

APPENDIX A

Introduction

For the reasons discussed in Joint Applicants' attached Brief on Exceptions, the changes set forth below to the Administrative Law Judge's Proposed Order should be adopted.

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Position of the Municipalities

The Municipalities complain that there will be an increase in rates following the Proposed Transaction, and that any savings as a result of the transaction are not tracked. The Municipalities assert that, if the Proposed Transaction is so beneficial, the Joint Applicants should commit to no increase in rates for a period after it closes. Instead, they already have planned to file in late 2007 for a rate increase.

The Municipalities also assert that the costs associated with adequate investment in AWW's infrastructure are very large. They further allege that Staff failed to identify savings, to propose an accounting system to track savings, or to consider the timing of the next rate case. The Municipalities additionally suggest that the Joint Applicants' witnesses profit from the transaction, so their testimony should be discounted.

Bolingbrook adds that the Proposed Transaction will result in ongoing Sarbanes-Oxley costs. Bolingbrook contends that such costs are an adverse rate effect within the meaning of Section 7-204(b)(7), and, as such, the entire transaction should be rejected.

Urbana additionally asserts [a concern](#) that IAWC's pension plan is not fully funded, and urges that any approval be conditioned upon full funding of pension liabilities. ~~Urbana asserts that unfunded liabilities that were allowed to accrue during RWE's ultimate ownership should not be passed on to ratepayers. Instead, Urbana proposes that they such liabilities~~ should be funded from the proceeds of the Initial Public Offering or other offering, or otherwise from the reorganization of the Joint Applicants, prior to the distribution of those proceeds to RWE shareholders.

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Commission Conclusion

Section 7-204(b)(7) requires that “the proposed reorganization is not likely to result in any adverse rate impacts on retail customers.”¹⁰ The Joint Applicants state that they will not seek to recover the costs of the Proposed Transaction from ratepayers. Furthermore, the status of IAWC as a subsidiary of AWW will not change as a result of the Proposed Transaction.

We concur with Staff that Section 7-204(b)(7) requires that no adverse rate impacts, i.e., costs or other externalities, be imposed on ratepayers, and that this is not the same as requiring that demonstrable benefits be traceable to the reorganization. Staff correctly points out that, if such benefits do accrue from the transaction, they will be realized through lower costs in the test year of the next rate case, and not an ongoing cash account mechanism.

Furthermore, IAWC’s stated intention to file a rate case later in 2007 is not evidence of an adverse rate impact within the meaning of this subsection. The utility will have to establish its costs in that case. It already has stated that the costs of the Proposed Transaction will be excluded. Furthermore, the previous rate case was filed in 2002, so existing rates already have been in effect for several years.

The Municipalities assert that the witnesses for the Joint Applicants are not credible because they will profit if the Proposed Transaction is approved. It is true that they will receive bonuses that are contingent upon the approval of the reorganization and upon their continued work for the reorganized entity. All of the witnesses in this case, however, had a financial or professional interest in testifying. In short, testifying in this matter was a duty related to their respective jobs; we therefore decline the argument of the Municipalities.

Bolingbrook alleges that compliance with the Sarbanes-Oxley Act will impose new costs if the reorganization is approved, and that such costs constitute an adverse rate impact. They do not. Whether such costs are recovered at all is a matter for a future rate case, and therefore they are not properly attributed to the proposed reorganization itself. By extension, the Sarbanes-Oxley costs do not fall within the scope of Section 7-204(b)(7).

Finally, Urbana asserts that ~~the unspecified~~ pension liabilities should be fully funded before the proceeds of the reorganization are distributed to RWE’s shareholders. However, Urbana offered no evidence that American Water’s pension was not fully funded or that there was any connection between pension funding and the Proposed Transaction. The Joint Applicants’ evidence demonstrated contend that they have complied with the requirements of ERISA, but that is not the issue that the pension

¹⁰ 220 ILCS 5/7-204(b)(7).

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plan is properly funded and financially sound. The Joint Applicants also pointed out that there was no connection between pension funding, which is a normal, ongoing utility operating expense, and the Proposed Transaction. Because there is no basis in the record to support Urbana's proposed condition, it is rejected. At issue is whether a less-than-fully funded pension is or becomes an adverse rate impact at the time of the distribution of proceeds of the reorganization. It is the adverse rate impact analysis, and not ERISA compliance, that falls within the scope of Section 7-204(b)(7) of the Public Utilities Act. To be clear, failing to comply with ERISA would be prima facie evidence of an adverse rate impact, but the converse does not hold.

~~———— In a recent rate case, the unfunded pension liability has been fully disallowed from rate base because it represents cost-free capital for shareholders.⁴¹ An unfunded pension liability must be recovered at some point. If such recovery occurs after the distribution of the proceeds of reorganization to shareholders of the former parent, ratepayers suffer an adverse rate impact in the amount of the unfunded liability. In other words, the incidence of the unfunded liability vests on either ratepayers or the former shareholders at the time of the distribution of the proceeds from the reorganization. The only manner to ensure that the unfunded liability is not converted into an adverse rate impact, i.e., to ensure compliance under Section 7-204(b)(7), is for the existing pension liability to be fully funded prior to any distribution of proceeds. We therefore reject the Joint Applicants' assertion that there is no connection between pension liability and the Proposed Transaction, and their contention that carrying a less-than-fully funded pension through the reorganization would pose no adverse rate impact.~~

~~———— The Joint Applicants also argue that conditioning approval of the Proposed Transaction upon a fully funded pension is a taking without compensation. Their argument lacks merit. Eminent domain is not at issue; this proceeding concerns a reorganization proposed by the Joint Applicants. Section 7-204(f) of the Act gives the Commission authority to impose exactly such a condition on the Proposed Transaction,⁴² no less so where the condition must be met in order to fulfill the requirements of any subsection of the statutory checklist provided by Section 7-204(b). Furthermore, the Joint Applicants failed to identify any property that would be taken from them; if anything, the condition merely prevents the unjust transfer of an existing liability onto the post-reorganization owners. Finally, even if the pension funding condition were to be construed as a taking, the Joint Applicants already had notice and an opportunity to be heard on the issue during the trial on March 6, 2007. Accordingly, the condition proposed by Urbana on this point shall be adopted.~~

¹¹ See *Central Illinois Light Company*, 01-0465, 01-0530, 01-0637 (cons.), Order (Mar. 28, 2002) at 37 (“unfunded pension liability represents a cost-free source of capital for the shareholders, it is appropriate to reduce rate base for the full amount of the unfunded liability.”) While the Commission adopted this reasoning in explaining an uncontested adjustment in *Central Illinois Light Company*, it follows the rationale in the instant case.

¹² Section 7-204(f) states: “In approving any proposed reorganization pursuant to this Section the Commission may impose such terms, conditions or requirements as, in its judgment, are necessary to protect the interests of the public utility and its customers.” 220 ILCS 5/7-204(f).

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Pension Liability

As discussed under Section 7-204(b)(7) *supra*, Proposed Condition MU-B is not warranted and shall be ~~adopted~~rejected. Any potential concerns with pension funding are addressed by Condition 19.

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FINDINGS AND ORDERING PARAGRAPHS

Joint Applicants have demonstrated that the Proposed Transaction meets the requirements of Section 7-204 of the Act. Joint Applicants have shown that AWW will be financially sound following the Proposed Transaction and IAWC will be able to continue to attract capital on reasonable terms and maintain a reasonable capital structure. Joint Applicants have also shown that the Proposed Transaction will not diminish IAWC's ability to provide adequate, reliable, efficient, safe, and least-cost public utility service, and that the Proposed Transaction will not have an adverse impact on rates.

Having considered the entire record herein and being fully advised in the premises, the Commission is of the opinion and finds that:

(1) IAWC is engaged in the business of providing water and sewerage services to the public in the State of Illinois and, as such, is a public utility within the meaning of Section 3-105 of the Act;

(2) the Commission has jurisdiction over the parties and the subject matter herein;

(3) pursuant to Section 7-204(b) of the Act, and based on the application of the [22-21](#) Conditions adopted herein:

(a) the Proposed Transaction will not diminish the ability of IAWC to provide adequate, reliable, efficient, safe, and least-cost public utility service;

(b) the Proposed Transaction will not result in the unjustified subsidization of non-utility activities by IAWC or its customers;

(c) costs and facilities will be fairly and reasonably allocated between utility and non-utility activities in such a manner that the Commission may identify those costs and facilities which are properly included by IAWC for ratemaking purposes;

(d) the Proposed Transaction will not impair the ability of IAWC to raise necessary capital on reasonable terms or to maintain a reasonable capital structure;

(e) IAWC will remain subject to all applicable laws, regulations, rules, decisions, and policies governing the regulation of Illinois public utilities;

(f) the Proposed Transaction is not likely to have a significant adverse effect on competition in those markets over which the Commission has jurisdiction; and

(g) the Proposed Transaction is not likely to result in any adverse rate impacts on IAWC's retail customers;

(4) any savings that may occur from the Proposed Transaction in future rate case test years shall be allocated entirely to ratepayers; and the costs of the Proposed Transaction as detailed above are not recoverable in rates;

(5) the capitalization of IAWC will be unchanged as a result of the Proposed Transaction and, as a result, will be consistent with the provisions of Section 6-103 of the Act;

(6) the Proposed Transaction therefore is not contrary to the public interest and is not detrimental to the interests of IAWC's customers;

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(7) approval of the Proposed Transaction should be granted, subject to the [22-21](#) Conditions as set forth and enumerated below; (said conditions are identified for discussion in the prefatory portion of this Order as S-A and SB; UW-A through UW-D; [and](#) AG-A through AG-P; ~~and MU-B~~); and
(8) Conditions 2, 3, and 4 imposed in the Order in Docket 01-0832 are superseded by the terms of this Order.

IT IS THEREFORE ORDERED by the Illinois Commerce Commission that the Proposed Transaction described herein is approved, subject to the following [22-21](#) Conditions:

- Condition 1. The common equity ratio of American Water Works Company, Inc. (“AWW”) shall be at least 45% at the time of the initial public offering (IPO). The calculation of the common equity ratio shall not include equity-like instruments.
- Condition 2. Illinois-American Water Company (“IAWC”) shall inform the Commission of any changes to the corporate credit ratings of American Water Capital Corporation (“AWCC”) by filing a copy of the complete credit report, within 15 days of publication, with the Chief Clerk of the Commission, with a second copy provided to the Finance Department Manager. In addition, the reporting requirement shall be extended to American Water should Moody’s Investors Service, Standard & Poor’s, or Fitch Ratings rate its indebtedness or overall creditworthiness.
- Condition 3. IAWC will pass through to IAWC’s customers, in future rate cases, any actual savings from efficiencies resulting from the Proposed Transaction and the continued ownership of IAWC by AWW.
- Condition 4. The Proposed Transaction will not adversely affect IAWC’s policies with respect to service to customers, employees, operations, financing, accounting, capitalization, rates, depreciation, maintenance, or other matters affecting the public interest or utility operations.
- Condition 5. IAWC will provide safe, adequate, and reliable service in fulfillment of its obligations under Illinois and federal law.
- Condition 6. IAWC will continue to make contributions to the state and local economies, and continue IAWC’s commitment to be a good corporate citizen in the local communities IAWC serves.
- Condition 7. IAWC will make no attempt to recover through IAWC’s rates any costs of the Proposed Transaction, purchase price, goodwill, early termination payment, change in control payment, incentive or retention bonus payment in connection with the Proposed Transaction, either directly or indirectly through American Water Works Service Company, Inc., or any other affiliate, or by any other means.

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IPO, the required infusion into AWW will be provided prior to the IPO. The calculation of the common equity ratio will not include equity-like financial instruments. AWW will file a balance sheet as of the quarter ended immediately preceding the IPO.

- Condition 18. For a period of three years from the date of this Order (and after it has first notified IAWC employees), IAWC will notify the Commission, and if applicable, the Utility Workers Union of America, AFL-CIO, of a planned reduction of 5% or more in IAWC's work force.
- Condition 19. AWW will continue to fund the pension plans of the union and non-union employees of IAWC in compliance with the Employee Retirement Income Security Act ("ERISA") and the Pension Protection Act of 2006 ("PPA"). IAWC will not seek to recover from its customers any increased pension funding expense or other costs that would be incurred to remedy any violation of ERISA's minimum funding requirements during RWE's ownership if it should be determined that any such violation has occurred. Neither AWW nor IAWC is aware of, nor do they believe that, any such violation has occurred.
- Condition 20. For one year following the occurrence of the IPO, staffing levels for collectively bargained employees will not drop below 90% of the number of collectively bargained individuals employed by IAWC on January 1, 2007 (excluding those employees hired on a temporary or limited duration basis). Likewise, for one year following the occurrence of the IPO, staffing levels for all employees (union and non-union collectively) will not drop below 90% of the number of the number of individuals employed by IAWC on January 1, 2007 (excluding those employees hired on a temporary or limited duration basis).
- Condition 21. IAWC agrees to honor all terms and conditions of the existing collective bargaining agreements between IAWC and the applicable local union of the Utility Workers Union of America (the "Collective Bargaining Agreements") through the termination dates of those agreements. Any successor to IAWC will assume the Collective Bargaining Agreements and all obligations thereunder through the termination dates of those agreements.
- ~~Condition 22. IAWC shall fully fund any pension plan liabilities from the proceeds of any IPO or other offering or proceeds received from the reorganization of the Company; none of the costs related to the reorganization (including unfunded pension plan liabilities) shall be passed on to ratepayers.~~