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**I. BACKGROUND; PROCEDURAL HISTORY; NATURE OF OPERATIONS;  
TEST YEAR**

**A. Background**

In this proceeding, Illinois-American Water Company (“IAWC” or the “Company”) requests an increase of approximately \$31.27 million in base water and sewer rates for the Company’s Illinois service districts. The Company’s last rate case was in Docket No. 02-0690. Since the last case, the Company has experienced increased operating expenses, and, for certain service areas, substantially increased rate base. These increases are as a result of capital expenditures necessary to meet customer service needs (including a new 15 million gallon per day (“MGD”) ground water treatment facility planned for IAWC’s Champaign District, the Champaign County Water Treatment Facility (the “Champaign Facility”)) and implementation of a number of programs designed to maintain high quality service. As IAWC’s President, Karla O. Teasley, explains, the Company has proposed in this case a rate increase designed to produce the additional revenues needed to provide, for each of its service districts, an opportunity to recover operating expenses and a reasonable rate of return on rate base. (IAWC Ex. 1.00 (Teasley Dir.), p. 7.)<sup>1</sup> The proposed increase is necessary to allow the Company to maintain a high level of service to its customers. (*Id.*, p. 8.) The Company has proposed use of a future test year ending on June 30, 2009.

One of the major test year plant additions is the Champaign Facility, which will help provide high quality water to a growing customer base in Champaign when the plant is in service in December 2008. (IAWC Ex. 8.00 (Suits Dir.), p. 2.) Growth in the City of Champaign area

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<sup>1</sup> In this Initial Brief, IAWC’s citations will identify the IAWC Exhibit number and witness. Citations to a witness’s testimony are, where applicable, to the final “Revised” or “Corrected” version included in the evidentiary record. Where testimony or an exhibit have been revised or corrected, such revision or correction will be indicated in the summary of the respective witness’s testimony in the Procedural History section below. Subsequent citations in this Initial Brief will not identify testimony or exhibits as revised or corrected.

has caused peak maximum day water demand to approach the rated capacity of existing Champaign District water treatment facilities. (Id.) As a result, after conducting studies and analysis, IAWC determined that it was necessary to build new capacity. (Id.) The proposed rate base amount related to the Champaign Facility is \$44.5 million, the average level of investment in the Champaign Facility for the test year. (IAWC Ex. 16.00, Scheds. B-2, p. 5 of 8, B-7, B-7.1; Tr. 134.) The Commission reviewed the details of the Champaign Facility in Docket 07-0371, in which IAWC received approval to issue long-term debt to fund capital projects, including the Champaign Facility. Illinois-American Water Co., Docket 07-0371 (Jan. 16, 2008) (“Docket 07-0371 Order”). In the Docket 07-0371 Order, the Commission approved IAWC’s financing proposal and, with respect to the Champaign Facility, found that “IAWC is reasonably required to expand its water supply source and water treatment plant capacity in the Champaign District and application of the net proceeds from the indebtedness to the purposes set forth herein, including construction of the Champaign Facility, is reasonable and should be approved.” Docket 07-0371 Order, p. 16. IAWC witness James Jenkins explained that IAWC’s financing program for 2007 through June, 2009 included the issuance of up to \$28,500,000 in long-term debt (IAWC received Commission approval for this issuance in Docket 07-0371), primarily to finance a portion of the capital costs of the Champaign Facility. (IAWC Exs. 2.00 (Jenkins Dir.), p. 4; 2.21.)

As described by IAWC witness Alan DeBoy (IAWC Ex. 7.00 (DeBoy Dir.), pp. 6-19), the Company completed approximately 30 major capital investment projects between the last rate case and 2006, and projected completion of over 20 additional major projects from 2007 through the end of the test year. (Id., pp. 13-19.) These capital investment projects included construction of transmission mains and booster stations, and improvements and upgrades to

water and wastewater treatment facilities, all intended to enhance the quality of service IAWC provides to customers. The Company has also achieved enhancements to service quality and efficiency through smaller projects, such as those relating to replacement of mains, services, hydrants and meters, that do not meet the definition of a “major capital project.” (Id., p. 6.)

To maintain high-quality service, IAWC has undertaken a number of programs which have contributed to an increase in operating expenses. (IAWC Ex. 3.00 (Ruckman Dir.), pp. 3-4.) IAWC witness Mr. Frederick Ruckman described three of these programs in particular. First, in the Chicago Metro District, IAWC is in the process of replacing all meters in this area with automatic radio-read meters. (Id., p. 4.) As Mr. Ruckman explained, the installation of radio-read meters will provide a continuing benefit to customers by reducing estimated reads and reducing the need to issue bills for prior unbilled service. Second, as Mr. Ruckman explained, the Company has increased its employee count by hiring 38 additional employees to perform hydrant and valve inspections and maintenance, and related activities, throughout the IAWC system. (Id.) Hiring and maintaining these personnel will allow the Company to continue to perform required inspection and maintenance activities in a timely and efficient fashion. (Id.) Third, the Company has devoted significant resources to identifying and, where economically justified, mitigating levels of unaccounted-for water. Also, as explained by IAWC witness Edward Grubb (IAWC Ex. 4.00 (Grubb Dir.), pp. 15-38), there has been an increased level of services provided by the American Water Works Service Company, Inc. (“Service Company”), which benefits IAWC customers.

The Company’s initial filing in this case showed, for all service districts, that the Company’s operating expenses since the test year in the last rate case have increased by approximately \$17.7 million and rate base has increased by over \$113 million, thus requiring

additional annual revenue of approximately \$35.4 million to afford the Company the opportunity to earn a reasonable rate of return. (IAWC Ex. 1.00 (Teasley Dir.), p. 8.) As a result of various adjustments discussed below, the record shows that, for all service districts in the aggregate, additional annual revenue of approximately \$31.27 million is needed to afford the Company the opportunity to earn a reasonable rate of return. (IAWC Ex. 6.21 (Second Revised).) The Company has proposed rate increases or decreases for each of its Rate Areas (defined below). For each Rate Area, the final proposed operating income statement and rate base are shown on the designated sheet of IAWC Exhibit 6.21 (Second Revised) and Exhibit 6.23 (Second Revised), respectively. The Company proposes to implement the requested rate increase across the board in each Rate Area for which an increase is requested. (IAWC Ex. 4.00 (Grubb Dir.), p. 39.)

The Company proposes an overall rate of return of 8.23%, which includes a cost of common equity of 11.24%. As explained by IAWC witness Pauline Ahern, such a return on common equity is reasonable, based on her assessment of the market-based cost rates of proxy companies of relatively similar risk, with an appropriate adjustment for IAWC's business risk relative to the proxy groups (because IAWC's common stock is not publicly traded, a market-based common equity cost rate cannot be determined directly for IAWC). (IAWC Ex. 12.00 (Ahern Dir.), pp. 3-7, 35-37.)

## **B. Nature of Operations**

IAWC is a corporation organized and existing under the laws of the State of Illinois with its principal office in the City of Belleville, Illinois. IAWC currently owns, operates, and maintains potable water production, treatment, storage, transmission and distribution systems, and wastewater collection, pumping, and/or treatment systems for the purpose of furnishing water and wastewater service for residential, commercial, industrial, and governmental users in

its various districts. IAWC's service districts include Alton, Cairo, Champaign, Chicago Metro, Interurban, Lincoln, Pekin, Peoria, Pontiac, South Beloit, Sterling, and Streator. Overall, IAWC serves approximately 302,000 customers in 129 communities in Illinois. IAWC is a wholly-owned subsidiary of American Water Works Company, Inc. ("American Water"), a holding company that owns the stock of water and sewer utility subsidiaries operating in 23 states. (IAWC Ex. 3.00 (Ruckman Dir.), p. 3.)

**C. Test Year**

The test year in this proceeding is a future test year consisting of the twelve month period ended June 30, 2009. No party has opposed use of this future test year. IAWC witness Edward Grubb explained how IAWC's test year projections were developed. (IAWC Ex. 4.00 (Grubb Dir.), pp. 2-7.) Mr. Grubb further explained that the test year projections were developed in accordance with the "Guide for Prospective Financial Information (2006)" ("AICPA Guide") issued by the American Institute of Certified Public Accountants. (Id., p. 6.) In Schedule G-2 (see IAWC Exhibit 20.00), the Company submitted the opinion of Kerber, Eck & Braeckel LLP, certified public accountants, that the preparation and presentation of the projections comply with the AICPA Guide. Mr. Grubb stated that the projections are reasonable, reliable, and were made in good faith, and the assumptions and methodologies used in developing the projections are the same as those reflected in the test year projections prepared for the Company's management, as adjusted to reflect the rate increase proposed in this proceeding. (Id., p. 7.)

**D. Procedural History**

On August 31, 2007, IAWC filed its new and/or revised tariff sheets for water and sewer service. In conjunction with the filing of these tariffs, the Company filed the schedules and other materials required under 83 Ill. Adm. Code Part 285. For the purposes of this case, IAWC's service districts have been grouped into the following seven rate areas: (1) the SPSPSB District

(including the Southern service district (Alton, Cairo, and Interurban), and Peoria, Streator, Pontiac and South Beloit service districts); (2) the Chicago Metro District-Water; (3) the Chicago Metro District-Sewer; (4) the Champaign District; (5) the Pekin District; (6) the Sterling District; and (7) the Lincoln District (each a “Rate Area”). The Company filed for rate increase or decreases for each Rate Area, and the Company’s schedules of operating income and rate base include separate designated pages for each Rate Area. The Company also aggregated, where applicable, the data in each of its schedules into a “Total Company” schedule, reflecting the operating income, rate base or other information on a total Company-wide basis. The Company presented its projected capital structure on a Total Company basis only.

Notice of the filing of the proposed rate increase was posted in IAWC’s service district business offices and was published twice in newspapers of general circulation within each service district, in accordance with the requirements of Section 9-201(a) of the Public Utilities Act (the “Act”) (220 ILCS 5/9-201(a)) and the provisions of 83 Ill. Adm. Code 255. In addition, the Company sent notice of the filing to its customers with the first billing issued after the filing.

The Company’s proposed rates were suspended on October 11, 2007 and resuspended on January 16, 2008.

Leave to intervene in the proceeding was granted to: the City of Champaign; the People of the State of Illinois, by the Attorney General of the State of Illinois (“AG”); the Citizens Utility Board (“CUB”); the Illinois Industrial Water Consumers (“IIWC”); the City of Pekin; the Village of Bolingbrook; Fosterburg Water District; Jersey County Rural Water Co., Inc.; Bond Madison Water Company; the City of Peoria; the University of Illinois; the Village of Homer Glen (“Homer Glen”); the Village of Orland Hills; the City of Urbana; the Village of St. Joseph; and the Village of Savoy.

The Company presented the testimony and exhibits of the following witnesses:

**Karla O. Teasley.** Ms. Teasley offered the following testimony and exhibits: Direct Testimony (IAWC Ex. 1.00, filed on 8/31/07) with Direct Exhibits (IAWC Ex. 1.1-1.2, filed on 8/31/07), Rebuttal Testimony (IAWC Ex. 1.10, filed on 2/11/08) with Rebuttal Exhibits (IAWC Ex. 1.11-1.12, filed on 2/11/08), Surrebuttal Testimony (IAWC Ex. 1.20 (Revised), filed on 4/18/08), and the Affidavit of Karla O. Teasley (IAWC Ex. 1.30, filed on 4/1/08).

Ms. Teasley testified regarding the description of the Company and its operations, and discussed factors related to the application for an increase in rates. She also discussed the Order issued by the Commission in Docket 05-0681/06-0094/06-0095 (consol.) (“Docket 05-0681 Order”). In addition, she testified regarding the provision of incentive compensation and executive perquisites by IAWC, rate levels in the Chicago Metro District as compared to rates charged in neighboring municipalities, and measures being undertaken by the Company to minimize costs and rates.

**James M. Jenkins.** Mr. Jenkins offered the following testimony and exhibits: Direct Testimony (IAWC Ex. 2.00, filed on 8/31/07, and incorporating the Errata filed on March 24, 2008), Rebuttal Testimony (IAWC Ex. 2.10, filed 2/11/08) with Rebuttal Exhibits (IAWC Ex. 2.11-2.15, filed on 2/11/08), Surrebuttal Testimony (IAWC Ex. 2.20, filed on 3/18/08) with Surrebuttal Exhibits (IAWC Ex. 2.21-2.22, filed on 3/18/08), and the Affidavit of James M. Jenkins (IAWC Ex. 2.30, filed on 3/26/08).

Mr. Jenkins also sponsored the following schedules that IAWC has provided as required by the Standard Information Requirements contained in Title 83 of the Illinois Administrative Code, Part 285 (“Schedules”) (filed on 8/31/07 unless otherwise noted): Schedule D-1 (First Revised) (filed on 12/5/07) and Schedule D-1.3.

Mr. Jenkins testified regarding IAWC's capital structure and cost rates of short- and long-term debt.

**Frederick Ruckman.** Mr. Ruckman offered the following testimony and exhibits: Direct Testimony (IAWC Ex. 3.00, filed on 8/31/07) with Direct Exhibit (IAWC Ex. 3.01, filed on 8/31/07), Rebuttal Testimony (IAWC Ex. 3.10, filed on 2/11/08), and Surrebuttal Testimony (IAWC Ex. 3.20 (Revised), filed on 4/18/08).

Mr. Ruckman testified regarding the Company's operations. He also described recently-instituted operating programs that will provide ongoing benefits to customers and discussed unaccounted-for water and certain proposed tariff revisions.

**Edward J. Grubb.** Mr. Grubb offered the following testimony and exhibits: Direct Testimony (IAWC Ex. 4.00 (Revised), filed on 12/05/07 and incorporating the Errata filed on March 24, 2008) with Direct Exhibits (IAWC Ex. 4.01-4.04, filed on 8/31/07), Supplemental Direct Testimony (IAWC Ex. 4.00 SUPP, filed on 12/05/07) with Supplemental Exhibits (IAWC Ex. 4.05-4.07 SUPP, filed on 12/05/07), Rebuttal Testimony (IAWC Ex. 4.10 (Revised) – Public & Proprietary versions, filed on 3/21/08) with Rebuttal Exhibits (IAWC Ex. 4.11-4.16, filed on 2/11/08), and Surrebuttal Testimony (IAWC Ex. 4.20, filed on 3/18/08) with Surrebuttal Exhibits (IAWC Ex. 4.21-4.22, filed on 3/18/08).

Mr. Grubb also sponsored the following Schedules (filed on 8/31/07 unless otherwise noted): Schedules B-2.2 (First Revised) (filed on 12/05/07), B-2.3, B-2.4, B-9, B-9.1, C-5 (First Revised) (filed on 12/05/07), C-5.1, C-5.2 (First Revised) (filed on 12/05/07), C-5.3 (First Revised) (filed on 12/05/07), C-5.5, E-1, E-2, E-3, E-4, E-5 (First Revised) (filed on 12/05/07), E-6, E-7 (First Revised) (filed 12/05/07), G-1, G-7, G-8, G-9, G-9a, and G-13.

Mr. Grubb testified regarding the Company's future test year projection of its revenue, expenses, and capital expenditure. He also addressed certain C and G Schedules, incentive compensation, revenues, management fees, and rate design and tariff issues.

**Scott W. Rungren.** Mr. Rungren offered the following testimony and exhibits: Direct Testimony (IAWC Ex. 5.00, filed on 8/31/07) and the Affidavit of Scott W. Rungren (IAWC Ex. 5.10, filed on 3/26/08).

Mr. Rungren also sponsored the following Schedules (filed on 8/31/07 unless otherwise noted): Schedules C-2.1, C-3, C-4 (First Revised) (filed on 12/05/07), C-6, C-6.1, C-6.2, C-7, C-8, C-9 (First Revised) (filed on 12/05/07), C-10 (First Revised) (filed on 12/05/07), C-10.1, C-11.1 (First Revised) (filed on 12/05/07), C-11.2a, C-11.2b, C-11.3 (First Revised) (filed on 12/05/07), C-13 (First Revised) (filed on 12/05/07), C-17, C-18, C-19, C-20, C-21, C-23, C-25, D-1.1, D-1.2, D-1.4, D-2 (First Revised) (filed on 12/05/07), D-3 (First Revised) (filed on 12/05/07), D-6, D-7 (First Revised) (filed on 12/05/07), D-8, D-8a, D-9, D-10, D-11, D-12, G-6, G-10, G-11, G-12, G-15, G-17, and G-18.

Mr. Rungren testified regarding the data contained in the Schedules he sponsors.

**Rich Kerckhove.** Mr. Kerckhove offered the following testimony and exhibits: Direct Testimony (IAWC Ex. 6.00, filed on 8/31/07 and incorporating the Errata filed on March 24, 2008), Rebuttal Testimony (IAWC Ex. 6.10, filed on 2/11/08) with Rebuttal Exhibits (IAWC Ex. 6.11-6.19, filed on 2/11/08), and Surrebuttal Testimony (IAWC Ex. 6.20, filed on 3/18/08) with Surrebuttal Exhibits (IAWC Ex. 6.22, 6.24-6.30, filed on 3/18/08), (IAWC Ex. 6.21, 6.23 (Second Revised), filed on 3/25/08)

Mr. Kerckhove also sponsored the following Schedules (filed on 8/31/07 unless otherwise noted): Schedules A-1, A-2 (First Revised) (filed on 12/05/07), A-2.1 (First Revised)

(filed on 12/05/07), A-3 (First Revised) (filed on 12/05/07), A-4 (First Revised) (filed on 12/05/07), A-5, B-1 (First Revised) (filed 12/05/07), B-2 (First Revised) (filed 12/05/07), B-2.1, B-3, B-4 (First Revised) (filed on 12/05/07), B-5 (First Revised) (filed on 12/05/07), B-5.1, B-5.2, B-6 (First Revised) (filed on 12/05/07), B-7 (First Revised) (filed on 12/05/07), B-7.1 (First Revised) (filed on 12/05/07), B-7.2, B-8 (First Revised) (filed on 12/05/07), B-8.1 (First Revised) (filed on 3/18/08), B-10 (First Revised) (filed on 2/22/08), B-12, B-14, B-15, C-1 (First Revised) (filed on 12/05/07), C-2 (First Revised) (filed on 12/05/07), C-2.2, C-2.3, C-2.4, C-2.5, C-2.6 (First Revised) (filed on 12/05/07), C-2.7, C-2.8, C-2.9 (First Revised) (filed on 12/05/07), C-2.10, C-2.11 (First Revised) (filed on 12/05/07), C-2.12, C-5.4 (First Revised) (filed on 12/05/07), C-12 (First Revised) (filed on 12/05/07), C-14, C-15, C-16 (First Revised) (filed on 12/05/07), C-26, G-2, G-3, G-4, G-5, and G-16.

Mr. Kerckhove testified regarding the data contained in the Schedules he sponsored. He also testified regarding plant in service and other rate base adjustments, tank painting expense and other operating income adjustments.

**Alan DeBoy.** Mr. DeBoy offered the following testimony and exhibits: Direct Testimony (IAWC Ex. 7.00 (Revised), filed on 12/05/07 and incorporating the Errata filed on March 24, 2008) with Direct Exhibits (IAWC Ex. 7.01, filed 8/31/07), Rebuttal Testimony (IAWC Ex. 7.10, filed 2/11/08), Surrebuttal Testimony (IAWC 7.20, filed 3/18/08), and the Affidavit of Alan DeBoy (IAWC Ex. 7.30, filed on 3/26/08).

Mr. DeBoy testified regarding the tank painting needs of the Company, as well as the major capital projects completed in 2004, 2005 and 2006, those major capital projects planned for 2007 and 2008, and those planned for the test year.

**Barry L. Suits.** Mr. Suits offered the following testimony and exhibits: Direct Testimony (IAWC Ex. 8.00 (Revised), filed on 12/05/07), Rebuttal Testimony (IAWC Ex. 8.10 (Revised), filed on 3/26/08) with Rebuttal Exhibits (IAWC Ex. 8.11-8.14 (Withdrawn), filed on 2/11/08), and Surrebuttal Testimony (IAWC Ex. 8.20, filed on 3/18/08).

Mr. Suits testified regarding the need for, cost of construction of, and alternatives considered to the Champaign Facility.

**Earl M. Robinson.** Mr. Robinson offered the following testimony and exhibits: Direct Testimony (IAWC Ex. 9.00, filed on 8/31/07) with Direct Exhibits (IAWC Ex. 9.01-9.02, filed on 8/31/07), Supplemental Testimony (IAWC Ex. 9.00 SUPP, filed on 12/05/07) with Supplemental Exhibits (IAWC Ex. 9.03-9.05 SUPP, filed on 12/05/07), Rebuttal Testimony (IAWC Ex. 9.10, filed on 2/11/08) with Rebuttal Exhibits (IAWC Ex. 9.11-9.14, filed on 2/11/08), and Surrebuttal Exhibits (IAWC Ex. 9.20, filed on 3/18/08).

Mr. Robinson testified regarding his review and analysis of IAWC's plant in service, which was conducted in the process of preparing depreciation studies of the Company's water and wastewater plant assets as of December 31, 2005. Reports of his review and analyses are contained in IAWC Exhibit 9.01, titled "Illinois American Water-Water Division Depreciation Study as of December 31, 2005," and IAWC Exhibit 9.02, titled "Illinois American Water-Wastewater Division Depreciation Study as of December 31, 2005."

**Bernard L. Uffelman.** Mr. Uffelman offered the following testimony and exhibits: Direct Testimony (IAWC Ex. 10.00, filed on 8/31/07), Rebuttal Testimony (IAWC Ex. 10.30 (Revised), filed on 3/21/08) with Rebuttal Exhibit (IAWC Ex. 10.31, filed on 2/11/08), Surrebuttal Testimony (IAWC Ex. 10.60, filed on 3/18/08) with Surrebuttal Exhibits (IAWC Ex.

10.61-10.63, filed on 3/18/08), and the Affidavit of Bernard L. Uffelman (IAWC Ex. 10.64, filed on 3/26/08).

Mr. Uffelman, of the firm Deloitte & Touche LLP (“Deloitte & Touche”) was engaged by IAWC to analyze the approach used to establish rates for both publicly-owned and investor-owned water and wastewater utilities. Mr. Uffelman was also requested to identify and quantify where possible, examples of differences that utility ownership, regulatory authority and/or ratemaking approach and cost structure may have when comparing IAWC’s rates for water and sewer service to the rates of municipally-owned utilities (“MOUs”). Mr. Uffelman’s analysis appears in Section III of the “Analysis of Water Rates, Fees and Charges for Selected Cities in the Vicinity of the Chicago Metro District” (“Report”), which is marked as IAWC Exhibit 10.20 (IAWC Exhibit 10.20 incorporates the Errata filed on March 24, 2008). He is responsible for Section III of the Report, and jointly responsible with Mary Kane of Stifel, Nicolaus & Company (“Stifel”), which prepared Section II of the Report, for the Report’s Executive Summary (Section I) and Conclusion (Section IV). Mr. Uffelman also provided testimony in response to AG witness Rothstein regarding benchmarking and Mr. Rothstein’s proposed Chicago Metro District-Water operations and maintenance (“O&M”) expense adjustment.

**Mary C. Kane.** Ms. Kane offered the following testimony and exhibits: Direct Testimony (IAWC Ex. 10.10, filed 8/31/07) with Direct Exhibit (IAWC Ex. 10.20, filed on 8/31/07), Rebuttal Testimony (IAWC Ex. 10.40, filed on 2/11/08), Surrebuttal Testimony (IAWC Ex. 10.70, filed on 3/18/08) with Surrebuttal Exhibit (IAWC Ex. 10.71, filed 3/18/08), and the Affidavit of Mary C. Kane (IAWC Ex. 10.72, filed on 3/26/08).

Ms. Kane, of Stifel, was requested by IAWC to provide consulting and advisory services on matters relating to municipal finance and the issue of the reasonableness of IAWC’s rates as

compared to surrounding municipalities. Ms. Kane testified regarding relevant information that affects MOUs operated by certain municipalities in the vicinity of IAWC's Chicago Metro District. The municipalities studied include Downers Grove, Lemont and Woodridge. Stifel prepared Section II of the Report. Ms. Kane is responsible for Section II of the Report, which was prepared by her or under her direction. She also is responsible jointly with Mr. Uffelman for the Report's Executive Summary (Section I) and Conclusion (Section IV). Stifel has worked in cooperation with Deloitte & Touche, which is responsible for Section III of the Report. Ms. Kane also provided testimony in response to AG witness Rothstein regarding benchmarking and Mr. Rothstein's proposed Chicago Metro O&M expense adjustment.

**Stephen P. Schmitt.** Mr. Schmitt offered the following testimony: Rebuttal Testimony (IAWC Ex. 10.50 (Revised), filed 3/21/08), Surrebuttal Testimony (IAWC Ex. 10.80, filed 3/18/08), and the Affidavit of Stephen P. Schmitt (IAWC Ex. 10.81, filed on 3/26/08).

Mr. Schmitt testified in response to AG witness Rothstein, addressing certain differences in the operating characteristics and service standards of the water/wastewater systems of IAWC as compared to those of the MOUs referenced by Mr. Rothstein.

**Paul R. Herbert.** Mr. Herbert offered the following testimony and exhibits: Direct Testimony (IAWC Ex. 11.00, filed 8/31/07) with Direct Exhibit (IAWC Ex. 11.01, filed 8/31/07), Rebuttal Testimony (IAWC Ex. 11.10, filed 2/11/08) with Rebuttal Exhibits (IAWC Exs. 11.11, filed 2/11/08 and 11.12, filed on 3/28/08), and Surrebuttal Testimony (IAWC Ex. 11.20, filed 3/18/08) with Surrebuttal Exhibit (IAWC Ex. 11.21, filed 3/18/08).

Mr. Herbert testified regarding the methods and procedures used for conducting the customer class demand study and discussed the results of the demand study as set forth in IAWC Exhibit 11.01. Mr. Herbert also testified regarding rate design issues.

**Pauline M. Ahern.** Ms. Ahern offered the following testimony and exhibits: Direct Testimony (IAWC Ex. 12.00 (Revised), filed 12/05/07), Rebuttal Testimony (IAWC Ex. 12.10, filed 2/11/08) with Rebuttal Exhibits (IAWC Exs. 12.11-12.24 and 12.26-12.27, filed 2/11/08 and IAWC Ex. 12.25 (Revised), filed 3/21/08), and Surrebuttal Testimony (IAWC Ex. 12.30 (Corrected), filed 3/27/08) with Surrebuttal Exhibits (IAWC Ex. 12.31-12.38, filed 3/18/07).

Ms. Ahern testified on behalf of IAWC as to the appropriate rate of return on common equity.

Staff of the Commission (“Staff”) presented the testimony of the following witnesses: Burma C. Jones, Daniel G. Kahle, Sheena Kight-Garlich, Cheri L. Harden, Peter Lazare, Mike Luth, William H. Atwood, Jr., William R. Johnson, Thomas Q. Smith, and Bonita C. Pearce. The AG presented the testimony of David Effron, Eric Rothstein and Scott Rubin.<sup>2</sup> CUB presented the testimony of Christopher Thomas. IAWC presented the testimony of Michael Gorman, Brian Collins, and Brian Janous. Homer Glen presented the testimony of Jim Daley and Mary Niemiec. Champaign presented the testimony of Mark Dixon and Craig Rost.<sup>3</sup>

Evidentiary hearings were held in this matter on March 25 and 26, 2008. Appearances were entered by counsel on behalf of IAWC, Staff, AG, IAWC, the City of Champaign, Homer Glen, the Village of Orland Hills, the City of Urbana, the Village of St. Joseph, the Village of Savoy, CUB, the Village of Bolingbrook, Fosterburg Water District, Jersey County Rural Water Co., Inc., and Bond Madison Water Company. At the end of the evidentiary hearings on March 26, 2008, the record was marked heard and taken.

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<sup>2</sup> The AG also pre-filed the Rebuttal Testimony of Jeffrey Pesavento. Upon motion by IAWC, the testimony of Mr. Pesavento was ordered stricken in its entirety. See Notice of Administrative Law Judges’ Ruling, March 20, 2008.

<sup>3</sup> Champaign also pre-filed the testimony of Charles Park. Champaign withdrew the testimony of Mr. Park prior to hearing.

## **II. RATE BASE**

### **A. Introduction**

The Company proposed a rate base for each Rate Area. The combined totals for the rate bases for each Rate Area produced a Total Company rate base of \$549,796,183. (See IAWC Ex. 16.00, Sched. B-2 (First Revised).) As a result of the adjustments discussed below, the Company's proposed rate base on surrebuttal is \$532,579,528, as shown on IAWC Exhibit 6.23 (Second Revised). Rate base for each of the Rate Areas individually is shown on the respective designated sheet of IAWC Exhibit 6.23 (Second Revised).

### **B. Resolved Issues**

#### **1. Plant in Service**

The Company forecast capital expenditures of approximately \$109 million in the test year (IAWC Ex. 1.00 (Teasley Dir.), p. 8), including major capital projects discussed by IAWC witness Alan DeBoy. (IAWC Exs. 7.00 (DeBoy Dir.), pp. 5-19; 7.10 (DeBoy Reb.), p. 3.) Staff witness Jones proposed adjusting the Company's forecasted plant additions based on a comparison of forecasted to actual capital expenditures over a three-year historical period. (ICC Staff Ex. 1.0, pp. 10-12.) IAWC accepted Staff witness Jones's plant-in-service adjustment. (IAWC Ex. 6.10 (Kerckhove Reb.), p. 3.) As a result of IAWC's accepting this adjustment, AG Witness Effron withdrew an adjustment he had proposed to the forecasted level of expense for transmission and distribution mains. (AG Ex. 1.2, p. 2.)

#### **2. Champaign Facility**

As discussed above, the Company is currently constructing the Champaign Facility, which is one of the capital projects that will be completed during the test year and which, as discussed above, the Company is seeking to include in rate base in this proceeding. (IAWC Ex. 8.00 (Revised), p. 2.) IAWC witness Suits provided detailed testimony explaining: (1) the

background of the existing system; (2) the need for the new capacity; (3) the need for a new source of water supply; (4) the proposed design and construction of the Champaign Facility; and (5) the alternatives considered to the Champaign Facility. (Id., pp. 2-14.) Staff reviewed the Company's evidence regarding the conditions and capacities of the Company's existing water facilities in its Champaign District, as well as the forecasted future growth of water demand in the Champaign District, and concluded that the Champaign Facility is used and useful in meeting the demands of IAWC's customers and "therefore prudent in providing a solution to meet the Champaign District's water supply and treatment needs." (ICC Staff Ex. 8.0, pp. 15-16.) Staff recommended that the Commission include the proposed level of investment in the Champaign Facility in the Company's rate base. (Id., p. 16.) No party has questioned the need for the Champaign Facility or challenged the rate base amount for the Champaign Facility.

### **3. Cash Working Capital**

As discussed by Mr. Kerckhove, Schedule B-8 provided the calculation of the Company's request for cash working capital in rate base. (IAWC Ex. 6.00 (Kerckhove Dir.), p. 9.) In support of the Company's request, a lead-lag study was performed as directed in the order in Docket No. 02-0690. (Id.) Staff witness Jones proposed adjustments to Cash Working Capital to: (1) reflect all of Staff's proposed changes to those accounts included within the cash working capital calculation; (2) exclude the total amount of uncollectible accounts expense from revenue; and (3) adjust the lead days for chemical expenses and waste disposal expenses. (ICC Staff Exs. 1.0, pp. 12-16; Sched. 1.9.) The Company accepted Ms. Jones' proposed adjustments. (IAWC Ex. 6.10 (Kerckhove Reb.), pp. 4-5.)

### **4. Other Adjustments to Utility Plant in Service**

Mr. Kerckhove discussed four other proposed adjustments to utility plant in service. These adjustments include: (1) removal from plant-in-service of the cost of a 1.377 acre parcel of

land in the SPSPSB District which IAWC has sold to the Illinois Department of Transportation for use in a road construction project (IAWC Ex. 6.10 (Kerckhove Reb.), p. 3); (2) removing certain salvage and removal costs from the Reserve for Accumulated Depreciation and Amortization for the Champaign District (id., pp. 3-4); (3) correcting the cost of the Valley Marina Excess Flow Improvements project, listed as a test year capital project by IAWC witness Alan DeBoy (IAWC Ex. 7.00 (DeBoy Dir.), p. 19), to remove an amount of \$380,000 that was inadvertently included twice (IAWC Ex. 6.10 (Kerckhove Reb.), p. 3); and (4) correcting the test year Materials and Supplies balance shown on Schedule B-8.1 (p. 3 of 8) for Chicago Metro District-Water (IAWC Ex. 6.20 (Kerckhove Sur.), p. 6). All of these adjustments are reflected in the Company's final proposed rate base shown on IAWC Exhibit 6.23 (Second Revised).

### **C. Contested Issues**

#### **1. Impact of Depreciation Expense**

IIRC witness Collins proposes an adjustment to reduce test year depreciation expense by \$5.792 million. (IIRC Ex. 2.0, p. 2.) Such an adjustment would also require an adjustment to the rate base component for accumulated deferred depreciation. Neither the Company nor Staff believe that such an adjustment is warranted. Mr. Collins's adjustment is addressed in Section III.C.3 below. Also, as discussed in Section III.B.4 below, Staff and the Company have agreed to an adjustment to accumulated deferred depreciation consistent with the Company's acceptance of Staff's proposed depreciation rates for water meters and the level of depreciation expense proposed by Staff.

#### **2. Deferred Tank Painting**

Staff witness Kahle proposed certain rate base adjustments related to his proposed adjustments to reduce test year deferred tank painting charges and the related amortization expense to reflect the average level of tank painting expenditures between 2003 and 2007. (ICC

Staff Exs. 12.0-C, p. 2; Sched. 12.1 (Corrected)). As discussed in Section III.C.4 below, Mr. Kahle's proposed adjustments should be rejected, and therefore no rate base adjustment for deferred tank painting charges is warranted.

### **3. Other**

[This section is intentionally left blank. IAWC is not including any "Other" issues with respect to rate base in this Brief.]

#### **D. Recommended Rate Base**

The Company's recommended Total Company rate base is \$532,579,528, as shown on IAWC Exhibit 6.23 (Second Revised). The rate bases for each Rate Area are shown on the designated sheets of IAWC Exhibit 6.23 (Second Revised).

### **III. OPERATING REVENUES AND EXPENSES**

#### **A. Introduction**

The Company presented schedules showing, for each Rate Area and for the Total Company, the operating revenues, expenses, and income at present and proposed rates for the test year. Staff and other parties proposed adjustments to the Company's proposed operating statements as discussed below. The Company's proposed operating income statement for the Total Company is shown on IAWC Exhibit 6.21 (Second Revised). The operating income statement for each Rate Area is shown on the respective designated sheet of IAWC Exhibit 6.21 (Second Revised).

#### **B. Resolved Issues**

##### **1. Chicago Metro Sewer Revenues**

Attorney General witness Effron proposed an adjustment to increase test year sewer revenues in the Chicago Metro District-Sewer by \$626,000. IAWC accepted Mr. Effron's adjustment. (IAWC Ex. 4.20 (Grubb Sur.), p. 17.)

## **2. Executive Perquisites**

In direct testimony, Staff witness Pearce recommended an adjustment to remove the amount of executive perquisites included in test year operating expenses. (ICC Staff Ex. 3.0, p. 10.) This expense related to use of an automobile for Company business purposes. IAWC explained that the Company's policy for reimbursement of automobile expense recognizes the fact that certain Company executives use a personal automobile for travel to conduct necessary business for the benefit of the ratepayers. (IAWC Ex. 4.10 (Grubb Reb.), pp. 9-10.) Because of this, the executive is provided a monthly automobile allowance. Ms. Pearce withdrew this adjustment in her rebuttal testimony. (ICC Staff Ex. 13.0, p. 10.)

## **3. Advertising Expenses**

Staff witness Kahle proposed an adjustment to remove advertising expenses that he deemed to be of a promotional, goodwill or institutional nature. (ICC Staff Ex. 2.0, p. 5.) IAWC accepted the adjustment. (IAWC Ex. 6.10 (Kerckhove Reb.), p. 5.)

## **4. Depreciation Expense**

The Company proposed to implement an 18-year average service life for metal water meters 1 inch and under and a 25-year service life for metal water meters over 1 inch. (IAWC Ex. 9.0 (Robinson Dir.), p. 27.) Staff witness Johnson recommended use of the average service lives for water meters approved by the Commission in Docket No. 00-0340 (11 years for metal meters 1 inch and under, and 10 years for metal meters over 1 inch). (ICC Staff Ex. 9.0, pp. 3-7.) The Company accepted this recommendation. (IAWC Ex. 9.10 (Robinson Reb.), p. 2.) For Account 334.41, metal water meters 1 inch and under, the Company will maintain a depreciation rate of 11.92%, which assumes an average service life of 11 years. (Id.) For Account 334.42, metal water meters over 1 inch, the Company will maintain a depreciation rate of 12.87%, which assumes an average service life of 10 years. (Id.) Staff witness Jones proposed an adjustment to

depreciation expense for meters in each Rate Area based on Mr. Johnson's proposed changes. (ICC Staff Ex. 1.0, p. 12; Sched. 1.8.) Staff witness Jones also proposed a related adjustment to accumulated depreciation based on Mr. Johnson's recommendation. (Id.) The Company accepted Ms. Jones's proposed adjustment. (See Staff Ex. 11.0, p. 8.)

**C. Contested Issues**

**1. Test Year Revenues for Water Sale for Resale for the SPSPSB, Chicago Metro District-Water, and Champaign Districts**

**a. SPSPSB Sale For Resale Water Revenue**

The Company's projections of sale for resale revenues were based on an historical average. (IAWC Ex. 20.00, Sched. G-5, p. 1.) This projection methodology was developed in accordance with the guidelines for presentation of projected information set forth in the AICPA Guide (defined above), as attested to in the opinion of Kerber, Eck & Braeckel LLP, certified public accountants. (IAWC Ex. 20.00, Sched. G-2.) Mr. Grubb explained that the Company based its test year projection of \$9,781,000 for sale for resale revenues for the SPSPSB District on an average of sale for resale water usage for the four years 2001 through 2004. (IAWC Ex. 4.10 (Grubb Reb.), p. 12.) AG witness Effron, however, proposed to increase the test year revenue level by \$296,000 to reflect the actual sale for resale revenues (adjusted to eliminate QIP rider revenue) for a single twelve month period ended June 2007. (AG Exs. 1.0, pp. 7-9; 1.2, pp. 2-4.) As discussed below, Mr. Effron's proposal should be rejected.

As Mr. Grubb explains, as compared to Mr. Effron's proposed use of data for a single year, an average of usage data for an historical period is more representative of the prospective sale for resale revenues in SPSPSB because an average will smooth out weather-related impacts and variations in usage. (IAWC Ex. 4.10 (Grubb Reb.), pp. 11-12.) In addition, the twelve months ended June 2007 include certain months (the months July through September 2006 and

the months May and June 2007) that were hotter and drier than the 2001-2004 average for the SPSPSB area, thus causing increased water use during that time period. (IAWC Ex. 4.20 (Grubb Sur.), p. 13.) As a result, the use of revenue for the June 2007 time period as the basis for the test year sale for resale revenues projection, as Mr. Effron proposes, is unreasonable because it would overstate the projected level of revenues. (Id.) As explained by Mr. Grubb, the average of SPSPSB District sale for resale revenues for the years 2004 through 2007 is \$9,829,000, which is substantially similar to the Company's test year projection, thus confirming that the test year projection of SPSPSB District sale for resale revenues is reasonable. (Id., p. 14.)

Mr. Effron's assertion that his adjustment is already "conservative" in that it assumes no growth in sale for resale from 2007 to the 2009 test year (AG Ex. 1.0, p. 9) is misplaced. As discussed above, Mr. Effron's adjustment does not account for weather variations in the year ended June 2007. In fact, as Mr. Grubb explained, the Company is projecting a decline in sale for resale volumes for the SPSPSB District from the year ended June 30, 2007 through the test year, which is consistent with the Company's projection of a general decline in per customer usage. (IAWC Ex. 4.20 (Grubb Sur.), p. 14; Sched. C-3; Sched. G-5, p. 1.) Thus, no adjustment to SPSPSB District sale for resale revenues is warranted.

**b. Chicago Metro District-Water Sale for Resale Revenue**

As Mr. Grubb explained, the Company's projection for the test year water revenues from the Chicago Metro District-Water sale for resale customer class is \$100,857. (IAWC Ex. 4.20 (Grubb Sur.), p. 15.) The Company, consistent with its projection of an overall decline in usage per customer (see IAWC Ex. 20.00, Sched. G-5, p. 1) for sale for resale customers, is projecting in Schedule C-3 that this declining trend will continue through the test year. (IAWC Ex. 4.20 (Grubb Sur.), p. 15.) As noted above, sale for resale revenue projections were made in

accordance with the guidelines for presentation of projected information set forth in the AICPA Guide.

AG witness Effron proposed an adjustment to Chicago Metro District-Water sale for resale revenues to increase test year revenues by \$93,000. (AG Ex. 1.2, pp. 4-5.) Mr. Effron asserted that, if the sale for resale customers primarily serve residential customers, there is no reason to believe that the prospective volume of sale for resale in the years ending June 2008 and June 2009 should be lower than the volume in the year ended June 2007. (AG Ex. 1.0, p. 9.) Mr. Effron's adjustment to the sale for resale customer class of the Chicago Metro District-Water, however, is not appropriate.

As shown on Schedule C-3 (p. 3), sale for resale volumes in the Chicago Metro District-Water have shown a declining trend from the year ended June 2006 to the year ended June 2007. In light of the declining trend (which is consistent with the Company's overall projection as discussed above), adopting Mr. Effron's proposal to use sale for resale revenues for the year ended June 2007 in the Chicago Metro District-Water would overstate revenues in the test year. The Company's projection for the test year revenues from the Chicago Metro District-Water sale for resale customer class is \$100,857 (see Schedule E-5, p. 1 for the Chicago Metro Water District – Lake Supply). This amount, as discussed by Mr. Grubb, reflects the necessary adjustment to remove purchased water surcharge revenues (an adjustment to remove purchase water received is required as both purchased water revenue and cost are excluded from the test year income statement). (IAWC Ex. 4.20 (Grubb Sur.), p. 15; AG Ex. 1.2, pp. 2-3.) The test year level of revenues from the Chicago Metro District-Water sale for resale customer class of \$100,857 is slightly less than Mr. Effron's estimate of test year revenues of \$103,000 as shown on AG Exhibit 1.3. Thus, with purchased water cost removed, IAWC's projected level of resale

revenue for the Chicago Metro District-Water sale for resale class is comparable to that of Mr. Effron. Accordingly, there is no basis for an adjustment to test year revenues from the Chicago Metro District-Water sale for resale customer class. (IAWC Ex. 4.20 (Grubb Sur.), pp. 15-16; see also IAWC Ex. 4.10 (Grubb Reb.), pp. 12-13.)

**c. Champaign District Water Sale for Resale Revenues**

As discussed by Mr. Grubb, the Company originally proposed a test year level of water sale for resale revenues in the Champaign District of \$239,000. (IAWC Ex. 4.10 (Grubb Reb.), p. 13.) As Mr. Grubb's rebuttal testimony explained, however, the Company determined that an adjustment to the projected level of sale for resale revenues in the Champaign District is warranted. (Id.) The appropriate adjustment is to use an average of the last three years as this would mitigate some of the impacts of dry and wet weather conditions that have occurred during these years. (Id.) Using a three year average, the level of sale for resale revenues for the Champaign District would be \$568,000. This level of revenues is reflected in the Company's final operating income statement. (IAWC Ex. 6.21 (Second Revised) (Champaign).)

Despite the Company's revision to its test year sale for resale revenues in the Champaign District, Mr. Effron proposed an adjustment to increase revenues by \$116,000 for the Champaign District sale for resale customer class. (AG Exs. 1.2, pp. 5-6; 1.3, Sched. C-1.) As discussed above, the Company's projection of sale for resale revenue was made in accordance with the guidelines for presentation of projected information set forth in the AICPA Guide. Mr. Effron's proposal, however, relies again on a single data point, using the actual year ended June 2007 revenues of \$684,000 as the basis for his adjustment. (Id.) Mr. Effron's use of the period ending June 2007 to establish sale for resale revenues in Champaign should be rejected, because, as indicated above, certain months during that period were hotter and drier than average in the Champaign District. By averaging the years ended June 2005 through June 2007, the effects of

weather variations are normalized. (IAWC Ex. 4.20 (Grubb Sur.), p. 16.) Furthermore, Mr. Effron's suggestion that sale for resale revenues could reach \$880,000 for the Champaign District in the test year is unreasonable. (AG Ex. 1.2, p. 6.) As discussed above, the Company projects a decline in usage per customer for sale for resale, and the Company is projecting that test year sale for resale usage and revenues in the Champaign District will decline somewhat from their level in the year ended June 2007. (IAWC Ex. 4.20 (Grubb Sur.), p. 16.) Moreover, the year ended June 2007 sale for resale revenues reflect the effect of drier weather in that time period. (Id.) Thus, a projection that Champaign District sale for resale revenues would increase to \$880,000 in the test year is not reasonable. (Id., p. 17.) The Commission should reject Mr. Effron's adjustment and accept the Company-proposed level of sale for resale revenues for Champaign, which is included in the Company's final proposed operating statement for the Champaign District. (IAWC 6.21 (Second Revised) (Champaign).)

**2. Test Year Revenues for "Other" Revenues for the SPSPSB, Chicago Metro District-Water, Champaign, Sterling, and Pekin Districts**

The Company based its projection of "other" revenues for all districts on a five-year average of 2001 – 2005. (IAWC Ex. 4.10 (Grubb Reb.), p. 14.) As Mr. Grubb explained, the use of averages to determine the projected level of "other" revenues is appropriate because "other" revenues vary considerably from year to year due to a number of factors. (IAWC Ex. 4.20 (Grubb Sur.), p. 17.) For example, changes in the number of customer activations, forfeited discounts, Non-sufficient Funds Charges and Reconnections Charges will cause the level of "other" revenues to vary up or down over time. (Id.) As a result, an increase from one given year to the next does not mean that the increased level of revenues will continue. (Id.) To reflect the variability of "other" revenue, use of a three-year revenue average is appropriate. (Id.)

In his rebuttal testimony, Mr. Grubb explained that, in light of proposals made by Mr. Effron, averaging more current information is appropriate. Mr. Grubb stated that a calculation of a three-year average ended June 2007 produces a test year level of “other” revenues of \$1,875,000 for the SPSPSB, Chicago Metro-Water, Champaign, Sterling, Lincoln, and Pekin Rate Areas. (IAWC Exs. 4.10 (Grubb Reb.), p. 14; 4.12.) The Company believes this level of “other” revenues is appropriate for these Rate Areas (Chicago Metro District-Sewer “other” revenues were treated separately and no adjustment was proposed, see IAWC Ex. 4.12). Use of this three-year average results in an aggregate downward adjustment of \$7,000 from the Company’s original projection of \$1,882,000 for “other” revenues for the SPSPSB, Chicago Metro Water, Champaign, Sterling, Lincoln, and Pekin Rate Areas. (Id., pp. 14-15). This level of “other” revenues is reflected in the Company’s final Total Company operating income statement on surrebuttal and in the operating statements for the SPSPSB, Chicago Metro-Water, Champaign, Sterling, Lincoln, and Pekin Rate Areas. (IAWC Ex. 6.21 (Second Revised).)

Despite the Company’s modification of its level of “other” revenues, Mr. Effron continues to propose an adjustment increasing “other” revenues by \$700,000. (AG Ex. 1.0, p.12.) As explained above, Mr. Effron based his adjustment on the actual “other” revenues for the twelve months ended June 2007. (Id.) This adjustment is unwarranted. As discussed above, the use of an average for calculating “other” revenues is more appropriate than using a single data point due to fluctuations in the amount of “other” revenues. (IAWC Ex. 4.20 (Grubb Sur.), p. 3.) The Commission should reject Mr. Effron’s proposed adjustment for an increase in “other” revenues, and adopt the Company’s adjustment to projected “other” revenues based on an average of more recent data, as shown on IAWC Exhibits 4.12 and 6.22 for the SPSPSB, Chicago Metro-Water, Champaign, Sterling, Lincoln, and Pekin Rate Areas.

### 3. Depreciation Expense

Mr. Earl Robinson of AUS Consultants conducted a review and analysis of the Company's plant in service, and prepared depreciation studies for the Company's water and wastewater plant assets. (See IAWC Exs. 9.00 (Robinson Dir.); 9.01; 9.02.) In preparing these reports, Mr. Robinson investigated and analyzed the Company's historical plant data, and reviewed the Company's past experience and future expectations to determine the remaining lives of the Company's water and wastewater plant assets. (IAWC Ex. 9.00 (Robinson Dir.), p. 2.) The studies utilized the resulting remaining lives, the results of a salvage analysis, the Company's vintaged plant in service investment, and depreciation reserve to develop recommended average remaining life depreciation rates and depreciation expense related to the Company's plant in service. (Id.) Based on these depreciation studies, the Company proposed test year depreciation expense of \$31,525,166. (IAWC Ex. 17.00, Sched. C-12, p. 3 of 16.) As discussed above, IAWC accepted Staff witness Jones's recommended adjustment to increase depreciation expense for meters in each Rate Area and the related adjustment to accumulated depreciation reserve. (See Staff Exs. 1.0; Sched. 1.8-CMW; 11.0, p. 8.) IAWC is the only party contesting Staff's proposed level of depreciation expense.

IAWC witness Collins asserts that IAWC's proposed depreciation rates are based on excessive net salvage ratios, which unnecessarily raises rates for today's ratepayers and produces intergenerational inequities, and that IAWC's proposed net salvage ratios differ considerably from net salvage ratios proposed and/or adopted through settlement by other American Water affiliates in neighboring states. (IAWC Ex. 2.0, p. 2.) He recommended that the Commission use an average of the net salvage ratios adopted by other American Water affiliates to calculate IAWC's depreciation rates in this case. (Id.) His proposal would reduce IAWC's water plant

depreciation expense by \$5.792 million. (Id., p. 3.) For the reasons discussed below, Mr. Collins' arguments should be rejected.

**a. The Commission Should Reject the Use of Net Salvage Ratios of IAWC Affiliates to Determine Net Salvage Ratios for IAWC.**

Mr. Robinson explains why Mr. Collins's recommendation to use net salvage factors from affiliates as the basis for IAWC net salvage depreciation component is not appropriate. (IAWC Ex. 9.20 (Robinson Sur.), p. 2.) Mr. Collins has made simple comparisons between the net salvage factors of affiliate companies located in other jurisdictions to those underlying the Company's proposed depreciation rates. (Id.) He then proposes to use the affiliates' net salvage values in lieu of actual IAWC net salvage data without specific knowledge or empirical evidence as to the reason for the variances between the net salvage value of IAWC and its affiliates. (Id.)

As Mr. Robinson explained, the use of alternative source information in the preparation of depreciation studies is a valid option when information is not available for a utility's plant for which a depreciation study is being performed. (IAWC Ex. 9.10 (Robinson Reb.), p. 16.) However, simply using life or salvage information from other entities in lieu of specific company data that is available is inappropriate and unwarranted. (Id.) As Mr. Robinson testified, where, as here, internal company data is available for a range of years, such information should be given the greatest weight in estimating future net salvage factors in as much as the data is the direct product of recent past utility-specific practices and policies, and has the highest probability of being representative of what will occur during future years. (Id.)

Mr. Collins indicated that he reviewed net salvage ratios for Indiana-American Water Company, Kentucky-American Water Company, and Missouri-American Water Company. (IIWC Ex. 2.0, p. 13.) Mr. Collins has not provided, however, any specific detailed analysis of the salvage ratios that he reviewed. (IAWC Ex. 9.10 (Robinson Reb.), pp. 16-17.) Accordingly,

the levels of actual net salvage that these entities may have historically experienced as compared to what levels were incorporated into these entities' requests in various dockets is unknown. (Id., p. 16.) As Mr. Robinson explained, not only may there be variances between net salvage experience levels and requested levels, but there could be valid reasons such as the size of the service territory versus the number of operations centers, the density of the customer base, the current age of plant in service, etc. for the experienced levels being different between various operating entities. Thus, there is no support for Mr. Collins's proposal with regard to the use of alternate company based net salvage proposals in lieu of available IAWC-specific data. (IAWC Ex. 9.10 (Robinson Reb.), pp. 17-18.)

As Mr. Robinson explained, contrary to what Mr. Collins suggests, it is not the Company's responsibility to investigate any and all accounting data from other operating companies in the performance of depreciation and/or other studies relative to IAWC. It is not IAWC's obligation to support or discredit depreciation factors from other operating companies. As Mr. Robinson indicated, IAWC's obligation is to show that the depreciation factors proposed for its property are applicable and the most likely to be experienced by IAWC in future years, and IAWC has made this showing. (IAWC Ex. 9.20 (Robinson Sur.), p. 3.)

Staff agrees with the Company on this issue. Staff witness Johnson reviewed Mr. Collin's proposal to use net salvage ratios from IAWC's affiliates and rejected this approach. (ICC Staff Ex. 18.0, pp. 1-4.) Mr. Johnson found that IAWC witness Robinson provided an in-depth (historical net salvage) analysis for the period 1980-2005 for which data was available, and that the net salvage analysis performed by Mr. Robinson is an accepted practice used by depreciation professionals. (Id., pp. 2-3.) Mr. Johnson concluded that, because IAWC provided actual company-specific data to perform its depreciation study, and actual company specific data

provides a clearer picture of how a company retires its plant investments, he did not support Mr. Collins's proposal to base water depreciation rates on net salvage ratios of IAWC's affiliates. (Id., pp. 3-4.) Mr. Collins's proposed net salvage ratios, based upon the average net salvage ratios of three IAWC affiliates, were not reflective of the Company's plant retirement policies and/or experience. (Id., p. 3.) It is Mr. Johnson's opinion that Mr. Robinson prepared a comprehensive company-specific depreciation study that takes both current and future IAWC ratepayers into consideration in the determination of depreciation rates. (Id.)

**b. IAWC's Net Salvage Ratios Do Not Produce Intergenerational Inequities**

Mr. Robinson explained that, with respect to Mr. Collins's concerns about intergenerational inequities, the straight line recovery of future net salvage (both positive and negative net salvage) over the life of the related asset is and has been the standard recovery mechanism for years throughout the utility industry. (IAWC Ex. 9.20 (Robinson Sur.), p. 3.) Rate base rate of return concepts and application have consistently been, with limited exception, based upon nominal dollars. (Id.) Mr. Collins now implicitly advances the concept to selectively alter the rate case process by treating a single component (negative net salvage recovery) differently than the remaining items. (Id.)

Mr. Collins further states that the Company's future net salvage incorporated within its proposed depreciation rates generates an annual net salvage recovery of \$8.153 million, while its average annual cash expenditures for net salvage over the past ten years were \$0.958 million. (IIWC Ex. 2.0, p. 2.) This discussion, however, is simply a continued reference to historical cash expenditures for past net salvage and not to an estimate of future net salvage on an accrual basis as is appropriate for inclusion in the Average Remaining Life ("ARL") based depreciation rates. (IAWC Ex. 9.10 (Robinson Reb.), p. 8.) As Mr. Robinson explained, the very definition of

ARL-based depreciation (which Mr. Collins accepts) requires the use of estimates for annual future net salvage percentages, and not historic net salvage experienced cash expenditures as proposed by Mr. Collins. (Id., pp. 8-9.) Mr. Collins position is incorrectly based on the assumption that current customers should pay no more for cost of removal than the amount of actual cash that the Company is spending for net salvage (net of gross salvage and cost of removal/retire). (Id., p. 9.) Current customers, however, must pay their fair proportional share of the total cost of the assets (first cost plus end-of-life costs) that are being consumed in their receipt of service. (Id.) Given that the cost to remove/retire assets occurs at the end of the property's service life and the fact that the major portion of the Company's plant has yet to be retired, the current level of actual cash cost of removal/retire will be lower at this period of time as compared to future years. (Id.) As Mr. Robinson indicated, notwithstanding that fact, current customers still need to annually contribute to the costs that will occur at the end-of-life of the current plant in service. (Id.)

Furthermore, as Mr. Robinson explained, Mr. Collins's process of restating the Company's cash-based experienced net salvage from 2000 to 2010 price levels is simply an arithmetic exercise that does not represent the future net salvage that will be experienced at the end of the life of the Company's plant in service. (IAWC Ex. 9.10 (Robinson Reb.), pp. 9-10.) First, Mr. Collins has deviated from longstanding and widely accepted methods for net salvage analysis and estimation to support an estimate of future net salvage that is below the Company's requested level of negative net salvage. (Id.) Mr. Collins proposes a cash expenditure amount for net salvage that he believes the Company will be "spending in cash" at the time of the final rate order of this rate proceeding. (Id.) As Mr. Robinson explained, however, depreciation recovery rates for future net salvage, however, should not be based upon a going cash level at the

time of the rate proceeding – they should be based upon the rational and systematic recovery of the estimated future net salvage cost over the life of the assets providing service to the Company’s customers. (Id.) Cash accounting, and accrual accounting (a ratable and systematic apportionment of cost), are two different amounts. As Mr. Robinson concluded, any use of cash-based net salvage recovery in the development of proposed depreciation rates is improper. (Id.)

Mr. Collins argues, incorrectly, that the net salvage experience should not be applied to today’s investment because doing so causes today’s ratepayer to pay costs associated with future inflation. (IAWC Ex. 9.20 (Robinson Sur.), p. 3.) As Mr. Robinson explained, Mr. Collins’s hypothesis fails to acknowledge that there always has been inflation and there effectively always will be inflation. (Id.) While inflation levels will vary from year to year, over time such levels will fall within a general range. (Id.) In fact, the historically based net salvage analysis actually understates (and in various circumstances materially understates) the anticipated level of future net salvage. (Id.; IAWC Ex. 9.10 (Robinson Reb.), pp. 9-12.) The Company’s plant in service investments and related recovery are not static because new investments are constantly being added as existing plant is being retired. (IAWC Ex. 9.20 (Robinson Sur.), p. 4.) Hence, as Mr. Robinson indicated, the complexity of the investment recovery flows equally to various generations of customers. (Id.)

Mr. Collins also fails to acknowledge the ongoing relationship of original cost and net salvage (cost or removal/retirement). As Mr. Robinson explained, original cost always has and always will occur at the beginning of the asset’s life while net salvage always has and always will occur at the end of the property’s life. (IAWC Ex. 9.10 (Robinson Reb.), p. 10.) There will always be a span of time between when property is placed into service and when it is retired from service. (Id.) While levels of inflation vary over time, it is reasonable to accept that such

levels will tend to level out over the more typical, longer lives of utility property. In fact, there is a key factor, which impacts the anticipated future net salvage versus that experienced historically, that Mr. Collins fails to acknowledge. Within the historical net salvage that has been experienced to date, the average age of retirements that generated the cash-based net salvage amounts occurred at ages far less than the average service lives estimated for each of the Company's property categories. (Id.) To the extent that the retirements occurred at average ages far less than the applicable average service lives, the negative net salvage (as a percentage of original cost) is far lower than what can be anticipated for the remaining portion of the present plant in service for each of the applicable property groups. This circumstance is the product of the fact that large portions of the cost to remove/retire are related to labor costs that continue to increase with the future span of time. Accordingly, as Mr. Robinson explained, even the Company's estimated future net salvage percents are conservative, and likely do not fully capture the level of future negative net salvage that will occur with regard to future plant retirements. (IAWC Ex. 9.10 (Robinson Reb.), pp. 10-11.)

Mr. Collins also asserts that the Company's inclusion of future net salvage within its proposed depreciation rates will benefit future ratepayers at the detriment of current ratepayers. (IIWC Ex. 2.0, p. 2.) As Mr. Robinson explained, however, Mr. Collins fails to recognize a variety of circumstances that occur throughout the life of property. (IAWC Ex. 9.10 (Robinson Reb.), p. 12.) The Company's property investments are not a single asset. (Id.) They are groups of investments represented by groups of assets that experience different service lives. (Id., p. 13.) Some assets retire early in life and other assets retire later in life. (Id.) In addition to the simple recovery of the group of asset costs (whose units and dollar investments decline over time), the utility of the assets is declining over time, maintenance costs are increasing over time, and the

number of customers being served by the declining assets would likewise be decreasing. (Id.) Lastly, and most importantly, as Mr. Robinson points out, Mr. Collins overlooks a basic tenet of ARL depreciation: that the full cost of the property (original cost and end-of-life cost) be recovered by the time that the property is retired from service. (Id.)

Mr. Collins's criticism of Mr. Robinson's Exhibit 9.13 is based on the premise that the Company will experience net salvage of negative 100%. (IAWC Ex. 9.20 (Robinson Sur.), p. 4.) He states that "it would be obvious that using any net salvage level substantially below 100% would produce a significant shortfall." (IIWC Ex. 5.0, p. 7.) Mr. Collins then again refers to net salvage factors incorporated within other companies' depreciation rates. Section 8 (pages 8-65 and 8-66) of the Company's depreciation study report (IAWC Ex. 9.01) contains extensive long-term empirical evidence showing that the Company has continuously experienced far in excess of negative 100% net salvage in conjunction with the retirement of its Account 335-Hydrants investments. (IAWC Ex. 9.20 (Robinson Sur.), p. 4.)

Mr. Robinson notes that the correct and appropriate net salvage analysis approach identifies the net salvage percentage by comparing the total net positive or negative salvage to the book cost of the property investment retired. (IAWC Ex. 9.10 (Robinson Reb.), p. 6.) The method used to estimate the retirement cost is a standard analysis approach used by operating companies and regulators to identify a company's historical experience with regard to what the end-of-life cost will be relative to the cost of the plant when first placed into service. (Id., pp. 6-7.) This information, along with knowledge about the average age of the historical retirements that have occurred to date, allows for an estimation of the level of retirement cost that will be experienced by the Company at the end of each property group's useful life. (Id. at 7.) The study methodology utilized has been extensively set forth in depreciation textbooks, such as the

NARUC 1996 Public Utility Depreciation Practices manual, and has been the accepted practice by depreciation professionals for many decades. (Id.) Furthermore, as Mr. Robinson explained, the above-referenced cost of removal analysis method, as discussed in the NARUC 1996 Public Utility Depreciation Practices manual, is the standard practice used for estimating future net salvage for the purpose of identifying the applicable depreciation rate for a property group. (Id.) There is a direct relationship between the installation of specific plant and its corresponding removal. The installation is its beginning-of-life cost while the removal/retirement cost is its end-of-life cost. Also, as Mr. Robinson indicated, it is important to note that ARL depreciation rates incorporate future net salvage, which is typically more representative of recent or forecast future net salvage versus long-term historical average net salvage. (Id.)

As Mr. Robinson explained, the Company's historical net salvage experience was analyzed to identify the historical net salvage factor for each applicable property group. (IAWC Ex. 9.10 (Robinson Reb.), p. 7.) This analysis routinely finds that historical retirements have occurred at average ages significantly shorter than the property group's average service life. (Id.) The occurrence of historical retirements at an age which is significantly younger than the average service life of the property category demonstrates that the historical data does not appropriately recognize the true level of retirement cost at the end of the property group's useful life. (Id., pp. 7-8.) An additional level of cost to retire will occur due to the passage of time until all the current plant is retired at the end of its life. (Id., p. 8.) That is, the level of retirement costs will increase over time until the average service life is attained. (Id.) The additional inflation in the estimate of retirement cost is related to those additional years' cost increases (primarily the result of higher labor costs over time) that will occur prior to the end of the property group's average life. (Id.)

As Mr. Robinson explained, Mr. Collins's conclusion that the Company's proposed net salvage ratios produce an "excessive" depreciation expense is inappropriately based on the Company's historic level of annual net salvage expense. (IAWC Ex. 9.10 (Robinson Reb.), p. 5.) The Company's level of experienced net salvage is simply what the Company has spent relative to the retirement to date of a portion of the total plant in service. (Id.) The majority of the current plant in service is still in service and will be retired during future years. (Id.) Equally important is the fact that the historic net salvage does not give any consideration to the portion of property's end-of-life cost consumed by customers in the receipt of service for property that is not yet retired from service. (Id.)

Mr. Robinson explained how IAWC Exhibits 9.13 and 9.14 demonstrate the impropriety of Mr. Collins's proposal. IAWC Exhibit 9.13 illustrates that, under IAWC's proposal, at the end of the property life of the property group, the costs incurred (original cost and end-of-life costs) are fully recovered. On the other hand, Exhibit 9.14 shows that, under Mr. Collins's proposal, there is a significant shortfall in the recovery over the life of the assets. (IAWC Ex. 9.10 (Robinson Reb.), pp. 13-15.) Mr. Collins's position must therefore be rejected.

#### **4. Tank Painting Expense**

IAWC's proposed current and test year levels of tank painting expenditures are consistent with the Company's plan to accomplish necessary tank painting every year. (See IAWC Ex. 7.01.) Mr. DeBoy explained that the Company maintains approximately 200 structures that periodically require painting. (IAWC Ex. 7.00 (DeBoy Dir.), pp. 3-4.) The Company has a comprehensive five-year painting schedule, which is periodically updated as circumstances dictate. (IAWC Ex. 7.01.) As Mr. DeBoy indicated, the Company has determined through experience that the average interior coating system life expectancy is 12 years and 8 years for exterior coating systems. (IAWC Ex. 7.20 (DeBoy Sur.), p. 1.) Based on these experiences, a

combination of 41 structure interior and exterior coating systems are expected to be rehabilitated each year. (Id., p. 2.) The cost to paint the interior and exterior of a tank varies from \$3.95 to \$5.27 depending on the type and size of the structure, as well as the surface preparation and coating system used, and miscellaneous additional costs that are incurred in each project. (Id.; IAWC Exhibit 7.01.) Thus, to meet the Company's tank painting needs, normalized expenditures for the Total Company of \$2.44 million per year should be reflected in rates. (IAWC Ex. 7.20 (DeBoy Sur.), p. 2.)

Staff witness Kahle proposes to reduce current year and test year deferred tank painting charges and the related amortization expense to reflect the average level of tank painting expenditures between 2003 and 2007 for the SPSPSB, Chicago Metro - Water, Champaign, Sterling, and Pekin Rate Areas (Mr. Kahle updated this average level to reflect Company's revised response to the Illinois Attorney General's data request AG 2.15 which includes payments to outside vendors and internal labor and overhead). (ICC Staff Ex. 12.0-C, p. 3.)

Mr. Kahle's proposed level of tank painting expense, however, is below the required annual level of tank painting cost. As Mr. Kerckhove explained, the five-year average used by Mr. Kahle for proposed tank painting expense does not represent IAWC's projected level of future tank painting expenditures because: (1) it is insufficient to meet the Company's tank painting needs; and (2) tank painting expenditures were unusually low during certain years included in Mr. Kahle's selected five-year period. (IAWC Ex. 6.10 (Kerckhove Reb.), p. 6.) Although total annual tank painting costs will fluctuate from year-to-year, the Company's Schedule B-10 (First Revised) indicates that projected expenditures for tank painting for all districts are approximately \$2.59 million for the year ending June 30, 2008, and \$2.37 million for

the test year. No party to this proceeding has disputed the methodology and assumptions underlying the Company's tank painting program as it is reflected in IAWC 7.01.

Mr. DeBoy explained that the Company's tank painting expenditures were unusually low in 2003 and 2005, two of the years included in Mr. Kahle's five year average. (IAWC Ex. 7.20 (DeBoy Sur.), p. 3.) In 2003, the Company initiated a comprehensive tank painting program by inspecting all of its steel structures. (IAWC Ex. 6.10 (Kerckhove Reb.), p. 6.) During that year, only a limited number of tanks were painted. (Id.) As a result, the level of tank painting cost incurred during 2003 was abnormally low. In addition, there was a reduction in the amount of tank painting to \$342,000 in 2005. (Id.) By contrast, \$2.5 million was spent to paint tanks in calendar year 2004, \$1.9 million in calendar year 2006, and \$2.3 million in calendar year 2007. (Id.) Thus, 2005 also is not a representative year with regard to tank painting cost. (Id.)

The amounts expended for tank painting in calendar years 2004, 2006, and 2007, which average \$2.23 million, show that the Company is adhering to its plan to maintain all of its steel structures, with expenditures consistent with the Company's plan presented in IAWC Exhibit 7.01. (Id.) More recent data also supports IAWC's position that the current and test year levels of tank painting are reasonable. For example, as Mr. Kerckhove explained, tank painting expenditures for the six months ended December 31, 2007 were \$1.2 million, and total tank painting expenditures were \$2.5 million for calendar year 2007. (IAWC Ex. 6.20 (Kerckhove Sur.), pp. 3-4.) The tank painting expenditures for the six months ended December 31, 2007 (the first half of the current year ending June 30, 2008), in the amount of \$1.2 million, also support the Company's projected level of tank painting expenditures. (Id., p. 4.)

While the Company and Staff appear to share the same objective of developing a normalized level of tank painting expense, Staff's approach of using an historical five-year

average results in normalized level of expense of \$1.38 million (ICC Staff Ex. 12.0-C, Sched. 12.1 (All) (Corrected)), which is approximately one-half of the average expenditures of \$2.23 million per year for calendar years 2004, 2006 and 2007 (and approximately one-half of the \$2.48 million forecasted for the test year). (IAWC Ex. 7.20 (DeBoy Sur.), p. 3.) Staff's proposal therefore does not produce a normalized level of expense sufficient for the Company to recover its normalized tank painting costs of \$2.44 million per year. (Id.) Because the Company's method of normalization results in an amount more reflective of both normal historical and test year expenditures, the Commission should reject Staff's adjustment. As discussed above, more recent tank painting data, showing tank painting expenditures of \$2.5 million for calendar 2007, support IAWC's position that Mr. Kahle's normalized level of tank painting expense is too low. Moreover, even if the Commission was to adopt Staff's adjustment, Mr. Kahle's adjustment ignores the effect of inflation with respect to the tank painting expenses he uses to create his 5-year average. As the Company's evidence showed, even using an inflation rate of 2.3%, and adjusting historical expenditures for inflation, will not yield sufficient revenues for the Company to fully recover normalized tank painting costs. (IAWC Ex. 6.20 (Kerckhove Sur.), p. 5.) Thus, the amount of forecasted tank painting expense that should be reflected is \$2.44 million for the current year and \$2.37 million for the test year as proposed by the Company.

## **5. Incentive Compensation Expense**

Ms. Teasley explained, and no party disputes, that it is customary in the utility industry to utilize incentive compensation plans as a part of employee compensation. (IAWC Ex. 1.10 (Teasley Reb.), p. 2.) The inclusion of such plans in the employment compensation package offered to non-union salaried employees by IAWC allows the Company to be more competitive in attracting and retaining highly qualified personnel. (Id.) Attracting and retaining highly-

qualified personnel better enables IAWC to provide a high level of service to customers and operate its business more efficiently. (Id.) For the Total Company, IAWC proposed to reflect \$1,515,083 as the test year level of incentive compensation expense.

Staff witness Ms. Pearce proposes to disallow recovery of incentive compensation expense. She proposes an adjustment to remove all incentive compensation expense because IAWC must meet a certain financial target for any Annual Incentive Plan (“AIP”) award, whether for financial, operational or individual goals, to be paid to the employees. (ICC Staff Ex. 3.0, pp. 4-6.) The Company acknowledges that no AIP awards are paid if certain financial targets are not met. (IAWC Ex. 4.10 (Grubb Reb.), pp. 2-3.) The Commission, however, permits recovery of incentive compensation expense where the incentive compensation plan confers tangible benefits on ratepayers. Commonwealth Edison, Docket 05-0597, Final Order, p. 96 (July 26, 2006); Consumers Illinois Water Co., Docket 03-0403, Final Order, p. 15 (April 13, 2004). As Mr. Grubb explained, the AIP benefits rate payers by helping IAWC to attract and retain competent personnel, reduce expenses, maintain the financial health of the Company, improve service to customers, and increase operational efficiencies. (IAWC Ex. 4.10 (Grubb Reb.), pp. 3-4.) Staff does not dispute this evidence.

As Mr. Grubb explained, there are three components to IAWC’s incentive plan: financial, operational, and individual. The Company demonstrated in detail that each of the components provides net benefits to ratepayers. (See IAWC Exs. 4.10 (Grubb Reb.), pp. 3-7; 4.11). The financial element of the incentive plan provides incentives to Company personnel related to meeting the overall financial goals of the Company. (IAWC Ex. 4.10 (Grubb Reb.), pp. 3-4.) Approximately 60% of the Company’s proposed incentive plan expense, moreover, is related to operational and individual goals that also have net ratepayer benefits. (Id., p. 3.) The presence

of these operational and individual goals provides employees with incentives to increase efficiencies and improve service. (Id.)

Mr. Grubb further explained that the financial element of the incentive plan provides incentives to Company personnel related to meeting the overall financial goals of the Company, such as operating income. (IAWC Ex. 4.10 (Grubb Reb.), p. 4.) This benefits ratepayers because a financially healthy company is in a better position to meet its public service obligations. (Id.) A financially healthy company will be able to: (1) raise capital at relatively lower cost; (2) better respond to changes in business conditions or to additional water quality regulations; and (3) meet the challenges of emergencies that occur from time to time. (Id.) The financial element provides an incentive to reduce waste or increase efficiency, both of which in the long term will provide a customer benefit. (Id.) As Mr. Grubb indicated, it is in the customer's interest to have a compensation plan that motivates employees to support the Company's sound financial performance. (Id.)

Mr. Grubb also explained how the operational and individual components of the AIP provide further tangible benefits to ratepayers. (IAWC Ex. 4.10 (Grubb Reb.), pp. 5-7.) A participant in the AIP may receive incentive compensation if certain targets are met for operational metrics and individual performance goals, which motivates such participants to work to ensure that service is reliable and efficient and that customer satisfaction is high. (Id.) The Company presented extensive evidence regarding the types of operational and individual goals and the ratepayer benefits that these goals create. (IAWC Exs. 4.10 (Grubb Reb.), pp. 4-7; 4.11.)

Operational metrics include targets such as:

- Notices of Violation, which measures the number of times that an official notice is issued by a primacy agency for failure to comply with a federal, state, or local environmental statute or regulation that is covered by the Environmental

Management Plan. (A participant in the plan may receive incentive compensation when Notices of Violation remain below a certain level.)

- Lost Work Day Case Rate, which measures the number of total OSHA recordable injuries and/or illness cases with lost workday(s) per 200,000 hours worked. (A participant in the plan may receive incentive compensation if the Lost Work Day Case Rate measure remains below a certain level.)
- Quality Measures (Shared Services Center), which measures the timeliness and number of errors in financial and accounting statements.

Examples of individual performance goals include targets such as:

- All 2” meters and larger will be tested and/or changed in accordance with the schedule. This benefits the customer by providing improved efficiency and reliability within the system.
- By year-end, all accounts with malfunctioning meters will be reduced to no more than two consecutive zero readings. This benefits the customer by improving efficiency, reducing zero reads, and minimizing the number of estimated bills.
- No service outages for periods greater than six hours and average service outage not to exceed four hours. This assures improved continuity of service to the customer, minimizes inconvenience, and assures responsiveness to incidents causing breaks in service.

All of these goals create incentives for IAWC and Service Company employees to improve efficiencies and customer service, and so directly benefit customers. (Id., p. 7.)

Moreover, American Water has made payouts under the plan in each of the past five years. (IAWC Ex. 4.20 (Grubb Sur.), pp. 3-4.) For calendar year 2007, American Water has met 100% of its operating income target, and has made AIP payments in 2008 for the 2007 year. (Id.) As American Water has consistently paid out incentive compensation in each of the past five years, it is reasonable to project that American and IAWC will incur incentive compensation expense in the test year. Therefore, it is reasonable for IAWC to recover incentive compensation expense. (IAWC Ex. 4.10 (Grubb Reb.), pp. 2-3).

As noted above, Staff’s primary concern is that the AIP has a financial performance trigger and, thus, shareholders are the AIP’s primary beneficiaries. (ICC Staff Ex. 3.0, pp. 4-6.)

The Commission has disallowed incentive compensation expense that depended on meeting targets such as earnings per share goals. The Commission, however, has also allowed utilities to recover incentive compensation expenses even where a “financial trigger” is present. See Commonwealth Edison, Docket 05-0597, Final Order, pp. 96-97 (“In addition, when we compare the incentive compensation costs allowed to be recovered in the company’s previous rate case to the costs we allow here, we note that there was an additional financial trigger for the operational goals in the former.” (Emphasis added)); see also Aqua Illinois, Inc., Docket 04-0442, Final Order, pp. 14-22 (April 20, 2005) (rejecting Staff’s concern that incentive compensation was dependent on meeting financial goals, and declining to accept Staff’s proposed adjustment for incentive compensation expense); Consumers Illinois Water Co., Docket 03-0403, Final Order, pp. 13-15 (April 13, 2004) (same). As discussed above, the Commission allows incentive compensation expense where tangible ratepayer benefits are present. IAWC has demonstrated that the AIP provides such benefits, and thus IAWC’s proposed incentive compensation expense should be allowed.

Staff’s concern overlooks at least two aspects of the benefits of the AIP to IAWC’s customers. First, the AIP, in setting individual and operational goals, helps align the goals of Company employees with the Company’s regulatory requirements under the Act and the Commission’s rules. (IAWC Ex. 4.20 (Grubb Sur.), p. 5; Tr. 74-75 (Grubb).) The Company is required to provide adequate and reliable service to its customers, 220 ILCS 5/8-401, and in doing so must comply with various requirements of the Act and of the Commission’s rules. It is the function of Company management to develop the strategic and annual goals and objectives needed for the Company to comply with regulatory and other requirements. (See IAWC Ex. 1.00 (Teasley Dir.), pp. 2-3.) Incentive compensation is a useful tool for focusing each employee

on specific actions and goals required to meet the Company's objectives as determined by management. (IAWC Ex. 4.20 (Grubb Sur.), p. 5.)

Second, as Mr. Grubb explained, the AIP provides incentives to employees that benefit ratepayers regardless of whether the financial trigger is met and payments are made. Employees will work toward their incentive goals on the assumption that payment will be made if the goals are met. (IAWC Exs. 4.10 (Grubb Reb.), p. 8; 4.20, p. 4.) Even if the trigger is not met, the ratepayer has still received the benefit of the employees work towards that goal. Thus, even with a financial trigger, the AIP provides tangible ratepayer benefits.

Under Staff's proposal, IAWC can never be authorized to collect in rates any incentive compensation expense, even when the financial and operational goals of the Company and the achievement of the individual goals of the employees results in efficiencies and savings to ratepayers. (IAWC Ex. 4.10 (Grubb Reb.), p. 7.) As Staff acknowledges, however, the Commission has "generally disallowed recovery of incentive compensation costs except where the utility has demonstrated that its [incentive compensation plan] has reduced expenses and created greater efficiencies in operations." (Emphasis added). (ICC Staff Ex. 3.0, p. 9, citing Docket 06-0070/0071/0072 (Consol.), Final Order, p. 72 (Nov. 21, 2006).) Given the substantial ratepayer benefits shown by IAWC for the financial, individual and operational components of the AIP, and the fact that employees will work to achieve the goals set out in the individual and operational components regardless of the overall level of the Company's financial performance, it is reasonable to allow recovery of 100% of IAWC's incentive compensation expenses. (IAWC Ex. 4.10 (Grubb Reb.), p. 7.)

Ms. Pearce's concern regarding the purported "circular" relationship between rates and the expenses such rates are designed to recover is unwarranted. (ICC Staff Ex. 3.0, p. 7.)

American Water has paid out incentive compensation awards in each of the last five years. (IAWC Ex. 4.20 (Grubb Sur.), pp. 3-4.) Incentive compensation expense therefore represents real, not theoretical, expenses that IAWC must pay. (Id.) IAWC's proposed rates therefore properly recover this expense, which IAWC's ratepayers benefit from. (IAWC Exs. 4.10 (Grubb Reb.), p. 8; 4.20 (Grubb Sur.), pp. 3-4.) The fact that American Water has made payments in each of the past five years (including 2007) indicates that it has met its financial target and made payments under the AIP, and supports the conclusion that such payments will be made in future years, including the test year. (IAWC Ex. 4.20 (Grubb Sur.), pp. 4-5.)

Staff's statement that IAWC can alter its Plans to primarily benefit ratepayers by, among other measures, removing the award payment trigger, is misguided. As explained above, the AIP plan already provides tangible ratepayer benefits. (IAWC Ex. 4.20 (Grubb Sur.), p. 4.) The financial element of the incentive plan provides incentives to Company personnel to meet the goals that provide these benefits. (Id.) Ratepayers receive the benefit of efforts made to meet these goals regardless of whether the financial trigger is met and payments are made. Therefore, there is no need for American Water to modify its program. (Id.) And while it is always possible that incentive plans may be refined or modified in the future, American Water has no present intent to significantly modify or eliminate the AIP. (Id., p. 5.)

The Company also opposes Mr. Effron's proposed adjustment for incentive compensation expense. Mr. Effron's adjustment should be rejected for the reasons discussed above in connection with Staff's proposed adjustment. (See IAWC Ex. 4.10 (Grubb Reb.), p. 15.)

**6. Management Fees**

**a. The Company Has Demonstrated Its Management Fees Are Reasonable**

As Mr. Grubb explained, IAWC receives a wide range of services from the Service Company (defined above), including Accounting, Administration, Communication, Corporate Secretarial (Legal), Engineering, Financial, Human Resources, Information Systems (IT), Operations (Network, Maintenance, Production, Leak Detection), Rates and Revenue (Rate Regulation), Risk Management, and Water Quality services. (IAWC Ex. 4.00 (Grubb Dir.), p. 15.) The support services provided to IAWC are essential to providing safe and adequate services to customers. (Id.) In his direct testimony, Mr. Grubb provided a detailed description of the services provided and the benefits that those services provide to ratepayers. (Id., pp. 15-30.)

The test year management fee expense for the Total Company in the amount of \$18,523,751 reflects the projected provision of these services to IAWC. (IAWC Ex. 4.00 (Grubb Dir.), p. 30.) As Mr. Grubb explained, the Company's forecast for the test year management fees was based on a detailed, item by item development of the budgeted costs that the Service Company anticipates to incur to provide the necessary services to IAWC in the test year. (IAWC Exs. 4.10 (Grubb Reb.), p. 19; 4.22.) This process looked at individual business units and individual accounts such as labor, insurance, rents, depreciation, taxes, employee benefits, maintenance and other operating costs. (IAWC Exs. 4.20 (Grubb Sur.), p. 19; 4.22.) As discussed above, the test year forecast, which includes the management fee projection, was audited and certified as complying with the AICPA Guide (defined above). (IAWC Ex. 4.00 (Grubb Dir.), p. 6.) The Company further demonstrated that its test year management fee expense is reasonable by explaining the basis for the change in cost from the level for the test

year in the Company's last rate case (2003) to the test year level in this case, for each category of service provided.

Mr. Grubb explained that the change in management fee expense from 2003 through 2006 was based on a recategorization of certain costs from the prior test year and five additional factors, including general inflation, new functions being performed that resulted in new services being provided to IAWC by the Service Company, increased call activity at the Customer Service Center ("CSC"), increased pension expense, and a restructuring that shifted services from IAWC to the Service Company (with significant savings for IAWC). (IAWC Ex. 4.00 (Grubb Dir.), pp. 30-37.) The factors discussed by Mr. Grubb are summarized as follows:

- Recategorization – In the Company's last rate case, the proposed amount of management fees was \$6,843,171. Based on a recategorization of costs associated with the Service Company employees who resided in Illinois as "in-state" employees, the total management fee expense level in 2003 is \$9,824,737. (IAWC Ex. 4.00 (Grubb Dir.), pp. 31-32.)
- Inflation – Mr. Grubb explained that, since 2003, inflation has affected the management fee costs. (IAWC Ex. 4.00 (Grubb Dir.), p. 33.) Inflation accounts for an increase in management fee expense of approximately \$950,961 from 2003 to 2006. (Id.)
- New Services – Mr. Grubb explained that the Service Company is performing beneficial new services for IAWC since the last rate case, including the Supply Chain, Environmental Compliance, Network, Maintenance, and Production functions. (IAWC Ex. 4.00 (Grubb Dir.), p. 34.) The total cost associated with these five functions is \$1,178,187. (Id.)
- CSC – Mr. Grubb explained that the CSC costs allocated to Illinois have increased by \$632,523 since 2003 through 2006. (IAWC Ex. 4.00 (Grubb Dir.), p. 34.) The increase in cost net of inflation, approximately \$341,865, can be attributed to additional resources required by increased call volume since 2003, which has required an increase in staffing at the CSC. (Id.)
- Pension Expense – Mr. Grubb also explained that, from 2003 to 2006, the increase in pension cost for the Service Company as a whole was \$7,378,117. (IAWC Ex. 4.00 (Grubb Dir.), p. 35.) The Company's portion of the cost increase, based on a customer allocation factor of 9%, is \$664,031. (Id.) Removing the estimated impact of inflation (which is taken into account above), the resulting net increase is approximately \$655,367. (Id.)

- Restructuring – American Water initiated an organizational restructuring in 2004 that ultimately eliminated a number of positions from the payroll of IAWC. (IAWC Ex. 4.00 (Grubb Dir.), p. 35.) The restructuring eliminated 31 employee positions from the Company. (IAWC Ex. 4.00 (Grubb Dir.), p. 36.) The services performed by these 31 employees were subsequently provided by the Service Company. (IAWC Ex. 4.20 (Grubb Sur.), p. 18.) The reduction of costs to IAWC as a result of this restructuring exceeded the amount of service costs shifted to the Service Company and charged back to IAWC after the restructuring by at least \$312,969. (IAWC Ex. 4.00 (Grubb Dir.), p. 36.)

As Mr. Grubb explained, with regard to the change in management fees from 2006 to the test year, the major drivers for the increase are the projected levels of wage and benefits expense and the normal inflation of non-payroll costs. (IAWC Ex. 4.10 (Grubb Reb.), p. 19.) The projected level of expense reflects the filling of current vacancies at the Service Company and the addition of new employee positions needed to allow the Service Company to perform required services for IAWC. (Id.) As Mr. Grubb explained, the combined effect of the factors projected to affect the level of management fee expense is that the level of expense will increase from 2006 through the test year by an average annual amount of 4.1%. (IAWC Ex. 4.00 (Grubb Dir.), p. 31.) Based on the evidence provided by Mr. Grubb, the forecasted level of management fee expense is reasonable and should be reflected in rates.

**b. The AG’s Adjustment to Management Fees Should Be Rejected**

AG witness Effron proposes an adjustment to reduce management fees by \$2.667 million (net of his proposed adjustment to eliminate incentive compensation, which, as discussed above should be rejected). (AG Ex. 1.3, Sched. C-3.1.) Mr. Effron accepted as reasonable the Company’s explanation supporting the increase in management fees from 2003 to 2006 for four of the six factors listed above: recategorization of costs from the last rate case, inflation, the provision of new services, and increased pension expense. (AG Exs. 1.0, pp. 15-20; 1.3, Sched. C-3.1.) In total, Mr. Effron believes that \$14,584,000 of IAWC’s proposed test year level of

management fee expense was adequately explained. (AG Exs. 1.0, p. 21; 1.3, Sched. C-3.1.) Mr. Effron asserted, however, that the increased costs of the CSC were unexplained, and excluded the cost associated with increased call volume at the CSC in the amount of \$341,865. (Id., p. 17; AG Ex. 1.3, Sched. C-3.1.) Mr. Effron also asserted that, with regard to the 2004 restructuring, only the costs associated with nine employees who were actually transferred from IAWC to the Service Company should be included in management fees, calculating the amount he proposed to allow as \$1,028,000. (AG Exs. 1.0, pp. 19-20; 1.3, Sched. C-3.1). Mr. Effron further asserted that the calculation of the increase in management fees from 2006 to the test year should be based on an inflation factor instead of the Company's detailed, audited budgeting process. (AG Exs. 1.2, pp. 8-9; 1.3, Sched. C-3.1.) For the reasons discussed below, these adjustments should be rejected. Staff, which performed its own analysis of management fees, also agrees that no adjustment is necessary to the Company's test year level of management fees. (ICC Staff Ex. 12.0, p. 8.)

**i. CSC Costs Have Increased Due to Increased Call Volume**

With regard to the CSC, Mr. Effron incorrectly suggests that forecasted call volume for the CSC for the test year is actually less than the volume in 2003. (AG Ex. 1.0, p. 17.) As Mr. Grubb explained, however, the Company has seen a significant increase in call volume from 2003 through 2006, which explained the increase in CSC costs over that period. (IAWC Ex. 4.10 (Grubb Reb.), pp. 16-17.) Between 2003 and 2006, the call volume increased by 51,148 or 10.3%. (Id., p. 17.) The final call volume for 2007 at the call center, including calls handled by a third party vendor, was 600,509, or 103,832 greater than 2003. (Id.) This represents a 20.9% increase over 2003. (Id.) Mr. Grubb explained that the CSC costs allocated to Illinois have increased by \$632,523 since 2003 through 2006. (IAWC Ex. 4.00 (Grubb Dir.), p. 34.) This

represents a 21.6% increase over the three years. (Id.) Inflation since 2003 accounts for approximately \$290,658 of these costs. (Id.) As Mr. Grubb explained, the remaining increase in cost, of approximately \$341,865, can be attributed to additional resources required by increased call volume since 2003, which has required an increase in staffing at the CSC. (Id.)

**ii. The 2004 Restructuring Transferred Services, and Associated Costs, Performed by 31 IAWC Employees to the Service Company**

Mr. Effron's proposal (AG Ex. 1.0, p. 20) to include in management fee expense only an amount of \$1,028,000 (for nine employees transferred to the Service Company as discussed below) resulting from the 2004 corporate restructuring is also unjustified. (See IAWC Ex. 4.10 (Grubb Reb.), p. 17.) Mr. Grubb explained that, in late 2003, American Water initiated an organizational restructuring, which included creating the American Water Central Region, that ultimately eliminated a number of positions from the payroll of IAWC and shifted the services performed by employees in those positions to the Service Company. (IAWC Exs. 4.00 (Grubb Dir.), p. 35; 4.20 (Grubb Sur.), p. 19.) The effect of this was to increase support services cost charged to IAWC from the Service Company but reduce IAWC's labor and other related costs. (Id.)

As Mr. Grubb explained, the restructuring removed 31 employee positions from the Company. (IAWC Ex. 4.00 (Grubb Dir.), p. 36.) Nine of these 31 positions were transferred directly to the Service Company. As a result of the restructuring, however, the other 22 IAWC positions were eliminated. (IAWC Ex. 4.20 (Grubb Sur.), p. 18.) The services performed by these 31 employees (including the nine transfers) were shifted to the Service Company, where, due to the efficiencies generated by the Service Company, the services could be provided at a lower cost than would be incurred had the employees remained at IAWC. (Id., p. 19.)

Mr. Grubb explained that the types of services shifted to the Service Company include, for example, the Legal Function, which was expanded at the Service Company to include seven lawyers, a contract administrator, a paralegal and two administrative personnel who provide IAWC with services as needed and appropriate. (IAWC Ex. 4.10 (Grubb Reb.), p. 10.) Likewise, the Finance Function has expanded to include a Manager of Compliance and three staff individuals who provide IAWC with services as needed and appropriate. (Id.) The Human Resource function expanded to provide IAWC services for overseeing employees from the beginning of their employment to the end of their employment, including the formation of an Employee Benefits Center that can be used by current and former employees as a contact or source of information regarding their benefits. (Id.) The Customer Relations function expanded to provide IAWC with services to assist in the day to day coordination between IAWC's local operations and the Shared Business Services Teams (Call Center and Shared Services). (Id.) In addition, the Operational Risk Function expanded to include eight professionals in the field of Risk Management who provide IAWC with services as needed and appropriate. (Id.)

The elimination of the 31 positions resulted in a reduction of costs of \$4,355,373 for IAWC. (IAWC Ex. 4.04.) As Mr. Grubb explained, the reduction of costs to IAWC as a result of this restructuring exceeded the amount of service costs shifted to the Service Company and charged back to IAWC after the restructuring by at least \$312,969. (IAWC Ex. 4.00 (Grubb Dir.), p. 36.) This amount represents a net savings to ratepayers, which is reflected in test year expenses. (Id.)

Mr. Effron fails to recognize that, as a result of the reorganization and the formation of the Central Region, IAWC began receiving expanded services from the Service Company in 2004 that replaced the services provided by the 31 eliminated IAWC employees. Mr. Effron

acknowledges that the cost associated with the nine employees transferred directly from IAWC to the Service Company should be included in management fee expense. (AG Ex. 1.3, Sched. C-3.1.) Mr. Effron's analysis, however, did not account for the shift in services performed by the remaining 22 employees to the Service Company, where, due to the efficiencies generated by the Service Company, they could be provided to IAWC at a lower cost than had the employees remained at IAWC. (IAWC Exs. 4.10 (Grubb Reb.), pp. 17-19; 4.20 (Grubb Sur.), pp. 18-19.) As Mr. Grubb explained, because Mr. Effron has failed to include these shifts in services, he understated management fee expense by approximately \$2.757 million (the cost of the services formerly provided by the 22 employees eliminated from IAWC and of related expanded services). (IAWC Ex. 4.10 (Grubb Reb.), p. 19.) Adding his adjustment of \$1.028 million for the nine employees to the \$2.757 million, and then adding this result (\$3.785) million to the components of management fee expense recognized by Mr. Effron on Schedule C-3.1 of AG Exhibit 1.3 results in an adjusted level of management fee expense for 2006 of \$16.394 million. (Id., p. 19.) This amount is slightly below the Company's adjusted 2006 management fee level of \$16.736 million. (IAWC Ex. 4.00 (Grubb Dir.), p. 31.) As Mr. Grubb explained, the difference between these amounts is the adjustment for the increased CSC cost of \$341,865, which was discussed above. (IAWC Ex. 4.10 (Grubb Reb.), p. 19.)

**iii. Mr. Effron's Proposed Use of an Inflation Factor as a Substitute for the Company's Detailed Forecast Is Not Appropriate**

In lieu of the detailed projection of test year management fees based on the level of services expected, Mr. Effron proposes an adjusted level, which he computes by applying an inflation factor to the 2006 level of cost. Mr. Effron also proposes the use of a "reasonable" inflation component for management fees from 2006 to the test year, treating management fees above the level of inflation as unexplainable. (AG Ex. 1.0, p. 18.) This proposal is unfounded.

As Mr. Grubb explained, the Company's forecast for the test year management fees was based on a detailed, item by item development of the level of projected costs that will be incurred for necessary services provided by the Service Company to IAWC in the test year. (IAWC Exs. 4.20, p. 19; 4.22.) This process looked at individual business units and individual accounts such as labor, insurance, rents, depreciation, taxes, employee benefits, maintenance and other operating costs. (IAWC Exhibit 4.22.) As Mr. Grubb explained, the major drivers for the increased level of management fees from 2006 to the test year included projected wage and benefits increases, as well as normal inflation on non-payroll costs. (IAWC Ex. 4.20 (Grubb Sur.), p. 19.) All of these projections were made in accordance with the AICPA Guide. (IAWC Ex. 20.00, Sched. G-2.) Because the Company's forecast of management fees increases from 2006 to the test year is based on a detailed budgeting process, not just a general inflationary increase, the Company's forecasted increase in the level of Management Fees is reasonable and should be recovered in rates. (IAWC Exs. 4.10 (Grubb Reb.), pp. 19-20; 4.20 (Grubb Sur.), pp. 19-20.)

As shown above, Mr. Effron's concern that the Company has not adequately explained or justified its projected increase in management fees (AG Ex. 1.2, p. 10) is unjustified. IAWC's management fee expense projection is based on a detailed, audited forecast, and IAWC has explained in detail the factors supporting the increase in management fees from 2003 to 2006 and from 2006 to the test year. Thus, there is no basis for Mr. Effron's adjustments to management fee expense.

**7. Operations and Maintenance (“O&M”) Cost Adjustment and Rate/Cost Comparisons**

**a. Background**

In the Docket 05-0681 Order, the Commission indicated that, based on a comparison of IAWC’s water and wastewater rates to four MOUs (defined above), IAWC’s rates may be unreasonable. The Commission also stated that, if a rate proceeding was filed by IAWC within six months of the date of the Docket 05-0681 Order (and this proceeding was filed within that time frame), parties could present evidence addressing the reasonableness of IAWC’s rates. Docket 05-0681 Order, pp. 45-46.

As Ms. Teasley explained, the relationship of IAWC’s rates in the Chicago Metro District relative to the rates of certain MOUs has been a source of customer concern and a concern for IAWC.<sup>4</sup> (IAWC Ex. 1.20 (Teasley Sur.), p. 2.) As Ms. Teasley indicated, IAWC understands these concerns, but cannot address the concerns by setting its rates to match those of MOUs, which are subject to different cost and accounting structures as compared to those applicable to IAWC. (Id.) As will be discussed, IAWC has responded to concerns regarding relative rate levels with extensive efforts to review and minimize its specific costs and rates. (Id., pp. 2-6.)

In this proceeding, IAWC presented evidence through several witnesses that supports the proposed level of revenue requirement and rates, including, but not limited to, the Schedules, which are required by 83 Ill. Admin. Code Part 285. In addition, in response to the concern

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<sup>4</sup> The witnesses on behalf of Homer Glen, Mr. Daley and Ms. Niemiec, for example, state that IAWC’s rates are high in comparison to neighboring municipalities. (HG Ex. 1.0, p. 5.) As Ms. Teasley noted, however, IAWC’s proposed rates are intended to yield revenues sufficient to recover test year operating expenses and to produce a reasonable return on rate base. (IAWC Ex. 1.10 (Teasley Reb.), p. 4.) The Homer Glen witnesses acknowledge that the “increase in rates in this case may not appear on a percentage basis to be high.” (HG Ex. 1.0, p. 4.) Moreover, neither of the Homer Glen witnesses has analyzed or taken a position regarding any specific cost or expense of IAWC – in fact, Homer Glen acknowledges that “[n]either Mr. Daley nor Ms. Niemiec presented any testimony concerning the appropriateness or reasonableness of any IAWC cost.” (IAWC Ex. 1.11.) Thus, the Homer Glen witnesses present no specific basis for their first concern. Further, as discussed above, IAWC has addressed the issue of the comparability of municipal rates in detail in the testimonies of Mr. Uffelman, Ms. Kane and Mr. Schmitt, as well as in the Report (IAWC Exhibit 10.20). (IAWC Ex. 1.10 (Teasley Reb.), p. 4.)

expressed in the Docket 05-0681 Order, IAWC retained Stifel, a firm that specializes in providing, along with other services, public-finance banking services and financial consulting services with regard to governmental entities, and Deloitte & Touche, a firm that provides, along with other services, audit and financial advisory services. (IAWC Ex. 10.20, pp. 17, 31.) Stifel and Deloitte & Touche were asked to gather information as appropriate, and to analyze that information to determine whether a comparison of IAWC's rates to those of MOUs would indicate whether or not IAWC's rates are reasonable. Stifel and Deloitte & Touche assembled information, performed the requested analysis and summarized their findings and conclusions in the Report (defined above). The Report is supported by the testimonies of Mr. Uffelman of Deloitte & Touche (IAWC Ex. 10.00) and Ms. Kane of Stifel (IAWC Ex. 10.10).

As discussed in the Report, the cost structures on which the rates of investor-owned utilities ("IOUs"), such as IAWC, are based differ in many respects from those of MOUs. As a result, a comparison of IAWC's rates or costs to those of MOUs does not support a conclusion that IAWC's rates or costs are unreasonable. (IAWC Ex. 10.20, p. 1.)

**b. The Report**

To obtain information for the analysis, representatives of Stifel met with officials from three of the MOUs referenced in the Docket 05-0681 Order, the municipalities of Downers Grove, Lemont and Woodridge. (IAWC Ex. 10.20, p. 2.) (The fourth MOU referenced in Docket 05-0681, the Village of Darien ("Darien"), was unwilling to provide necessary information – IAWC Ex. 10.40 (Kane Reb.), p. 7; IAWC Ex. 10.70 (Kane Sur.), pp. 4-5.) The three participating MOUs (Downers Grove, Lemont and Woodridge) provided extensive information, including but not limited to, their Comprehensive Annual Financial Reports ("CAFRs") or annual audits, budgets and Five Year Capital and Financing Plans and Programs. The Report notes, however, that the MOUs are not required to, and therefore do not maintain, all

of the information and data of the type maintained by an IOU, such as IAWC. Thus, in many cases, estimation is required, and certain cost structure/rate differences between IOUs and MOUs cannot be quantified with the available data. (IAWC Ex. 10.20, p. 2.)

**c. Cost Structure and Rate Setting Differences**

As the Report discusses, the cost structure and rate setting practices of MOUs differ in significant respects from those of an IOU, such as IAWC. (IAWC Ex. 10.20, p. 3.) The following is a discussion of several differences in approach, each of which is more fully discussed in the Report.

**i. Utility (or COS) v. Cash Needs Approaches**

Significant differences exist between the utility or cost of service (COS) and “cash needs” bases of accounting/rate setting for utility operations. (IAWC Ex. 10.20, pp. 3-4, 19-21.) Most MOUs, including the three MOUs that are studied in the Report, prepare their budgets and set their rates on the basis of cash needs. (Id., p. 3.) The cash needs basis considers in setting rates only cash expenditures of the MOU, and does not include a rate recovery for non-cash, accrued items. Under the cash needs approach, for example, depreciation expense, a non-cash item, is not included as an MOU operating expense. IOUs, such as IAWC, however, recover depreciation cost in rates in the accounting period when the cost is accrued. When the cost is recovered as accrued (as it is by IOUs), the customers who benefit from use of the plant pay rates that reflect the applicable depreciation cost (even though depreciation expense is not then paid out in cash). For IOUs, depreciation cost is not deferred for future rate recovery, as it is for MOUs. (Id., pp. 3-4.)

IOUs also recover in rates accrued amounts related to the cost of providing pension or other post-employment benefits (“OPEBs”) for employees who provide service during a particular accounting period. As in the case of depreciation expense, assignment of accrued

pension and OPEB costs to the accounting period in which employees work to provide service is deemed appropriate as a matter of regulatory policy. Under this approach, the rates of the IOU reflect the full cost of the service provided, even though cash outlays for payment of pension and OPEB costs may occur at a future time. MOUs, on the other hand, recover in rates only cash outlays for pension or OPEB costs, which may or may not reflect the full applicable cost. (IAWC Ex. 10.20, p. 4.)

For the three MOUs, the Report quantifies the effect of cash/utility (COS) accounting differences. With respect to depreciation expense, for example, the Report determines that, to recover the applicable depreciation expense level, Downers Grove, Lemont and Woodridge would have been required to increase their 2006 fiscal year revenue by approximately 22%, 16% and 35%, respectively. (IAWC Ex. 10.20, p. 25.) Reporting pension costs on an accrual basis rather than the cash basis would have required approximate fiscal year 2006 operating revenue increases for Downers Grove, Woodridge and Lemont of 2%, 9% and 4%, respectively. (Id., p. 29.) In addition, two of the MOUs, Downers Grove and Woodridge, reported that they provide their employees with OPEBs. (Id., pp. 26-27.) Reporting OPEB costs on an accrual basis rather than the cash basis would require operating revenue increases for each of these MOUs of approximately 1%. (Id., p. 27.)

## **ii. Shared Resource Subsidization**

As discussed, each of the three MOUs operates its waterworks and sewerage system on a cash needs basis, but because MOU costs are accounted for in a fund for the MOU (“Enterprise Fund”) (as further defined in the Report – IAWC Ex. 10.20, p. 3), each MOU allocates certain costs, including operation and maintenance and administration costs, through interdepartmental payments to the respective municipality’s general fund (“General Fund”). (Id., p. 4.) In certain past years, all three of the municipalities completed cost allocation plans to support the allocation

of costs incurred by the General Fund to the Enterprise Fund (the “Indirect Cost Allocation Plan” or “Plan”). Each of the three MOUs, however, reported that they do not annually update their Plan; for at least two of the MOUs, it has been many years since the Plan was updated. (Id.) In preparing the Report, Stifel identified, for each of the three MOUs, specific examples of tax-supported resources used by the MOU in providing utility service, with no cost for the tax-supported resource allocated to the Enterprise Fund of the MOU for recovery in utility rates (e.g., Downers Grove – MOU utilizes space in municipal buildings for personnel without an allocation of cost to the MOU (id., p. 13); Lemont – municipality does not allocate to the MOU the cost of certain tax-supported resources used (id., p. 16); Woodridge – MOU utilizes tax-supported municipal buildings, including a public works garage, for utility functions without paying the full cost; the Woodridge MOU also does not pay full cost for municipal human resource and data processing functions (id., p. 10-11)). It is Stifel’s assumption, based on experience with municipalities throughout Illinois, that the payment by each MOU to the General Fund could be understated by approximately 20%. (Id., p. 4.) The MOUs, however, do not have available studies or data to confirm this estimate. As an example, assuming a 20% increase in the General Fund payment, the rates of Woodridge would increase by \$.07 for each 1,000 gallons of water. (Id.)

### **iii. Other Tax Subsidies**

As compared to the operations of IAWC, MOU operations receive significantly greater tax subsidies, thus reducing the extent to which MOUs are required to recover utility-related costs in rates. As the Report explains, two of the MOUs, Downers Grove and Woodridge, buy wholesale water from only one entity, the DuPage Water Commission (“DWC”), which was established in the early 1990s. (IAWC Ex. 10.20, p. 4.) The two MOUs were charter members of the DWC, which provides the MOUs with a cost advantage. The DWC has the lowest

wholesale cost of water of all regional providers in the Chicago Metro Area utilizing Lake Michigan Water due to the period of its construction (late 1980's) and a significant sales tax subsidy. (Id.)

The DWC receives revenues from three significant sources: (1) payment for water sold; (2) a DWC area wide sales tax of 0.25% imposed throughout DuPage County; and (3) tax exempt bonds for the improvement and upgrade of its infrastructure. (IAWC Ex. 10.20, pp. 4-5.) According to the Fiscal Year ("FY") 2006 audit of the DWC, sales tax revenues were sufficient to fund all system capital improvements for DWC and a statutory payment to DuPage County of \$15 million (\$75 million over 5 years since 2003), and also to provide an alternate funding source for debt service. Sales tax revenues also were used to make all general obligation bond payments in FY 2006. In addition, according to the FY 2006 audit, \$7.1 million of sales tax revenues were used to reduce customer fixed cost payments for FY 2006 by 50%, a practice that has been in effect since 1998. (Id., p. 5.)

The sales tax subsidy of DWC water purchase costs is significant in connection with the charges for water service of the Downers Grove and Woodridge MOUs, which purchase water only from this source. The sales taxes supporting DWC are a cost component (not reflected on the water bill) for residents subjected to that tax. Also, the sales tax subsidizes the rates that the DWC charges Downers Grove and Woodridge, which, in turn, allows them to sell water to their customers at lower rates. (IAWC Ex. 10.20, pp. 5, 23.) In 2006, had these municipalities not received the benefit of the sales tax subsidy, their costs (and presumably rates) would have been higher by 29% for Downers Grove and 28% for Woodridge. (Id., pp. 23-24.) IAWC also purchases water from DWC for areas where DWC water is available. Water purchased from

DWC, however, is only a small portion of IAWC's total purchases for the Chicago Metro District. (Id., p. 5.)

#### **iv. Service Area Characteristics**

The service area characteristics of each of the MOUs studied differ significantly from those of IAWC's Chicago Metro District. (IAWC Ex. 10.20, p. 5.) Each of the MOUs serves concentrated service areas of approximately seven to ten square miles. As a result, their personnel, facilities and infrastructure are able to focus on a relatively compact area. In contrast, IAWC's Metro District operations serve multiple municipalities and wholesalers across a wide geographic area. (Id.; AG Cross-Examination Ex. 19.) As Mr. Stephen Schmitt, Vice President of Operations for the Service Company, explained, IAWC's Chicago Metro District comprises 25 separate water service areas, 11 of which also provide wastewater service. (IAWC Ex. 10.50 (Schmitt Reb.), p. 6.) As Mr. Schmitt indicated, the need for IAWC's maintenance personnel to travel long distances in populated areas through heavy traffic has a significant impact on IAWC's cost of service as compared to that of the more compact MOUs. (Id., p. 7; IAWC Ex. 10.80 (Schmitt Sur., p. 3.) Also, as Mr. Schmitt testified, IAWC experiences the effect of spreading the cost of a fixed asset base over the relatively small population of each of twenty-two separate medium and small systems (each serving a population below 10,000), which represent 88% of the twenty-five IAWC Metro District systems. (IAWC Exs. 10.80 (Schmitt Sur.), p. 3; 10.50 (Schmitt Reb.), pp. 6-7.) As Mr. Schmitt explained, on an individual system basis, each of the MOU systems (referring to the three MOUs studied in the Report and the Village of Wheaton ("Wheaton") MOU referenced by AG Witness Rothstein) serves a customer base that is relatively large (over 10,000 people) as compared to that of the multiple small and medium systems served by IAWC. (IAWC Ex. 10.50 (Schmitt Reb.), p. 7.)

**v. Non-Resident Surcharges**

Two of the MOUs (Woodridge and Downers Grove) impose surcharges of 43.9% and 100%, respectively, on water sold to customers outside the geographic limits of the municipality. (IAWC Ex. 10.20, p. 5.) The imposition of non-resident surcharges is a common practice of MOUs. IAWC, on the other hand, serves all Chicago Metro District customers without the imposition of surcharges based on residency status. (Id.)

**vi. Municipal Plant Funding Mechanisms**

MOUs utilize sources of funding for capital projects that are not available to the same extent for IOUs, such as IAWC, under applicable regulatory requirements. Each of the three municipalities, for example, has issued tax exempt general obligation (“GO”) bonds, the proceeds of which were used to fund capital improvements. (IAWC Ex. 10.20, p. 5.) Because two of the municipalities are Home Rule units, they can issue water utility debt utilizing the municipality’s full faith and credit obligation (i.e., general tax revenue base) without regard to the repayment source. As a result, this GO bond debt carries a lower interest rate (and fewer covenant restrictions) as compared to revenue bond debt which would rely for payment solely on the MOU water revenue. Thus, the MOUs’ cost of debt is subsidized by the municipalities’ use of GO bonds supported by the general tax revenues of the municipality. (Id., p. 6.)

As the Report explains, connection fees or impact charges assessed by the MOUs are another source of funds available to finance capital improvements and expansions to the MOU system. (IAWC Ex. 10.20, p. 6.) All three of the MOUs have water connection fees established to generate additional revenues for capital improvement projects, and two of the MOUs have used grants and/or state low interest loan programs to expand their systems and facilities. In certain cases, connection fee revenues are also used by the MOUs to cover ongoing operating costs, thus creating a need for future customers to fund capital projects. (Id.) Under applicable

regulations, IOUs, including IAWC, also fund a portion of their plant investment with contributions. However, as the Report demonstrates, the per customer level of plant cost reflected in rates for the MOUs is substantially below the level of plant cost which IAWC is required to support in rates under the applicable regulations and regulatory policies. (Id.)

For these reasons, as compared to IAWC customers, customers of the MOUs pay a relatively higher proportion of the utility infrastructure cost through connection fees and other up front payments. For IAWC customers, a greater proportion of infrastructure costs is recovered in water rates. As the Report demonstrates, without alternative sources of capital funding, the Lemont, Woodridge and Downers Grove MOUs would have required increased FY 2006 revenues of approximately 4%, 19% and 18%, respectively. (IAWC Ex. 10.20, pp. 6, 24-25.)

**vii. Other Differences in Cost Structure and Rate Setting Approaches**

As the Report explains, other factors also cause differences between the cost structures and rate setting approaches of IOUs and MOUs.

As Ms. Teasley indicates, IAWC and its customers experience significant cost advantages as a result of its membership in the American Water system. (IAWC Ex. 1.00 (Teasley Dir.), pp. 13-14.) IAWC utilizes the expertise in accounting and finance, legal, human resources, water quality, engineering, safety and loss control areas that the professional management and administrative staff offer through the Service Company. Through the Service Company, IAWC is able to obtain, without the expense of contracting with outside service providers, expert capabilities that a stand-alone MOU cannot feasibly provide. The cost of maintaining this management and administrative staff through the Service Company is allocated among all of American Water's operating subsidiaries. The services of these personnel can, therefore, be accessed by IAWC at a lower cost than if IAWC maintained such staffing itself.

Similarly, American Water's consolidation of separate customer service centers into a national customer service center located in Alton, Illinois, has produced efficiencies that benefit all American Water customers, including customers in Illinois. The national call center is available to customers in all IAWC districts to make account or service inquiries 24 hours a day. The national call center is staffed by full-time trainers. IAWC is also able to take advantage of statewide and national contracts through the Service Company for mass purchase of a variety of goods, including office supplies, pipe, chemicals and meters, at a lower cost. IAWC can also take advantage of the Service Company's national laboratory, which is located in Belleville, Illinois, for processing water quality samples. Finally, the Service Company can provide highly specialized expertise in such areas as security, environmental management, and planning that would not be cost effective for IAWC to provide for itself. (IAWC Ex. 10.20, p. 6-7.)

MOU/IOU cost structure differences also relate to variations in operational and regulatory service standards. As Mr. Schmitt explained, Federal environmental regulations set the minimum requirements. At the state level, however, primacy agencies have the ability to increase compliance levels (as an example – to set lower MCLs for certain contaminants), which results in differences in treatment processes (and related costs) from state to state. (IAWC Ex. 10.50 (Schmitt Reb.), p. 8.) Also, unlike MOUs, IOUs, such as IAWC, are subject to service standards promulgated by state regulatory commissions. (Id.)

There also are costs that IOUs, such as IAWC, incur that an MOUs would not. Examples of these include: property and franchise taxes paid to local authorities; income and franchise taxes paid to state authorities; and income taxes and payroll taxes paid to the federal government. Property taxes are based on the assessed value of utility property located within the jurisdiction of the taxing authority. For IOUs, detailed property records establishing the book value of utility

plant investment must be maintained for multiple municipalities and each taxing body also has its own individual tax rates. IOUs also provide a return on the investment in utility plant at cost rates that exceed that of tax-exempt municipal debt. As the Report indicates, the recovery of the cost of local property tax increases the present Chicago Metro District water and wastewater rates by 2.02% and 2.19%, respectively. (IAWC Ex. 10.20, p. 7.)

### **viii. Quantifications**

As explained above, the Report, where reasonably possible, quantifies the effect of identified cost structure differences for the three MOUs. The discussion above referenced the Report's quantification for the three MOUs of the effect of cost structure differences related to the sales tax subsidy, the use of different capital funding mechanisms and cash/utility (COS) accounting differences.

As the Report also indicates, however, it is not feasible to quantify all of the cost structure differences. (IAWC Ex. 10.20, p. 32.) Indeed, AG's witness Rothstein criticizes the Report's effort to quantify differences on the ground that assumptions are required and acknowledges that, as a result, differences are "not readily quantifiable." (AG Ex. 2.0, p. 19.) Yet, despite this criticism, Mr. Rothstein admits that his own cost comparisons (which will be discussed) also required "a number of assumptions . . . due to differences in reporting and available detail in the financial statements and budgets" of MOUs. (Id., p. 20.) As the Report explains, with the cost structure differences that can reasonably be quantified, the required percentage increase in the fiscal year operating revenue of Downers Grove, Lemont and Woodridge MOUs would be approximately 72%, 24% and 92%, respectively. (IAWC Ex. 10.20, p. 32.) As the Report also explains, however, it is not reasonably possible to quantify the myriad of IOU/MOU cost structure differences related to such factors as differing service area characteristics, IAWC efficiencies, applicability of tax laws and/or cost of capital variances. (Id.)

**ix. Mr. Rothstein's Criticisms of the Report are Unfounded**

While Mr. Rothstein agrees with much of the analysis in IAWC's Report, (see, e.g., AG Ex. 2.1, p. 8), he proffers four concerns, none of which withstand scrutiny. First, Mr. Rothstein asserts that the Report "provides a review of only three selected municipalities" and that "[w]hile a review of three selected municipalities may illustrate different approaches to determining revenue requirements, it does not provide evidence that IAWC's costs components that are common to both municipal and privately owned, regulated operations are reasonable or appropriate." (AG Ex. 2, pp. 8-9.) As Ms. Kane explained, IAWC selected for detailed study in the Report three of the four MOUs referenced in the Docket 05-0681 Order. (IAWC Ex. 10.40 (Kane Reb.), p. 7.) As discussed above, IAWC was unable to obtain adequate information for analysis from the fourth MOU, Darien. (Id.)

Mr. Rothstein's comment also reflects a misunderstanding of the Report's purpose. As Mr. Uffelman explained, the Report is not intended itself to demonstrate the reasonableness of IAWC's revenue requirement or the specific cost components thereof. (IAWC Ex. 10.30 (Uffelman Reb.), p. 5.) IAWC submitted other evidence – including extensive testimony and the detailed Schedules of the Commission's Standard Filing Requirements – to demonstrate the test year cost of service level and reasonableness of the proposed cost components. The Report's analysis demonstrates that there are significant differences between IAWC's cost structure and those of MOUs, and supports the Report's conclusion that comparisons of IAWC's rates to those of MOUs does not show that IAWC's rates are unreasonable. (IAWC Exs. 10.20, p. 32; 10.30 (Uffelman Reb.), pp. 5-6.)

Second, Mr. Rothstein suggests that the Report "oversimplif[ies] the relevant differences in revenue requirements bases." (AG Ex. 2.0, p. 9.) He points to language in the Report that

allegedly indicates that MOUs do not incur costs for depreciation expense, and suggests that the wear and tear of municipal property is included in MOU revenue requirements under “[a]sset renewal and rehabilitations.” (*Id.*, pp. 9-10.) Mr. Rothstein, however, is wrong to suggest that the Report oversimplifies the differences between IAWC and the MOUs. Indeed, as Ms. Kane explains, the Report discusses an important difference with respect to MOU “asset renewal and rehabilitation” that Mr. Rothstein ignores: MOUs often address asset renewal and rehabilitation costs through grants, low interest loans, developer contributions, and tax-exempt bonds. (IAWC Ex. 10.40 (Kane Reb.), p. 8.) Also, as Mr. Uffelman testified, the Report points out that IOU/MOU differences in the cost recovery approach make it necessary to adjust MOU rates to reflect the timing of recovery for depreciation expense. (IAWC Ex. 10.30 (Uffelman Reb.), p. 8.) In this regard, Mr. Rothstein’s own testimony contradicts his alleged concern. He concedes that: (1) MOUs often defer “asset renewal and replacement costs;” (2) historically this deferral has been problematic; and (3) IAWC “quotes an appropriate warning to this effect.” (AG Ex. 2.1, p. 6.) Yet, he fails to conduct any analysis to determine whether any amount for “asset renewal and replacement costs” are recovered in the rates of any of the MOUs to which he proposes to compare IAWC. (IAWC Rothstein Cross-Exam. Ex. 1, Data Response IAWC-AG 1.49.)

Third, Mr. Rothstein indicates that MOUs “do not escape costs associated with accrued pension and OPEBs for employees but rather may recognize these costs in different time frames than privately owned utilities.” (AG Ex. 2, p. 10.) He proclaims without supporting analysis that differences in accounting for these items should have only a limited effect on costs. (*Id.*) As Ms. Kane explained, while it is correct that MOUs do not escape costs associated with pensions and OPEBs, the difference in timing of cost recovery *does* have a direct impact on rates. (IAWC Ex. 10.40 (Kane Reb.), p. 8.) As the Report explained, MOUs (unlike IOUs, such as IAWC) are

not required to record OPEB and pension costs on an accrual basis, thus allowing MOUs to defer recovery of the cost of these items from present to future ratepayers. (IAWC Ex. 10.20, pp. 3-4, 25-29.) Mr. Rothstein offers nothing to call into question the accuracy of the Report's conclusion in this regard. Mr. Rothstein also did not investigate whether costs for pensions or OPEBs are reflected in the rates of the MOUs to which he compares IAWC. (IAWC Rothstein Cross-Exam. Ex. 1, Data Response IAWC-AG 1.50.)

Fourth, Mr. Rothstein questions the Report's proposition that Downers Grove, Lemont and Woodridge subsidize their MOU Enterprise Funds by not allocating to the Enterprise Funds the costs that the MOUs cause the municipalities to incur. (AG Ex. 2.0, pp. 10-13.) According to Mr. Rothstein, the more common occurrence where he has worked is for MOUs to subsidize General Funds by over-allocating costs to Enterprise Funds. He thus asserts that, "assumptions are made [by the Report about shared-resource subsidization], based on the witnesses' experience with other municipalities, for which no supporting evidence is provided." (Id., p. 10.)

Mr. Rothstein's criticism of the Report's assessment of shared-resource subsidization in the examined MOUs does not withstand scrutiny. To begin with, Mr. Rothstein is simply wrong to suggest that the Report provides no "supporting evidence." (AG Ex. 2.0, p. 10.) To the contrary, as discussed above, the Report identifies specific instances for each of the three municipalities in which the MOU uses tax-supported municipal resources without allocating costs to the Enterprise Fund, (IAWC Exs. 10.40 (Kane Reb.), p. 9; 10.20, pp. 10-11, 13, 16), and Mr. Rothstein does not dispute the accuracy of the Report in this regard. In addition, Ms. Kane testified with regard to Stifel's experience that many Illinois municipalities do not allocate to their MOUs all the MOU costs. (IAWC Ex. 10.40 (Kane Reb.), p. 9.) While Mr. Rothstein criticizes the reliance on Ms. Kane's expert experience, he concedes that he conducted no studies

or analyses whatever to support his position and relies solely on his experience to justify his claims with respect to shared-resource subsidization. (IAWC Rothstein Cross-Exam. Ex. 1, Data Response IAWC-AG 1.54.) Further, as Ms. Kane explained, the MOUs for which Mr. Rothstein has worked – and on which his conclusion is based – are not comparable to the MOUs studied in the Report. The former are large urban communities, with declining tax bases. The studied MOUs, on the other hand, are small suburban communities with stable populations, increasing tax bases, and part-time elected officials. Based on her experience, Ms. Kane explained that, because MOUs of the type studied have rate-setting flexibility, it is not uncommon for them to delay increases to the detriment of other municipal funds. (IAWC Ex. 10.40 (Kane Reb.), pp. 9-10.) Mr. Rothstein does not question these differences between the studied MOUs and the larger systems to which he refers.

**d. Mr. Rothstein’s Rate/Cost Comparisons**

Although Mr. Rothstein seems to acknowledge as accurate the Report’s discussion of significant IOU/MOU cost structure differences (e.g., AG Ex. 2.1, p. 8), he proceeds to disregard the differences and to set forth comparisons of IAWC’s rates and individual cost components to those of certain MOUs.

**i. Rate Comparisons**

On Table 1 and in Exhibit EPR-1, Mr. Rothstein purports to compare IAWC’s rates to those of certain MOUs, including the three MOUs studied in the report and the Village of Wheaton (which, according to Mr. Rothstein, is the only other MOU with available data – IAWC Ex. 10.70 (Kane Sur.), p. 2; AG Ex. 2.1, p. 3). As Ms. Kane explained, however, Mr. Rothstein’s rate comparisons are flawed. First, Mr. Rothstein does not address any of the cost structure differences identified in the Report and discussed above, such as differences in operations, facilities, service area characteristics, accounting and cost recovery practices, tax

subsidies, shared resource subsidization, or other factors. Mr. Rothstein admits that he, “conducted no separate analyses of the comparability of utility systems, facilities or operating practices” of the MOUs referenced in Table 1 (and Exhibit EPR-1). (IAWC Rothstein Cross-Exam. Ex. 1, Data Response IAWC-AG 1.42.) Thus, Mr. Rothstein provides no basis to believe that the rates or cost structures of the Table 1 MOUs should be deemed comparable to those of IAWC.

Moreover, as Mr. Rothstein stated, Table 1 does not consider all amounts paid for utility service by MOU customers (see AG Ex. 2.0, p. 6), although it does reflect all such amounts for customers of IAWC. Table 1 thus compares IAWC’s billed charges only to amounts reflected on utility bills issued by the MOUs, disregarding amounts paid by MOU customers for utility service through their tax payments or payments to other entities that provide a portion of their utility service. (IAWC Ex. 10.40 (Kane Reb.), pp. 3-5.) As Ms. Kane explained, at least two of the MOUs, Lemont and Downers Grove, have their wastewater treated by other governmental entities, which impose an additional charge for these services on users and also impose a property tax to the user for this treatment cost. (IAWC Ex. 10.40 (Kane Reb.), p. 3.) As stated in Section II of the Report (IAWC Ex. 10.20, p. 14), the entity for Lemont is the Metropolitan Water Reclamation District of Greater Chicago (the “MWRD”). Lemont charges a collection fee and the MWRD assesses a property tax for wastewater treatment purposes based upon the type of user and/or the volume of wastewater discharged. In Downers Grove, the Downers Grove Sanitary District has a sewer charge based on the cubic feet or unit of water used and also levies a property tax. Also, in a data response, Mr. Rothstein notes that Woodridge receives “Connection Fees/Other Income” that, “may include some tax revenues.” (IAWC Ex. 10.40 (Kane Reb.), p. 3.) In another data response, Mr. Rothstein recognizes the omission from

Table 1 of amounts paid for the MOU utility service through tax collections. (Id., pp. 3-4.) As Ms. Kane explained, the failure to identify these additional charges to the MOU user significantly distorts and incorrectly reports the comparative data on Table 1. Exhibit EPR-1 also reflects such omissions. (Id., p. 4.)

With respect to water service charges, as discussed above, two of the MOUs shown on Table 1, Woodridge and Downers Grove, were charter members of the DWC. As was also discussed, the DWC is supported in part by a sales tax subsidy. (IAWC Ex. 10.40 (Kane Reb.), p. 4.) The sales tax supporting DWC is a cost component for residents subjected to that tax, but is not reflected in the MOU water service charges shown on Table 1. (Id.)

Thus, for the reasons explained above and in the Report, Mr. Rothstein's rate comparisons are incomplete, misleading and provide no basis to question the reasonableness of IAWC's rates. (IAWC Ex. 10.40 (Kane Reb.), p. 5.)

## **ii. O&M Cost Comparisons**

In addition to the rate comparisons discussed above, Mr. Rothstein proposes to compare IAWC's O&M costs to those of 193 entities that reported data for fiscal years ending in 2004 or 2005 for a benchmarking survey ("Survey") conducted in 2006 by the American Water Works Association ("AWWA"), and also to certain costs of the four Chicago area MOUs used by Mr. Rothstein for his Table 1 (discussed above). As will be discussed, nearly all of the Survey entities (188 out of 193) are MOUs. (IAWC Ex. 10.30 (Uffelman Reb.), p. 11.) Based on Mr. Rothstein's comparisons, (AG Ex. 2.0, p. 24), he proposes to disallow for ratemaking purposes O&M cost for the Chicago Metro District of \$2,050,000 (AG Ex. EPR-3) in an adjustment adopted by AG Witness Effron in AG Exhibit 1.1 (\$977,000 after revision of the adjustment by Mr. Effron to reflect an income tax effect and the effect of other adjustments proposed by Mr. Effron). As will be discussed, this adjustment relates to all components of

Chicago Metro District-Water O&M expense other than “Purchased Water” and eliminates, inter alia, nearly all “Maintenance & Repair” cost incurred by the Chicago Metro District-Water. AG Exhibit EPR-3 also shows an alternative O&M cost adjustment in the amount of \$750,000, which purports to relate to Metro District-Water O&M cost other than “Purchased Water” and “Maintenance & Repair” cost. This alternate adjustment, however, is not referenced by AG Witness Effron. In any event, for the reasons discussed below, neither of the O&M cost adjustments shown on Exhibit EPR-3 should be adopted.

In Exhibit EPR-3, Mr. Rothstein compares IAWC’s O&M expenses to what he characterizes as O&M expenses for the MOUs of Downers Grove, Lemont, Woodridge, and Wheaton. (As Mr. Rothstein’s data on Exhibit EPR-3 demonstrates (and as will be discussed), none of the MOUs studied by Mr. Rothstein report cost data in an account format similar to that used by IAWC under the Commission’s Uniform System of Accounts for Class A Water Utilities (“USOA”). It is thus not possible to confirm what MOU functions that the cost data used by Mr. Rothstein actually relates to, and there is no basis to believe that the MOU data covers all O&M costs incurred by the MOUs. (IAWC Ex. 10.60 (Uffelman Sur.), p. 8.)) In making his comparisons, Mr. Rothstein recognizes that “municipal utility financial reporting is formatted differently,” and thus that he relies on “a number of assumptions and supporting calculations due to differences in reporting and available detail in the financial statements” for the MOUs. (AG Ex. 2.0, p. 20.) Mr. Rothstein concludes that IAWC’s O&M expenses are “generally higher” than the expenses of the MOUs. (Id.)

With regard to the O&M cost comparisons, Mr. Uffelman noted that Mr. Rothstein prepared no analyses or studies that provide a basis for the comparisons he set forth. (IAWC Ex. 10.30 (Uffelman Reb.), p. 2.) As Mr. Uffelman explained, Mr. Rothstein’s responses to

IAWC Data Requests confirm that he did not review or analyze the cost structure of any of the MOUs shown on Exhibit EPR-3 or of the Survey participants. (Id., p. 3.) Mr. Rothstein conducted, “no separate analysis of the comparability of utility systems, facilities or operating practices” of the MOUs or Survey participants to those of IAWC. (Id. (quoting Data Response IAWC-AG 1.42).) In addition, Mr. Rothstein admits in a data response that he did not examine individual components of IAWC’s operating expenses. (IAWC Ex. 10.30 (Uffelman Reb.), p. 3 (citing Data Response IAWC-AG 1.68, marked as IAWC Ex. 10.31).) In fact, Mr. Rothstein acknowledges that there are, “some significant differences between the cost structures of IAWC” and the MOUs and Survey participants. (IAWC Ex. 10.30 (Uffelman Reb.), p. 3 (quoting Data Response IAWC-AG 1.44).) Mr. Rothstein also admits that he did not review the accounting assumptions and methodologies of any Survey participant to determine their comparability to the accounting assumptions and methodologies of IAWC. (IAWC Ex. 10.30 (Uffelman Reb.), p. 3 (citing Data Response IAWC-AG 1.64, marked as IAWC Ex. 10.61).) Under these circumstances, as Mr. Uffelman testified, comparisons of the costs recorded by the MOUs or Survey participants (or their rates) to those of IAWC are meaningless for ratemaking purposes. (IAWC Ex. 10.30 (Uffelman Reb.), p. 3.)

As Mr. Uffelman explained, the use of benchmarking data as proposed by Mr. Rothstein in this proceeding to disallow costs for ratemaking purposes is inappropriate. (IAWC Ex. 10.30 (Uffelman Reb.), p. 10.) Mr. Rothstein unambiguously, “agrees that [his] referenced benchmarking data and cost comparisons alone do not enable one to propose specific adjustments to individual cost categories.” (AG Ex. 2.1, p. 7.) In addition, Mr. Rothstein acknowledged in a data response that the ratemaking allowance for O&M expenses should not be based on “averages or benchmarks” without analysis of individual expense components.

(IAWC Ex. 10.30 (Uffelman Reb.), p. 10 (quoting Data Response IAWC-AG 1.73).) Yet, he proposed to do just that. Although Mr. Rothstein concedes that he conducted no analysis of individual IAWC cost components (IAWC Ex. 10.31, Data Response IAWC-AG 1.68), he proceeds anyway to propose an O&M expense adjustment, thus doing exactly what he said should not be done. (IAWC Ex. 10.30 (Uffelman Reb.), p. 10.)

As Mr. Uffelman points out, the Survey states that it is prepared solely for informational purposes, and does not suggest that it should be used for ratemaking. (IAWC Ex. 10.30 (Uffelman Reb.), p. 11.) In addition, as Mr. Schmitt explained, the Survey is, at best, in a developmental stage. (IAWC Ex. 10.80 (Schmitt Sur.), pp. 1-2.) The Survey notes in its Introduction that “[a] narrow project scope was chosen as a starting point,” and, as Mr. Schmitt explained, the AWWA has announced that, based on feedback regarding the Survey, it will attempt to improve the survey process and will not conduct a survey in 2008. (Id.) Further, as Mr. Schmitt indicated, only 193 entities participated in the Survey—less than 0.4% of the total U.S. water system. (IAWC Ex. 10.50 (Schmitt Reb.), p. 5.) Moreover, as discussed above, all but five of the utilities providing data for the survey are MOUs, which, as discussed above and in IAWC’s Report, have vastly different accounting practices and cost structures as compared to IOUs, such as IAWC. (IAWC Ex. 10.30 (Uffelman Reb.), pp. 11-12.) In addition, as Mr. Schmitt points out, Mr. Rothstein’s adjustment for inflation is flawed. Mr. Rothstein testified that, for his comparisons, he adjusted IAWC’s cost data for the test year that ended on June 30, 2009, by 4% per year for each of three years. (AG Ex. 2.0, p. 17.) The Survey’s cost data, however, was derived from fiscal years ending in 2004 and 2005. (IAWC Ex. 10.80 (Schmitt Sur.), p. 4.) Mr. Rothstein applies an inflation adjustment for only three years (thus taking costs for the test year ending June 30, 2009, to an assumed level for a year ending June 30,

2006, not a level for 2004 or 2005). (Id.) As a result, the IAWC costs to which Mr. Rothstein compares the Survey cost data from the years 2004 and 2005 are overstated.

In connection with IAWC's effort to review and minimize its specific costs (that will be further discussed in a later Section of this Brief), certain comparative cost and operating data is considered. As Mr. Schmitt explained, however, Mr. Rothstein's comparison of a broad category of dissimilar costs (all O&M costs) among different types of entities, with no standardized accounting/cost regarding practices and no similarity of service area characteristics, operating practices or processes, facilities or applicable service and regulatory standards, does not provide meaningful information. (AG Cross-Exam. Exs. 16, 17.)

Because Mr. Rothstein provided no evidence showing that either the Survey participants or Exhibit EPR-3 MOUs should be deemed "comparable" to IAWC (and because IAWC's evidence proves that they are not), Mr. Rothstein's proposed O&M cost adjustment should be disregarded. See Central Ill. Light Co., et al., Docket Nos. 06-0070, 06-0071, 06-0072 (Cons.) Final Order, p. 27 (May 16, 2007). Consistent with longstanding Illinois law, the Commission should not "afford any appreciable weight or reliance on" a comparison of utility rates or costs to those of entities not shown to be "comparable." Id.; see also Antioch Milling Co. v. Public Serv. Co. of N. Ill., 4 Ill.2d 200, 210 (1954) (holding that evidence on the rates charged by other utilities should be disregarded where the party proffering the evidence failed to show "that the [utilities'] conditions of service were comparable"); Citizens Util. Co. of Ill., Docket No. 94-0481, 1995 WL 612576, \*7 (Sept. 13, 1995) (declining to rely on a depreciation study where evidence demonstrated how non-comparable the utility at issue was to other water and sewer utilities). IAWC's Report provided extensive evidence (most of which is not disputed)

demonstrating conclusively that MOUs, such as those selected for Exhibit EPR-3 or the Survey participants, differ from IAWC in a myriad of respects.

Mr. Rothstein speculates that, while there are IOU/MOU cost structure differences, these differences may be less “acute” in connection with O&M costs, as compared to other costs. (AG Ex. 2.1, p. 5.) Mr. Rothstein’s own testimony, however, directly and repeatedly contradicts his assumption that O&M expenses across utilities are necessarily comparable. Mr. Rothstein agrees that “[b]enchmarking across multiple utilities has important limitations and by no means offers a precise portrait of utility performance.” (AG Ex. 2.0, p. 15.) Mr. Rothstein also notes that “[i]t is undoubtedly true that systems of different sizes with varying geographic and other characteristics exhibit different cost characteristics.” (AG Ex. 2.1, p. 17.) He also testifies that “there are undoubtedly important differences among utility systems, labor pools, and operating environments” (AG Ex. 2.1, p. 5), and that “[s]ystems may require different water treatment processes, have different age distributions and deterioration curves, and have different arrangements for field operations, administration and customer service.” (AG Ex. 2, p. 15.) “For utilities in the Chicago region,” Mr. Rothstein admits that O&M “functions (and associated costs) may be particularly impacted by weather factors, labor unionization, system densities and geographic dispersion.” (AG Ex. 2.1, p. 4.) Mr. Rothstein’s own testimony, therefore, undermines his suggestion that O&M expenses are necessarily comparable across utilities.

As Mr. Uffelman explained, Mr. Rothstein performed no review at all of the comparability of IAWC and MOU accounting, cost reporting, rate setting methodologies, utility systems, utility facilities or operating practices. (IAWC Ex. 10.60 (Uffelman Sur.), p. 7.) Thus, Mr. Rothstein’s assumption that the IAWC/MOU O&M costs must somehow be comparable

amounts to nothing more than baseless speculation. (Id.) In proposing his adjustment, Mr. Rothstein disregards all of this.

Mr. Uffelman discusses five principal categories of cost structure/operating differences between IOUs and MOUs that directly impact O&M cost. Those areas are:

1. Utility (or COS) v. Cash Needs Approach – While Mr. Rothstein is correct in noting that the difference in approach with regard to depreciation expense would not affect O&M expense, the difference in approach with respect to other items, such as accounting for pension and OPEB costs, would affect this cost category. (IAWC Ex. 10.60 (Uffelman Sur.), pp. 7-8.)

2. Other Accounting Differences – As noted in IAWC Exhibit 10.20, IOUs, such as IAWC, are required to utilize a Uniform System of Accounts with specific instructions related to the accounting and reporting of costs, including O&M expense, while MOUs are not. As an example, Mr. Rothstein’s \$2,050,000 adjustment shown on Exhibit EPR-3 and adopted by Mr. Effron is based, in part, on a comparison of a component of IAWC’s expense for “Maintenance & Repair” and that same component for each of his four comparison MOUs. Yet, three of the four MOUs show no expense at all in the cost category of “Maintenance & Repair.” Mr. Rothstein speculates in his Rebuttal Testimony that the MOUs may “capitalize” maintenance expense, but he at no point explains the complete absence of specific cost data for this category for the three MOUs. (IAWC Ex. 10.60 (Uffelman Sur.), p. 8.) Thus, Mr. Rothstein is comparing IAWC’s expense for this category to that of MOU entities that record none. As a result, as Mr. Uffelman testified, Mr. Rothstein’s O&M adjustment in the amount of \$2,050,000 disallows almost all of IAWC’s Chicago Metro District-Water “Maintenance & Repair” cost shown on the Exhibit EPR-3. The Chicago Metro District-Water amount shown on Exhibit EPR-3 for this cost is \$1,324,357. Mr. Rothstein’s adjustment for maintenance cost is \$1,300,000 (\$2,050,000 (with

maintenance cost) less \$750,000 (without)). Thus, as Mr. Uffelman indicated, Mr. Rothstein would disallow rate recovery of nearly all of the Chicago Metro District-Water maintenance cost despite his admission (discussed above) that he has not reviewed the reasonableness of this (or any other specific) IAWC cost. (Id., pp. 8-9.)

As Mr. Uffelman also pointed out, the only MOU that recorded any “maintenance and repair” cost is Lemont. When Lemont’s recorded maintenance and repair cost was added, Lemont’s O&M cost per customer (as calculated by Mr. Rothstein on Exhibit EPR-3) increased by approximately 37% (from \$186.99 to \$255.36). As Mr. Uffelman noted, this is the only data Mr. Rothstein provides about the effect of including maintenance cost in MOU O&M expense. (IAWC Ex. 10.60 (Uffelman Sur.), p. 9.) Yet, when he calculated the change in overall O&M cost for the MOUs to include maintenance cost, he added almost nothing (adjusting the cost from \$225.23 per customer to \$225.72 per customer), which is why his procedure disallows nearly all of IAWC’s Maintenance & Repair cost. Had he instead increased the MOU O&M cost per customer by 37% to reflect maintenance cost (based on the only available data), his O&M cost per customer would have increased to \$309.23, which is 16% above IAWC’s O&M cost (including maintenance). As Mr. Uffelman indicated, this cost per customer figure is based on a more reasonable assumption than Mr. Rothstein’s assumption that maintenance cost has almost no effect on MOU O&M expense. Applying this assumption, the Exhibit EPR-3 approach suggests that, to increase IAWC’s O&M expense (including maintenance) to that of MOUs, an increase in IAWC’s expense of \$411,890 is required (\$13,761,044 (which is \$309.23 times 44,501 customers) less IAWC’s Chicago Metro District-Water O&M cost of \$13,349,154). As Mr. Uffelman explained, this benchmarking adjustment would have more support than Mr. Rothstein’s adjustment. (IAWC Ex. 10.60 (Uffelman Sur.), p. 10.) Mr. Uffelman, however,

did not recommend such an increase in recoverable cost based on benchmarking in light of his belief that the amount of cost recoverable in rates should reflect the costs of the specific utility involved. (Id.) This data demonstrates, however, that, contrary to the assertion in Mr. Rothstein's Rebuttal Testimony, the accounting and cost structure differences discussed in IAWC Exhibit 10.20 have a direct and significant bearing on O&M expense. (Id.)

As another component of the O&M expense adjustment calculated on Exhibit EPR-3, Mr. Rothstein compares IAWC's "Customer Service/Accounting" expense to that of the MOUs. (IAWC Ex. 10.60 (Uffelman Sur.), p. 10.) Yet, none of the MOUs on Exhibit EPR-3 show any cost at all in this category. Thus, the effect of Mr. Rothstein's proposal could be to also disallow entirely IAWC's expense for "Customer Service/Accounting," because the MOUs apparently do not record this cost either. Mr. Rothstein has done nothing to show that the O&M expense recorded by IAWC reflects a comparable approach to that of the MOUs with respect to the expensing or capitalization of O&M costs (including such costs as those for "Personnel" and "Maintenance & Repair") or the categorization of such costs into the applicable accounts as the MOUs are not subject, as is IAWC, to the USOA. (Id., pp. 10-11.)

3. Shared Resource Utilization – Mr. Uffelman further noted that IAWC's Report demonstrates that the MOUs use tax-supported resources to support their utility operations, and, as explained above, there is no data available from the MOUs to quantify precisely the extent of this practice. (IAWC Ex. 10.60 (Uffelman Sur.), p. 11.) For example, as noted above, Mr. Rothstein's MOUs may not record "Customer Service/Accounting" expense because municipal personnel not directly assigned to the MOU perform this function. The absence of "Maintenance & Repair" cost for three of the MOUs also may relate, in whole or in part, to the performance of such functions by other municipal employees, such as municipal public works

department employees. Despite Mr. Rothstein's data, it does not seem possible that the MOUs perform no maintenance and make no repairs. (Id.) Further, although two of the four MOUs on Exhibit EPR-3 record no "Personnel Expense," it is also difficult to believe that no municipal personnel are used in connection with the utility function.

4. Service Area Characteristics – As IAWC's Report and the Rebuttal Testimony of Mr. Schmitt discuss, there are differences in service area characteristics and these also affect O&M costs. (IAWC Exs. 10.60 (Uffelman Sur.), p. 11; 10.80 (Schmitt Sur.), p. 3.)

5. Service and Regulatory Standards – As Mr. Schmitt also discusses, IAWC applies different service and regulatory standards as compared to the MOUs. (IAWC Exs. 10.60 (Uffelman Sur.), p. 12; 10.80 (Schmitt Sur.), pp. 5-6.) Particularly at the state level, IOUs, such as IAWC, are subject to extensive regulatory responsibilities that do not apply to MOUs, and which do affect relative O&M cost levels. (IAWC Ex. 10.80 (Schmitt Sur.), pp. 5-6.) As Mr. Schmitt indicated, for IAWC, certain of those differences relate to the applicability to IAWC of the provisions of 83 Ill. Admin. Code, Part 600 "Standards of Service for Water Utilities," which are not applicable to MOUs. (Id., p. 5.) MOUs are not subject to the regulatory requirements established by the Act, or other rules and regulations promulgated by the Commission (in addition to Part 600). (Id.)

As Mr. Schmitt explained, the requirements of 83 Ill. Admin. Code, Part 600 and other Commission rules are extensive and address operational and service level requirements, including maps, asset and customer records, and maintenance of the same; meter testing, replacement and reporting; system operation and maintenance requirements, including minimum service pressures, service interruption requirements, ability to meet maximum day demands with redundancy, and valve and hydrant inspection and maintenance programs; specific requirements

and reporting for unaccounted-for water; requirements for meter reading frequency and customer billing and bill information provision; provision of emergency customer notification systems and customer hot lines; handling and reporting of customer complaints; and specific requirements relative to extending water service to new customers and financial dealings with developers. Illinois MOUs are not subject to any of the requirements established by the Commission in these areas, which are applicable to IAWC and affect the level of O&M cost incurred. (IAWC Ex. 10.80 (Schmitt Sur.), pp. 5-6.)

**e. Further Effort to Quantify Differences Between the Cost Structures of IAWC and MOUs Should Not Be Required**

Mr. Rothstein suggests that IAWC should be required to perform additional analyses to quantify or “delineate” differences between its cost structure and that of MOUs. (AG Ex. 2.1, p. 7.) As Mr. Uffelman testified, Mr. Rothstein’s data responses confirm that he does not rely on any prior study or analysis, or any regulatory commission order, that has involved a study of the type he proposes. (IAWC Ex. 10.60 (Uffelman Sur.), p. 4.) Furthermore, with regard to his proposal, Mr. Rothstein has nothing specific in mind. When asked to “[e]xplain in detail the nature of the ‘delineation’ analysis that [he] proposes,” Mr. Rothstein responded that, he “is not proposing any particular methodology or analysis.” (IAWC Rothstein Cross-Exam. Ex. 1, Data Response IAWC-AG 2.08(2).) Nor was he able to produce, when asked, even one document (study, analysis, memorandum or other) showing an example of the type of additional analysis he proposes in the context of a utility rate proceeding or in any other context. (IAWC Rothstein Cross-Exam. Ex. 1, Data Response IAWC-AG 2.08(3).)

As discussed above, in response to the Docket 05-0681 Order, IAWC assembled extensive information regarding reasons for differences between its rates and cost structure as compared to those of MOUs, and, where reasonably possible, IAWC quantified the effect of

those differences. As Mr. Uffelman explained, with additional cost and effort, some further quantification of differences could be possible. (IAWC Ex. 10.60 (Uffelman Sur.), p. 13.) As Mr. Uffelman indicated, however, such further effort is not warranted (in light of the associated cost), and would only bolster the already supported conclusion of IAWC's Report that IAWC/MOU cost comparisons do not produce meaningful information for ratemaking purposes. (Id.)

To attempt more quantification, additional expert analysis would have to be focused on areas of difference of the type discussed above and extensive additional information from MOUs would be required. (IAWC Ex. 10.60 (Uffelman Sur.), p. 13.) As Mr. Uffelman testified, this analysis would involve for the O&M area:

1. Quantification of the Effect of Cash Needs v. Utility Accounting – The MOUs' non-cash expenses that affect O&M cost would have to be further studied, quantified and added to the MOUs' cost structures. The MOU employee personnel data, including compensation and benefits, would need to be obtained and analyzed. (IAWC Ex. 10.60 (Uffelman Sur.), p. 13.)

2. Standardization of Accounting – Accounting personnel would need to fully analyze and audit the accounting methodologies and practices of the MOU and municipality, and chart the MOU accounts as required to match the USOA so that O&M expenses could be made more comparable. A standardized approach, including instructions related to such matters as the capitalization or expensing of costs, would be needed. Detailed MOU and municipal accounting information would have to be obtained for the account restructuring. (IAWC Ex. 10.60 (Uffelman Sur.), pp. 13-14.)

3. Shared Resource Utilization – All aspects of MOU operations would have to be reviewed by operating experts to determine areas where the MOU is utilizing tax supported

personnel and resources, and a complete cost allocation study would need to be made to allocate to the MOU the cost for personnel, equipment and facilities of the municipality that are utilized, in whole or in part, by the MOU. Extensive personnel interviews and access to employee-time reports and equipment/facility-use reports would be needed for the analysis. (IAWC Ex. 10.60 (Uffelman Sur.), p. 14.)

4. Shared Area and System Characteristics – The nature of each MOU service area would have to be studied, and the relative impact of the MOU service area characteristics would need to be analyzed. Also, system characteristics, such as construction materials used, system components, age of components, water source, contaminants present and required treatment processes, would have to be examined in detail. The MOU would need to provide relevant information, and provide access to all facilities and data for inspection including O&M and construction policies and budgets. (IAWC Ex. 10.60 (Uffelman Sur.), p. 14.)

5. Regulatory and Service Standards – The applicable regulatory and service standards of the MOU would need to be obtained, analyzed and compared to an analysis and quantification of differences between the MOU and those of IAWC. MOU regulatory and service standards in areas such as the following would be needed: (a) number of customer offices and office hours; (b) call center approach, including hours of operation time required to answer calls, foreign language capability; (c) nature of MOU computer hardware and software for all O&M functions; (d) level water service pressure and flow maintained; (e) main and hydrant inspection and maintenance practices (e.g., frequency, scope); (f) valve inspection and maintenance practices; (g) customer bill and meter reading frequency; (h) procedure for handling customer complaints; (i) policy for service maintenance, new service and termination of service call outs (e.g., after hours service); (j) extent of emergency notification capability; and (k) other

regulatory and service standard information, as applicable. Detailed MOU information concerning these items would be needed. (IAWC Ex. 10.60 (Uffelman Sur.), pp. 15-16.)

The prospect for obtaining the information needed from unregulated MOUs for additional study was discussed by Ms. Kane. As Ms. Kane explained, in developing information for the Report, Stifel submitted a detailed request for information to each MOU studied, and engaged in direct conversations and interviews with each MOU that lasted several hours. (IAWC Ex. 10.70 (Kane Sur.), p. 3.) On numerous occasions, follow-up calls were conducted to ensure an adequate understanding of the information obtained. (Id., p. 3; IAWC Ex. 10.71.) Given Stifel's experience in assembling information for the Report, Ms. Kane testified that neither the three MOUs studied in the Report nor other MOUs could reasonably be expected to participate voluntarily in the gathering of significant additional information and the audit process described by Mr. Uffelman that would be needed to attempt the additional quantifications suggested by Mr. Rothstein. (IAWC Ex. 10.70 (Kane Sur.), p. 5.)

As Mr. Grubb explained, through March 11, 2008, IAWC had incurred cost for the study of cost and rate differences in the amount of \$206,273 (a portion of which is reflected as a recoverable cost in this proceeding). (IAWC Ex. 4.20 (Grubb Sur.), pp. 22-23.) Further, as Mr. Uffelman explained, an additional quantification effort would involve significant additional cost with no reasonable expectation of benefit. As Mr. Uffelman explained, based on Ms. Kane's testimony with regard to the ability to obtain additional information, an additional quantification study could require use of formal approaches for obtaining information, such as the use of Freedom of Information Act ("FOIA") requests and formal discovery procedures against the MOUs. (IAWC Ex. 10.60 (Uffelman Sur.), p. 16.) As Mr. Uffelman stated, the cost of such a review and information gathering process could itself well exceed the overall level of

rate case expense proposed for all aspects of this rate case, thus doubling the rate case cost. (Id.) For all of the reasons discussed, IAWC should not be required to expend such resources or incur costs of this magnitude for an additional quantification effort. As Mr. Uffelman indicated, IAWC has already provided a thorough and well-supported Report explaining IOU/MOU cost and rate differences, and the further quantification effort suggested by Mr. Rothstein would not be productive. (Id., pp. 16-17.) As Mr. Uffelman explained, the development of additional quantifications of IAWC/MOU cost structure differences, if such quantifications are possible, would serve only to further bolster the already well-supported conclusion of the Report. (Id., pp. 12-13.)

**f. The Fact that Additional Cost Difference Quantifications Are Not Warranted Does Not Suggest that IAWC's Specific Costs Have Not Been Reviewed and Minimized**

As Mr. Uffelman indicated, the fact that a further effort to quantify IAWC/MOU cost differences is not warranted does not mean that IAWC's specific costs have not been reviewed and minimized. (IAWC Ex. 10.60 (Uffelman Sur.), p. 4.) As a public utility, the Act requires that IAWC provide service that is "adequate, efficient, reliable and environmentally safe and which, consistent with these obligations, constitutes the least-cost means of meeting . . . [its] obligations." 220 ILCS 5/8-401. To meet this requirement, IAWC engages regularly in a review of all aspects of its specific operating and capital costs. As Ms. Teasley explained, cost control begins with appropriate budgeting and planning. IAWC has a budget against which it manages and controls costs. (IAWC Ex. 1.20 (Teasley Sur.), p. 3.) Monthly meetings are held with senior management to evaluate actual performance compared to budget, and to discuss reasons for any variance. In addition, management personnel are evaluated against performance measures that are focused on meeting service and quality objectives in a cost-effective manner. Management

continuously monitors expenses to ensure that the Company purchases necessary, cost effective goods and services. (Id.) As Ms. Teasley discussed, there are a number of measures used by IAWC to manage and control costs in a manner that is consistent with quality service and regulatory requirements. For example, in the area of purchasing, the Supply Chain department of American Water Works Service Company (“Supply Chain”) engages in strategic sourcing on behalf of IAWC. (Id.) Ms. Teasley also explained other cost control measures, such as IAWC’s use of an energy management group (maintained by the Service Company) and measures in place to manage labor-related costs and assure the ability to attract and retain skilled employees. (Id., pp. 3-4.) Ms. Teasley also discussed significant efficiencies attained through IAWC’s participation in American Water system programs. (Id., pp. 5-6.)

As Mr. Uffelman explained, aside from the regular ongoing cost control efforts discussed by Ms. Teasley, IAWC presented detailed evidence in this case regarding its specific operating and capital expenses. (IAWC Ex. 10.60 (Uffelman Sur.), p. 4.) The Commission Staff and other parties in this case, including the Attorney General which sponsors Mr. Rothstein’s testimony, submitted extensive data requests regarding specific areas of expense and invested capital which each party deemed appropriate for review. (Id.) During the proceeding, IAWC responded to those requests. Mr. Rothstein does not question in his testimony any specific component of IAWC’s operating or capital costs. As indicated by IAWC Exhibit 10.31 (an AG Data Response), Mr. Rothstein admits that he chose to conduct no analysis at all of IAWC’s specific expenses. (Id.) Another AG Witness, Mr. Effron, and other witnesses have nevertheless proposed adjustments to certain specific IAWC costs, and IAWC has submitted responsive evidence. Presumably, each party in this case conducted such discovery and review of IAWC’s specific costs as the party deemed appropriate. (Id.)

For all of these reasons, there is no basis to believe that a further effort to quantify differences between the cost structure of IAWC as compared to MOUs is warranted. IAWC has already developed extensive evidence addressing this matter, which demonstrates that such comparisons do not call into question the reasonableness of IAWC's costs or rates. IAWC also has presented extensive evidence supporting the reasonableness of its specific proposed levels of costs and rates, which demonstrates that the rate increase proposed in this proceeding should be approved in full. Thus, Mr. Rothstein's proposed O&M cost adjustment and proposed additional cost difference quantification study should be rejected.

## **8. Other**

[This section is intentionally left blank. IAWC is not including any "Other" issues with respect to operating income in this Brief.]

### **D. Recommended Operating Income/Revenue Requirement**

On a Total Company basis, additional annual revenue of \$31,271,429 is needed to afford the Company the opportunity to earn a reasonable rate of return, as shown on IAWC Exhibit 6.21 (Second Revised). The operating income statement for each Rate Area is shown on the respective designated sheet of IAWC Exhibit 6.21 (Second Revised).

#### IV. COST OF CAPITAL/RATE OF RETURN

##### A. Capital Structure

IAWC's requested capital structure and cost of capital is summarized in the Table below (see IAWC Ex. 2.22) :

	Capital Structure Ratios	Cost Rate	Weighted Return
Long-Term Debt	52.97%	5.92%	3.14%
Short-Term Debt	<u>3.26</u>	5.28	<u>0.17%</u>
Total Debt	55.23		3.31
Preferred Stock	0.00	0.00	0.00
Common Equity	<u>43.77</u>	11.24	<u>4.92</u>
Total	<u>100.00%</u>		<u>8.23%</u>

The Company's proposed capital structure is explained in the testimony of James Jenkins (IAWC Exs. 2.00 (Jenkins Dir.); 2.10 (Jenkins Reb.); 2.20 (Jenkins Sur.)), and is uncontested. However, while the Company accepts Staff's methodology for computing the test year common equity balance (see Staff Ex. 14.0, p. 3), the Company believes that the correct common equity balance is \$291,751,184, as shown on IAWC Ex. 2.22, which reflects the Company's proposed revenue increase in this proceeding. (IAWC Ex. 2.20 (Jenkins Sur.), p. 2.) The Company also recommends that the revenue increase ultimately approved by the Commission in this proceeding should be reflected in the common equity balance used for computing the authorized rate of return on rate base, using the methodology that the Company and Staff have employed in their analyses. (Id.)

##### B. Cost of Debt

IAWC's cost of long term debt is 5.92%. (IAWC Ex. 2.21.) The cost of short term debt is 5.28%. (Id.) No party disputes the cost of debt.

### **C. Cost of Common Equity**

The Company retained Ms. Pauline Ahern of AUS Consultants, Inc. to estimate the Company's cost of capital. Ms. Ahern's direct testimony recommends a cost of common equity of 11.25%. (IAWC Ex. 12.00 (Ahern Dir.), p. 3.) In response to Staff direct testimony recommending a cost of equity of 11.24%, the Company indicated that it would not dispute Staff's recommendation. (IAWC Ex. 12.10 (Ahern Reb.), p. 1.) The Company's recommended cost of equity of 11.24% is reasonable and should be adopted. Staff's revised recommendation of 10.38%, as well as IIRC's recommendation of 9.9% and CUB's recommended 8.58%, are unreasonable and should be rejected.

Ms. Ahern's recommendation is based on the midpoint of cost rates indicated by the widely-accepted discounted cash flow ("DCF") model and capital asset pricing model ("CAPM"). As Ms. Ahern explained, the theory of the DCF model is that the present value of an expected future stream of net cash flows during the investment holding period can be determined by discounting the cash flows at the cost of capital, or the capitalization rate. (IAWC Ex. 12.00 (Ahern Dir.), p. 23.) DCF theory suggests that an investor buys a stock for an expected total return rate which is expected to be derived from the cash flows received in the form of dividends plus appreciation in market price (the expected growth rate). Thus, the dividend yield on market price plus a growth rate equals the capitalization rate, *i.e.*, the total return rate expected by investors. (*Id.*) The traditional, or annual, single stage DCF model assumes that stock dividends are paid annually. Virtually every utility pays dividends on a quarterly basis. Ms. Ahern, therefore, utilized a "quarterly compounded growth DCF," which takes into account quarterly dividend payments. (*Id.*) Ms. Ahern utilized Zacks estimated long-term growth in earnings per share ("EPS") in her forecasted growth rate. (*Id.*)

As Ms. Ahern indicated, the CAPM theory defines risk by measuring the co-variability of an individual security's return as compared to that of the overall market. (IAWC Ex. 12.00 (Ahern Dir.), p. 28.) This variability is measured by beta ("β"), an index measure of an individual security's variability relative to the market. A beta less than 1.0 indicates lower variability while a beta greater than 1.0 indicates greater variability. (Id.) The CAPM assumes that all other risk, i.e., all non-market or unsystemic risk, can be eliminated through diversification. The risk that cannot be eliminated through diversification is called market, or systemic, risk. (Id.) The CAPM presumes that investors require compensation for risks that cannot be eliminated through diversification. Systemic risks are caused by macroeconomic and other events that affect the return on all assets. Essentially, the model is applied by adding a risk-free rate of return to a market risk premium. The market risk premium is adjusted proportionately to reflect the systemic risk of the individual security relative to the market as measured by beta. (Id.) The risk-free rate utilized by Ms. Ahern is 5.33%, which is based upon the average consensus forecast of the reporting economists in the July 1, 2007 Blue Chip Financial Forecasts of the expected yield on long-term U.S. Treasury bonds for the six quarters ending with the second calendar quarter 2007. (Id., p. 29, Sched. 12.09.)

Ms. Ahern's use of the DCF and CAPM approach is consistent with the approach used in a number of recent cases, including Docket Nos. 03-0403, 04-0442, 05-0071/05-0072 (consolidated) and 06-0285. As Ms. Ahern explained, because IAWC's common stock is not publicly traded, a market-based common equity rate cost rate cannot be determined directly for IAWC. (IAWC Ex. 12.00 (Ahern Dir.), p. 4.) Therefore, in accordance with Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944) and Bluefield Water Works & Improvement Co. v. Public Service Comm'n, 262 U.S. 679 (1923), Ms. Ahern used a

comparable company approach to arrive at a recommended return on equity. (Id.) Using multiple measures to ensure comparability, Ms. Ahern assessed the market-based cost of equity rates of eight water companies (“Water Sample”) and 13 utility companies (“Utility Sample”) of relatively similar risk, i.e., proxy group(s), for insight into a recommended common equity cost rate applicable to IAWC and suitable for cost of capital purposes. (Id., pp. 18-21.) Because no proxy group can be selected to be identical in risk to IAWC, she adjusted the proxy groups’ results to reflect the greater relative business risk of IAWC. (Id., pp. 35-37.) This business risk adjustment is described below, followed by a response to other parties’ criticism of Ms. Ahern’s cost of equity recommendation.

### **1. Business Risk Adjustment**

As discussed by Ms. Ahern, it is necessary to adjust the results of the DCF and CAPM analysis by 10 basis points to account for IAWC’s business risk relative to the proxy groups. (IAWC Ex. 12.00 (Ahern Dir.), pp. 35-37.) Staff, IAWC and CUB oppose such an adjustment.

#### **a. Company Position**

As Ms. Ahern explains, business risk is important to the determination of a fair rate of return because the greater the level of risk, the greater the rate of return investors demand, consistent with the basic financial precept of risk and return. Examples of business risk include the quality of management, the regulatory environment, customer mix, service territory growth and the like, which have a direct bearing on earnings. (IAWC Ex. 12.00 (Ahern Dir.), p. 8.)

Ms. Ahern also explains that some forms of business risk are unique to the water industry. For example, the water industry experiences lower depreciation rates relative to other utilities. Depreciation rates are one of the principal sources of internal cash flows for all utilities, and lower depreciation rates mean that water utility depreciation as a source of internally-generated cash is far less than for electric, natural gas or telephone companies. Water utilities’ assets have

longer lives and, hence, longer capital recovery periods. As such, water utilities face greater risk due to inflation which results in a higher replacement cost per dollar of net plant than for other types of utilities. (IAWC Ex. 12.00 (Ahern Dir.), p. 11.) Additionally, the water industry's need for substantial infrastructure capital spending and increased anti-terrorism security spending require regulatory support in the form of adequate and timely rate relief, as recognized by NARUC, so water utilities will be able to successfully meet the challenges they face. (Id., p. 13.) As Ms. Ahern indicated, IAWC itself is facing an expected "massive capital investment" as it projects company-funded capital expenditures of \$412.728 million for the years 2007 through 2012, representing an increase of 65% over the December 31, 2006, net plant of \$637.654 million. (Id.)

Ms. Ahern also explained that smaller companies tend to experience greater business risk than larger ones. (IAWC Ex. 12.00 (Ahern Dir.), pp. 13-14.) Smaller companies are less capable of coping with significant events which affect sales, revenues and earnings. The loss of revenues from a few larger customers, for example, would have a greater effect on a small company than on a much larger company with a larger customer base. (Id., p. 14.) Because IAWC is the regulated utility to whose rate base the ICC's ultimately allowed overall cost of capital and fair rate of return will be applied, the relevant risk reflected in the cost of capital must be that of IAWC, including the impact of its small size on common equity cost rate. IAWC's size, i.e., total capital of \$563.874 million at December 31, 2006 (see IAWC Ex. 12.00 (Ahern Dir.), Schedule 12.01, p. 3), relative to average total capital of \$555.480 million in 2006 for the proxy group of eight water companies (see page 3 of Schedule 12.01), and \$11.638 billion for the proxy group of 13 utilities, indicates similar business risk relative to the eight water companies and greater business risk relative to the 13 utilities for IAWC. (Id., p. 15.) Based on

actual returns over time and a general premise contained in basic finance textbooks, investors perceive that smaller companies are more risky, which causes investors to expect greater returns as compensation for the greater risk. (Id.)

Ms. Ahern's analysis shows that adjustments for business risk of 0.21% and 1.97% are indicated for the Water Sample and Utility Sample, respectively. However, Ms. Ahern recommends an "extremely conservative" adjustment of just 0.10% (10 basis points). (IAWC Ex. 12.00 (Ahern Dir.), pp. 36-37.)

**b. Staff Position**

Staff asserts that no "size adjustment" is warranted because such an adjustment is "contrary to financial theory and unsupported by empirical studies." (Staff Ex. 4.0, p. 31). Staff cites two prior Commission orders, in Dockets 97-0351 and 03-0403, where the Commission previously rejected size adjustments. According to Staff, because IAWC is "a wholly-owned subsidiary within a much larger organization," the adjustment is unwarranted. (Staff Ex. 4.0, p. 31.)

Staff, however, misunderstands the purpose of the business risk adjustment. The adjustment is not recommended solely because of IAWC's size, rather, the adjustment reflects a perceived business risk that impacts the cost of common equity capital. Evaluating business risk requires a consideration of size, but the adjustment is not being recommended solely because of IAWC's size. The discussion in pages 8 through 16 of Ms. Ahern's direct testimony (IAWC Ex. 12.00) make this clear. Ms. Ahern specifically refers to the adjustment as a "business risk adjustment." (See id., pp. 35-37.)

While Staff correctly notes that the Commission, in Docket 03-0403, rejected a "size adjustment" for CIWC, the Commission noted that "other factors might warrant a business risk adjustment." Docket 03-0403 Order, p. 43. The Commission rejected the idea that a business

risk adjustment could not be applied simply because the Commission rejected such an adjustment in Docket 97-0351. Rather, “it is appropriate to consider all available information of record.” Id. In light of the record evidence presented in Docket 03-0430, “the Commission concludes that a business risk premium is warranted under the facts of this case as applied to CIWC, and should be included in the cost of equity in the amount of the 30 basis points proposed by the Company.” Id. Thus, the Docket 03-0403 Order supports the Company’s position, not Staff’s position, for this proceeding. Ms. Ahern spelled out in considerable detail the factors warranting a business risk adjustment. (See IAWC Ex. 12.00 (Ahern Dir.), pp. 8-16, 35-37.) Staff has failed to respond to this evidence. That the Commission has denied size adjustments in different cases with different evidentiary records is not a basis to deny a business risk adjustment based on the record evidence in this case.

**c. IWC Position**

IWC also contests the adjustment for business risk. IWC witness Gorman claims that such an adjustment is not reasonable because the proxy companies in both of Ms. Ahern’s groups were selected based upon having similar risk to IAWC; therefore, any risk associated with IAWC is already reflected in the proxy groups. (IWC Ex. 1.0, p. 15.)

To support his assertion that IAWC is a low-risk regulated water utility, Mr. Gorman points to now outdated Standard & Poors (“S&P”) revised financial guidelines published on June 7, 2004. (Id., p. 7.) As Ms. Ahern explained, however, the publication upon which Mr. Gorman relies has been superseded by the November 30, 2007 publication of S&P’s “U.S. Utilities Ratings Analysis Now Portrayed In The S&P Corporate Ratings Matrix.” (See IAWC Ex. 12.10 (Ahern Reb.), p. 35.) It is true that S&P characterizes the regulated operations of American Water, and by inference IAWC, as of low operating risk. However, as discussed in Ms. Ahern’s rebuttal testimony (see id., pp. 35-36), IAWC, as proxied by both American Water Capital

Corporation (“AWCC”) and American Water, has greater risk, not less, than the proxy companies, and indeed greater risk than any of the proxy companies utilized by any witness in this proceeding. (See IAWC Exs. 12.10 (Ahern Reb.), p. 36; Sched. 12.25, pp. 1-2). Both AWCC and American Water have been assigned an S&P credit rating of “A-” and an “Aggressive” financial risk profile, both of which are more risky than the average credit ratings and financial risk profiles of all the proxy companies utilized in this proceeding. (See IAWC Schedule 12.25, pp. 1-2.) In addition, a review of either S&P’s November 9, 2007 Issuer Ranking: U.S. Investor-Owned Water Utilities, Strongest to Weakest, based upon S&P’s former business profile system, or the more current February 7, 2008 Issuer Ranking: U.S. Investor-Owned Water Utilities, Strongest to Weakest, based upon S&P’s new business risk / financial risk matrix, reveals that American Water and AWCC are at the bottom of the ranking lists and, hence, characterized by S&P as the weakest (and hence riskiest) water utilities among those ranked by S&P. (IAWC Ex. 12.30 (Ahern Sur.), pp. 6-7.) As Ms. Ahern pointed out, notwithstanding S&P’s characterization of American Water as a low-risk regulated water utility, its regulated water subsidiaries, including IAWC, are among the riskiest of the water utilities, whether measured by S&P’s current matrix or S&P’s former business profile system. Thus, IAWC continues to be riskier than the average utility in any of the proxy groups utilized by the rate of return witnesses in this proceeding, Mr. Gorman’s contentions to the contrary notwithstanding. (IAWC Ex. 12.30 (Ahern Sur.), pp. 6-7.) As demonstrated on Schedule 12.25 of IAWC Ex. 12.10, based upon S&P bond/credit ratings, business risk and financial risk profiles, IAWC is indeed more risky than either the Water Sample or Utility Sample. (IAWC Ex. 12.10 (Ahern Reb.), p. 38.)

Mr. Gorman also states that “a bond rating reflects all operating risk of the enterprise including the risk associated with the size of the operation.” (IWC Ex. 1.0, p. 15.) However, bond and credit ratings and business risk profiles of the proxy companies reflect the size of those companies, not IAWC. (IAWC Ex. 12.10 (Ahern Reb.), p. 38.) In addition, the bond and credit ratings and risk profiles of AWCC reflect AWCC’s size and not that of IAWC. (Id.)

As Ms. Ahern explained, Mr. Gorman’s contention that IAWC’s risk is mitigated because of its corporate structure and the management experience offered by its parent company is also incorrect. While the Service Company provides greater breadth of management experience to IAWC than small companies could typically support on their own, the cost of this benefit, like the lower fixed capital costs, is passed on to ratepayers. (IAWC Ex. 12.10 (Ahern Reb.), p. 39.) None of these lower costs or benefits reflect the risk of investing in the common stock of IAWC. (Id.)

As discussed in Ms. Ahern’s rebuttal testimony, it is the rate base of IAWC, and IAWC alone, to which the overall rate of return set in this proceeding will be applied. (See IAWC Ex. 12.10 (Ahern Reb.), pp. 39-40.) Therefore, IAWC should be evaluated as a stand alone utility. Consequently, the Commission should focus on the risk and return on common equity investment in IAWC’s jurisdictional rate base. It is IAWC’s rates that will be set in this proceeding, and it is IAWC’s rate base that serves its ratepayers and to which the authorized rate of return set in this proceeding will be applied. Furthermore, the risk of the common equity investment in IAWC’s rate base is independent of the source of that equity capital. Ms. Ahern’s rebuttal testimony supports the basic financial principle that it is the use of the funds invested which gives rise to the risk of an investment, not the source of those funds. (IAWC Ex. 12.10 (Ahern Reb.), p. 40.)

As discussed above, Ms. Ahern explained how current and future needs for infrastructure replacement and expansion create additional risk for water utilities relative to other utilities. Mr. Gorman and Mr. Janous respond by claiming that the current level of investment and growth in water utility rate base is a temporary phenomenon. (See IWC Exs. 4.0, p. 17; 6.0, pp. 6-7.) However, as Ms. Ahern indicated, it is well known that water utilities are much more capital intensive than electric, natural gas or telephone utilities. (See IAWC Ex. 12.30 (Ahern Sur.), p. 8.) The greater relative capital intensity of water utilities has been persistent for the ten years ending 2006 at an average 2.24 times greater than that of electric utilities, 2.59 times greater than that of combination electric and gas utilities, 3.01 times greater than that of gas distribution utilities and 3.05 times greater than that of telephone utilities. (Id.) As Ms. Ahern stated, based upon the stability of the relationship of the capital intensity of water utilities relative to that of other types of utilities, it is clear that water utilities will continue to be substantially more capital intensive than other types of utilities well into the future. (Id., pp. 8-9; see also IAWC Ex. 12.10 (Ahern Reb.), Schedule 12.35, Value Line Investment Survey.)

Not only does Value Line expect continued, persistent investment in water utility infrastructure, it expects an increase in the number of common shares outstanding for water utilities, as Ms. Ahern testified, while dampening the effect of the “temporary” increase in utility earnings Mr. Gorman envisions on a per share basis. This increase in the number of shares would still result in a level of EPS growth in line with the 5-year analysts’ consensus growth rates utilized by the witnesses in this proceeding and deemed unsustainable by Staff, CUB and IWC. (IAWC Ex. 12.30 (Ahern Sur.), p. 9.) Moreover, NARUC also recognizes that large capital investment by water utilities will persist well into the future. (IAWC Ex. 12.00 (Ahern Dir.), pp. 10-11; see also Schedule 12.36, Resolution Supporting Consideration of Regulatory

Policies Deemed as “Best Practices”; IAWC Ex. 12.00, Moody’s Investors Service January 2004 Special Comment, p. 12.) Thus, as Ms. Ahern explained, the water utility industry will continue to experience substantial investment in infrastructure, i.e., rate base, and rate base will also continue to grow substantially well into the future.<sup>5</sup> Consequently, as Ms. Ahern indicated, Mr. Gorman’s implication that the current growth in rate base and related earnings is temporary is unfounded. (IAWC Ex. 12.30 (Ahern Sur.) pp. 16-17.)

**d. CUB Position**

CUB also disagrees with a business risk adjustment, but for different reasons than those expressed by the other parties. Mr. Thomas argues that the Commission grants returns based on the book value of assets, not the market value. Because IAWC’s book value is slightly less than the book value of the sample companies, he claims a size adjustment is unwarranted, and that Ms. Ahern is inappropriately recommending a return based on market capitalization. (CUB Ex. 2.0, p. 13.) Mr. Thomas is mistaken. Apart from the fact that Ms. Ahern does not recommend an adjustment based solely on size, it is clear from pages 2 and 3 of Ms. Ahern’s direct testimony (IAWC Ex. 12.00) that her recommended common equity cost rate is to be applied to the book value common equity financed portion of IAWC’s jurisdictional rate base. Her recommended common equity rate is applicable to IAWC witness Jenkins’ recommended common equity ratio of 43.77%. (See IAWC Ex. 2.22.)

Moreover, Mr. Thomas’s citation of a recent decision in Docket 07-0242, where the Commission stated, “[m]arket value is not utilized in this calculation because it typically includes appreciated value (as reflected in its stock price) above the Utilities’ actual capital

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<sup>5</sup>Confirming the fact that substantial construction in the water industry is expected for the foreseeable future, Ms. Ahern explained under cross-examination that the Environmental Protection Agency is projecting \$276 billion in renewable construction over the next 20 years. (Tr. 267.)

investments,” is precisely Ms. Ahern’s point. As Ms. Ahern explained, the calculation to which the Commission refers in Docket 07-0242 (Order, pp. 95-96) is the calculation of the ratemaking capital structure which is based upon book values and not market values. However, the Commission noted that the stock price reflects the appreciated or market value of the stock. Since size is a risk factor which is taken into account by investors in making their pricing decisions and since investors pay market prices for common shares, relative size must be based upon the relative market values between two different investments, all else equal, as Ms. Ahern discusses. (IAWC Exs. 12.00 (Ahern Dir.), pp. 13-16; 12.30 (Ahern Sur.), pp. 18-19.) What Mr. Thomas does not recognize is that in arriving at recommended return rates on common equity, all the witnesses in this proceeding have relied upon the market data of proxy companies. Therefore, as Ms. Ahern points out, it is entirely appropriate and consistent with financial theory to compare the estimated market capitalization of IAWC with that of the proxy companies to determine whether any risk adjustment is warranted. (IAWC Ex. 12.30 (Ahern Sur.), p. 19.)

In summary, the cost rate for common equity investment in IAWC must be determined without regard to the source of capital, i.e., American Water and AWCC, and must reflect the risk to which such capital is put, i.e., invested in IAWC. (See IAWC Ex. 12.10 (Ahern Reb.), p. 41.) Consequently, the specific risk of investment in IAWC, including its small size and greater financial risk, relative to the proxy water and utility companies utilized to estimate the cost rate of common equity capital by all witnesses in this proceeding, must be reflected in determining the appropriate common equity cost rate. (IAWC Ex. 12.30 (Ahern Sur.), pp. 13-14.) The Commission should, therefore, accept Ms. Ahern’s proposed 10 basis point business risk adjustment.

## **2. Other**

Apart from whether a business risk adjustment is appropriate, Staff and IWC's criticism of Ms. Ahern's cost of equity recommendation centers on her use of a single-stage DCF methodology based on analysts' projected 5-year growth rates. Staff and IWC take the position that such growth rates are unsustainable in the long term, therefore justifying use of a multi-stage DCF methodology that uses GDP growth as a proxy for long-term growth rates. CUB also criticizes Ms. Ahern's selection of growth rates, but its main argument, according to its witness, Mr. Thomas, is that the Commission should reinvent the approach to estimating the cost of equity that has been used at the Commission for many years. Each of these arguments is addressed below.

### **a. Growth Rates**

Staff criticizes the Company's use of the same long-term growth rates that its own witness originally relied on and now disavows. In direct testimony, Ms. Kight-Garlich applied the quarterly version of the constant-growth DCF model utilizing Zacks consensus forecasted 5-year growth rates in earnings per share ("EPS") the same growth rates used by Ms. Ahern. (Staff Ex. 4.0, p. 13 and Schedule 4.5.) Ms. Kight-Garlich's use of a constant growth, single-stage DCF methodology yielded an ROE recommendation of 11.24%, one basis point below Ms. Ahern's recommendation. (Staff Ex. 4.0, p. 9.) Subsequently, Ms. Kight-Garlich determined that the growth rates forecasted for her water sample proxy group were "much higher than the long-term growth forecasts for the United States economy." and therefore not sustainable over the long-term. (Staff Ex. 14.0, p. 4.) Based on this conclusion, Ms. Kight-Garlich revised her DCF analysis by utilizing a three stage, non-constant DCF methodology, using projected growth in GDP as a proxy for the long term (i.e., third stage) growth rate. This change in methodology

led Ms. Kight-Garlich to revise her ROE recommendation downward to 10.38%. (See ICC Staff Ex. 14.0, p. 9.)

IIRC's Mr. Gorman similarly asserts that analysts' consensus forecasts of growth in earnings per share "are excessive and cannot be sustained in the long run." (IIRC Ex. 4.0, p. 6.) Thus, IIRC's witness, Mr. Janous, used a 2-stage DCF approach, also using projected growth in earnings per share for the first stage and GDP growth for the second stage. (IIRC Ex. 3.0, pp. 16-17.)

There are at least two problems with Staff's and IIRC's use of a non-constant DCF approach utilizing GDP growth as a proxy for earnings growth. First, neither Staff nor IIRC has established that projected growth in GDP is a proper growth rate to use in a non-constant DCF analysis. Specifically, as Ms. Ahern explained, no party has provided any empirical support that the expected growth in GDP is an appropriate measure of sustainable growth rate for utility companies, in general, and water companies, in particular. (IAWC Ex. 12.30 (Ahern Sur.), pp. 3, 7-8, 12.) As Ms. Ahern testified, there is also no empirical evidence that in the second growth stage any company, especially the relatively stable utility companies, would grow at the average of the U.S. economy. (IAWC Ex. 12.10 (Ahern Reb.), p. 32.) The average growth in the U.S. economy is just that, an average. Some companies will grow faster and some will grow slower. It is a mismatch to use five-to-ten-years growth in GDP as a proxy for the years six through perpetuity. As Ms. Ahern pointed out, no party has cited evidence that a five-to-ten-year growth rate in GDP accurately represents the expected in-perpetuity growth rate in GDP. (Id., pp. 32-33.)

Mr. Gorman's reliance on work by Brigham and Houston to support the use of the growth in nominal GDP for use in a non-constant NDCF model is misplaced. As Ms. Ahern indicates, Mr. Gorman ignores the authors' recommendation of an assumed 8% normal growth rate to be

used in the NCD CF. (IAWC Ex. 12.30 (Ahern Sur.), pp. 11-12.) Mr. Gorman attempts to draw further support for his conclusion that GDP growth rate is the maximum sustainable growth rate for use in a DCF model from Morningstar, Inc.'s Stocks, Bonds, Bills and Inflation – Market Results for 1926-2007 – Valuation Edition (“SBBI”). (See IWC Ex. 4.0, p. 17.) As Ms. Ahern indicated, however, the study reported in SBBI relates growth in the earnings and dividends of the stock market as a whole to GDP growth from 1926-2006. Since the stock market as a whole, whether measured by the NYSE or S&P 500, is a broad-based representation of all the common stocks traded in the U.S., it stands to reason that the earnings and dividends of the market as a whole would track GDP growth. However, as Ms. Ahern indicated, neither SBBI nor Mr. Gorman have provided any empirical support that the earnings and dividends of utility companies, in general, or water companies, in particular, or indeed any specific company or industry, track GDP growth. (IAWC Ex. 12.30 (Ahern Sur.), p. 12.)<sup>6</sup>

Second, Staff and IWC ignore the fact that investors look to analysts' growth rates in forming their expectation of future dividend growth. The use of such forecasts is consistent with the prospective nature of ratemaking, cost of capital analysis and the Commission Staff's practice of using such forecasts in its cost of common equity analyses. As Ms. Ahern explained, analysts' forecasts of EPS growth are extremely relevant to investors in making their investment

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<sup>6</sup> Contrary to Mr. Janous's testimony (IWC Ex. 6.0, p. 6), IWC has not provided empirical data supporting utility company growth rates in line with GDP. As Ms. Ahern explained, information provided in response to data request IWC-IAWC 1.91 found nothing to support Mr. Janous's assumption that the EPS of utility companies can be expected to grow at the GDP growth rate. (IAWC Ex. 12.30 (Ahern Sur.), p. 15.) The attachment provided in response to IWC-IAWC 1.91 is merely a chart of energy usage, electricity usage and real GDP over an approximately 20-year period. Given that the U.S. economy is so energy dependent, it is not surprising that U.S. economic growth and energy/electricity growth are similar. (Id., p. 16.) Likewise, the article provided in response to IWC-IAWC 1.32 provides no insight whatsoever into the relationship between nominal GDP growth and the growth in EPS for utility and / or water companies. (Id.) In addition, as previously discussed, since the stock market as a whole, whether measured by the NYSE or S&P 500, is a broad based representation of all the common stocks traded in the U.S., it stands to reason that the earnings and dividends of the market as a whole would track GDP growth. But such a tracking does not provide empirical support for the contention that the rates of growth in earnings and dividends of utility companies in general, or water companies in particular, track GDP growth rates. (Id.)

decisions. It is the goal of rate of return analysts to emulate investor behavior. Consistent with the efficient market hypothesis (“EMH”), the market prices of securities reflect all known and relevant information at all times. (IAWC Ex. 12.10 (Ahern Reb.), p. 31.) As Ms. Ahern testified, this implies that prices adjust instantaneously to new information, such as analysts’ forecasts of EPS growth. There is a wealth of empirical and academic literature that supports the superiority of analysts’ forecasts of EPS as measures of investor expectations. (See IAWC Exs. 12.10 (Ahern Reb.), pp. 29-32; 12.30 (Ahern Sur.), p. 12.) Mr. Janous, in fact, agrees that “one can reasonably assume that investors are using security analyst estimates in determining how to correctly value a stock. In other words, security analyst growth estimates are the most likely growth estimates that are built into stock prices.” (IIWC Ex. 3.0, pp. 11-12.) It is, therefore, appropriate to rely upon such forecasts in a DCF analysis, and analysts’ forecasts of EPS growth should be used to estimate today’s market cost of capital. As Ms. Ahern indicated, there is no need to reject the empirical evidence of the proven reliability of analysts’ forecasts of EPS by turning to a non-constant DCF model as Staff and IIWC suggest. (IAWC Ex. 12.10 (Ahern Reb.), pp. 30-32).

As Ms. Ahern explained, the exercise of estimating cost of capital is to attempt to replicate investor behavior. Investors evaluate expected growth, or market appreciation, when making their pricing decisions relative to common stock. There is a wealth of empirical and academic research, of which investors are aware in accordance with the EMH, which supports the superiority of analysts’ forecasts of EPS, such as those provided by Zacks, as measures of investor expectations. (IAWC Ex. 12.30 (Ahern Sur., pp. 3-4.) Hence, as Ms. Ahern indicated, there is no supportive rationale or empirical support for the conclusion that analysts’ forecasted growth rates are “not sustainable.” (Id.; see also IAWC Ex. 12.10 (Ahern Reb.), pp. 29-33.)

**b. IWC Position**

IWC's Mr. Janous recommends a cost of equity of 9.9%. (IWC Ex. 3.0, p. 2.) IWC's other witness, Mr. Gorman, concedes that this cost estimate is too low, stating that an ROE "in the range of 10%" is sufficient for IWC to maintain financial integrity. (IWC Ex. 4.0, p. 11.)

Mr. Gorman is mistaken. As Ms. Ahern pointed out, although Mr. Gorman cites a November 15, 2007 Standard & Poor's ("S&P") report for his conclusion, S&P is silent relative to any specific utility subsidiary of American Water. (IAWC Ex. 12.30 (Ahern Sur.), p. 5.) In addition, S&P does not rate IAWC's credit standing. The only record S&P provides for IAWC is shown in IAWC Ex. 12.10, Schedule 12.31, which merely lists a profile of IAWC and related entities. (Id., pp. 5-6.) Nowhere does S&P provide a credit rating, bond rating, rating rationale, business risk profile or financial risk profile. Therefore, as Ms. Ahern indicated, there is no support for Mr. Gorman's conclusion that S&P would view an authorized ROE for IAWC "in the low 10% area" as supportive of IAWC's credit standing. (Id., p. 6.)

There are several other flaws in IWC's cost of equity recommendation. For example, Mr. Janous's water and gas utility proxy groups are problematic for several reasons. First, Mr. Janous states that "the [water] group has slightly lower financial risk (i.e. less debt), but slightly higher business risk than Illinois-American (i.e., business profile score of "3")." (IWC Ex. 3.0, p. 8.) This conclusion is based, in part, on the water proxy group's average common equity ratios of 53% and 51%, which are "slightly higher than the common equity ratio for Illinois-American of 44%." (Id.) Mr. Janous's comments relative to the water proxy group are inconsistent with his comments relative to the gas distribution proxy group, where he states that "the group's common equity ratio of 55% to 50%, representative of financial risk, is reasonable comparable to Illinois-American's ratios of 45% . . . the average business risk profile score from Standard & Poor's for the gas proxy group is "3" indicating a business risk that is similar to,

though slightly higher than, Illinois-American's business risk." (IWC Ex. 3.0, p. 9.) As Ms. Ahern indicated, it is inconsistent for Mr. Janous to conclude that the water companies' average common equity ratios of 51% and 53% can be slightly higher than Illinois-American's common equity ratio of 44%, but then conclude that the 50% to 55% average common equity ratios of the gas distribution companies are "reasonably comparable" to IAWC's common equity ratio of 45% (the latter percentage, 45%, is apparently a typographical error in Mr. Janous's Direct Testimony). (IAWC Ex. 12.10 (Ahern Reb.), p. 27.)

Similarly, as Ms. Ahern also explained, Mr. Janous's conclusion of the similarity in the risk of IAWC relative to his proxy groups are founded upon an outdated S&P U.S. Utilities and Power Ranking List of May 4, 2007 based upon the S&P's financial guidelines published on June 7, 2004 (see IAWC Ex. 12.00 (Ahern Dir.), Schedule 12.02, pp. 10-15), which, as discussed previously with regard to a business risk adjustment, has been superseded with a new ratings matrix. In view of S&P's revised financial matrix, Mr. Janous's comparison to the former S&P financial benchmark financial ratios is misplaced and should be disregarded. (IAWC Ex. 12.10 (Ahern Reb.), pp. 34-35.) As Ms. Ahern indicated, in light of S&P's revised ratings matrix, IAWC is riskier than both of Mr. Janous's proxy groups. (IAWC Ex. 12.10 (Ahern Reb.), p. 29.)<sup>7</sup>

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<sup>7</sup> Even based upon the current, February 7, 2008 (Schedule 12.33) S&P Issuer Ranking: U.S. Investor-Owned Water Utilities, Strongest to Weakest and Issuer Ranking: U.S. Natural Gas Distributors and Integrated Gas Companies, Strongest to Weakest, the relationship of the credit ratings, business risk profiles and financial risk profiles shown on Schedule 12.25, page 1 for Mr. Janous's two proxy groups, as well as American Water and AWCC, remains the same. Page 1 of Schedule 12.25 indicates that both of his proxy groups have been assigned an average credit rating of "A," an average business risk profile of "Excellent" and an average financial risk profile of "Intermediate" by S&P, while American Water and AWCC have been assigned credit ratings of "A-," business risk profiles of "Excellent" and financial risk profiles of "Aggressive," indicating similar business risk relative to Mr. Janous's proxy groups but greater financial and overall risk due to American Water's and AWCC's more risky "Aggressive" financial risk profile and more risky "A-" credit rating. Consequently, Mr. Janous's disagreement with Ms. Ahern's rebuttal testimony is based upon an incomplete review of American Water's and AWCC's, and hence IAWC's, total credit profile which includes S&P's assigned credit ratings, as well as business and financial risk profiles. Therefore, his proxy groups are not comparable in total risk to IAWC which has greater financial risk. (IAWC Ex. 12.30 (Ahern Sur.), pp. 14-15.)

Mr. Janous's CAPM analysis is also flawed. He asserts, for example, that the Commission should rely on "observable and verifiable actual current market costs" in determining appropriate interest rates to use in a CAPM analysis. (IIRC Ex. 3.0, p. 4.) As Ms. Ahern pointed out, however, events that affect the future market impact volatility. Investors are interested in the future, making it appropriate to rely on forecasted interest rates in a CAPM analysis. (IAWC Ex. 12.10 (Ahern Reb.), p. 26.) Additionally, Mr. Janous inappropriately developed his equity market risk premium ("EMRP") through a basically historical analysis because he merely added prospective inflation of 2.3% to the historical arithmetic mean real market return for the years 1926-2006 to derive a forecasted market return. As Ms. Ahern indicated, this is inconsistent with Commission practice of developing the forward looking EMRP by using the DCF results for the S&P 500, as both Ms. Kight-Garlisch and Ms. Ahern did. (IAWC Ex. 12.10 (Ahern Reb.), p. 33.) Mr. Janous also incorrectly derived the historical EMRP because, although correctly utilizing the arithmetic mean total market return from 1926-2006, he incorrectly subtracted the total return on long-term U. S. Treasury bonds. (*Id.*, p. 34.) As Ms. Ahern indicated, the Ibbotson Study upon which he relies to determine his EMRP specifically recommends that the income return on long-term U.S. Treasury bonds is the appropriate return to be subtracted from the total market return in order to develop the EMRP for use in the CAPM.

(*Id.*)

Mr. Gorman's criticism of Ms. Ahern's development of an EMRP for her CAPM analysis is also misplaced. Ms. Ahern developed a forward looking EMRP consistent with the methodology used by the Commission Staff previously and historically relied on by the Commission in arriving at an authorized return on equity. (IAWC Ex. 12.10 (Ahern Reb.), p. 37.) In addition, Mr. Gorman cites an undated Value Line Investment Survey 3-5 year capital

appreciation of 50% for the 1,700 stocks it follows, and an associated dividend yield of 1.9%. (IWC Ex. 1.0, p. 13.) As shown on IAWC Ex. 12.10, Schedule 12.27, the most recently available Summary & Index of Value Line Investment Survey, February 8, 2008, projects a median price appreciation potential of 65% for the next 3-5 years, which translates to an annual appreciation of 13.34% which, when added to the 2.1% median 3-5 year estimated dividend yield Value Line Investment Survey is projecting, results in an expected total market return of 15.44%, significantly higher than either the 13.46% Ms. Ahern relied upon based upon a DCF analysis for the S&P 500 or the 13.55% Ms. Kight-Garlich of the Commission Staff relied upon. (IAWC Ex. 12.10 (Ahern Reb.), p. 37.)

As Ms. Ahern indicated, the results of Mr. Janous's two-stage DCF analysis also fail a common sense test as they are inadequate relative to recently authorized ROEs for electric and gas utilities against which IAWC, through AWCC, must compete for capital in the capital markets. (IAWC Ex. 12.10 (Ahern Reb.), p. 33.) Mr. Janous's average two-stage DCF result of 8.4% for the water group and 9.0% for the gas distribution group are below the low end of the range of authorized ROEs shown on Schedule 12.20 of 9.1% and 11.5%. As Ms. Ahern pointed out, IAWC is more risky than the companies in either of Mr. Janous's proxy groups. (IAWC Ex. 12.10 (Ahern Reb.), pp. 32-33.)<sup>8</sup>

In light of the above, IWC has failed to support its cost of equity recommendation or to effectively rebut the Company's recommendation.

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<sup>8</sup> As Ms. Ahern notes, although the lowest awarded ROE shown on her Schedule 12.20 is 9.1%, it is for Orange and Rockland Utilities. Regulatory Research Associates (RRA), an SNL Energy Company, noted that it views that decision as "negative from an investor viewpoint" and "is the lowest ROE authorized an energy utility nationwide in at least 30 years." (IAWC Ex. 12.10 (Ahern Reb.), p. 37.)

**c. CUB Position**

CUB's cost of equity witness, Mr. Thomas, would have the Commission disregard accepted approaches to estimating the cost of equity for Illinois utilities. His recommended cost of equity of 8.58% (CUB Ex. 1.0, p. 2) defies credibility and should be rejected.

Mr. Thomas's purported analysis begins with a criticism of the CAPM methodology. Mr. Thomas argues that the Commission should re-examine its historic reliance on the CAPM because of persistent differences between actual and forecasted stock returns. (See CUB Ex. 1.0, p. 5.) Mr. Thomas's criticism of the CAPM and his reliance on the DCF model is, however, misplaced. As Ms. Ahern explained, as a rate of return analyst Mr. Thomas should attempt to emulate investor behavior because investors do not rely on any single approach in forming their expectations. An analyst should not rely on a single common equity cost rate model in determining a cost rate of common equity. As Ms. Ahern indicated, the results of multiple cost of common equity models should be taken into account as primary, not corroborating, methods. (IAWC Exs. 12.00 (Ahern Dir.), pp. 2-3; 12.10 (Ahern Reb.), pp. 17-18.) Substantial academic literature supports the conclusion that reliance on multiple cost of equity models is necessary to arrive at a recommended common equity cost rate. (See IAWC 12.10 (Ahern Reb.), pp. 3-6). Thus, investors are, or should be, aware that multiple models are available for use in determining a common equity cost rate. As Ms. Ahern indicated, a rate of return analyst also should consider more than one model as a primary method. (*Id.*, pp. 3-6.)

Indeed, Mr. Thomas's statement that "the Commission's overarching goal should be to minimize forecast error in the CAPM model" (CUB Ex. 1, p. 9) applies equally to the DCF model upon which he relies as a primary estimation approach.<sup>9</sup> Ms. Ahern pointed out, however,

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<sup>9</sup> Despite his criticism of the CAPM approach, Mr. Thomas inexplicably uses this approach to "confirm the accuracy" of his DCF calculation. (CUB Ex. 1.0, p. 19.)

the assumptions of the DCF do not necessarily hold in reality. For example, each of the principal DCF assumptions that: (1) the dividend growth rate is constant in perpetuity; (2) the price/earnings (P/E) multiple is constant in perpetuity; and (3) that the dividend payout ratio remains constant in perpetuity does not hold true in reality. (See IAWC Ex. 12.10 (Ahern Reb.), pp. 7-8.) It is thus clear that both the CAPM and the DCF approaches have shortcomings and forecast error associated with them. Therefore, as Ms. Ahern indicated, the Commission should continue to give weight to the results of both models in arriving at its authorized return rate on common equity and not use the CAPM as a corroborative model only. (IAWC Ex. 12.10 (Ahern Reb.), pp. 6-8.)

Mr. Thomas also rejects the use of adjusted betas in the CAPM, claiming that betas of utility stocks have not been shown to move toward the beta of non-utilities. (CUB Ex. 1.0, p. 11.) Mr. Thomas acknowledges that the Commission has traditionally relied upon adjusted betas in arriving at common equity cost rates for Illinois utilities. (Id.) He also agrees that an adjustment may be appropriate for companies with betas which are greater than 1.00, stating that, “[i]t seems intuitive that the risk of companies with high betas often moves towards 1.0 over time as companies learn their business and reduce their exposure to risk.” (Id.) As Ms. Ahern explained, while it is true that companies can reduce their exposure to risk, they cannot reduce their exposure to systematic risk as measured by beta. As discussed above, the total risk of any company is composed of systematic (market or non-diversifiable) and non-systematic (non-market or diversifiable) risk. (IAWC Ex. 12.10 (Ahern Reb.), p. 9.) Beta, as a measure of systematic risk, is largely out of the control of management. (Id.) Systematic, or market, risk arises predominantly from macroeconomic factors which affect all companies. Non-systematic risks are those risks predominantly associated with a company’s operations and financial profile.

(Id.) As Ms. Ahern indicated, the market price fluctuations which give rise to beta are largely out of the hands of management and are in the hands of investors, who price common stocks based upon their perceptions of the riskiness of investing in them based upon macroeconomic events which affect all stocks. (Id.) Thus, systematic, or market, risk represents a non-diversifiable risk to shareholders that may affect the financing decisions of companies relative to the issuance of additional shares of common stock. (Id.) Mr. Thomas cites a single study to support his assertion that utility betas do not revert to 1.00 over time. (CUB Ex. 1, p. 12.) As Ms. Ahern points out, however, Mr. Thomas ignores the myriad evidence that in general betas revert to 1.00. (See IAWC Ex. 12.10 (Ahern Reb.), pp. 8-11.)

Mr. Thomas's own analysis demonstrates the reasonableness of using unadjusted betas in a CAPM analysis. As Ms. Ahern indicated, the unadjusted betas of Mr. Thomas's proxy companies range from 0.20 to 1.15, averaging 0.83. (See IAWC Ex. 12.10 (Ahern Reb.), Schedule 12.16, p. 4.) If York Water Co.'s clearly low-risk beta of 0.20 is excluded, the unadjusted betas for Mr. Thomas's water utility group range from 0.72 to 1.15, averaging 0.93. (IAWC Ex. 12.10 (Ahern Reb.), p. 11.) With the market, by definition, having a beta of 1.00, it is clear that the majority of companies in Mr. Thomas's group are not low-risk. Moreover, as shown on page 1 on Schedule 12.16, the unadjusted betas of the companies in Mr. Thomas's group of eight water companies, excluding York Water Co., have clearly trended toward 1.00 from early 1999 through 2007. (Id., pp. 11-12.) Hence, as Ms. Ahern noted, using Mr. Thomas's own logic, the adjusted betas of these companies should be utilized in a CAPM analysis. (IAWC Ex. 12.10 (Ahern Reb.), pp. 11-12 & 23.)

In regards to the EMRP component of CAPM, Mr. Thomas's discussion incorrectly centers on his presumption that the Commission has traditionally "relied on EMRP estimates

calculated by individual analysts in individual cases from historical stock market data.” (CUB Ex. 1.0, p. 16.) As Ms. Ahern explained, contrary to Mr. Thomas’s presumption, the Commission has not used historical stock market data but, rather, has consistently used a DCF analysis for the S&P 500 to derive the EMRP. (IAWC Ex. 12.10 (Ahern Reb.), p. 12.) This is the technique which both Staff witness Kight-Garlich and Ms. Ahern utilized in this case. (Id.)

Mr. Thomas also contends that the interest rate used in a CAPM analysis should be based on current market data, rather than on forecasted interest rate data, the latter of which he contends “overstates the risk-free rate by a significant margin.” (CUB Ex. 1.0, p. 42.) As stated above, however, both ratemaking and the cost of capital are prospective. As Ms. Ahern noted, it is therefore appropriate to utilize a forecasted risk-free rate in a CAPM analysis. (IAWC Ex. 12.10 (Ahern Reb.), pp. 23-24.) Furthermore, Ms. Ahern’s forecasted risk-free interest rates are not “overstated.” Mr. Thomas’s comparison of Ms. Ahern’s 5.33% forecasted 30-year U.S. Treasury Note yield based upon the July 1, 2007, Blue Chip Financial Forecasts with a current 4.53% yield for December 2007 is a mismatch. IAWC Ex. 12.20, Schedule 12.23, illustrates that the average consensus estimate of the 30-year U.S. Treasury Note yield for the six quarters ending with the second quarter 2009 from the February 1, 2008 Blue Chip Financial Forecasts is 4.32%, identical to the then-most recent, January 18, 2008 30-year U.S. Treasury Note yield as also shown on Schedule 12.23. (IAWC Ex. 12.10 (Ahern Reb.), p. 24.)

Mr. Thomas’s peculiar application of the DCF method relies on a “sustainable” or “fundamental” growth rate based on historical growth, as opposed to growth rates based on prospective market conditions. As Ms. Ahern explained, however, Mr. Thomas’s use of a sustainable or fundamental growth rate is inconsistent with the prospective nature of both ratemaking and the cost of capital. (IAWC Ex. 12.10 (Ahern Reb.), p. 20.) By ignoring

projections of earnings per share and common equity expected three to five years in the future, Mr. Thomas ignores valuable information that influences investors. (Id.)<sup>10</sup>

Indeed, Mr. Thomas's use of historical returns in his internal growth analysis exacerbates the circularity of using such an index as a measure of expected future sustainable growth. Historical returns for water companies are the direct result of Commission authorized ROEs. Mr. Thomas correctly states that the "Commission does not grant utilities a specific return each year." (CUB Ex. 2.0, p. 15.) However, as Ms. Ahern pointed out, the returns actually achieved in each year are the product of the rates set in the most recent rate proceeding, based upon the authorized ROE, which then give rise to the realized ROE in each subsequent year until a new rate proceeding sets new rates and a new authorized ROE. Therefore, realized ROEs in each year are indeed a function of the then current authorized ROE. Since these historical realized ROEs give rise to internal growth rates, such as those derived by Mr. Thomas, those historical internal growth rates are inherently circular and do not obviate the circularity inherent in the sustainable growth method of determining a DCF growth rate. (IAWC Ex. 12.30 (Ahern Sur.), pp. 19-20.)

Mr. Thomas's recommended common equity cost rate of 8.58% is plainly unreasonable. As Ms. Ahern indicated, a common equity cost rate of 8.58% represents a 252 basis points (2.52%) equity risk premium above a recent yield on "A-" rated public utility bonds of 6.06%. (IAWC Ex. 12.10 (Ahern Reb.), p. 21.) As Ms. Ahern explained, this risk premium is not consistent with the average spread of 4.23% between (1) authorized returns on common equity for electric and gas utilities with which IAWC (through AWCC) must compete for capital in the

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<sup>10</sup> Mr. Thomas's states: "Value Line estimates of growth . . . are not as easy for investors to obtain." (CUB Ex. 1.0, pp. 35-36.) However, Value Line Investment Survey is a widely subscribed service, having over 100,000 subscribers and is also available free of charge in the reference section of nearly every well-stocked public library in the United States. Therefore, Mr. Thomas's supposition that Value Line "may have less influence on the expectations of individual investors" (id., p. 36) is unsubstantiated. (IAWC Ex. 12.10 (Ahern Reb.), pp. 19-20.)

capital markets and (2) the yields of Moody's "A-" rated public utility bonds for the year 2007, as shown on page 2 of Schedule 12.20, IAWC Ex. 12.10. (Id.) Nor is it consistent with the historical equity risk premium based upon a study of the holding period returns of the S&P Utility Index from 1928-2006 of 4.51% as shown on Schedule 12.21. (Id.) Consequently, as Ms. Ahern indicates, Mr. Thomas's recommended 8.58% common equity cost rate does not represent an appropriate cost of common equity for IAWC. (Id.)

In summary, CUB provides no persuasive evidence that the Commission should "reconsider" its traditional cost of common equity analysis. Mr. Thomas has provided no proof that the forecast error of the CAPM is any greater than the forecast error of the DCF. And he has provided no evidence that the use of unadjusted betas in a CAPM analysis will ameliorate the forecast error of the CAPM.

#### **D. Recommended Overall Rate of Return**

Applying an 11.24% return on equity to IAWC's capital structure yields an overall return of 8.23%, as shown in IAWC Exhibit 2.22.

### **V. RATE DESIGN; TARIFF TERMS AND CONDITIONS**

#### **A. Introduction**

As Mr. Grubb explained, the Company's proposed rates are based upon across-the-board revisions to all rates for all Rate Areas for which a rate increase or decrease is proposed, in accordance with revenue requirements applicable to each Rate Area. (IAWC Ex. 4.00 (Grubb Dir.), p. 39.) The Company's present rate design was established based on a cost of service analysis in Docket 02-0690, and there is no change in circumstances since that time that would warrant a change in the design of the Company's rates, with two exceptions, discussed below, pertaining to sewer collection charges for the Chicago Metro District-Sewer and for South Beloit. (Id.) Rate design matters are addressed by Mr. Grubb and Mr. Herbert.

## **B. Resolved Issues**

### **1. Municipal Franchise Fees**

Staff Witness Harden testified, in direct testimony, that the Company had not supported its proposal to change certain municipal franchise fees. (ICC Staff Ex. 5.0, pp. 25-29.) Mr. Grubb explained, however, that franchise fees are determined as a result of franchise agreements with the applicable municipalities, and change as Company revenue changes (with the exception of Champaign, which is discussed below). (IAWC Ex. 4.10 (Grubb Reb.), pp. 23-24.) For areas other than Champaign, franchise fees are set to collect from customers in a municipality the cost of water provided, without charge to the municipality. This allows the Company to recover the cost of the water provided to the municipality directly from (and only from) the residents of the municipality that benefits from use of the water. (Id., p. 23.) The Company's proposal to change the fees reflects the change in the cost of the water used by municipalities that results from the rate increase proposed by the Company. (Id.)

With respect to the franchise fee for Champaign, Mr. Grubb explained that this fee is a pass through cost set by a formula in the "Agreement Between the City of Champaign and Illinois-American Water Company Concerning the Use of the Public Ways of the City, Fire Protection and Other Related Matters" ("Champaign Agreement"). Accordingly, it is appropriate for the Company to amend the fee in accordance with the Champaign Agreement's terms. (IAWC Ex. 4.10 (Grubb Reb.), p. 24.) On rebuttal, Ms. Harden accepted this explanation and recommended that the Commission approve the Company's proposal to change certain municipal franchise fees. (ICC Staff Ex. 15.0, p. 10.)

### **2. Uniform Miscellaneous Charges**

As discussed by Mr. Grubb, the Company proposed to implement certain uniform miscellaneous charges in certain Rate Areas. (IAWC Ex. 4.00 (Grubb Dir.), p. 13.) Staff

witness Harden testified that, “[u]niformity of the miscellaneous charges for IAWC provides benefits for customers, the Company and the Commission.” (ICC Staff Ex. 5.0, p. 21.) Staff therefore agreed with the Company’s proposal to implement a non-sufficient funds (“NSF”) charge of \$15 in the South Beloit District (id., p. 22), and recommended that the Company apply a \$32 reconnection fee in all Rate Areas for service reconnections performed during normal business hours. (Id., pp. 23-25.) For reconnections that occur after normal business hours, Ms. Harden recommended the adoption of tariff language, for all Rate Areas, which states that the charge for service turned on at the customer’s request after regular business hours will be the actual cost incurred by the Company. (Id., p. 25.) The Company accepted Ms. Harden’s recommendation. (IAWC Ex. 4.10 (Grubb Reb.), p. 20.)

### **3. Refund Period for Customer Advances**

In its initial filing, the Company proposed tariff changes for rules governing sewer and water main extensions and construction of sewer facilities (“Rules”), as applicable, for all Rate Areas. (IAWC Ex. 3.00 (Ruckman Dir.), p. 10.) As Mr. Ruckman explained, the Company proposed to change the period of time under the Rules in which the Company must make refunds of one and one-half times annual revenue for attaching customers from ten years to one year. (Id., pp. 10-11.) The intent of the proposal was to reduce the amount of investment in rate base made by the Company in circumstances where a developer or other applicant advances funds for new or extended facilities under the Rules. (Id., p. 11.) Currently, as Mr. Ruckman explained, the Rules require that the Company issue refunds to the applicant for customers who attach to the facilities over a period of ten years. (Id.) The proposed changes would reduce that period to one year from the date of completion of the extension of water or sewer mains, thereby reducing the total refunds the Company must make and ultimately reducing, over time, the level of required

future investment in rate base from the level the present rule would require. (Id.) Over time, Mr. Ruckman noted, this change would mitigate future rate increases.

In rebuttal testimony, however, IAWC withdrew, for the purposes of this proceeding, its proposal. (IAWC Ex. 3.10 (Ruckman Reb.), p. 2.) The Company believes that the present approach places an undue burden on ratepayers. (Id.) Because IAWC believes that certain other changes to the existing main extension deposit approach are also needed, IAWC intends to seek an appropriate change in a rulemaking proceeding under 83 Ill. Adm. Code Part 200.210. (Id.)

#### **4. Tariff Clarifications**

Staff witness Harden recommended certain clarifications to the Company's tariff for "Multiple residential units not individually metered for water service – per residential unit" ("Multi Residential"). (ICC Staff Ex. 15.0, p. 11.) The Company agreed to amend the tariff to clarify that Multi Residential customers are not charged a volumetric rate. (IAWC Ex. 4.20 (Grubb Sur.), p. 7.)

#### **5. Sewage Treatment Plant Connection Fee**

The Company proposed to change its Sewage Treatment Plant Connection Fee. As Mr. Grubb explained, the current average projected unit cost of \$831.76 per population equivalent (PE), found in Rule 16 of the Rules, Regulations and Conditions of Service of the Chicago Metro District-Sewer (ILL. C.C. No. 5, Sheet No. 53), is based on 2002 construction costs. (IAWC EX. 4.00 (Grubb Dir.), p. 13.) Since 2002, when the unit cost was last adjusted, the Company has experienced an increase in the construction unit prices, attributable to new environmental regulations and the increase in inflation. (Id., pp. 13-14.) Mr. Grubb explained that two nationally recognized construction cost indices show an approximate increase of 24% in construction cost since 2002. (Id., p. 14.) He also explained that IAWC's recently bid project for the Oak Valley Water Reclamation Facility expansion is projected to cost \$8,697,930. (Id.)

This expansion will add treatment capacity for 7,500 PE at a unit cost of \$1,159/PE, a cost which reflects more stringent treatment standards and inflation. (Id.) Therefore, IAWC is proposing that the Average Project Unit Cost be revised to \$1,159/PE. (Id.) Staff recommends approval of this change. (ICC Staff Ex. 5.0, pp. 29-31.)

### **C. Contested Issues**

#### **1. \$10 Activation Charge**

The Commission, in Docket Nos. 00-0340 and 02-0690, approved a \$10 Customer Activation Charge for customers in the Champaign District. The Company proposes to apply a \$10 Customer Activation Charge to all customers in all Rate Areas. (IAWC Ex. 4.00 (Grubb Dir.), p. 13.) As Mr. Grubb explained, the purpose of the fee is to recover the cost of turning on service to all new customers in a consistent manner in all Rate Areas. By implementing a Customer Activation Charge, existing customers do not bear the cost of activating service for new customers. (IAWC Ex. 4.10 (Grubb Reb.), p. 21.)

Staff witness Harden recommends, however, that the charge not be extended to other Rate Areas and, furthermore, that it be eliminated in the Champaign District. (ICC Staff Ex. 5.0, pp. 25-29.) Ms. Harden does not believe that the Company has documented a need for such a charge. Contrary to Ms. Harden's assertion, however, the Company has provided support for the implementation of a \$10 customer activation fee for all service areas. As Mr. Grubb explained, the costs to be recovered in the fee include labor, overhead and transportation costs. (IAWC Ex. 4.10 (Grubb Reb.), p. 21.) In response to Staff data request CLH 2.04, the Company provided a discussion and cost breakdown analysis supporting the \$10 charge. (See IAWC Ex. 4.13.) Mr. Grubb explained that the cost breakdown shown on CLH 2.04 reflects the overhead, transportation, and labor costs related to the \$10 activation charge on a Company-wide basis (i.e., costs that would apply in all Rate Areas, not just for the Champaign District). (IAWC Ex. 4.20

(Grubb Sur.), p. 7.) In addition, the \$10 charge is reflected in the Company's E Schedules, the amount of revenue that would be collected from this charge is incorporated in the Company's revenues at proposed rates in Schedule C-1, and the revenues from the charge are specifically included in Schedule E-5 (Other Operating Revenues) for the Rate Areas. (IAWC Ex. 4.10 (Grubb Reb.), pp. 21-22.) Thus, the Company has supported the \$10 charge and, because implementing the charge means existing customers do not subsidize service activation, the charge is reasonable and should be approved. Implementation of the charge in all Rate Areas would also be consistent with Staff's desire for uniformity of service charges in all Rate Areas, as discussed by several of its witnesses. (See ICC Staff Exs. 5.0, pp. 21-22; 6.0, p. 28; 7.0, pp. 17-18.)

## **2. Sewer Collection Charge and Section 8-306(h)**

As explained by Mr. Grubb, the Company is proposing to change the rate structure in the Chicago Metro District-Sewer. (IAWC Ex. 4.00 (Grubb Dir.), p. 40.) The Company is proposing to move to a combination fixed and volumetric rate structure for residential collection and treatment customers in Chicago Metro District-Sewer. (Id.) The current rate structure is a fixed charge of \$45.52 per month. (Id.) The Company's proposal is to move to a fixed charge of \$26.07, with an included usage allowance of 1,000 gallons per month, and volumetric rates of \$3.7891 for the next 7,000 gallons and \$1.9311 for all usage over 8,000 gallons. (Id.) The Company believes the proposed combination structure is a more reasonable rate design. (Id.)

The proposed rate structure applies the volumetric rates to actual usage levels during the months of November through April. (IAWC Ex. 4.00 (Grubb Dir.), p. 40.) For the months of May through October, the volumetric rate is determined based on the average winter usage level during the months of November through April. (Id.) As explained by Mr. Grubb, the use of a

winter average usage for the summer months is appropriate in light of the impact during summer months of outdoor water use, which does not affect the sanitary wastewater flow. (Id.)

The purpose of this rate structure change is also to comply with the requirement of Section 8-306(h) of the Act, 220 ILCS 5/8-306(h), which requires: “Each public utility that provides water and sewer service must establish a unit sewer rate, subject to review by the Commission, that applies only to those customers who use less than 1,000 gallons of water in any billing period.” The Company’s proposed fixed charge of \$26.07, coupled with a usage allowance of 1,000 gallons per month, represents such a “unit sewer rate” that applies only to those customers who use less than 1,000 gallons of water.

AG witness Rubin asserted (AG Ex. 3.10, p. 1) that IAWC is required to also adopt a low volume user rate for sewer collection-only service in Chicago Metro District-Sewer, and recommended that the Commission order IAWC to implement a consumption-based rate for collection-only wastewater customers. Section 8-306(h), however, does not require a volumetric charge for collection-only customers.

For residential sewer collection-only customers, as shown on Schedule E-7, the Company is proposing a flat rate charge of \$17.60 that applies to all residential collection-only customers. (IAWC Ex. 4.20 (Grubb Sur.), pp. 20-21.) As Mr. Grubb explained, the Company has not proposed a separate rate for sewer collection-only customers who use less than 1,000 gallons, because such a rate would not be practical. (Id.) As Mr. Grubb indicated, the cost of serving collection-only customers consists primarily of fixed costs. (Id.) The variable costs associated with collection-only service are small (approximately \$24,000 annually for fuel and power costs for sewer collection service to Chicago Metro District – Sewer customers). (Id.) A separate volumetric charge recovering the variable cost would be approximately \$0.01 per ccf, or

\$0.01335 per 1,000 gallons. (Id., see also Tr. 301.) Accordingly, from a practical and administrative standpoint, it is appropriate to have a single fixed rate for collection-only customers.

If, however, the Commission determines that Mr. Rubin's proposal should be accepted (which it should not), based on the variable cost of \$0.01 per ccf referenced above, the fixed component of a low-volume charge (assuming an average water usage by residential collection-only customers of 7,000 gallons per month), with a 1,000 gallon allowance as is proposed for collection and treatment customers, would be \$17.52. In addition, a volumetric charge of \$0.01355 per 1,000 gallons would apply. Thus, the difference between monthly charges to a collection-only user using 1,000 gallons or less and other collection-only users would be minimal. (IAWC Ex. 4.20 (Grubb Sur.), pp. 20-21.)

Mr. Rubin also questioned the use of winter usage to calculate the volumetric sewer rate. (AG Ex. 3.0, pp. 16-18.) Mr. Rubin agrees that it is reasonable for the Company to charge sewer rates based on the amount of metered water consumption. (Id.) However, rather than base sewer charges on the amount of water consumed during the months of November through April, as proposed by the Company, Mr. Rubin recommends that sewer treatment charges for residential, single-family customers be based on all metered water consumption throughout the year. (Id.) IAWC witness Herbert explained, however, that sewer charges are often based on winter usage because a significant amount of the excess usage in summer months is attributable to outdoor usage that is not returned to the sewer system, such as usage for lawn watering, irrigation and swimming pools. (IAWC Ex. 11.10 (Herbert Reb.), pp. 7-8.) Thus the proposed use of winter consumption recognizes the use of water for outdoor purposes in the summer months. (Id.)

Mr. Rubin states that there is not enough evidence to show that summer use is significantly different than winter use, citing the water customers' usage by month from IAWC's 2006 annual report. (AG Ex. 3.0, p. 16.) However, as Mr. Herbert explained, the water usage by month for sewer customers is quite different from overall water customer usage. (IAWC Ex. 11.10 (Herbert Reb.), p. 8.) Analysis of the monthly water use for sewer customers shows that the average usage for the summer months is about 37% higher than the average usage in the winter months. (IAWC Ex. 11.12.) It is therefore appropriate to base volumetric sewer billing on winter usage, as IAWC proposes.

### **3. "Across-the-board" Increases vs. Staff Cost of Service Study**

As noted above, the Company proposes an across-the-board rate increase. The Company's position with respect to Staff's Cost of Service Study ("COSS") is that, although the Commission could reasonably establish rates based on moving toward the Staff cost of service studies (as corrected in Staff's rebuttal testimony), an across-the-board increase is preferable in this case. (IAWC Exs. 4.20 (Grubb Sur.), pp. 21-22; 11.10 (Herbert Reb.), pp. 1-5.) As Mr. Grubb's explained, an across-the-board increase would mitigate the substantial rate impact that Staff's proposed rate design would impose in certain areas. (IAWC Ex. 4.20 (Grubb Sur.), pp. 21-22.) The Company also has specific concerns the impact of Staff's COSS approach with respect to South Beloit and fire protection charges, as discussed in Sections V.C.5 and V.C.7, respectively, below.

### **4. Pontiac District Rate Design**

In Docket 02-0690, the Company was ordered to move the Pontiac rate blocks to match the Southern, Peoria, and Streator (now in the SPSPSB District) block structure. As Mr. Grubb explained, this has been proposed in this case. (IAWC Ex. 4.00 (Grubb Dir.), p. 41.) Also, the

Company has completed the transition of Peoria's third and fourth rate block rates to match the Southern and Streator rates at the proposed rates. (Id.)

For Pontiac, the rates proposed by Staff under the COSS are generally aligned with Staff's cost of service results. Staff's proposed rates, however, do not move Pontiac's rates towards the SPSPSB District rates in accordance with the intent of the order in Docket 02-0690. (IAWC Ex. 11.10 (Herbert Reb.), p. 5.) As Mr. Herbert explained, the Company supports moving Pontiac rates towards the rates of the other portions of the SPSPSB District as a continued effort to consolidate rates. (Id.) The overall increase in revenue in Pontiac under the Company's proposal is 12.5%, whereas the Staff proposed cost of service increase is over 23%. (Id.) Although the Company's proposal produces small decreases for certain customers, elimination of the separate rate for Pontiac is appropriate and the Company's proposal should be adopted. (Id.)

AG witness Rubin recommends that Pontiac rates be modified to adopt the rate blocking in effect in the Southern area (now the SPSPSB District), but he disagrees with the Company's proposal to charge the same rates in Pontiac that are charged in the SPSPSB District. (AG Ex. 3.0, pp. 5-6.) As discussed above, however, the Company supports moving Pontiac's rates to the SPSPSB District rates in order to continue rate consolidation. (IAWC Ex. 11.10 (Herbert Reb.), p. 6.)

## **5. South Beloit District Rate Design**

As discussed above, the Company is proposing to combine the revenue requirement for the Southern (Alton, Interurban, and Cairo), Peoria, Streator, Pontiac, and South Beloit service districts (into the SPSPSB District) and develop an across-the-board increase for these service districts. (IAWC Ex. 4.00 (Grubb Dir.), p. 40.) As Mr. Grubb explained, the Company believes that combining service districts will mitigate possible substantial rate impacts on South Beloit

customers. (Id.) Due to the relatively small size of South Beloit, the average Southern, Peoria, Streator and Pontiac residential customer's bill is impacted by the inclusion of South Beloit by less than \$0.15 per month. (Id., p. 41.)

If the Commission accepts Staff's COSS instead of the Company's proposed across-the-board increase, however, the Company is concerned with the rate impact in South Beloit. (IAWC Ex. 4.10 (Grubb Reb.), p. 31.) As Mr. Grubb explained, under the Staff COSS proposal, the rates for South Beloit residential customers and the commercial, industrial, public authority and fire service classes will be increased significantly when compared to the other service areas within the SPSPSB District. (Id.) In particular, as Mr. Grubb noted, Staff's recommended rates for SPSPSB produce a rate increase of 56.7% for South Beloit residential customers, and 45.0%, 54.8%, 42.4% and 309.8% for commercial, industrial, public authority, and fire service classes, respectively. (Id.) If the Commission adopts Staff's COSS, the Company recommends that the final rate design in this case reflect the rate increases to South Beloit in such a manner that the percentage increase will be approximately one-half way between the Southern service district cost of service and the South Beloit cost of service. (Id.) Mr. Grubb explained that, using this approach and the Staff's current cost of service, the residential customer rate for South Beloit would increase 36.1%, and the commercial, industrial, public authority and fire service rates would increase by 31.4%, 42.1%, 31.3% and 139.4%, respectively. (Id.) This alternate proposal is reasonable if rates are set in accordance with Staff's COSS. (IAWC Ex. 4.20 (Grubb Sur.), p. 22.)

## **6. Southern Service District Competitive Customers Rate Design**

In IAWC's Southern service district (part of the SPSPSB District), certain customers (the Sauget Industrial Water Customers ("SIWC"), the Sauget OPA Water Customers ("SOWC"), the Metro-East Municipal Joint Action Water Agency ("MEMJAWA") and the City of O'Fallon

(“O’Fallon”) (together “Competitive Service Tariff Customers’’) have Competitive Service Tariffs, which specify rates that are not revised in a general rate case. Instead, under the Competitive Service Tariffs, charges are revised annually in accordance with the terms of the respective tariffs, or in the case of O’Fallon, in accordance with an approved water supply agreement. (IAWC Exs. 4.00 SUPP (Grubb Suppl. Dir.), p. 6; 4.10 (Grubb Reb.), pp. 27-29; 4.20 (Grubb Sur.), p. 9.)

As Mr. Grubb explained, the Competitive Service Tariff rate for MEMJAWA, SIWC and SOWC is developed by a formula that has two primary drivers: the per 1,000 gallon cost of water charged by the City of St. Louis; and the amount of water used in the previous year by the Competitive Service Tariff Customer. (IAWC Ex. 4.20 (Grubb Sur.), p. 11.) The rates for SIWC, SOWC and MEMJAWA are adjusted on January 1st of each year. (IAWC Ex. 4.10 (Grubb Reb.), pp. 27-29.) For O’Fallon, as Mr. Grubb explained, the Competitive Service Tariff rate increases annually in accordance with the Consumer Price Index for Water and Sewer Maintenance. (IAWC Ex. 4.20 (Grubb Sur.), p. 9.) The rates for O’Fallon under the Competitive Service Tariff are adjusted in August of each year. (Id., p. 9.) O’Fallon, however, has the option to elect billing under either the terms of the Competitive Service Tariff or, in the alternative, the General Water Service Tariff. (Id., p. 12.)

Although O’Fallon had elected prior to August, 2007 to take service under the Competitive Service Tariff (and the Company’s original filing reflected this election), in August, 2007 (at the time of the annual August rate change), O’Fallon changed its election and began taking service under the General Water Service Tariff. (IAWC Exs. 4.10 (Grubb Reb.), p. 29; 4.20 (Grubb Sur.), pp. 11-12.) Accordingly, in the Company’s update filing on December 4,

2007, the Company calculated the projected level of revenue for O'Fallon based on application of the General Water Service Tariff. (IAWC Ex. 4.20 (Grubb Sur.), pp. 11-12.)

In the income statement initially filed by the Company, the projection of revenues at proposed rates incorrectly reflected a rate increase for customers served under the Competitive Service Tariffs, when no rate increase would occur under the terms of those tariffs. (IAWC Ex. 4.20 (Grubb Sur.), p. 9.) Accordingly, in the update, except with respect to O'Fallon, the revenue increase initially reflected for the remaining Competitive Service Tariff Customers (SIWC, SOWC and MEMJAWA) was eliminated from the income statement. (Id.; IAWC Ex. 4.00 SUPP (Grubb Suppl. Dir.), p. 6.) Thereafter, at the time of the Company's rebuttal filing, the level of income statement revenue under the respective Competitive Service Tariffs for these customers was updated to reflect new rates that became effective in January, 2008. (IAWC Exs. 4.10 (Grubb Reb.), pp. 28-29; 4.16.) For O'Fallon, as discussed above, revenue was projected in the December 4, 2007 update filing based on application of the General Water Service Tariff, in light of O'Fallon's election to take service under that tariff. (IAWC Exs. 4.10 (Grubb Reb.), p. 29; 4.16.)

**a. Projected Increase For Present Rates for Competitive Service Tariff Customers**

As explained above, except with respect to O'Fallon, the applicable rates under the Competitive Service Tariffs (for SIWC, SOWC and MEMJAWA) change in January of each year. For O'Fallon, the Competitive Service Tariff rate changes each August. Thus, during the test year, the rates applicable under the respective Competitive Service Tariffs for SIWC, SOWC and MEMJAWA will change in January, 2009; and the rate applicable to O'Fallon (if it were to again elect service under the Competitive Service Tariff) would change in August, 2008. In rebuttal testimony, Staff witness Luth proposed that the level of revenue projected by the

Company be adjusted to reflect the expected changes in rates that would occur under the Competitive Service Tariffs during the test year. (ICC Staff Ex. 17.0, p.6.)

The Company agreed that the projected change in revenue resulting from test year changes in rates under the Competitive Service Tariffs should be reflected. (IAWC Ex. 4.20 (Grubb Sur.), p. 10.) As Mr. Grubb explained, however, Mr. Luth's proposal should be modified. As Mr. Grubb indicated, Mr. Luth proposed to increase annual revenue under the Competitive Service Tariffs for SIWC by 9.96%; for SOWC, by 8.29%; for MEMJAWA by 6.07% and for O'Fallon by 10.08%. (IAWC Exs. 4.20 (Grubb Sur.), p. 10; 4.16.) Mr. Luth stated that these increases represent a "reasonable estimate" of the Competitive Service Tariff rates as of June 30, 2009. (ICC Staff Ex. 17.0, p. 6.) As Mr. Grubb indicated, however, these percentage increases are not a reasonable estimate of the increase in annual revenue for these customers during the test year ended June, 2009. (IAWC Ex. 4.20 (Grubb Sur.), pp. 10-11.) As Mr. Grubb explained, the rate changes under the Competitive Service Tariffs for SIWC, SOWC and MEMJAWA will be in effect for only one-half of the test year, and not for a full twelve months as Mr. Luth assumed. (Id., p. 10.) Accordingly, for these customers, one-half of the revenue increase reflected by Mr. Luth should be removed. (Id., p. 11.) For O'Fallon, the Competitive Service Tariff rate change would take place on August 15, 2008, and thus be in effect for approximately 46 weeks of the test year. (Id.)

Mr. Grubb further explained that Mr. Luth's proposal does not reflect the variable nature of Competitive Service Tariff rates. (IAWC Ex. 4.20 (Grubb Sur.), p. 10.) As discussed above, the Competitive Service Tariffs for MEMJAWA, SIWC and SOWC are developed by a formula based on two factors that can vary from year to year (for example, an increase in usage by Competitive Service Tariff Customers can drive the tariff rate down). Mr. Grubb explained,

therefore, that it is appropriate to project the increase in Competitive Service Tariff rates for MEMJAWA, SIWC and SOWC based on a three-year historical average. (Id., p. 11.) Under this approach, Mr. Grubb recommended, for the SIWC and SOWC Competitive Service Tariffs, the rates be increased by approximately 4.93%. (Id.) Additionally, Mr. Grubb stated the amount of test year revenues attributed to this increase should be one-half of the annual amount for 2009, and the remainder of the test year revenues determined at one-half of the annual amount for 2008, to account for the fact that the new rate will only be in effect half of the test year. (Id.) For the MEMJAWA competitive tariff group, the average annual increase over the last three years has been 3.26%. (Id.) Again, the amount of test year revenues attributed to this increase should be one-half of the annual amount for 2009. (Id.)

**b. O'Fallon Is Expected to Switch to its Competitive Service Tariff Rate if That Rate Is Lower than the Metered General Service Tariff Rate**

For O'Fallon, as discussed above, the Competitive Service Tariff rate increases annually by the Consumer Price Index for Water and Sewer Maintenance. (IAWC Ex. 4.20 (Grubb Sur.), p. 11.) The average annual increase for the Consumer Price Index for Water and Sewer Maintenance over the last three years has been 5.14%. (Id.) As was also discussed, however, O'Fallon has presently elected to take service under the General Water Service Tariff, but can at any time elect to again take service under the terms of the Competitive Service Tariff. (Id., pp. 11-12.)

As Mr. Grubb explained, in the event that the rate increase approved in this proceeding would result in a level of charges to O'Fallon under the General Water Service Tariff that exceeds the level it would experience under the Competitive Service Tariff, O'Fallon can be expected to elect to be served under the Competitive Service Tariff. (IAWC Ex. 4.20 (Grubb Sur.), p. 12.) As Mr. Grubb indicated, such an election by O'Fallon would reduce the level of

revenue realized by the Company from service to O'Fallon by \$206,255, as shown on IAWC Exhibit 4.21. (Id., IAWC Ex. 4.21.) Accordingly, if the approved rate increase results in a level of charges for to O'Fallon that would result in a transfer of O'Fallon's service to the Competitive Service Tariff, the revenue effect of that transfer should be reflected in determining the level of revenue at proposed rates for the SPSPSB District. (IAWC Ex. 4.20 (Grubb Sur.), p. 12.)

## **7. Fire Protection Charges**

As discussed above, the Company proposed an across-the-board rate increase, and the Company has no concerns with fire protection changes under its across-the-board proposal. If the Commission adopts Staff's COSS, however, the Company is concerned about significant changes in public and private fire protection rates in certain districts. As explained by Mr. Herbert, the following changes in fire protection rates were not considered acceptable, particularly in light of the percentage rate increases to other classes of service for the applicable Districts (IAWC Ex. 11.10 (Herbert Reb.), pp. 1-5):

- For the Champaign District, a decrease to public fire revenues of almost 30%, where other classes are receiving increases in the 50% to 70% range.
- For the Sterling District, the decrease to public fire revenues of almost 36%, where other classes are receiving increases in the 35% to 50% range.
- For the Pekin District, the decrease to private fire revenues of about 20%, where other classes are receiving increases in the 14% to 27% range.
- For the Southern service district, the decrease to public and private fire revenues of 5.6% and 36.8%, where other classes are receiving increases in the 15% to 32% range.
- For the South Beloit service district, an increase to public fire revenues of 290.1%.

As Mr. Herbert further explained, although Staff's COSS would support the referenced increases or decreases in public and private fire protection rates, it would be more appropriate, if Staff's COSS is adopted, to leave fire protection rates at present rates. (IAWC EX. 11.10

(Herbert Reb.), pp. 1-4.) This would mitigate the impact of the rate increases in the various districts. (IACW Ex. 11.20 (Herbert Sur.), p. 6.) For South Beloit in particular, the public fire protection charge is high at 290%, which raises concerns about rate impact. For South Beloit, the Company recommended, if the Staff COSS is adopted, a more gradual approach to public fire rates with no more than a 100% increase. (IAWC Ex. 11.10 (Herbert Reb.), p. 5.)

Staff asserts that it is bound by the provisions of the Section 9-223 of the Act, 220 ILCS 5/9-223, which requires that fire protection charges reflect the costs associated with providing fire protection service. (See ICC Staff Ex. 16.0, p. 3.) While it is correct that Section 9-223 requires that fire protection charges be “sufficient to cover a reasonable portion of the cost of providing the capacity, facilities and the water necessary to meet the fire protection needs of any municipality or public fire protection district” (emphasis added), the cost of providing fire protection service is not the sole consideration for the Commission. The Commission has in the past declined to adopt fire protection charges based strictly on cost of service where there were concerns about the ratepayer impacts of the fire protection charges. Citizens Utilities Co. of Ill., Docket 94-0481 (Sept. 13, 1995). Thus, it is appropriate to set fire protection charges at a level which, while considering on cost of service, also will mitigate ratepayer impacts. As a result, if the Commission adopts Staff’s COSS, the Company’s proposals to leave fire protection rates at present rates to mitigate the impact of rate increases, and to limit the fire protection charge increase in South Beloit to 100%, are reasonable.

## **8. Other**

### **a. Tariff Harmonization**

Staff witness Luth recommended that the Commission order the Company to create “streamlined uniform tariffs,” and file the new tariffs by September 30, 2009. (ICC Staff Ex. 7.0, p. 18.) As Mr. Grubb explained, the Company acknowledges that there is a lack of consistency

in the tariff language for each of IAWC's service districts. (IAWC Ex. 4.10 (Grubb Reb.), p. 25.) This is due to mergers and acquisitions that took place over the years. (Id.) Mr. Grubb explained that, in Docket 05-0681, the Company agreed to revise and amend its rules, regulations and conditions of service to achieve consistency across service districts. This effort is presently underway. As Mr. Grubb further explained, the Company agrees, in principle, that a "streamlining" effort may be warranted, and understands Mr. Luth's proposal to be directed at achieving standardization in the text of schedules of rates and charges tariffs where applicable, including ILL. C.C. numbering. (Id., p. 26.) The Company further understands that this process would not involve changes to rules, regulations and condition of service tariffs, which are being addressed in accordance with the Docket 05-0681 Order. (Id.) The Company does not oppose Mr. Luth's proposal to have a first complete version of its revised tariffs for Staff's review by April 30, 2009. (IAWC Ex. 4.20 (Grubb Sur.), p. 8.) As Mr. Grubb explained, however, the Company remains concerned about allowing Staff sufficient time to complete its review. (Id.) Therefore, the Company proposes that, as an alternative, it will provide a first complete version of its revised tariffs for Staff's review by April 30, 2009, and will agree to file the final version of the revised tariffs within 90 days after Staff completes its review. (Id.)

## **VI. CONCLUSION**

For the reasons set forth above, the Company requests the Commission approve the rate increases for each of the Rate Areas as set forth in IAWC Exhibit 6.21 (Second Revised), spreading the increase across the board as proposed by the Company.

April 22, 2008

Respectfully submitted,

ILLINOIS-AMERICAN WATER  
COMPANY

By: /s/ Albert D. Sturtevant

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