

**STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION**

Illinois-American Water Company,)	
American Water Works Company, Inc.,)	
Thames Water Aqua US Holdings, Inc., and)	
Thames Water Aqua Holdings GmbH)	
)	
Joint Application for Approval of Proposed)	Docket No. 06-0336
Reorganization and Change in Control)	
Of Illinois-American Water Company)	
Pursuant to Section 7-204 of the)	
Illinois Public Utilities Act)	

**CITIES OF CHAMPAIGN AND URBANA’S
BRIEF ON EXCEPTIONS
TO THE PROPOSED ORDER**

The Cities of Champaign and Urbana and the Village of Homer Glen file this Brief on Exceptions to the Proposed Order. The Proposed Order errs in granting Illinois American Water Company’s (IAW or Company) application to spin itself back out from its German parent.

The Proposed Order erroneously finds that IAW should be allowed to spin out from RWE because the Company has met all of the statutory requirements under 220 ILCS 5/7-204(b). In this Docket, IAW fails to meet three separate subsections of 5/7-204(b): (1), (4) and (7). The Proposed Order errs in finding that (i) IAW currently provides, and will in the future provide, adequate service to its customers, (ii) the proposed transaction will not significantly impair IAW’s ability to raise necessary capital on reasonable terms and (iii) the proposed transaction is not likely to result in any adverse rate impacts on retail customers. Failure to meet any single criterion is fatal to the application. (“In reviewing any proposed reorganization, the Commission **must** find that:” 220 ILCS 5/7-204(b))

The Proposed Order ignores IAW's reversal of its position a short four years ago that it was necessary for the Company to merger into RWE in order to obtain capital at a reasonable cost. The Proposed Order also ignores the bias of its two witnesses who will walk away from the hearing with a huge payday for their favorable testimony in this docket while ratepayers will continue to receive poor service and even higher water bills from the Company.

Champaign, Urbana and Homer Glen request that the Proposed Order be modified as set out in these exceptions. Proposed substitute language also is being provided with these exceptions.

Exception 1
**The Proposed Order erroneously concludes that IAW
provides adequate service today
and will provide adequate service in the future.**

The Proposed Order finds the Company is providing adequate, safe, least cost and efficient service currently. This finding is contrary to the record that shows:

- IAW has been found by this Commission to have violated numerous ICC rules and regulations concerning health and safety issues that require remediation by the Company;
- The Commission has reopened a docket to examine safety issues because of the Company's failure to inspect and to repair fire hydrants, thus endangering the property and lives;
- The Company must run an emergency generator 24 hours a day, seven days a week to avoid boil orders in Champaign.

The Proposed Order brushes these issues aside by stating that poor service issues "have been addressed" by the Commission in other orders. Proposed Order at 6. This is

not true. The Commission granted rehearing in Docket Nos. 05-0681, 06-0094 and 06-0095 because of safety issues over IAW's fire hydrant inspection program that was originally ordered in the Docket due to IAW's unwillingness to provide data on malfunctioning fire hydrants to local fire departments on a timely basis. Further, the Proposed Order ignores the fact that Docket No. 05-0599 is still pending with no proposed order issued (no hearing has yet been conducted) in that case. Docket No. 05-0599 concerns a series of boil orders issued by IAW in Champaign. As a stop-gap measure, the Company runs an emergency generator 24 hours a day, seven days a week to avoid inadequate pressure issues in Champaign.

In this Docket, Champaign's witness described the deterioration of service that occurred as the result of the last IAW reorganization:

For many years, predecessors to IAWC did an admirable job of providing quality water to the residents of Champaign. After RWE acquired IAWC, the Company went through a significant reorganization, apparently to reduce costs. A number of employees did not retain their jobs. Jobs that were previously performed locally were changed to other locations. As a result, we saw a deterioration of quality of service provided in Champaign.

Champaign Ex. 1 at 4/81-86.

IAW's service problems in Champaign identified in this Docket include, among others:

- Five boil orders in one summer due to significant drops in pressure in the water system. Champaign Ex. 1.0 at 4/89-90. "The fact that IAW cannot keep pressure above 20 psi at all times demonstrates that the system is neither adequate nor reliable." Champaign Ex. 2.0 at 2/44-46.

- IAW's band-aide approach to keep pressure above 20 psi by operating an emergency generator 24 hours a day, seven days a week. Champaign Ex. 2.0 at 2/46-3/50. "The use of diesel generators to provide electric power for equipment is not likely to be the least-cost means of providing water." Champaign Ex. 2.0 at 3/48-50.
- IAW's inability to inspect and to maintain fire hydrants resulted in the Champaign Fire Department responding to a fire and finding that the caps on two fire hydrants nearest the fire were inoperable. The fire department had to connect to a third hydrant in order to pump water to the fire. Champaign Ex. 1.0 at 5/97-100.

Champaign's witness concluded that the last IAW transfer of ownership resulted in pressures to increase the profit of the company by reducing service. That in turn has caused health and safety failures by IAWC in Champaign. We are concerned that this change of ownership will result in further deterioration of the service provided.

Champaign Ex. 1.0 at 5/107-110.

Deterioration of IAW's service also was observed first hand in Urbana, where the problems included:

- The inability of the Urbana Fire Department to open an IAW hydrant as a fire spread. It took a sledge hammer and pry bar to get the hydrant to operate. Urbana Ex. 1.0 at 5/98-108.
- In September 2006, the Urbana Fire Department conducted an audit of 150 IAW fire hydrants which found 41 with some level of disrepair or defectiveness resulting in a 27.3 deficiency rate.

Urbana Ex. 2.0 at 2/30-45. “Urbana does not believe that a failure rate this high is an indication of a public utility that is providing adequate, reliable and safe service to the community.” *Id.* at 2/46-3/47.

IAW’s service was no better in Homer Glen. The village’s witness testified:

- The ICC Staff in Docket No. 06-0095, Homer Glen’s complaint case against IAW, found that IAW did not have any records to verify that it had inspected any fire hydrants or critical valves in Homer Glen—ever. IAW contends that it has since made the inspections “but it refuses to provide a copy of the inspections to the local fire departments that need this vital information.” HG Ex. 2.0 at 3/52-58. As a result, a fire department can hook up to a fire hydrant that IAW knows is not working, requiring the fire department to subsequently disconnect and try to find a working fire hydrant, a process that “can result in the loss of property, injury or death.” *Id.* at 3/58-60. This issue is the subject of a rehearing in the docket.
- IAW engaged in billing practices that were contrary to ICC rules by backbilling customers for usage over 12 months and hiding the fact that the customers were being back billed. HG Exhibit 2.0 at 2/30-40.

It is this poor management of IAW’s operations that convinced its parent RWE to dump IAW and its related companies. RWE’s board was told that the water company’s

management not only was poor, but was “worse than presumed.” Moreover, RWE viewed that if it kept IAW, then replacing IAW and its parent’s management team “would be essential.” Champaign-Urbana Ex. 5 at 2.

The Proposed Order ignores RWE’s own assessment and instead finds all to be well with the level of IAW’s service and its management. This conclusion is in error and should be corrected.

Exception 2
**The Proposed Order erroneously concludes
the Proposed Transaction will not significantly impair
IAW’s ability to raise capital on reasonable terms.**

The Proposed Order erroneously finds that the starting point for considering whether IAW’s cost of capital will increase should be today, rather than when RWE announced its plan to divest IAW. When the Company filed four years ago to be rolled up into RWE, IAW’s main selling point was that by being owned by a larger company, IAW’s cost of capital would be less because it would borrow internally from RWE. RWE’s credit rating is “A.” Since the divestiture was announced, American Water’s credit rating has fallen to “A-.” The Company argues, and the Proposed Order agrees at 10, that the credit rating to use as a benchmark is the post-divestiture announcement level, not the existing rating for RWE. The measure should be the difference between what IAW’s imputed capital costs are under RWE versus the cost without RWE. Since credit markets are forward looking, the market already has devalued the new IPO company as if it were not part of RWE. If there were no divestiture, IAW’s imputed credit rating still would be “A” rather than the lower “A-.” As a result, IAW’s imputed cost of capital will be higher as a result of the transaction.

IAW's own testimony in the RWE first merger case confirms the conclusion that it would cost the Company and its ratepayers more if IAW is spun out. A short four years ago, the Company argued to this Commission that it must be part of RWE to save ratepayers money. Now, the Company, using some of the same witnesses, claims ratepayers would be better off without RWE. Were IAW's witnesses wrong in their testimony then or are they wrong now?

The Proposed Order mistakenly accepts as fact that RWE's reason for dumping IAW is that RWE changed its focus. This is contrary to the company's own documentation on the decision by RWE to get rid of IAW. RWE minutes reveal that RWE found it had made a bad investment in a company with poor management ("worse than presumed," in the words of RWE's own minutes)—the same management that will continue to run IAW in the future.

Some of IAW's flip-flopping before the Commission can be attributed to the witnesses financial incentive to have the Commission approve this transaction. Combined, the IAW witnesses stand to gain nearly a million and a half dollars for their favorable testimony to support the transaction. The Proposed Order naively states that all witnesses to the proceeding had a stake in the outcome, so there is no potential bias by IAW's witnesses receiving bonuses contingent upon the outcome. Proposed Order at 13. There is a vast difference between a city employee testifying at hearing and receiving a regular government salary (or in the case of Homer Glen's witness, no salary) and IAW's witnesses one of whom has a success bonus of nearly a half million dollars, Champaign-Urbana Ex. 4 and the other of whom has a bonus of nearly a million dollars, Champaign-Urbana Ex. 6 riding on their testimony. IAW's success completion bonus agreements

clearly are the type that have the potential to affect the testimony and bias of IAW's witnesses. *Batteast v. Wyeth Laboratories*, 137 Ill. 2d 175, 185 (1990).

Finally, the Proposed Order erroneously concludes that IAW's promise to inform the Commission when its equity falls below 45 per cent protects ratepayers, Proposed Order at 10. However, there is no penalty for failure to maintain this level, so the agreement by the Company is illusory at best.

Exception 3
**The Proposed Order errs in finding
the transaction will not adversely
impact IAW's rates.**

As noted above, the capital costs to IAW already have increased as a result of the proposed transaction since the imputed credit rating for the Company has slipped to A- from A. Thus, the borrowing costs of IAW have increased. These increased costs will be passed onto ratepayers by IAW in its next rate case planned for later this year.

In its filing, the Company admits that it projects no savings as a result of the transaction. Tr. at 166/21-167/7. The Proposed Order does not require that IAW keep track of any savings that may result from the transaction. This is contrary to the language in 220 ILCS 5/7-204(c) that prevents the Commission from approving a reorganization "without ruling on: (i) the allocation of any savings resulting from the proposed reorganization." Since the Commission is not requiring any tracking of savings, the Proposed Order fails this statutory requirement. Indeed, the failure of the Proposed Order to require tracking of any savings violates this statutory requirement and is legally fatal to the approval of the reorganization.

IAW already has announced that it will increase rates significantly as soon as the transaction closes, Tr. at 168/8-16, a factor not considered by the ICC Staff in its analysis. Tr. at 255/8-20.

The Proposed Order erroneously concludes that merely because the cost of the transaction will be excluded from future rates that there is no impact on rates. Proposed Order at 13.

Because the proposed transaction already has increased IAW's borrowing costs, it is adversely impacting the Company's rates.

Exception 4
**The Proposed Order erred
not attaching conditions
to the proposed transaction.**

The Proposed Order rejects the request by Champaign, Urbana and Homer Glen to impose conditions on the transaction if it is approved. Under 220 ILCS 5/7-204(d), 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."

The record shows that IAW has a history of ignoring health and safety issues. In particular, the Company has a history of requiring boil orders because it cannot maintain adequate pressure in Champaign. This Commission also has found that the Company has not properly inspected fire hydrants and critical valves. Even so, the Proposed Order does not require any health and safety conditions be attached to the reorganization because the issues were previously adjudicated. Proposed Order at 22. Rather than continuing to let IAW violate the Commission rules and regulations, the Proposed Order should include appropriate terms and conditions to protect the public safety and health.

Champaign, Urbana and Homer Glen request that the Proposed Order be modified as set out herein and that the Commission deny IAW's reorganization plan.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, Richard C. Balough, do hereby certify that a true and correct copy of the foregoing Brief on Exceptions was served upon the service list in Docket No. 06-0336 on this 8th day of June 2007.

_____/rcb/_____
Richard C. Balough

SUBSTITUTE LANGUAGE FOR PAGES 6-7 OF PROPOSED ORDER:

Commission Conclusion

Section 7-204(b)(1) requires that “the proposed reorganization will not diminish the utility’s ability to provide adequate, reliable, efficient, safe and least-cost public utility service.”⁶ ~~The Joint Applicants established a *prima facie* case that they meet the requirements of Section 7-204(b)(1). Neither the structure of the Proposed Transaction nor the forward-looking status of IAWC foreshadow a decline in its ability to provide adequate, reliable, efficient, safe and least-cost service at issue in this subsection. None of the allegations advanced by the municipalities establish that Joint Applicants failed to meet the requirements of Section 7-204(b)(1).~~

~~Homer Glen’s complaints have been addressed in the final Orders entered in the two proceedings referenced above. As such, the determinations in those proceedings, including any remedies, extinguished those issues; they are not outstanding problems that establish an issue under Subsection (b)(1). Furthermore, Homer Glen’s evidence in the instant proceeding consists of testimony in this case as to the subject matter of testimony in the two prior cases for the purpose of establishing the problems alleged therein. The instant testimony is hearsay. Although it is in evidence due to the lack of any objection, having been included within an exhibit that was admitted, the hearsay is awarded zero weight.~~

~~Urbana alleges that one fire hydrant was difficult to open during an incident on October 25, 2005, and that several hydrants needed repair in 2006. In the 2006 hydrant inspection, all but one of the 150 hydrants were operational, and the remaining hydrant was being removed from service. IAWC states that it promptly repairs any hydrants when notified of the defects by the City, and Urbana witness Gray did not refute that the problems identified in the inspection were remedied. Furthermore, Urbana’s position vis-à-vis the requirements of Section 7-204(b)(1) is limited in that it references both administrative rules and its franchise agreement with IAWC, yet it apparently has never sought enforcement for the underlying issue. If there indeed was or is a systematic problem with their hydrants, it is mystifying that Urbana would identify various bases for relief but pursue none of them. Champaign similarly contends that, on one occasion in November, 2005, it experienced difficulty opening two hydrants. Champaign states that the two hydrants have been repaired.~~

~~The boil orders are at issue in Docket 05-0599, which is still pending; any remedy as to either the boil orders or the diesel generation is left to that Docket. In any event, it appears from the minimal evidence in the instant case that the boil orders were issued due to changes in system pressure following fluctuations in electricity supplied to IAWC’s Champaign West Water Treatment Plant, and that the diesel generation mitigates the possibility of losing system pressure in this manner. Furthermore, the boil orders are limited to the summer of 2005, and~~

apparently are not an ongoing problem. Therefore, while we reach no determination as to any issue being litigated in Docket 05-0599, the boil orders and diesel generation do not signify a failure to meet the requirements of Section 7-204(b)(1).

The Joint Applicants propose to keep its current management in place. As a result, the Commission can examine the current level of service today as a predictor of service after the proposed transaction. Champaign, Urbana and Homer Glen have presented evidence that IAWC currently is not providing adequate, reliable, efficient, safe and least-cost service today. IAWC has not met its burden of proof that it will make material changes in its operation to bring service up to a level where it is adequate, reliable, efficient, safe and least-cost.

This Commission found in Docket Nos. 05-0681, 06-0094 and 06-0095 that IAWC was not in compliance with several Commission regulations. In particular, the Commission expressed concern that inoperable fire hydrants suppressed fire department efforts on at least two occasions. Final Order, Docket Nos. 05-0681, 06-0094 and 06-0095 at 19. The Commission has reopened those dockets to further investigate IAWC's remedial program for inspection of fire hydrants and whether inoperable hydrants should be reported to the local fire departments.

In this docket, Champaign has raised the issue of whether IAWC is providing adequate, safe and least-cost service. The record indicates several instances of boil orders. The Commission is troubled by the fact that IAWC has needed to operate emergency generators on a 24 hour, seven day a week schedule. Operation of emergency diesel generators does not appear to be least-cost or adequate. IAWC has failed to justify its actions in this docket.

Urbana also demonstrated that IAWC is not properly maintaining its system. A failure rate of over 27 per cent for fire hydrants creates an unacceptable risk to the safety of the public and the firemen responding to emergencies.

Finally, both Champaign and Urbana presented evidence that the last time IAWC was involved in a reorganization that following the reorganization, service quality declined. IAWC has failed to present sufficient evidence in this docket that it either will remedy the deficiencies outlined by Champaign and Urbana or that it will bring its service to a minimum level of acceptable service.

The Commission concludes that IAWC has failed to demonstrate that as a result of the reorganization that it will provide adequate, reliable, efficient, safe and least-cost public utility service.

SUBSTITUTE LANGUAGE FOR PAGES 9-11 OF PROPOSED ORDER:

Commission Conclusion

Section 7-204 requires that “the proposed reorganization will not significantly impair the utility’s ability to raise necessary capital on reasonable terms or to maintain a reasonable capital structure.” As a preliminary matter, there is no disagreement that American Water will be considered investment grade after the Proposed Transaction.

The argument raised by the Municipalities is that RWE issuances are rated “A” while American Water issuances are rated “A-.” The Municipalities contend that grade “A” issuances have a lower cost than “A-” issuances do, all other things equal. There is no substantial argument against that general principle. The question instead is whether, and how, it applies to the instant situation. The Joint Applicants assert that RWE has announced a shift in its business focus away from the water business. RWE already has sold other water businesses it previously owned. The Joint Applicants further contend, and Ms. Wolf so testified, that capital which formerly flowed from RWE in previous years is less likely to be available in the future. ~~The Commission finds little reason to doubt this assessment, and, by downgrading AWW to “A-,” rating agencies signaled a similar belief in the substance of the position advocated by Joint Applicants.~~ The Commission finds Ms. Wolf’s testimony not to be credible. First, her statements that RWE will simply ignore American Water if the proposed transaction does not take place is speculative at best. When Applicants came before this Commission four years ago seeking to merge these companies into RWE, they undertook an obligation that this Commission takes seriously. The record indicates that shortly after it acquired the Applicants that RWE found they were poorly managed and needed huge capital infusions. These are facts that RWE should have discovered during its due diligence prior to the merger. Merely because RWE made a bad acquisition does not mean that this Commission should relieve it of its responsibility to provide adequate capitalization to IAWC. RWE further recognized that the management of the Applicants needed to be changed, but did not undertake reasonable steps to correct this deficiency. As a result, RWE wants to leave Illinois ratepayers footing higher bills because of RWE’s inactions. Thus, Ms. Wolf’s statements that RWE had a change of focus is not correct and is not supported by RWE’s own board minutes. Second, the Commission is concerned that the only witnesses that IAWC presented in this case had a vested, substantial financial interest in the outcome. While the Applicants argue that these contingent witness fees will not be collected in rates, the Applicant’s argument misses the point. The bonuses create the appearance of impropriety and raise concerns about the validity of the witnesses’ testimony.

Even if the Commission were to accept Ms. Wolf’s testimony, the relevant inquiry for the purpose of comparing costs of capital, therefore, is the not the existing “A-” rating for AWW today but rather the credit rating of RWE. Since

~~RWE's rating is "A", the proposed transaction will result in a downgrading to at least A-, and the forecast "A-" for AWW after the Proposed Transaction. Given that there is no difference in the ratings between now and after the Proposed Transaction, Thus, there is no a reasonable basis to conclude that ratepayers will face higher capital costs due to the transaction. Also, a rating of "A-" is considered to be investment grade. In the absence of additional evidence, there also is not a basis to conclude that the utility's ability to raise necessary capital on reasonable terms will become impaired by the Proposed Transaction.~~

~~Although ~~t~~The Municipalities argue are correct that RWE responsibly provided the necessary capital to IAWC in the past, ~~there is no guarantee~~ so it is reasonable that they will continue to do so in the event that the Proposed Transaction is denied since it would be against RWE's own economic interest to allow one of its subsidiaries to deteriorate further, and IAWC continues to be an unwanted subsidiary. Furthermore, the grade "A" rating of RWE is irrelevant if it ultimately is not available to IAWC, as the evidence in this matter suggests and as the market as a whole apparently believes.~~

The last issue for this subsection concerns whether the reorganized utility will maintain a reasonable capital structure. The record reflects commitments by Joint Applicants that American Water's equity ratio will be at least 45% at the time of the IPO; that IAWC's equity ratio will be within the range of 40-50% for a period of at least three years from the date of this Order; and that IAWC will notify the Commission within 30 days of any deviations from this range. The Commission concurs with the Municipalities ~~complain~~ that the commitments of the Joint Applicants are illusory. ~~We do not agree. The commitments that the Joint Applicants accepted during the course of this proceeding are reflected in this Order. The Conditions attached to the approval of the Proposed Transaction in this Order are subject to enforcement under the Act, as are any terms in any Order issued by the Commission. Furthermore, when the capital structure of IAWC is at issue in future rate cases, it still must be reasonable within the meaning of Section 9-201 of the Act.~~

In light of the foregoing, the Commission ~~does not find~~ finds a failure by the Joint Applicants to meet the requirements of Section 7-204(b)(4) of the Act.

SUBSTITUTE LANGUAGE FOR PAGES 13-15 OF PROPOSED ORDER:

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 Section 7-204(c) provides that the Commission “shall not approve a reorganization” without allocating “any savings resulting from the proposed reorganization.” The Commission concludes that the proposed transaction will have an adverse impact on retail customers and that the Applicants have failed to allocate any savings from the proposed transaction. 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.~~

As stated in our earlier conclusion, the proposed transaction will result in a lower imputed credit rating for the Applicant. This lower credit rating means that retail customers will pay more as a result of the transaction. Thus, the Applicants have failed to meet the statutory requirement to show no adverse impact on retail customers. Moreover, neither Applicants nor the ICC Staff have any plans or mechanisms in place to monitor or to track any savings resulting from the proposed transaction. Without such mechanisms, there is no way that the Commission can know what savings may result from the proposed transaction

and the Commission therefore cannot allocate the savings as required under the statute.

~~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, even if the Commission were to find no adverse impact on ratepayers based on the Applicants lower credit rating, the proposed transaction as currently structured adversely affects ratepayers because of the Applicants inadequately funded pension. So if the Commission were to otherwise approve the transaction, which it does not do, this deficiency needs to be corrected. Urbana asserts that the pension liabilities should be fully funded before the proceeds of the reorganization are distributed to RWE's shareholders. The Joint Applicants contend that they have complied with the requirements of ERISA, but that is not the issue. 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.¹¹ 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,¹² 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.~~ would be a requirement if the Commission would otherwise find the transaction does not adversely affect retail customers. However, for the reasons cited in this section, the Commission finds there is an adverse impact.

SUBSTITUTE LANGUAGE FOR PAGES 20-22 OF PROPOSED ORDER:

CONTESTED CONDITIONS PROPOSED BY THE MUNICIPALITIES

Having ~~rejected~~ accepted the contention of the municipal intervenors that approval of the Proposed Transaction should be denied, the remaining question is which, if any, of the contested conditions should be approved is moot. ~~To the extent that particular arguments underlying these proposed conditions were offered, they are discussed in the Statutory Analysis portion of this Order and will not be repeated here. However, for clarity of the record, the following observations are made.~~

* * *

Commission Conclusion

This section of the Order implements the conclusions reached *supra* as applied to the contested conditions. Discussion of the arguments is not be repeated here.

Unaccounted-for Water

The issue of unaccounted-for water levels has been resolved with the tariff filing made pursuant to recent legislation. The tariff renders moot Proposed Conditions MCC, MU-D, and MHG-C.

Fire Hydrant Inspections

This issue already was adjudicated, ~~and the relief granted, in a separate proceeding.²¹ Therefore, the issue, including any enforcement, will be left to that Docket. Accordingly, Proposed~~ and the Commission has previously found IAWC's failure to properly inspect fire hydrants to be a violation of the Commission's rules. The continuing obligations of IAWC is subject to a rehearing in another IAWC docket. However, the conditions requested by Champaign and Urbana are reasonable and further address safety issues. Conditions MC-E and MU-F are denied. If the Commission had approved the transaction, conditions MC-E and MU-F would have been imposed on IAWC.

Maintenance and Capital Investment Plans

The evidence indicates that these plans are the subject matter of certain terms in the Franchise Agreements between IAWC and Champaign and Urbana respectively. ~~It is not clear to what degree the two Municipalities sought to enforce these terms of their Franchise Agreements. It is clear, however, that the evidence in the instant case does not~~ would support the imposition of these conditions if the Commission had approved the transaction. Therefore, Proposed Conditions MC-B, MC-D, MU-A, MU-C, and MU-E ~~are all denied without prejudice, provided, however, that Urbana lacks standing to enforce the rights of "other municipalities affected" as stated in Proposed Condition MU-A.~~ would have been included.

Pension Liability

As discussed under Section 7-204(b)(7) *supra*, Proposed Condition MU-B is warranted and ~~shall~~ would have be adopted had the Commission approved the transaction.

Champaign Pressure

This issue is being litigated in pending Docket 05-0599. It therefore is inappropriate to grant the relief requested in this Docket, and, in any event, the evidence in the instant Docket would not support the imposition of this condition. Proposed Condition MC-A therefore is denied without prejudice. As with other conditions proposed by the Municipalities, this request is a health and safety issue. While it may be subject to another docket, this Commission cannot ignore IAWC's failure to ensure the adequacy and health and safety of Champaign's water supply. Had the Commission approved the transaction, condition MC A would have been imposed.

Homer Glen Rates and Audits

This issue ~~already was adjudicated, and the relief granted in part and denied in part. It therefore is not appropriate.~~ In Docket Nos. 05-0681, 06-0094 and 06-0095, the Commission required IAWC to either file a rate case within six months or be subject to a Commission rate investigation. If the Commission had approved the proposed transaction in this Docket, it would have also imposed Proposed Conditions MHG-A and MHGB in the instant Docket, and they are denied.

Homer Glen Purchase Option

The Commission ~~concurs with the Joint Applicants that an option to purchase is a valuable property right. Homer Glen failed to state any basis in Illinois law that would entitle it to such relief. As such, Illinois law permits municipalities to acquire water utilities operating in their jurisdiction without further approval from this Commission.~~ Proposed Condition MHG-D which confirms Homer Glen's rights, would have been included as a condition had the proposed transaction been approved. will not be adopted in this proceeding.

SUBSTITUTE LANGUAGE FOR PAGES 23-28 OF PROPOSED ORDER:

FINDINGS AND ORDERING PARAGRAPHS

Joint Applicants have failed to demonstrate ~~demonstrated~~ that the Proposed Transaction meets the requirements of Section 7-204 of the Act. Joint Applicants have not 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 failed to show ~~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 the Commission makes the following findings; ~~and based on the application of the 22 Conditions adopted herein:~~

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

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

(e) IAWC would ~~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 would ~~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;

(7) approval of the Proposed Transaction should be ~~denied~~, granted, subject to the ~~22 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; 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 denied, approved, subject to the following 22 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.~~

~~Condition 8. IAWC will not recover from IAWC's customers or have IAWC's~~

~~customers fund any portion of the costs of the Proposed Transaction, including financial, legal, severance payments, regulatory fees, investment services or the installation of the initial procedures for compliance with the Sarbanes-Oxley Act of 2002.~~

~~Condition 9. For three years following the date of this Order, IAWC will maintain its equity to capital ratio between 40% and 50%. If the equity to capital ratio falls outside of this range, IAWC will notify the Commission in writing within 30 days.~~

~~Condition 10. IAWC will flow through to the benefit of its customers under the Commission's normal ratemaking procedures any lower cost of debt applicable to IAWC as a result of its relationship with AWW in future rate cases.~~

~~Condition 11. AWW will not issue any debt that pledges as security or otherwise encumbers the assets of IAWC.~~

~~Condition 12. The payment for AWW stock will not be recorded on IAWC's books.~~

~~Condition 13. IAWC will not bear any costs incurred to comply with any law, regulation, standard, or practice of the United Kingdom, Federal Republic of Germany, or European Community necessary to complete the Proposed Transaction.~~

~~Condition 14. AWW or IAWC will file the following reports with the Commission or provide relevant Securities and Exchange Commission website where such reports are available: AWW's quarterly interim reports to its shareholders; AWW's annual report to its shareholders; and AWW's and IAWC's annual audit reports.~~

~~Condition 15. IAWC customers will experience no material adverse change in utility service due to the Proposed Transaction.~~

~~Condition 16. AWW and IAWC will fund and maintain IAWC's treatment, transmission, and distribution systems so as to provide service and facilities which are in all respects adequate, efficient, reliable and environmentally safe.~~

~~Condition 17. RWE has made a commitment that AWW's common equity ratio will be at least 45% at the time of the IPO. As of December 15, 2006, RWE has infused \$1.194 billion of common equity capital into AWW. If any additional equity is needed to achieve a common equity ratio for AWW of at least 45% at the time of the 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.~~

~~IT IS FURTHER ORDERED that Conditions 2, 3, and 4 as stated in the Order entered by the Commission in Docket 01-0832 are superseded by the terms of this Order.~~

~~IT IS FURTHER ORDERED that, in the event of a conflict between this Order and the Stipulation filed by Illinois American Water Company and the Office of the Illinois Attorney General, this Order shall control.~~

~~IT IS FURTHER ORDERED that, in the event of a conflict between this Order and the Stipulation filed by Illinois American Water Company and the Utility Workers Union of America, this Order shall control.~~

~~IT IS FURTHER ORDERED that this Order is public, and not confidential, in nature.~~

IT IS FURTHER ORDERED that, subject to the provisions of Section 10-113 of the Public Utilities Act and 83 Ill. Adm. Code 200.800, this Order is final; it is not subject to the Administrative Review Law.