Docket No. 07-0507
ICC Staff Exhibit 14.0C

CORRECTED REBUTTAL TESTIMONY

of

SHEENA KIGHT-GARLISCH

Finance Department

Financial Analysis Division

Illinois Commerce Commission

Illinois-American Water Company

Proposed General Increase in Water and Sewer Rates

Docket No. 07-0507

March 13, 2008

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WITNESS IDENTIFICATION

Q. Please state your name and business address.

A. My name is Sheena Kight-Garlisch. My business address is 527 East Capitol Avenue, Springfield, IL 62701.

Q. Are you the same Sheena Kight-Garlisch who previously filed testimony in this proceeding?

A. Yes, I am.

Q. Please state the purpose of your rebuttal testimony in this proceeding.

A. The purpose of my rebuttal testimony is to update my balance of common equity, cost of common equity and overall cost of capital recommendation for Illinois-American Water Company ("IAWC" or "Company"). I will also respond to the rebuttal testimony of IAWC witnesses James M. Jenkins (IAWC Exhibit 2.10) and Pauline M. Ahern (IAWC Exhibit 12.10), to the direct testimony of Illinois Industrial Water Consumers ("IIWC") witness Brian A. Janous (IIWC Exhibit 3.0) and to the direct testimony of Citizens Utility Board ("CUB") witness Christopher C. Thomas (CUB Exhibit 1.0).[1]

RESPONSE TO MR. JENKINS

Q. Please evaluate Mr. Jenkins' rebuttal testimony.

[1] My decision not to respond to an argument or arguments contained in the testimonies of Mr. Jenkins, Ms. Ahern, Mr. Janous, Mr. Gorman or Mr. Thomas should not be construed as my agreement with those arguments.

A. Mr. Jenkins' rebuttal testimony contains information or analysis that changes my opinion regarding the cost of long-term debt and an adjustment to reflect the effect of the proposed increase in rates in the balance of common equity.

Long-Term Debt

Q. Mr. Jenkins proposes two adjustments to the projected balance of long-term debt. Please respond.

A. First, Mr. Jenkins proposes updating the interest rate to December 2007 on the two variable rate debt instruments. I agree with Mr. Jenkins that the embedded cost of long-term debt should reflect the interest rate as of December 2007 for the two variable rate debt instruments. In my direct testimony, I relied on data from October 31, 2007, which was the most recent actual data available at that time. I updated the long-term debt schedule to reflect the December 2007 interest rates.

Second, Mr. Jenkins proposed a correction to the Unamortized Debt Expense for the Series 6.31% issuance. I also corrected the balance of Unamortized Debt Expense for the Series 6.31% issuance to $158,578 from $154,220. Both of Mr. Jenkins' adjustments are reflected in my long-term debt schedule presented in Schedule 14.1.

Q. Are there any other differences between your long-term debt schedule and that presented by Mr. Jenkins in IAWC Exhibit 2.12?

A. Yes, there is one difference. With respect to the Variable Series 3.65% issuance shown on Line No. 6 of Schedule 14.1, the Total Expense shown in Column N

should be $939,646, rather than the $1,091,505 as shown on IAWC Exhibit No. 2.12.

Q. What is IAWC's embedded cost of long-term debt?

A. As shown on Schedule 14.1, IAWC's embedded cost of long-term debt for average 2009 is 5.92%.

Adjustment to the Balance of Common Equity

Q. Did the Company address the concerns you presented in your Direct Testimony regarding its adjustment to reflect the effect of the proposed increase in rates on the balance of common equity?

A. Yes. Mr. Jenkins revised his adjustments to the common equity balance to reflect the Company's: 1) dividend policy; 2) test year net income as shown in IAWC's revised Part 285 filing on December 5, 2007; and 3) the timing of the rate increase.[2]

Q. What adjustments did you make to IAWC's proposed balance of common equity?

A. Mr. Jenkins' adjustment to the balance of common equity assumes the Commission will grant the Company's proposed rate increase. However, Staff's recommended rate increase differs from IAWC's proposal. Therefore, I modified the Company's average common equity balance to reflect Staff's recommended rate increase. Staff's common equity adjustment is shown on Schedules 14.2 and 14.6.

[2] IAWC Exhibit 2.10, pp. 4-5. Company's response to Staff data request SK 5-01.

RESPONSE TO MR. JANOUS

Q. Mr. Janous applies a non-constant growth DCF model to his water sample on the grounds that its growth rates are not sustainable over the long-term. Is a non-constant growth DCF model an appropriate tool in that situation?

A. Yes. A non-constant growth DCF ("NCDCF") model is appropriate when the growth rate estimates are not sustainable over the long-term. A NCDCF model employs more than one growth rate estimate, including a near-term growth rate covering the first five years and a sustainable growth rate into perpetuity. In contrast, a single-stage, constant growth DCF model employs a single growth rate estimate, which is assumed to be sustainable to infinity. Thus, the cost of common equity calculation derived from a constant growth estimate DCF is correct only if the near-term growth rate forecast for the sample as a group is expected to approximate its average long-term dividend growth. Neither the estimated 9.58% average 3-5 year growth rate for Mr. Janous' water sample nor the estimated 9.16% average 3-5 year growth rate for my Water Sample are sustainable over the long-term. Also, the sustainability of the estimated 5.54% average 3-5 year growth for my Utility Sample is questionable over the long-term. Since the current 3-5 year growth rate estimates are not likely to equal long-term growth, I also implemented a multi-stage, NCDCF model.

Q. Do NCDCF models pose difficulties not present in constant growth DCF models?

A. Yes. A NCDCF model has additional unobservable growth rate variables, for which published proxies are lacking. Specifically, no observable estimates of investor "transitional" and "steady-state" growth rate expectations for individual

companies exist.[3] Consequently, NCDCF analysis necessitates greater reliance on rate of return analyst judgment than constant-growth DCF analysis. Nevertheless, under certain circumstances, measurement error associated with a constant-growth DCF analysis exceeds that associated with a NCDCF model, making the latter model preferable.

Q. Why did you conclude that 3-5 year growth rates for the companies in your Water Sample and Utility Sample appear to be unsustainable over the long-term?

A. As I discussed in my direct testimony (ICC Staff Exhibit 4.0, pp.19-20), the economy is forecasted to grow approximately 5% per year in nominal terms. No company could sustain into infinity a growth rate any greater than that of the overall economy, or it would eventually grow to become the entire economy. Moreover, since utilities in particular are generally below-average growth companies, the sustainability of an above average growth rate is particularly dubious. At 9.16%, the average growth rate for the companies in my Water Sample is approximately 80% greater than that expected for the overall economy. Thus, given the large difference between the growth rates for my Water Sample companies and the overall growth of the economy, the sustainability of the Zacks growth rates for my Water Sample is implausible. The average growth rate for the companies in my Utility Sample, 5.54%, is approximately 10% greater than that expected for the overall economy. Although the difference between the growth rates for my Utility Sample companies and the

[3] The "steady-state" is defined as a period of long, indefinite length during which a company's expected rate of return on new investment does not vary. (A constant growth DCF model assumes a company is already in the "steady-state;" that is, the growth rate is the "steady-state" growth rate.) The "transitional" phase is a bridge between the current, near-term period and the "steady-state" level during which the company's rate of return on new investment adjusts from the current level to the "steady-state" level.

overall growth of the economy is much smaller, the continuous sustainability of the Zacks growth rates for my Utility Sample is questionable.

Q. Please describe how you modeled your NCDCF analysis.

A. I modeled three stages of dividend growth. The first, a near-term growth stage, is assumed to last five years. The second stage is a transitional growth period that spans the five-year period from the end of the fifth year through the end of the tenth year. Finally, the third, or "steady-state," growth stage, which begins at the end of the tenth year, is assumed to last into perpetuity. An expected stream of dividends is estimated by applying these stages of growth to the current dividend. The discount rate that equates the present value of this expected stream of cash flows to the company's current stock price equals the investor-required rate of return on common equity. Schedule 14.3 mathematically presents the relationship between the cash flow stream, stock price, and market required rate of return on common equity.

Q. How did you estimate the growth rate parameters?

A. For the first stage, I used the same Zacks growth rate estimates as of December 12, 2007 that I used for the constant growth DCF presented in my direct testimony. To estimate the long-term growth expectations for the third, steady-state stage, I utilized the implied 20-year forward U.S. Treasury rate in ten years, which reflects current expectations of the long-term overall economic growth during the steady-state growth stage of my non-constant DCF model.[4] An

[4] Excepting a small premium for interest rate risk, the implied 20-year forward U.S. Treasury rate in ten years represents the risk-free rate of return during the 20-year period beginning in 10 years and ending 30 years from today, as implied by current 10- and 30-year U.S. Treasury rates. As I explained in my direct testimony, the overall economic growth rate and the risk-free rate of return should be similar since

implied 20-year forward U.S. Treasury rate in ten years of 4.80% was derived from the 4.05% 10- and 4.51% 30-year U.S. Treasury rates as of December 12, 2007 using the following formula:

$$ {}_{20}f_{10} = [(1+{}_{30}r_0)^{30} / (1+{}_{10}r_0)^{10}]^{1/20} - 1 $$

Where ${}_{20}f_{10}$ = the implied 20-year forward U.S. Treasury rate in ten years;

${}_{30}r_0$ = the current 30-year U.S. Treasury rate; and

${}_{10}r_0$ = the current 10-year U.S. Treasury rate

The growth rate employed in the intervening, five-year transitional stage (second stage) equals the average of the Zacks growth rate and the steady-state stage growth rate. Schedule 14.4 presents the growth rate estimates for the companies in the Water Sample and Utility Sample.

Q. Why is an estimate of the long-term overall economic growth rate a reasonable proxy for the steady-state stage growth for your Samples?

A. Ideally, company-specific growth rate estimates for the very long term are preferable. Unfortunately, company specific long-term growth rate forecasts are not available. Nevertheless, for the reasons presented above, investors cannot reasonably expect utilities to sustain growth over the very long term equal to analysts' current 3-5 year growth rate estimates. Thus, while the overall economic growth rate might be slightly biased upward for generally low-growth companies such as utilities, it is much closer to the growth rate that investors could reasonably expect utilities to sustain over the long term.

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both are a function of production opportunities and consumption preferences. (ICC Staff Exhibit 4.0, pp. 19-21.)

Q. How did you measure the stock price?

A. I used the stock price data from December 12, 2007. This data was used in my constant growth DCF analysis presented in my direct testimony. Those stock prices appear on ICC Staff Exhibit 4.0, Schedule 4.6.

Q. How did you estimate the expected future quarterly dividends?

A. I estimated expected future quarterly dividends in the same manner as discussed in my direct testimony. ICC Staff Exhibit 4.0, Schedule 4.6 presents the current quarterly dividends for the prior year. ICC Staff Exhibit 4.0, Schedule 4.7 presents the expected quarterly dividends for the coming year. This technique was applied to produce dividend projections for the next 11 years, using the growth rate estimate from the applicable growth stage of my NCDCF analysis.

Q. Based on your NCDCF analysis, what are the estimated required rates of return on common equity for the Water Sample and the Utility Sample?

A. My NCDCF analysis estimated that the required rate of return on common equity for the Water Sample and Utility Sample are 8.58% and 9.34%, respectively, as shown on Schedule 14.5. Those results were derived from the growth rates presented on Schedule 14.4, and the stock prices and dividend payment dates presented on Schedule 4.6.

COST OF COMMON EQUITY RECOMMENDATION

Q. Based on your entire analysis, what is your updated estimate of the required rate of return on the common equity for IAWC?

A. Based on my updated analysis, in my judgment, the investor-required rate of return on common equity for IAWC is 10.38%.

Q. Please summarize how you estimated the investor-required rate of return on common equity for the Company.

A. First, I determined the investor-required rate of return from the NCDCF and the CAPM. For the NCDCF, I averaged the investor-required rate of return from the NCDCF for the Water Sample of 8.58% and the Utility Sample of 9.34%, which equals 8.96%. For the CAPM, I gave one-third weight to Water Sample CAPM of 12.11% and two-thirds weight to the Utility Sample CAPM of 11.75%, which equals 11.87%. Next, I averaged the results of the NCDCF and CAPM analyses to estimate the investor-required rate of return on common equity for the Samples, which equals 10.42%.

Finally, I adjusted the Samples' investor-required rate of return downward four basis points to reflect the lower risk of the Company relative to the two Samples. Thus, the average of the results for the Samples adjusted for risk is 10.38%. The analysis of the risk of the Company and of the Samples was explained in my direct testimony. (ICC Staff Exhibit 4.0.) Table 1 below presents the updated benchmark ratios.

Table 1 – Updated Benchmark Ratios

	AA	A
Financial Guideline Ratios		
FFO/IC	3.0-4.0X	2.0-3.0X
FFO/Debt	20-25%	12-20%
Staff Proposal – IAWC 2009		
FFOIC	4.4X	
FFO/Debt		19.9%
Utility Sample (Average 2004-2006)		
FFOIC	4.2X	
FFO/Debt		19.4%
Water Sample (Average 2004-2006)		
FFOIC	3.94X	
FFO/Debt		19.2%

The ratios for the Water Sample and Utility Sample imply a slightly higher level of financial risk than IAWC's ratios indicate. From the analysis of relative business risk described in my direct testimony (ICC Staff Exhibit 4.0, pp. 25-26) and this analysis of relative financial risk, I conclude that Staff's revenue requirement recommendations, including my cost of common equity recommendation, indicate a level of financial strength that is commensurate with a credit rating that is one notch higher than the Utility Sample's credit rating.[5] Thus, I made the same one notch adjustment (four basis points) as in my direct testimony. (ICC Staff Exhibit 4.0.)

[5] Credit ratings are only available for two of the seven companies in the Water Sample. Therefore, I determined the adjustment based upon the average credit rating of the Utility Sample.

Q. Why did you weight the CAPM derived cost of common equity estimates from your Water Sample and Utility Sample to estimate IAWC's cost of common equity?

A. In my judgment some of the beta estimates for the Water Sample companies used in the CAPM analysis are unrealistically high. This was fully addressed in my direct testimony. (ICC Staff Exhibit 4.0, p. 30.) Therefore, I gave the Utility Sample CAPM results twice the weight as the Water Sample CAPM results in developing my recommend cost of common equity.

OVERALL COST OF CAPITAL RECOMMENDATION

Q. What are the overall costs of capital for IAWC?

A. As shown on Schedule 14.6, IAWC's overall cost of capital is 7.85%. The estimate incorporates a cost of common equity of 10.38%.

RESPONSE TO MS. AHERN

Q. Ms. Ahern argues that the results of "Mr. Janous' two stage DCF analysis should be rejected"… "as they are woefully inadequate relative to recently authorized ROEs for electric and gas utilities against which IAWC, through AWCC, must compete for capital in the capital markets."[6] Please respond.

A. I disagree for two reasons. First, Ms. Ahern focuses on just the results of Mr. Janous' two stage DCF analysis and not on his overall recommended return on equity ("ROE"). There is a large degree of measurement error inherent in any estimate of a company's cost of common equity, which is exacerbated further

[6] IAWC Exhibit 12.10, p. 33.

when only one model is employed in that analysis. Consequently, Ms. Ahern, Mr. Janous, and I all measure cost of common equity with both the DCF and CAPM models. Applying the logic inherent in Ms. Ahern's approach focusing on each model's cost of common equity estimates would lead to the elimination of my non-constant DCF estimate for the Water Sample (8.58%) and both of my CAPM estimates (11.75% for the Utility Sample and 12.11% for the Water Sample), since they fall outside the range of authorized ROE's of 9.1% to 11.5% presented by Ms. Ahern.[7] That would leave me only with my Public Utility Sample non-constant growth DCF estimate of 9.34% for my ROE recommendation.

Second, Ms. Ahern's testimony fails to specify critical factors that influenced the allowed returns in those 69 proceedings.[8] For instance, Ms. Ahern only presents the common equity ratio. She does not identify the relative risk, as exemplified by credit rating or any other metric, of the utilities involved in those return decisions. Nor does she identify the amount of the common stock flotation cost adjustment, if any, that was included in each of those decisions. Without such data, any evaluation of the rate of return recommendations in this proceeding via comparison to the returns authorized in the 69 cases Ms. Ahern cites is useless since we have insufficient basis for assessing comparability.

[7] IAWC Exhibit 12.0, p. 33.
[8] IAWC Exhibit 12.10, Schedule 12.20.

RESPONSE TO MR. THOMAS

Q. Mr. Thomas states that "[i]f we accept that (1) current stock prices reflect all available information, and (2) the empirical research has found a pattern of upwardly biased analyst growth rate forecasts…[u]sing analyst forecasts as the only estimates of growth will overstate the cost of [common equity] capital..."[9] Do you agree?

A. The appropriate answer depends on the benchmark used to determine if analyst growth rates are too high. If analysts' growth rate estimates are too high relative to investors' true growth expectations, Mr. Thomas's statement is correct. That is, if analyst growth rates overstate investor expectations of future growth, use of those analyst growth rates will produce an overstated cost of common equity. However, Mr. Thomas's statement is made in the context of a discussion of whether or not analysts' growth estimates are too high relative to achieved growth, as measured after the fact. This suggests that he is assessing analyst growth rates on their ability to accurately predict future growth, not on their value as estimates of investors' ex ante expectations. If so, the study does not support the validity of his position. As noted above, the rationality of investors' true growth expectations is not at issue. Indeed, given that investors' growth expectations are forecasts of the future, they may differ significantly from the ex post achieved growth. A cost of common equity witness should estimate investors' growth expectations. To the extent that analyst growth rates reflect the investors' true growth expectations, use of analyst growth rates will provide an accurate estimate of the cost of common equity, if properly applied in a correctly specified DCF model, whether or not the predicted growth is ultimately realized.

[9] CUB Exhibit 1.0, pp.27-28.

Mr. Thomas has presented no evidence to demonstrate that analyst growth rates are poor proxies for investor growth expectations.

Q. Mr. Thomas claims that "[t]here is a disconnect between the way that investors actually receive cash flows and the way the Commission sets rates" … which allows a company to "recover its approved cost of equity over an entire year"… even though "investors receive dividend payments on a quarterly basis" and concludes that the quarterly DCF model is not appropriate for rate setting purposes.[10] Do you agree?

A. No. Mr. Thomas has raised a working capital issue, not a cost of common equity issue. His argument implicitly assumes that working capital is not correctly measured. A working capital allowance compensates a utility for any delay between the time it expends cash to provide service and the time it receives cash from its customer for that service.[11] If a utility is authorized an appropriate working capital allowance, by definition, it will receive cash to pay for all costs of service as they come due. Consequently, if one assumes an appropriate working capital allowance is authorized, Mr. Thomas's argument is invalid because the working capital allowance will eliminate any surplus or deficit in earnings created by the timing of the utility's cash collections and disbursements. Since utility companies pay cash flows (i.e., dividends) over the course of a year and not all at the end of the year, use of a quarterly DCF model is not only appropriate for rate setting purposes, it is necessary for a utility to recover its true cost of common equity.

[10] CUB Exhibit 1.0, p. 38.
[11] Hahne and Aliff, Accounting for Public Utilities, Mathew Bender, 1991, p. 5-2.

Q. Please evaluate Mr. Thomas's market to book value analysis.[12]

A. Mr. Thomas's market to book value analysis is based on the premise that one should expect a utility company to precisely earn its cost of capital on a continuing basis.[13] That premise is oversimplified. There are many utility ratemaking practices (e.g., deferred taxes and depreciation) that could result in a utility's market value exceeding its book value. That is, the authorized return for each company in his sample is not the only factor influencing its earnings. Thus, a market to book ratio in excess of one does not necessarily mean the authorized rate of return is too high.

Q. Mr. Thomas notes that the "Nagel Paper" rejected "the version of the CAPM traditionally used by the Commission."[14] Please respond.

A. Mr. Thomas is wrong. The Nagel Paper does not apply to Staff's CAPM, because it does not evaluate a CAPM that utilizes adjusted betas. As a matter of fact, the Nagel Paper found that a CAPM using raw betas was less accurate in predicting realized rate of returns than a forecast model that assumed future returns would equal the market average (beta equals 1.0).[15] Interestingly, Mr. Thomas relied on the version of the CAPM that used raw betas as a check to his DCF analysis.

[12] CUB Exhibit 1.0, pp. 22-23.
[13] CUB Exhibit 1.0, pp. 22-23.
[14] CUB Exhibit 1.0, p. 5.
[15] Gregory L. Nagel, David R. Peterson, and Robert S. Prati, The Effect of Risk Factors on Cost of Equity Estimation, Quarterly Journal of Business and Economics, Vol. 46 No. 1, p. 67.

Q. Mr. Thomas criticizes the use in the CAPM of betas adjusted for reversion to the market mean of 1.0.[16] Why did you adjust your raw beta estimates?

A. I adjusted the raw (i.e., historical) betas for the companies in my sample to improve the accuracy of my beta estimates. Ex post empirical tests of the CAPM suggest that the linear relationship between risk, as measured by raw beta, and return is flatter than the CAPM predicts.[17] That is, securities with raw betas less than one tend to realize higher returns than the CAPM predicts. Conversely, securities with raw betas greater than one tend to realize lower returns than the CAPM predicts. Adjusting the raw beta estimate towards the market mean of 1.0 results in a linear relationship between the beta estimate and realized return that more closely conforms to the CAPM prediction. Securities with betas less than one are adjusted upwards thereby increasing the predicted required rate of return towards observed realized rates of return. Conversely, securities with betas greater than one are adjusted downwards thereby decreasing the predicted rate of return towards observed realized rates of return. Thus, adjusted betas surpass raw betas as predictors of future returns and are, therefore, superior forward-looking betas. Consistently, Seth Armitage in his text, "The Cost of Capital," with regard to this argument, notes that studies have shown that such adjustments result in appreciably better forecasts, finding that the reduction in both bias and inefficiency is greater the further away from one the beta in question is.[18]

[16] CUB Exhibit 1.0, pp. 11-15.
[17] Litzenberger, Ramaswamy and Sosin, "On the CAPM Approach to the Estimation of A Public Utility's Cost of Common Equity Capital," Journal of Finance, May 1980, pp. 375-376.
[18] Armitage, S., The Cost of Capital: Intermediate Theory, 2005, pp. 284-285.

Q. Mr. Thomas presents academic research indicating that the proper expected common equity market risk premium for determining the investor-required rate of return is between 3 and 5%.[19] Do you agree?

A. No. The research cited by Mr. Thomas represents various academics' opinions of the common equity risk premium investors should expect, which is not necessarily the same as what the investors truly are expecting.[20] Since the relationship between the returns of the stock market and U.S. Treasury bonds is not stable over time, current returns provide the best indication of what investors are expecting going forward. Hence, my estimate of the common equity risk premium, derived by subtracting the current yield on long-term U.S. Treasury bonds from the first quarter return on the S&P 500 provides the actual difference between returns on risk-free and risky securities that exists in today's market.

Q. Does this conclude your prepared rebuttal testimony?

A. Yes, it does.

[19] CUB Exhibit 1.0, pp. 16-19.
[20] CUB Exhibit 1.0, pp. 54.

Docket No. 07-0507
ICC Staff Exhibit 14.0C
Schedule 14.1

Illinois-American Water Company

Embedded Cost of Debt
Average 2009

	Debt Issue Type, Coupon Rate (A)		Date Issued (B)	Maturity Date (C)	Original Principal Amount (D)	Face Amount Outstanding (F)	Debt Discount or (Premium) (H)	Unamortized Debt Expense (I)	Carrying Value (J)	Coupon Interest Expense (K)	Amortization of Debt Discount or (Premium) (L)	Amortization of Debt Expense (M)	Total Expense (N)
1	**General Mortgage Bonds**												
2	Series	6.073%	12/31/2008	12/31/2038	26,500,000	14,354,167		71,219	14,282,948	871,729		2,209	873,938
3	Series	6.310%	7/1/2008	7/1/2038	28,500,000	28,500,000		158,578	28,341,422	1,798,350		5,376	1,803,726
4	Series	6.593%	10/22/2007	9/30/2037	94,000,000	94,000,000		900,827	93,099,174	6,197,420		31,243	6,228,663
5	Series	9.220%	12/15/1998	12/1/2009	6,000,000	875,000		4,978	870,022	80,675		5,432	86,107
6	Variable Series	3.650%	3/28/2002	9/1/2032	24,860,000	24,860,000		747,266	24,112,734	907,390		32,256	939,646
7	Series	9.625%	3/15/1989	2/1/2019	6,000,000	6,000,000		30,205	5,969,796	577,500		2,995	580,495
8	Series	5.150%	9/23/1993	8/1/2023	6,000,000	5,745,000		234,232	5,510,768	295,868		16,062	311,930
9	Tax Exempt	5.500%	12/19/1996	12/1/2026	7,000,000	6,990,000		323,870	6,666,130	384,450		18,076	402,526
10	Series	5.000%	2/24/1998	2/1/2028	12,000,000	11,975,000		542,165	11,432,835	598,750		28,410	627,160
11	Tax Exempt	5.000%	2/25/1998	2/1/2028	6,000,000	5,875,000		277,341	5,597,660	293,750		14,533	308,283
12	Tax Exempt	5.100%	6/23/1999	6/1/2029	30,645,000	30,645,000		1,208,981	29,436,020	1,562,895		59,215	1,622,110
13	Variable Series	4.300%	5/1/1997	5/1/2032	23,325,000	23,325,000		209,254	23,115,746	1,002,975		8,968	1,011,943
14	**Total General Mortgage Bonds**				270,830,000	253,144,167	-	4,708,914	248,435,253	14,571,751	-	224,775	14,796,526
15	**Docket Nos 06-0650/0651**												
16	Series	5.520%	5/16/2007	12/21/2016	2,500,000	2,500,000		11,740	2,488,260	138,000		1,437	139,437
17	Series	5.620%	5/16/2007	12/21/2018	13,500,000	13,500,000		65,707	13,434,293	758,700		6,463	765,163
18	Series	5.770%	5/16/2007	12/21/2021	23,000,000	23,000,000		115,873	22,884,127	1,327,100		8,801	1,335,901
19	Series	5.390%	5/16/2007	12/21/2013	13,000,000	13,000,000		55,297	12,944,703	700,700		10,702	711,402
20	Series	5.620%	5/16/2007	3/23/2019	22,000,000	22,000,000		106,984	21,893,016	1,236,400		10,270	1,246,670
21	Series	5.620%	6/12/2007	12/21/2018	30,000,000	30,000,000		84,070	29,915,930	1,686,000		8,337	1,694,337
22	**Total Docket Nos 06-0650/0651**				104,000,000	104,000,000	-	439,671	103,560,329	5,846,900	-	46,010	5,892,910
23	**Notes Payable**												
24	Series	2.570%	5/15/2004	5/15/2024	1,586,381	1,329,514			1,329,514	34,169			34,169
25									-				
26	Series	9.870%	7/31/2002	12/1/2013	6,485,642	958,941			958,941	94,647			94,647
27	**Total Notes Payable**				8,072,023	2,288,455	-	-	2,288,455	128,816	-	-	128,816
28	**Reaquired Debt**												
29		6.100%	24-Nov-87	30-Sep-22				361,172	(361,172)			$26,267	$26,267
30		6.100%	24-Nov-87	30-Sep-22				210,656	(210,656)			$15,320	$15,320
31		6.150%	24-Nov-87	31-Aug-24				481,685	(481,685)			$30,746	$30,746
32		6.900%	25-Aug-04	28-Feb-21				251,303	(251,303)			20,655	20,655
33	**Total--Reaquired Debt**							$1,304,815	(1,304,815)			$92,988	$92,988
34						$359,432,622		$6,453,400	$352,979,222	$20,547,467		$363,773	$20,911,240
35													**5.92%**

Docket No. 07-0507
ICC Staff Exhibit 14.0C
Schedule 14.2

Illinois-American Water Company

Average Common Equity Balances

	Jun-08	Jul-08	Aug-08	Sep-08	Oct-08	Nov-08	Dec-08	Jan-09	Feb-09	Mar-09	Apr-09	May-09	Jun-09
Common Stock													
BOM	$ 199,061,157	$ 199,061,157	$ 199,061,157	$ 199,061,157	$ 199,061,157	$ 199,061,157	$ 199,061,157	$ 199,061,157	$ 199,061,157	$ 199,061,157	$ 199,061,157	$ 199,061,157	$ 199,061,157
Additions													
EOM	$ 199,061,157	$ 199,061,157	$ 199,061,157	$ 199,061,157	$ 199,061,157	$ 199,061,157	$ 199,061,157	$ 199,061,157	$ 199,061,157	$ 199,061,157	$ 199,061,157	$ 199,061,157	$ 199,061,157
Paid in Capital	$ 2,347,616	$ 2,347,616	$ 2,347,616	$ 2,347,616	$ 2,347,616	$ 2,347,616	$ 2,347,616	$ 2,347,616	$ 2,347,616	$ 2,347,616	$ 2,347,616	$ 2,347,616	$ 2,347,616
Retained Earnings													
BOM	$ 82,621,931	$ 83,349,257	$ 84,777,153	$ 89,146,284	$ 92,325,854	$ 94,872,071	$ 95,021,237	$ 88,358,474	$ 89,114,641	$ 89,889,459	$ 88,428,782	$ 88,871,293	$ 90,553,612
Additions	$ 727,326	$ 1,427,896	$ 1,406,370	$ 1,219,311	$ 819,596	$ 48,015	$ (686,824)	$ (683,279)	$ (700,133)	$ (769,297)	$ (399,857)	$ 541,518	$ 506,759
Rate Case NI*	$ -	$ -	$ 2,962,761	$ 2,568,689	$ 1,726,621	$ 101,151	$ 1,446,912	$ 1,439,446	$ 1,474,951	$ 1,620,656	$ 842,368	$ 1,140,801	$ 1,067,575
Total NI	$ 727,326	$ 1,427,896	$ 4,369,131	$ 3,788,000	$ 2,546,217	$ 149,166	$ 760,088	$ 756,167	$ 774,818	$ 851,359	$ 442,511	$ 1,682,319	$ 1,574,334
Dividends**				$ (608,430)			$ (7,422,851)			$ (2,312,036)			$ (1,825,292)
EOM	$ 83,349,257	$ 84,777,153	$ 89,146,284	$ 92,325,854	$ 94,872,071	$ 95,021,237	$ 88,358,474	$ 89,114,641	$ 89,889,459	$ 88,428,782	$ 88,871,293	$ 90,553,612	$ 90,302,653
Total Common Equity	$ 284,758,030	$ 286,185,926	$ 290,555,057	$ 293,734,627	$ 296,280,844	$ 296,430,010	$ 289,767,247	$ 290,523,414	$ 291,298,232	$ 289,837,555	$ 290,280,066	$ 291,962,385	$ 291,711,426
Average Monthly Equity		$ 285,471,978	$ 288,370,492	$ 292,144,842	$ 295,007,736	$ 296,355,427	$ 293,098,629	$ 290,145,330	$ 290,910,823	$ 290,567,893	$ 290,058,810	$ 291,121,225	$ 291,836,906
Average 2009 Common Equity Balance													**$ 291,257,508**

Notes:
Staff's Rate Case NI is calculated by taking Staff's ROE deficiency * 11/12 (number of months Rate increase is effective) divided by the Company's total Rate Case NI and multiplying each month by this proportion.
ROE Deficiency = Staff Weighted Rate of Return on Common Equity X Staff Rate Base - (Company Operating Income under Present Rates -
(Company Weighted Costs of Debt and Preferred Stock X Company Rate Base))

* * The Sept. 2008 and Dec. 2008 dividends are based on the Company's updated response to Staff data request SK 4-01, and reflect dividend paid on earnings before the rate increase.
The March 09 dividend is equal to 75% of the increased earnings for October to December rounded down to the nearest penny.
The dividend June 09 is equal to 75% fo the increased earnings for October to March minus the March dividend rounded down to the nearest penny.

Sources: Company response to deficiency No. 2
ICC Staff data request SK 4-01
IAWC Exhibit No. 2.14

Illinois-American Water Company

The Non-Constant Growth Discounted Cash Flow Model

The formula for measuring the cost of common equity, *k*, when growth, *g*, does not become constant until period φ, is as follows:

$$k = \left[\frac{D_{1,1}(1+k)^{\varphi-0.25} + D_{1,2}(1+k)^{\varphi-0.50} + D_{1,3}(1+k)^{\varphi-0.75} + \ldots + D_{\varphi,4} + P_{\varphi,4}}{P} \right]^{\left(\frac{1}{x+\varphi-0.25} \right)} - 1$$

where: P ≡ the current market value;

$D_{\varphi,q}$ ≡ the expected dividend at the end of quarter *q* in year φ, where *q* = 1 to 4 and φ = the number of periods until the steady-state growth period;

k ≡ the cost of common equity;

x ≡ the elapsed time between the stock observation and first dividend payment dates, in years; and

$P_{\varphi,4}$, the market value at the beginning of the steady-state growth stage, is calculated from the following equation:

$$P_{\varphi,4} = \frac{\sum_{q=1}^{4} D_{\varphi,q}(1+g_l)(1+k)^{1-[x+0.25(q-1)]}}{k-g_l}$$

where: $D_{\varphi,q}$ ≡ the dividend paid in quarter q during the last year of the transitional growth stage; and

g_l ≡ the steady-state growth rate.

Docket No. 07-0507
ICC Staff Exhibit 14.0C
Schedule 14.4

Illinois-American Water Company

Growth Rate Estimates

Water Sample

	Company	Growth Rates Stage 1[1]	Stage 2[2]	Stage 3[3]
1	Aqua America	10.80%	7.80%	4.79%
2	Artesian	5.00%	4.90%	4.79%
3	California Water	8.00%	6.40%	4.79%
4	Middlesex	8.00%	6.40%	4.79%
5	SJW	10.00%	7.40%	4.79%
6	SWWC	11.00%	7.90%	4.79%
7	York	11.33%	8.06%	4.79%

Utility Sample

	Company	Growth Rates Stage 1[1]	Stage 2[2]	Stage 3[3]
1	Atmos	5.75%	5.27%	4.79%
2	Centerpoint Energy	9.50%	7.15%	4.79%
3	Consolidated Edison Inc	3.67%	4.23%	4.79%
4	Nicor	4.00%	4.40%	4.79%
5	Northwest Natural Gas	5.25%	5.02%	4.79%
6	Nstar	6.50%	5.65%	4.79%
7	Piedmont Natural Gas Co	5.67%	5.23%	4.79%
8	WGL Holding Inc	4.00%	4.40%	4.79%

1 Zacks 3-5 year earnings per share growth rate estimates. (Zacks Investment Research, Inc.)

2 Equals the average of Stage 1 and Stage 3 growth rates.

3 The implied 20-year forward U.S. Treasury rate in ten years (20*f*10), based on the 10- and 30-year U.S. Treasury rates as of December 12, 2007. (The Federal Reserve Board, Federal Reserve Statistical Release: H.15, Selected Interest Rates, Weekly Update, www.federalreserve.gov/releases/H15/update/, December 13, 2007.

Docket No. 07-0507
ICC Staff Exhibit 14.0C
Schedule 14.5

Illinois-American Water Company

DCF- Cost of Common Equity Estimate

Water Sample

	Company		Cost of Equity Estimate
1	Aqua America		8.24%
2	Artesian		8.62%
3	California Water		8.81%
4	Middlesex		9.49%
5	SJW		7.46%
6	SWWC		7.79%
7	York		9.68%
		Average	8.58%

Utility Sample

	Company		Cost of Equity Estimate
1	Atmos		10.15%
2	Centerpoint Energy		10.24%
3	Consolidated Edison Inc		9.52%
4	Nicor		9.26%
5	Northwest Natural Gas		8.16%
6	Nstar		9.17%
7	Piedmont Natural Gas Co		9.12%
8	WGL Holding Inc		9.10%
		Average	9.34%

Docket No. 07-0507
ICC Staff Exhibit 14.0C
Schedule 14.6

Illinois-American Water Company

Staff's Proposed Weighted Average Cost of Capital

Class of Capital	Amount at Present Rates	Adjustment	Balance	Percent of Total Capital	Cost	Weighted Cost
Short-Term Debt	$ 21,696,082		$ 21,696,082	3.26%	5.28%	0.17%
Long-Term Debt	$ 352,979,222		$ 352,979,222	53.01%	5.92%	3.14%
Common Equity	$ 283,375,383	$ 7,882,125	$ 291,257,508	43.74%	10.38%	4.54%
Total	$ 636,354,605		$ 665,932,811	100.0%		7.85%