

Commission. [Tr. 419-21.] IAWC conducts a thorough inspection of each hydrant in the Pekin system annually. IAWC also conducts regular inspections of its well pumps. If there were a problem with gravel in the mains for the past decade, it would have been evident in these inspections. [IAWC Ex. 4.0R, pp. 4-5.] Like Pekin's other allegations, the "gravel problem" exists only for purposes of Pekin's testimony in this case.

With respect to all of the City's claims regarding Illinois-American's service and capital planning, it is important to note that (i) the City does not have any written documentation that the purported concerns exist (no memorandum, letter, note, report or other written material); and (ii) the City's representatives who, for purposes of their testimony purport to have so many concerns, have never submitted even one complaint to the Commission regarding Illinois-American's capital planning or service. [IAWC Ex. 2.0R, p.10.] What these officials have done is go on record in other forums recognizing Illinois-American's consistent record of satisfactory service. [IAWC Exs. 5.0, pp. 3, 12-13; 5.1, 5.7, 5.8; Tr. 173-74, 199.] For all of these reasons, the argument raised in Pekin's BOE (pp. 10-12) and its replacement findings (Pekin Exc., p. 38) are not supported by the record and should be rejected.

**4. The Proposed Order does not ignore evidence regarding alleged benefits of local control.**

Contrary to the representation in Pekin's BOE (p. 13), the Proposed Order does not ignore Pekin's evidence regarding perceived benefits of local control. Rather, the Proposed Order (p. 6) makes express reference to this evidence, and concludes (p. 41) that Pekin's position should be rejected for "the reasons given by Illinois-American." Those reasons are set forth by the Proposed Order in detail. [Proposed Order, pp. 14-15.] Thus, Pekin's suggestion that evidence was ignored is incorrect.

Furthermore, the Proposed Order's decision to reject Pekin's position is fully supported by the record.

The referenced "evidence" is testimony provided by City Manager Hierstein, who had previously admitted that he was entirely "satisfied" with the level of communication and coordination received from Illinois-American; that the City "greatly appreciated" the cooperation the City received from Illinois-American; and that coordination between the City and the Company had "greatly improved over the past years." [IAWC Exs. 4.11, 5.1, 5.2, 5.3.] The record provides numerous unrefuted examples of cooperation and coordination by and with Illinois-American, including, for example, the Company's participation in monthly utility coordination meetings conducted by the City; daily e-mails of the Company's work schedule to the City engineer; sharing and receiving input from the City in the preparation of the Company's annual capital improvement plan; and coordination of projects with the City's five-year street plan. [IAWC Ex. 4.00, pp. 9-11.] As explained by IAWC witness Randy West, the Operations Superintendent for IAWC's Pekin District, IAWC makes every effort to schedule capital projects around the City's plan for street repairs. [IAWC Ex. 4.00, p. 9.] Mr. West also described examples of Illinois-American's efforts in this regard. [Id., pp. 10-11.]

Pekin also criticized Illinois-American for lack of cooperation in adding new customers to the system. According to Pekin (BOE, p. 13), IAWC's "explanation" for the alleged "lack of cooperation" is that, "its customers would rather save on their water bills than share the cost of extending water mains that would promote increased growth and jobs in their community." According to Pekin (BOE, p. 14), IAWC made this

“determination privately, without any scrutiny by this Commission . . . “ These statements are, of course, patent misrepresentations.

Pekin’s criticism relates to the fact that Illinois-American was required under the Commission’s Main Extension Deposit Rules (“Rules”), to seek a variance authorizing the agreed arrangement with the City for the Hanna Steel project. [Pekin Ex. 1.0, p. 9.] In extending water mains, Illinois-American applies the Rules, which ensure that existing customers are not required to unfairly subsidize a main extension for a new applicant by paying water rates that reflect a disproportionate cost of constructing the extension. [IAWC Exs. 11.0R, p. 10-12; 2.0 pp. 15-17.] The Rules are incorporated into the Company’s tariffs filed with the Commission. [IAWC Exs. 2.0, p. 15; Ex. 2.5.] Any variance to the Rules must be approved by the Commission. [IAWC Ex. 2.0, p. 15.] Under the Rules, applicants requesting that water mains be extended to serve their property are responsible for providing a deposit to fund the extensions, subject to certain credit and refund requirements set forth in the Rules. [Id.] By requiring a developer to fund the costs associated with an extension of service, the developer must commit to the project. [IAWC Ex. 2.0, p. 17.] The Rules do not discriminate against any applicant for an extension, and the deposit requirements for main extensions do not differ based on the location of a development relative to the City limits or the willingness of the developer to annex to the City. [IAWC Exs. 2.0, pp. 15-17; 11.0R, p. 13.] Under the Rules, the revenue generated by existing customers does not unduly subsidize an extension of service. [Id.]

In appropriate circumstances, Illinois-American can request a variance from the Commission to cooperate with developers and the City in supporting development. An

example would be the very Hanna Steel development about which Pekin complains. [IAWC Ex. 4.0, pp. 12-13, 15.] In 1998, the City obtained a grant for the construction of a water main extension to the Hanna Steel property, but the grant required the City to own the extension for five years. [Id.] Although such ownership by the City is contrary to the Rules, IAWC sought and expeditiously obtained a variance from the Commission to allow the City to maintain ownership of the main extension for the five year period required by the grant. [Id.; IAWC Ex. 11.0R, p. 10.] In this manner, IAWC was able to cooperate with the City and aid in development without placing the burden for the development on current customers through increased rates. [IAWC Ex. 4.0, p. 13.] Thus, the record shows that the Hanna City project is an example of a creative cooperation, and not an indication of a problem.

As noted above, Pekin in its BOE (p. 14) characterizes the Hanna Steel situation as one in which IAWC determined “privately” and “without any scrutiny by the Commission” that customers should save on their water bills rather than subsidize the cost of extending service to Hanna Steel. IAWC acknowledges that, in accordance with the Rules, it attempts to avoid the undue subsidization by customers of service to new customers. This, however, is not a policy that was determined “privately” and is certainly not applied without “scrutiny by the Commission.” In applying this policy, IAWC follows the Rules mandated by the Commission. When it seeks a variance, IAWC files a Petition with the Clerk of the Commission. Pekin’s characterization of this situation says much about its lack of credibility and lack of willingness to recognize or act in the greater public interest.

In its suggested replacement findings (Pekin Exc., p. 38), Pekin refers to “overwhelming” voter approval of the proposed condemnation. Pekin, however, again prefers to ignore the actual facts. The claim of “overwhelming” public support is based on the results of a 2002 referendum initiated by the City shortly after IAWC filed for Commission approval of a sale of stock of its parent company, American, to RWE. [Hierstein Aff. to Pet., ¶¶ 27-31; Pekin Ex. 1.0, p. 8.] However, when the circumstances surrounding the referendum are examined closely, it is clear that the City’s claim of overwhelming support is without merit.

Shortly after the City’s Water Study Task Force Report was issued in 1999, IAWC initiated an advisory referendum to ensure the City did not proceed with a forced acquisition of IAWC without first obtaining direct voter input. [IAWC Ex. 5.0, p. 9.] The 2000 referendum asked voters the following straight-forward question:

Shall the City of Pekin, Illinois, purchase the facilities and business of Illinois-American Water Company which serve the Pekin area?

[IAWC Ex. 5.0, p. 10; Ex. 5.5.] Despite a vigorous campaign waged by the City in support of acquisition, 54% of those voting in the referendum voted against acquisition of the water system. [Id.]

In March 2002, triggered not by service issues or complaints (indeed, there have never been any complaints submitted by the City to the Commission), but by announcement of the sale of American’s stock, IAWC’s parent company, to RWE, the City again placed the acquisition issue before the voters in an advisory referendum. [Pekin Ex. 1.0, p. 8.] As noted above, in Docket 01-0832, the Commission approved the RWE transaction and found that “customers will benefit”. [IAWC Ex. 1.0 p. 5].

However, rather than placing a straightforward referendum on the ballot (comparable to the 2000 referendum), the City worded the referendum as follows:

Given the proposed sale of our local water company to a large, foreign corporation, should the city council take the necessary steps, including eminent domain, to obtain the water company, in order to preserve American ownership and obtain local control?

[IAWC Ex. 5.0, p. 14; Ex. 5.9.]

The result of the 2002 referendum was a 61% vote in favor of preserving “American” ownership. [Pekin Ex. 1.0, p. 8.] Of course, the results of the referendum in no way represent the opinions of the significant number of Pekin District customers who reside outside the City limits. [IAWC Ex. 5.0, p. 9.] The referendum results also are not reliable as a true gauge of the views of the City residents. The referendum language was misleading and confusing to voters in two respects. First, the language refers to the “sale” of the “local” water company. The RWE transaction was not a “sale” of IAWC, and certainly not a sale of a Pekin “local” water company, but instead involved a transfer of the stock of American to RWE. Also, the language of the referendum asks the voters if they want to preserve “American” ownership of the system, which, as demonstrated by a voter survey conducted by IAWC, could have easily been read by voters to refer to a retention of ownership by “American” Water, which continues to own Illinois-American, just as it did before and after both the referendum and the RWE transaction. [IAWC Exs. 5.0, p. 15; Ex. 5.10; 11.0R, p. 12.] In response to a survey question, one confused voter wrote as follows:

We were very dissatisfied with the vote “yes” for Pekin to buy Water Co. My wife and I felt the question on the voting ballot was very confusing and we both had to reread to insure our vote of “no” buyout.

[IAWC Ex. 5.0, pp. 14-15; 5.10.] The confusing nature of the referendum's wording in the context of a company owned by "American" is patent. For this reason, the referendum's result is not determinative.

For all of the reasons given, Pekin's arguments (BOE, pp. 13-14) and its suggested replacement findings (p. 38) should be rejected.

**5. The Proposed Order does not ignore Pekin's evidence regarding supposed "financial advantages of municipal ownership."**

Pekin also argues (BOE, p. 14) that the Proposed Order ignores its evidence regarding "financial advantages" for municipal ownership. This assertion is also false, as a review of page 6 of the Proposed Order demonstrates. As with Pekin's "lack of cooperation argument," the "financial advantages" argument also is rejected by the Proposed Order (p. 41) "[f]or the reasons given by Illinois-American." The evidence supposedly "ignored" is discussed at length by the Proposed Order, at pages 19-29.

On this issue, Pekin's proposed replacement findings (Pekin Exc., p. 38) have absolutely no basis in the evidentiary record. The City (BOE, pp. 14-15; Pekin Exc., p. 38) points to certain costs, such as income taxes, which, as it notes, would not be incurred if the City were to acquire ownership. The City admits, however, that the alleged cost savings are contingent upon the acquisition price. [Tr. 791.] In addition, the City completely ignores the advantages of the mass-purchasing programs and economies of scale provided by the American system which would disappear under City ownership (IAWC Ex. 2.0R, p. 18; 2.3R); and its failure to undertake the actions necessary to create a legitimate plan which would establish what the true operating costs would be under City ownership.

In support of this approach, the City suggests (Pekin Exc., p. 38) in replacement findings that there is “no evidence” that the savings from economies of scale would “outweigh” the cost reduction resulting from municipal ownership. This, however, is just not true. To quantify the revenue requirement effect that would result from City ownership, Illinois-American submitted in evidence a rate analysis that modified Pekin’s data to more accurately reflect both the acquisition price for the system and the increased costs that the Pekin District would incur from elimination of access to American Water system efficiencies. [IAWC Ex. 2.0R, pp. 17-18.]

Although Pekin may prefer to believe there was “no evidence,” as it suggests in its Exceptions (p. 38), the record is, in fact, very telling. As the record shows, under continued IAWC ownership based on Pekin’s model, the expected cumulative rate increase over the next ten years would be approximately 6.08% or an average increase of only about .6% annually. [IAWC Ex. 2.0R, p. 18 and 2.3R.] However, under Pekin ownership, the ten year cumulative rate increase is a dramatic 104.74%, or an annual average increase of about 10.48%. [Id., 2.2R.] The rate analysis submitted by Illinois-American unquestionably demonstrates that Pekin’s claim of a five year rate freeze after City ownership is utterly unattainable. As Mr. Gloriod explained, such a freeze on rates could only happen with a deferral of essential spending for both maintenance and capital programs. As a result of the deferral of programs, the condition of the water system would quickly deteriorate, as has occurred for many years for the City’s wastewater operation. [IAWC Ex. 1.0, p. 11.] Illinois-American witness, Ms. Ciccone, describes the significant deterioration and problems that have resulted

from Pekin's improper operation of the wastewater system. [IAWC Exs. 8.0, pp. 3-22; 8.0R.]

As Pekin acknowledges, its assumed purchase price for the system is the key to its assumption regarding cost savings. [Tr. 778; IAWC Ex. 7.1.] Yet, the City concedes that the valuation analysis it offers in support of its claims was performed by a consultant who is not a certified appraiser in the state of Illinois or any other state, who holds no appraisal designations from any appraisal certifying association, and who made no attempt whatsoever to follow generally accepted appraisal standards in performing her analysis. [Tr. 441-47.] Not surprisingly, the City's consultant selected a methodology that improperly equates the water system's value and net original cost, a methodology which she admits has not been accepted as valid in Illinois or anywhere else over the past ten years. [IAWC Exs. 2.0, p. 8; 10.0, pp. 19-20, 26; Tr. 514.]

In contrast to the obviously unqualified and unsupported opinions of the City's consultant, Illinois-American presented the testimony of Robert Reilly, a state-certified general appraiser in Illinois, who has qualified as an expert witness on valuation on numerous occasions and who has significant experience in all forms of business valuation. Mr. Reilly's analysis, which began with a detailed engineering analysis of the observed depreciation of all tangible assets in the system, included a comprehensive consideration of all three approaches to valuation consistent with generally accepted appraisal standards. Mr. Reilly concluded that the value of the Pekin District system would be no less than \$60.3 million. In contrast to the detailed analysis performed by Mr. Reilly, the City's valuation consultant admitted both that she did not perform a market-approach analysis, and that she disregarded the Reproduction Cost New Less

Depreciation (“RCNLD”) method of calculating value under the cost approach because it was simply “too complex.” [IAWC Ex. 10, p. 21; Tr. 482-83.]

In its BOE (p. 16), Pekin criticizes Illinois-American’s assumption that, as many courts have held, public utility property constitutes “special use property” for valuation purposes. This issue is thoroughly addressed in Illinois-American’s Initial Brief (pp. 60-62).

Illinois-American has submitted evidence demonstrating that the Pekin water system qualifies as special use property under Illinois law. [IAWC Exs. 10, p. 6; 10R, pp. 6-7.] Clearly, the Pekin system is devoted to the special purpose of supplying fire protection and potable water to the public, and the market for such a water system is limited in nature. While there are no Illinois eminent domain cases involving valuation of utilities, other jurisdictions have consistently held that utility property is special use property. See e.g., Massachusetts-American Water Co. v. Grafton Water District, 631 N.E.2d 59, 61 (Mass. Ct. App. 1994) (noting that a public utility is considered a special purpose and holding that, when the property taken by eminent domain is a special purpose property, the accepted way to determine fair market value is reproduction cost less depreciation); Township of Manchester Dep’t of Utilities v. Even Ray Co., Inc., 716 A.2d 1188 (N.J. Super. Ct. App. Div. 1998) (holding that sewer lines were special use property); Moon Township Municipal Authority Condemnation, 4 Pa. D. & C.3d 421 (1978) (finding that water authority’s treatment facility was unique so as to justify use of the replacement cost approach in lieu of the fair market value approach in valuing the water treatment facility condemned by the State of Pennsylvania). Because the Pekin

system is special use property, under Illinois law, RCNLD is the appropriate method to determine the value of the property in an eminent domain action.

Pekin (BOE, p. 16) also points out that the RCNLD methodology is not used internally by IAWC's parent in evaluating an acquisition opportunity. Pekin fails to note, however, that this point is meaningless. In assessing an investment opportunity, an investor, such as Illinois-American's parent, conducts a "feasibility analysis," it does not conduct a "fair market value" analysis of the type addressed by Mr. Reilly. A feasibility analysis is defined as an analysis undertaken to investigate whether a project will fulfill the objectives of the investor. The profitability of the specific project is thus analyzed in terms of the criteria of the specific investor. Appraisal of Real Estate, 12th Ed., p. 283 (Appraisal Institute, 2001). This approach contrasts with the constitutionally required fair market value analysis which, as Mr. Reilly explains, "estimates the price at which ownership of a property or system would transfer between a willing, well informed, and rational hypothetical buyer and willing, well informed and rational seller." [IAWC Ex. 10R, p. 9.] In a fair market value analysis, the characteristics of a specific investor are irrelevant. [IAWC Ex. 10.0R, pp. 9-10.] For these reasons, the arguments set forth in Pekin's BOE (pp. 14-17) and its replacement findings (p. 38) should be rejected.

**6. The Proposed Order properly considers Pekin's history of chronic environmental violations in operating its wastewater system.**

In its BOE (pp. 18-20) and Exceptions (Pekin Exc., pp. 38-39), Pekin suggests findings that downplay the evidence regarding significant deficiencies of the City's wastewater system. Pekin, however, cannot seriously hope to avoid the impact of this evidence. It was Pekin's own witness, Mr. Kief, who claimed in its direct testimony that, "the City's track record in dealing with the Wastewater Treatment System is a solid

basis upon which [he could] see nothing but positives for the public and the customers of the Pekin system, if the City acquires [the water system]." [Pekin Ex. 2.0, p. 12.]

In light of the actual history and condition of the wastewater system, the City's reference to it as being the "solid basis" for acquisition of the water system is nothing short of remarkable. An examination of the wastewater system reveals widespread problems and a history of chronic noncompliance with the requirements and directives of the Illinois Environmental Protection Agency ("IEPA"). These problems range from an inability to properly treat wastewater before dumping it into the river (or, for that matter, to provide any treatment at all), to inadequately addressing the issue of a suspected sewer overflow that the IEPA first brought to the City's attention almost ten years ago. The City's problems with its wastewater system raise significant doubt about the City's ability to properly operate the Pekin District water system. Second, the fact that the City would willingly point to its operation of the wastewater system in its testimony in this matter indicates that the City is either wholly ignorant of the magnitude of problems facing the wastewater system or finds such problems acceptable.

The City's problems with its wastewater system were addressed by IAWC's expert witness, Yvonne Ciccone. The City either could not or chose not to address these problems at the hearing, as the City waived its right to cross-examine Ms. Ciccone. In her direct testimony (IAWC Ex. 8.0), Ms. Ciccone discussed in great detail the operational breakdowns within wastewater treatment plant 1 ("WTP 1"), suspected squandering of funds by the premature shut down of treatment plant 2 ("WTP 2"), and the City's chronic and ongoing general inability to comply with all applicable IEPA regulations. While each of these problems directly hinders the ability of

the wastewater treatment system to adequately collect and treat wastewater, one of the more disturbing issues that was uncovered by Ms. Ciccone is the City's continued inability or unwillingness to locate a suspected sanitary sewer overflow ("SSO") identified years ago by IEPA.

This SSO could potentially be dumping thousands of gallons of raw sewage directly into the river. [IAWC Ex. 8.0R, p. 6.] Unfortunately, this is not a recent problem, as the IEPA has repeatedly warned the City about this problem for almost ten years. In 1996, the IEPA issued a report to the City stating that the SSO has been suspected "for the past few years." [IAWC Ex. 8.0, p. 20; IAWC Ex. 8.0R, p. 6.] In 1998, yet another report was issued by the IEPA stating that "it was apparent that sewage was being lost from somewhere along the interceptor." [IAWC Ex. 8.0, p. 20; IAWC Ex. 8.0R, p. 6.] The City's failure to locate and eliminate this SSO is even listed as a deficiency on the IEPA's CEI O&M report of 1998. [IAWC Ex. 8.0, p. 20; IAWC Ex. 8.0R, p. 6.] Despite this high level of concern on behalf of the IEPA, the City has never taken the necessary steps to determine the location of the SSO. The City is purportedly attempting to find a company to find and fix the SSO, but, even with the passage of ten years, it still had not occurred as of the hearing. [Pekin Ex. 6.0, p. 5; Tr. 278.]

The City's unwillingness to aggressively pursue and locate the SSO is indicative of the low standards to which the City holds its wastewater system. Mr. Kief made it clear that the City is concerned with certain environmental issues only if those issues are the direct cause of an excursion to the plant's NPDES permit. [Pekin Exs. 2.0, p. 9; 6.0, p.5; Tr. 293-94.] But even then the City does not strive for full compliance. For example, Mr. Kief stated at trial that he would be happy with four or five excursions at

the wastewater treatment plant each year. [Tr. 307.] When questioned about the numerous wastewater system excursions during the last three years, Mr. Kief retracted the statement he made in his direct testimony that the City “is in compliance with US and Illinois EPA regulations.” [Pekin Ex. 2.0, p. 9.] Instead of full compliance, Mr. Kief stated at trial that what he actually meant is that they were “generally in compliance.” [Tr. 260.] As testified to by Terry Gloriod, the President of IAWC, such low standards are not acceptable to IAWC. As Mr. Gloriod stated, almost in compliance with mandatory state and federal regulations is insufficient when it comes to providing safe drinking water. [Tr. 731.]

The City’s expert, Dr. Carl Adams, was not only incapable of addressing the issues raised by Ms. Ciccone, but his lack of preparation and the presence of numerous inaccuracies in his testimony further damages the City’s credibility in this case. The very premise of Dr. Adams’ testimony, that the City can manage and operate the Pekin District system due to its experience with the wastewater system, is faulty as Dr. Adams has virtually no experience whatsoever with water systems. According to Dr. Adams, his background is in wastewater and he does not consider himself an expert on the subject of drinking water regulations. [Tr. 559-60.] This admitted lack of experience, however, did not stop Dr. Adams from testifying at length with regard to the Pekin District water system. [Pekin Ex. 12.0, pp. 13-19.] As Dr. Adams admitted at hearing, his lack of knowledge concerning water systems prompted him to rely on the views of two other individuals, Robin Garibay and Sam Shelby not called as witnesses – a fact not disclosed to the Commission in Dr. Adams’ filed testimony. [Tr. 570.]