BPU Docket No. WR00060362, p. 25, Order dated 6/6/01. As Mr. Henkes testified, the primary beneficiaries of the achievement of earnings targets are shareholders by the resulting increases in their stock values or dividends, and accordingly the shareholders should bear the costs of the incentive compensation program. *Id.* at 30.

Finally, as Mr. Henkes testified, the incentive compensation expense is not known and measurable. *Id.* At this time there is no way of knowing if, and to what extent, the performance goals required to trigger the incentive compensation expense will be met. The history of the Company's incentive compensation program fuels this concern. In Aqua's prior rate case, BPU Docket No. WR03120974, which used a test year ended April 30, 2004, the Company had proposed pro forma incentive compensation expenses of $171,424.[2] However, this Company-proposed projected expense amount turned out to be more than twice as high as the actual expenses of $84,612 in 2004 and were almost double the actual expenses of $94,195 in 2005.

For these reasons, Rate Counsel recommends Your Honor reject for ratemaking purposes the Company's incentive compensation expense.

8. Power and Chemical Expenses

[2] Response to RAR-A-63 in Aqua's prior rate case, BPU Docket No. WR03120974.

The Company has proposed a projected 7.5% rate increase for power and a 15.0% rate increase for chemicals. RA-10 at 31. Mr. Henkes has accepted both of these projected rate increases. *Id.* The difference between Mr. Henkes' and Aqua's power and chemical expenses is solely attributable to timing. Mr. Henkes recommends the power and chemical unit cost rates should be applied the annualized level of million gallons produced based on actual customer levels at April 30, 2006, as opposed to the Company's projected October 31, 2006 date. RA-11 at 7-8. Rate Counsel recommends Your Honor adopt Mr. Henkes' recommendation of $970,593 for power expenses and $360,358 for chemical expenses.

9. Health, Life, LTD, Pension & OPEB Expenses

The Company proposes a level for these expenses for the Pro Forma Year ending April 30, 2007. Once again, by its timing choice, the Company is forced to estimate such expenses, in fact admitting "we have made our best effort to estimate those costs." PT-3 at 7. In contrast, Mr. Henkes on behalf of Rate Counsel has taken the more desirable position that the Board should reflect the Company's proposed annualized expense for the test year ended April 30, 2006. RA-10 at 36-37. Mr. Henkes' recommendation, which Rate Counsel urges Your Honor to adopt, results in an adjustment of $95,631. Schedule RJH-9, line 4 (Updated).

10. Expenses Based on 12+0 Test Year Data

This issue involves various expenses detailed in Mr. Henkes' direct testimony, such as insurance other than health insurance, management/data processing fees,

transportation, sludge removal, supplies, etc. RA-10 at 32. The Company has calculated its proposed pro forma expenses by starting out with projected 5+7 test year expenses and then increasing these 5+7 test year expenses by various inflation factors. Specifically, in order to arrive at its proposed pro forma adjusted O&M expenses for the above O&M expense categories, the Company applied the following inflation factors:

O&M Expense	Inflation Factor
- Insurance	5.0%
- Employee Benefits	3.0%
- Management Fees	7.0%
- Sludge Removal	5.0%
- Supplies	2.0%
- Audit Fees	2.5%
- Lab Expenses	2.0%

As Mr. Henkes testified, other than stating that these inflation factors represent "estimated increases" in these O&M expenses for the Pro Forma Year ended April 30, 2007, the Company has provided no support for these proposed inflation factors. RA-10 at 32. Mr. Henkes has adjusted these expense levels to reflect actual test year expense levels, without applying any inflation factors ending April 30, 2006. *Id.* at 33. As Mr. Henkes testified, these actual expenses levels are more accurate than the Company's projections, which by definition are speculative in nature. *Id.* Moreover, as explained above in the labor expenses section, the Board does not allow ratemaking treatment for unsupported inflation factors.

In their rebuttal testimonies, Aqua has accepted all of Mr. Henkes' adjustments on these expenses with the exception of a $20,681 adjustment for insurance other than health insurance. Schedule RJH-9 (Updated). As Mr. Henkes testified, the refusal to accept Mr. Henkes' adjustment for insurance represents inappropriate cherry picking that should be

rejected by Your Honor. RA-11 at 11. Rate Counsel recommends Your Honor reject this cherry picking and instead adopt Mr. Henkes' adjustments.

11. Outside Services Expenses

Rate Counsel and the Company are in agreement as to the proper ratemaking treatment of these expenses. Both Rate Counsel and the Company agree that Aqua's outside services expenses should be $508,870. Schedule RJH-12 (Updated).

12. Bad Debt Expenses

Rate Counsel and the Company are essentially in agreement as to this expense. Rate Counsel recommends a bad debt expense of $41,922, while the Company actually recommends a lower expense of $41,885. The reason for the slight difference between the recommended and Company-proposed bad debt expense levels is that the recommended and Company-proposed pro forma operating revenues are different.

13. Rate Case Expenses

The Company proposes rate case expenses stemming from this rate case of $195,000, amortized over 2 years. Rate Counsel does not dispute the expense amount or the 2 year amortization. Rate Counsel does assert, however, that Aqua's rate case expenses should be shared 50/50 between shareholders and ratepayers, an approach that is both equitable and consistent with firmly entrenched Board policy.

The theory behind the 50/50 sharing approach is that a utility's primary motivation in filing a rate case lies in adding shareholder value. Given this motivation, it is entirely appropriate that rate case expenses be borne in part by the Company's shareholders. This recommendation is entirely consistent with long-established Board policy. The Board has ruled in numerous rate cases that it is appropriate to have shareholders and ratepayers share the responsibility of the resulting rate case expenses. *See, e.g., I/M/O Pinelands Water Company and Pinelands Wastewater Company*, BPU Docket No. WR00070454 and WR00070455, Order dated 8/1/01; *I/M/O the Petition of Pennsgrove Water Company*, BPU Docket No. WR98030147, Order dated (6/24/99). Indeed, as Mr. Henkes testified, the Board has ruled that rate case expenses should be shared 50/50 in cases involving large utilities, as well as cases involving very small utilities, such as the Seaview Water Company, which had a customer base of 75. 132T:L17 – 133T:L9 (7/13/06). Aqua New Jersey is obviously a much larger company than Seaview, and indeed, its shareholders will no doubt benefit from any rate increase Aqua receives as a result of this case. Given this fact, Aqua's shareholders should be required to pay 50% of the Company's rate case expenses.

14. Interest on Customer Deposits

Mr. Henkes' adjustment for interest on customer deposits is $2,401 higher than Aqua's proposed customer deposit interest amount. Schedule RJH-9, line 20 (Updated). Mr. Henkes' recommended this adjustment in order to synchronize the interest expense with the customer deposit balance recommended by Rate Counsel that results in a deduction from the Company's proposed rate base. RA-10 at 35.

15. Acquisition Adjustment Amortization

Rate Counsel's position reflects Rate Counsel's adoption of the Company's proposed revision to its originally filed acquisition adjustment amortization stemming from the Original Cost Study of the Berkeley Water Company, submitted by Aqua on May 4, 2006. *Id.* at 35-36. In other words, Rate Counsel and the Company do not disagree on this issue. *See* Schedule RJH-9, line 21.

16. Other Operation and Maintenance (O&M) Expenses

These various expenses involve amortized relocation expenses, charitable contribution expenses, fines and penalties, lobbying, community relations, and Rotary and Coastal America Foundation Dues. Rate Counsel and the Company are in agreement as to the proper ratemaking treatment for these expenses. Consistent with the New Jersey Supreme Court's decision that the charitable contributions of a utility cannot be charged to ratepayers, Mr. Henkes disallowed the charitable contribution expenses for ratemaking purposes. *I/M/O Petition of New Jersey American Water Company, Inc., for an Increase in Rates for Water and Sewer Service and Other Tariff Modifications*, 169 *N.J.* 181, 184 (July 25, 2001). The Company conceded during the discovery phase that the fines and penalties expenses should be removed. RAR-A-109. Mr. Henkes also removed expenses for lobbying, community relations, and rotary and Coastal American Foundation dues, as such expenses are entirely unrelated to the provision of safe, adequate and proper service. RA-10 at 37. During the evidentiary hearings, Mr. Packer testified that Aqua agrees with Mr. Henkes' removal of these expenses. 106T:L17-23 (7/13/06). Finally, Rate Counsel

agrees with the $12,000 in relocation expenses noted in Mr. Packer's rebuttal testimony. Schedule RJH-13, fn. 2.

Accordingly, as previously stated, Aqua and Rate Counsel are in agreement as to the proper ratemaking treatment of these various O&M expenses.

17. Depreciation Expense

Mr. Henkes recommends a depreciation expense of $3,479,938, compared to the Company's recommended depreciation expense of $3,731,715. Schedule RJH-4 (Updated); P-40. This difference is attributable to the fact that Mr. Henkes used the actual plant in service balances as of April 30, 2006. RA-10 at 38. The Company, instead, used a plant balance projected to October 31, 2006. Rate Counsel recommends Your Honor adopt Mr. Henkes' recommended depreciation expense.

18. Revenue Taxes

Mr. Henkes recommends revenue taxes for Aqua of $2,971,979, which is $42,224 lower than Aqua's proposed revenue taxes of $3,014,203. Schedule RJH-7, line 13 (Updated). The revenue tax difference is due to the fact that Mr. Henkes' recommended revenue subject to revenue tax are lower than the Company's proposed revenues subject to revenue tax. Rate Counsel recommends Your Honor adopt Mr. Henkes' recommended revenue taxes.

19. Income Taxes

Rate Counsel's position and Aqua's position on the Company's federal income taxes differ to two aspects: (1) the "flow-through" effect of the recommended adjustments made by Mr. Henkes in the areas of operating revenues, operating expenses and pro forma interest; and (2) Mr. Henkes' recommended use of a 34% federal income tax rate rather than the 35% rate proposed by the Company. RA-10 at 39.

Aqua's taxable income for ratemaking purposes in this case is approximately $3.4 million under Aqua's position, and about $4.1 million under Rate Counsel's position. Schedule RJH-14 (Updated). The Internal Revenue Code provides that the first $10 million of taxable income is taxed at a rate of 34%. Company witness Mr. Schreyer confirmed this fact at the evidentiary hearings. 52T:L17 – 53T:L2 (7/13/06). This is one reason why Rate Counsel recommends Your Honor adopt a 34% income tax rate for Aqua New Jersey.

Yet, in this case the Company is using a 35% FIT rate rather than the 34% FIT rate required by the IRS based on Aqua's stand-alone taxable income numbers in this case. The only reason why the Company is using a federal income tax rate of 35% in this case is because it participates in the consolidated income tax filing of its parent company, Philadelphia Suburban Company (PSC).[3] This is because the consolidated PSC operations have taxable income in excess of $10 million, thereby triggering a 35% income tax rate for all companies that participate in the consolidated tax filing. RA-10 at 39-40. Unfortunately for Aqua New Jersey's ratepayers, the Company's proposed use of a 35% tax rate increase the Company's revenue requirement in this case. Rate Counsel asserts that PSC's consolidated income tax filing benefits the Company and should be used by the Company to offset the increased revenue requirement that Aqua is attempting

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[3] See response to RAR-A-113.

to pass on to its customers. Mr. Henkes testified to this very point during the evidentiary hearings:

> (Henkes) It is true that Aqua New Jersey has to take part in the consolidated income tax filing. It is true that when [PSC] makes its consolidated filing that the incremental tax bracket in the determination of the consolidated income tax is, indeed, 35 percent. But what the company fails to mention is the [sic] effect of[4] tax rate after they take into account all of the loss companies and the losses that are incurred by the parent company, the effective tax rate is much less than 35 percent or 34 percent.
> I have never seen a consolidated tax filing where the effective tax rate is equal to or more than the statutory tax rate. It's always less because you have losses. Losses that are incurred by the parent company; losses that are incurred by nonregulated subsidiary company. And those losses reduce the income taxes that the consolidated entity pays; and therefore, the effective tax rate is much less than 35 or 34 percent. And the company doesn't want to reflect this effective tax rate in this case.
>
> 121T:L19 – 122T:L13 (7/13/06).

The Company's position forces ratepayers to pay the 35% tax rate of the consolidated tax filing, while attempting to retain the benefits of that consolidated filing for shareholders. Rate Counsel asserts this position is inequitable and should be rejected by Your Honor and the Board. Your Honor should adopt the 34% federal income tax rate which is the proper statutory income tax rate to be paid by Aqua New Jersey on a stand-alone basis.

20. Revenue Conversion Factor

Rate Counsel recommends Your Honor adopt Mr. Henkes' revenue conversion factor of 1.76423, instead of the Company's factor of 1.79138. Schedule RJH-1, line 6

[4] Should be "effective."

(Updated). This difference is attributable to Rate Counsel's recommended 34% federal income tax rate, rather than Aqua's 35% rate.

Point V

YOUR HONOR AND THE BOARD SHOULD ADOPT RATE COUNSEL'S RECOMMENDED RATE DESIGN WHICH WOULD CONSOLIDATE THE COMPANY'S GENERAL METERED SERVICE RATE SCHEDULES, MOVE TOWARD THE CONSOLIDATION OF AQUA'S PUBLIC AND PRIVATE FIRE PROTECTIONS SERVICE RATE SCHEDULES AND EXCLUDE THE PROPOSED LOW INCOME PROGRAM

The ultimate purpose of a base rate case is for the Board to adopt a set of tariffs which are designed to recover the revenue requirement set by the Board. In furtherance of this goal, the Company proposes to recover 100% of its requested increase from its General Metered Service ("GMS") customers, i.e., no increase would be applied to the Company's public and private fire protection rates. (RA-2, at p.3) It is Rate Counsel's position that, absent a cost of service study, it is inequitable and without justification to assign a disproportionate rate increase to Aqua's GMS rate class.

As is detailed below, it is Rate Counsel's recommendation, based upon the existing rate structure, that Your Honor and the Board should order Aqua:

- to implement Rate Counsel's recommended class revenue distribution, which provides for an overall increase in total revenues of $476,501 (see attached schedules BK-1 through 3)[5]

- to adopt Rate Counsel's recommended rate design, which would consolidate the Company's General Metered Service rate schedules, and move toward the consolidation of Aqua's Public and Private Fire Protection Service rate schedules; and

[5] The total increase shown in Schedule BK-1 includes $14.00 of rounding and therefore is $476,487.

- to order the parties to pursue an appropriate method to develop a low-income assistance program for Aqua's customers, on a pilot basis, after the conclusion of this proceeding.

A. Company Rate Structure

Currently, the Company's primary rate classes consist of GMS, Public Fire Protection Service and Private Fire Protection Service. Such service classes are served via separate rate schedules. In addition, Aqua provides Sale for Resale ("Resale") and Non-Treated and Non-Potable Metered Service ("Non-Potable") to a limited number of customers.[6] In general, the Company's metered service rates consist of a fixed service charge, which varies by meter size, and a flat rate consumption charge. Aqua's fire protection rate schedules consist of fixed rates that are applicable to hydrants and sprinkler connections. **(RA-2, p.2)**

The Company's current GMS and fire protection charges vary by r**ate area.** The Company's tariff identifies separate Northern, Central, Southern and Berkeley Township ("Eastern") divisions.[7] In the case of GMS service, the Northern, Central and Southern division rates have been previously consolidated on Rate Schedule No. 1, with the Eastern division being served via a separate rate schedule.[8] Private fire protection rates for the Non-Eastern rate areas have also been previously consolidated on Rate Schedule No. 2. Public fire protection service for the Northern, Central and Southern divisions is

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[6] Resale service is provided via Rate Schedule No.6, and Non-Potable water service is provided to a single customer (i.e., Lopatcong Township Golf Course) via Rate Schedule No. 7.

[7] The Company maintains separate rates for former Bear Brook Village customers, which would not be adjusted in this proceeding.

[8] Accordingly, Rate Counsel will use the terms "Eastern" and "Non-Eastern" to distinguish between the Company's existing rate schedules, where appropriate.

provided via two (2) tariff sheets, i.e., Rate Schedule Nos. 3 and 4. **A** separate and distinct rate exists for both public and private fire service within the Eastern rate area. **(RA-2, p.3)**

B. Allocating a Revenue Adjustment Among the Rate Classes

There is no basis to allocate any utility revenue adjustment other than in an "across the board" manner without a current cost of service study. It is therefore Rate Counsel's recommendation that any revenue adjustment awarded to the Company in this proceeding be recovered via an across-the-board increase to both the Company's aggregate GMS and fire protection service rate classes. The apportionment of the proposed revenue adjustment in this proceeding to individual class revenue levels should be adjusted as calculated by Rate Counsel witness, Brian Kalcic. (RA-2 and schedule BK-1)

Rate Counsel is recommending an overall revenue increase of $476,501 or 2.17%, per line 18 of Schedule BK-1. This equates to an overall increase in sales revenue of 2.21% (per line 12). In the absence of cost-of-service information, a system average increase of 2.21% was assigned to the Company's GMS (line 3), Public Fire Protection (line 8) and Private Fire Protection (line 11) rate classes. (RA-2, p.5) The relative GMS increases shown on lines 1 and 2 of Schedule BK-1 were determined by consolidating (i.e., combining) the rate schedules applicable to the Company's Eastern and Non-Eastern GMS customers, while holding the overall GMS increase at 2.21%. This rate consolidation produces the differential rate increases shown on lines 1 and 2 of Schedule BK-1. (RA-2, p. 5)

Rate Counsel's recommended public fire service rate design would move the public fire charges contained in Rate Schedule Nos. 3 and 4 closer together, while maintaining the overall Public Fire Protection increase at 2.20%. (RA-2, p.5 and Schedules BK-1 and BK-2). The movement toward consolidation produces the small differences in the percentage increases reflected on lines 4-6 of Schedule BK-1.
No rate increase was assigned to public fire charges in the Company's Eastern rate area since the existing Eastern hydrant charge is significantly above those shown in Rate Schedule Nos. 3 and 4.

Current Private Fire Protection charges in the Company's Eastern rate area are significantly below those shown in Rate Schedule No. 2. In order to begin the process of consolidating the Company's Eastern and Non-Eastern private fire charges, our recommended rate design eliminates approximately one-sixth of the current difference in such charges, while maintaining the overall Private Fire Protection increase at 2.21%. As a result, the Eastern rate area would receive a private fire increase of 12.27%. (RA-2, p.6, and Schedule BK-1)

Rate Counsel is not recommending any changes to the Company's Miscellaneous Service charges or Miscellaneous revenues. (RA-2, p.7) Rate Counsel recommends a small change to the Company's Resale charges contained in Rate Schedule No. 6**.** Thus, Rate Schedule No. 6 is identical to Aqua's Rate Schedule No.1, except for a 1¢ (per thousand gallon) difference in the consumption charge.[9] Accordingly, the charges contained in Rate Schedule No. 6 will move "in step" with those on Rate Schedule No. 1.[10] Rate Counsel is not recommending any changes to the Company's Non-Potable

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[9] Resale customers are exempt from the existing water tax of $0.01 per 1,000 gallons.
[10] See line 13 of Schedule BK-1 for the resulting increase to Resale customers.

water service charges contained in Rate Schedule No. 7. There are limited revenues associated with Rate Schedule No. 7, such that any increase in such charges would not have a measurable impact on Aqua's remaining customers. (RA-2, p.8) Moreover, since the service pertains to non-potable water we concur with the Company that Rate Schedule No. 7 charges should not be adjusted in this proceeding.

Pursuant to our summary of the recommended General Metered Service rates, Schedule BK-3 compares present rates with Rate Counsel's recommended GMS charges. As shown in column 2 of Schedule BK-3, the Company's Eastern rate area would be consolidated with the Non-Eastern rate area under our recommended rate design. This consolidation necessitates that the Company's GMS fixed charges and consumption charges be assigned non-uniform percentage increases, as shown in column 4 of Schedule BK-3.

C. **<u>The Proposed Senior Program should be disallowed</u>**

Aqua is proposing to provide all seniors who qualify under the State of New Jersey's Pharmaceutical Assistance for the Aged and Disabled ("PAAD") program with a quarterly allowance of 6,000 gallons of water at no charge. Additional consumption in excess of the allowance would be considered discretionary and billed at the normal tariff rate. The Company determined the level of its proposed water allowance by estimating a senior citizen household's basic water needs per quarter.[11]

As filed, the Company assumed that 3,000 senior citizens would qualify and participate in the program. With a quarterly allowance of 6,000 gallons, these 3,000

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[11] See Aqua Statement PT-1 at 9.

customers would receive an aggregate discount of $278,105 per year at the Company's proposed consumption rate.[12] **T**he Company is proposing to recover th**e** projected $278,105 is revenue shortfall via the consumption charges paid by its remaining customers. In other words, the $278,105 cost is recovered in Aqua's proposed rate design.

Pursuant to Aqua's proposal, even if fewer than 3,000 senior citizens choose to participate in the program or, equivalently, that it takes some number of years to "ramp up" participation to 3,000 customers, the Company would still recover an amount equal to 100% of the projected discounts, each year, from its remaining customers, even though the actual annual cost of the senior discounts was less than projected.

Furthermore, the Company has no basis for its projected total of 3,000 customers enrolling in the Senior Program. In response to discovery, Aqua stated:

"[T]he Company has not performed any studies with respect to the number of eligible customers or the quantum of a quarterly allowance. Instead, these figures were proposals made by the Company in an effort to begin a dialogue with the Board, its Staff and the Rate Counsel on the issue of initiating an appropriate low-income customer assistance program. (RA-2, p.10)

It is Rate Counsel's position that Your Honor and the Board should **not** adopt the Company's proposed Senior Program at this time**.** The Company admits that its proposal was simply offered in an effort to begin a dialogue on low-income issues with interested parties. The Company presents no analysis in support of its proposed 6,000-gallon water allowance, or its projected 3,000 participants.

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[12] Multiplying 6,000 gallons, times 4 quarters, times 3,000 customers, times $3.86257 per 1,000 gallons results in a total Senior Program discount of $278,105.04.

Moreover, while the Company's proposal would attempt to address the needs of low-income senior citizens, Aqua has offered no explanation as to why the program should be limited to senior citizens at this time. In other words, why begin with senior citizens? Should other low-income populations be targeted first? Until such questions are answered, we do not believe that it would be prudent to go forward with any specific low-income program at the conclusion of this case.

Aqua also failed to perform the preliminary tasks ordered in its last base rate case (i.e., BPU Docket No. WR03120974) regarding development of a pilot low-income program, which could be implemented between base rate cases with appropriate deferred accounting of program costs. The pilot program was to be presented to the Board for approval during the course of the Company's next (i.e., this) base rate proceeding. Unfortunately, the pilot was not developed and therefore no actual data was collected. Nevertheless, Rate Counsel is willing to participate in such an endeavor after the conclusion of this proceeding.

Conclusion

For all of the foregoing reasons, Rate Counsel respectfully requests that an Initial Decision be rendered recommending the Board find and conclude that:

1) Aqua's actual capital structure as of April 30, 2006, including short-term debt, is the appropriate capital structure for Aqua.
2) The appropriate return on equity for Aqua New Jersey is 9.50%.
3) The appropriate revenue requirement increase for Aqua is $476,501.
4) Aqua's rate base should be set based on Aqua's test year ending April 30, 2006.

5) The sharing of rate case costs as recommended by Rate Counsel should be adopted.

6) All operating income issues, as set forth herein should be adopted.

7) All tax adjustments as set forth herein should be adopted.

8) The rate design recommended by Rate Counsel, which would consolidate the Company's general metered service rate schedules, move toward consolidation of Aqua's public and private fire protections service rate schedules, and exclude the proposed low income program, should be adopted.

Respectfully Submitted,

RONALD K. CHEN, ESQ.
PUBLIC ADVOCATE

By: ______________________________
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