

**STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION**

ILLINOIS-AMERICAN WATER COMPANY	§	
	§	DOCKET NO. 07-0507
PROPOSED GENERAL INCREASE	§	
IN WATER AND SEWER RATES	§	

**INITIAL HEARINGS BRIEF OF THE
CITIES OF CHAMPAIGN AND URBANA, AND
THE VILLAGES OF HOMER GLEN, ORLAND HILLS,
ST. JOSEPH AND SAVOY**

This initial hearings brief is filed on behalf of the Cities of Champaign and Urbana and the Villages of St. Joseph and Savoy in the Champaign District and the Villages of Homer Glen and Orland Hills in the Chicago Metro District (Municipalities).

I. Background

Illinois-American Water Company (IAW or Company) filed this rate case seeking increases in rates that vary by district. For the Champaign District, the requested increase is 59.83 per cent over existing rates and for the Chicago Metro District, the requested increase is 5.80 per cent over existing rates. While the rate increase for the Chicago Metro District may not appear on a percentage basis to be high, the Illinois Commerce Commission (ICC or Commission) needs to examine not only the current request but the cumulative effect and the comparison of the rates to what municipal utilities are charging in the area. Homer Glen Ex. 1.0 at 4/85-5/98.

The Champaign District municipalities filed testimony by Craig Rost and Mark Dixon. The testimony opposed IAW's proposal to shorten the recovery period to one year from 10 years under the company's line extension policy. Illinois Commerce Commission (ICC) Staff witness

Thomas Smith agreed that IAW's proposed change in the extension policy should be rejected. After Champaign's and the ICC Staff's testimonies were filed, IAW withdrew its request, so that issue is no longer contested.

The Chicago Metro municipalities through Homer Glen filed testimony of Jim Daley and Mary Niemiec (HG Exhibit 1.0) concerning the comparison of IAW's rates to the rates charged by surrounding municipal water systems.

All the Municipalities in this Initial Hearings Brief:

- Support the Illinois Industrial Water Consumers (IIWC) request that the Company's depreciation rates be adjusted to reflect a change in net salvage value.
- Support the IIWC, the ICC Staff and the Illinois Attorney General (AG) that the Commission reject IAW's request to include incentive compensation expenses in rates.
- Support the AG's request for an adjustment of \$977,000 to the Chicago Metro District's net operating expense to partially offset IAW's high rates in comparison to the rates of surrounding communities. AG Exhibit 1.0 at Schedule C-4.
- Request that an independent analysis be conducted for the Champaign District to determine if the rates in that district, when compared with municipally-owned utilities, should also receive an adjustment similar to the Chicago Metro District's operations and maintenance adjustment to bring it in line with municipally-owned utilities as recommended by the Attorney General.

As required by the Administrative Law Judges' (ALJs') order, the number of this brief will follow the mandatory outline. As a result, not all numbers appear in this Brief.

II. Rate Base.

C. Contested issues.

1. Impact of depreciation expense.

The issue of depreciation expenses is discussed in section III. C. 3. below. The result of implementing the recommendation as set out in Depreciation Expense is to reduce the Company's depreciation expense by approximately \$5.792 million. IWC Ex. 2.0 at 16/353.

III. Operating Revenues and Expenses

C. Contested Issues.

3. Depreciation Expenses.

In this Docket, IAW seeks \$8.153 million in net salvage value as part of its depreciation expense. James Collins for the Illinois Industrial Water Consumers found this amount to be more than "6.5 times larger than Illinois-American's actual expense adjusted for inflation." IWC Ex. 2.0 at 2/31-32. He recommended that, at a minimum, the Commission use an average of the net-salvage ratios adopted by other American-Water affiliates. This would make the net salvage value component of the depreciation rates \$3.317 million. "This is 2.5 times greater than Illinois-American's actual net salvage expense, adjusted for inflation." IICW Ex. 2.0 at 2/44-45. The Municipalities concur with IWC's recommendation.

As Mr. Collins explained in his testimony, he took no exception with the proposed life characteristics that IAW has utilized in development of water plant depreciation rates. Instead, he focused on the net salvage ratios. *Id.* at 5/103-105. "[N]et salvage is simply the value received from the sale or reuse of retired property (salvage value), less the cost of retiring such property (cost of removal) at the end of its useful life. Net salvage can either be positive or

negative.” *Id.* at 4/82-86. For IAW, negative net salvage “is a significant component of its proposed depreciation rates and expense.” *Id.* at 4/87-89.

The result of the Company’s treatment of net salvage expense

is that it unnecessarily raises rates for today’s ratepayers and produces intergenerational inequities. These inequities result from shifting cost burdens to today’s ratepayers from future ratepayers. This shift in cost burden occurs because the net salvage component of depreciation expense that Illinois-American has included in its proposed depreciation rates includes an estimate of future inflation. As a result, Illinois-American is asking current ratepayers to pay the costs associated with estimates of future inflation in their proposed depreciation rates.

Id. at 8/163-170.

Mr. Collins used a cash accounting approach to compare the level of net salvage expense the Company actually incurs to the level of net salvage expense that the Company is requesting in its proposed depreciation rates. IWC Ex. 5.0 at 2/36-39. He found there was a significant difference between the rates. His recommendation is for the Commission to utilize an average of recent net salvage ratios of other American Water affiliates.

Illinois-American’s proposed net salvage ratios are excessive when compared to the net salvage ratios used by other American-Water affiliates to develop commission approved depreciation rates. Because of this comparison, the Commission must ask itself—why are the net salvage ratios of the America-Water affiliates so much lower than those proposed by the Company? A comparison of the net salvage ratios seems to indicate that the American-Water affiliates are more cost efficient since they are able to retire similar plant assets at significantly lower net salvage costs than Illinois-American.

IWC Ex. 5.0 at 3/52-59.

The Municipalities agree with IWC and request that the Commission adopt this modification.

5. Incentive Compensation.

IAW sought \$1,631,000 in rates for incentive compensation statewide. This breaks down to \$211,054 (water) and \$67,701 (sewer) for the Chicago Metro District and \$302,406 for the Champaign District. ICC Staff Ex. 13.0, Schedule 13.1 CMW, 13.1 CMS and 13.1 C.

ICC Staff witness Bonita Pearce recommended that the Commission deny IAW's incentive compensation request. She found that the benefit for the incentive compensation plan went to shareholders, not rate payers, since it is linked to the financial performance of IAWC. ICC Staff Ex. 3.0 at 4/76-85. She said she was

very concerned that in the future, the goals of the Plans may not be met and thus the Company would incur no cost . . . There is no mechanism to protect ratepayers if American and IAWC do not achieve their financial targets (or any other established goals, for that matter) because the cost of the plans would be included in rates, regardless of whether future performance goals are met. After rates are set, ratepayers would pay the cost of incentive compensation whether or not American and/or IAWC incur it.

ICC Staff Ex. 3.0 at 7-164-8/173.

IAW witness Edward Grubb attempted to support the incentive compensation program by arguing that it gives incentives for employees to do such things as “ensure that 775 key valves are operated and inspected by year-end” and “ensure that 3,892 hydrants are inspected by year end.” IAW Ex. 4.10 at 6/125-130. Inspecting critical valves yearly and inspecting fire hydrants yearly are not items that should require the Company to provide incentive compensation in order to accomplish these tasks. These annual inspections are required by the ICC's own rules and regulations. Moreover, these are but two of the very items for which IAW was cited for violating in Docket Nos. 05-0681, 06-0094 and 06-0095 (Cons.) (three complaint cases brought

by an individual, the AG and Homer Glen) (Complaint Case). As the Commission noted in the Complaint Case:

As Homer Glen and the AG have stated, public fire protection is one of the most important functions of a public water supply system. It is imperative that this service be operational and well maintained in all service areas. We are particularly concerned about reports in the record that inoperable hydrants impeded fire suppression efforts on two occasions.

Final Order in Docket Nos. 05-0618, 06-0094 and 06-0095 at 20.

In fact, the Commission's Order in the Complaint Case stated:

We order IAWC to complete hydrant testing, valve testing and fire flow tests or the substitute ISO test described above and maintenance inspection for all of the Chicago Metro and Champaign areas within one year of the final order in this case. . .

We order IAWC to complete a valve testing and maintenance inspection for all valves in the Chicago Metro and Champaign service areas within one year.

Id.

So even after being ordered to do so by this Commission, IAW is telling the ICC today that the Company has to pay incentive compensation to its employees to perform these mandated functions since some of the incentive compensation goals "mirror the statutory requirements" set by this Commission. Tr. at 72.

Even more startling is the admission by the Company in cross examination that during the period that the Company was not following ICC rules and regulations, the Company nonetheless was awarding incentive compensation to its employees who were not ensuring that critical valves or safety related fire hydrant inspections were carried out annually as required by ICC regulation and common safety practices. Tr. at 77.

The Municipalities agree with the ICC Staff that IAW should not be able to recover incentive compensation costs from ratepayers.

7. Chicago Metro District operations and maintenance expenses.

The Commission also found in the Complaint Case that none of the factors cited by IAW as to why its rates were higher than those of surrounding municipal-owned utilities “would seem to account for the magnitude of the difference in rates.” Order at 45. The Commission also found that the “rates charged by IAWC in the Chicago Metro service may not be just and reasonable because they are disproportionately high relative to the rates charged in other nearby communities.” *Id.*

In this Docket, IAW filed testimony that failed to explain why its rates are significantly higher than municipal utility rates. IAW’s president Karla Teasley stated, “the cost structures and rate-making practices of municipally-owned entities in the vicinity of the Chicago Metro District differ significantly from those of IAWC.” IAWC Ex. 1.0 at 13/287-289. In other words, municipally-owned utilities will have lower rates than IAWC because IAWC’s costs are higher.

The fact that IAW cannot get its costs and rates in line with municipally-owned water utilities in the area was verified by the analysis conducted by AG witness Eric P. Rothstein. He testified that the “disparity in charges between municipally owned systems and investor owned systems raises the question of whether the costs and rates of the investor owned system are reasonable.” AG Ex. 2.0 at 7/129-131.

While IAW argues that being part of a large corporation gives it efficiencies that can lower costs, Mr. Rothstein did not find that to be the case. Instead, his analysis of IAW’s “adjusted operating expenses compared to selected regional utilities suggests that Chicago Metro’s expenses (excluding purchased water and maintenance expenses) are generally higher than those of selected municipalities in the Chicago region—again suggesting that the promise of private sector efficiencies has not been realized.” AG Ex. 2.0 at 22/537-541.

IAW's purported efficiencies also fail when the Company's performance is compared with water utility benchmarks compiled by the American Water Works Association (AWWA). The benchmark used information collected from 193 water and wastewater systems throughout the United States representing a wide range of physical systems and geographic areas. AG Ex. 15/343-348. As a result of the comparison between IAW and the benchmark, Mr. Rothstein found:

- The Chicago Metro District adjusted (or net) operations and maintenance expenses (O & M) do not indicate strong efficiencies. The cost per account is significantly higher than the threshold cost reported for the top quartile (\$240.21) or \$266 (including an adjusted maintenance expense) versus \$208.
- The median benchmark found in the study for O & M costs for water-only utilities is \$1,360 per MG processed; the Chicago Metro District net O & M is \$1,990, or 46.3 per cent higher (or including adjusted maintenance \$2,209 or 62.4 per cent higher).
- The Chicago Metro District bill for 7,500 gallons of water, excluding purchased water, is \$38.11 at current rates. This is 58 per cent to 61 per cent higher than the median AWWA benchmarked utilities' monthly bill.

AG Exhibit 2.0 at 18/409-19/432.

Whether IAW can get its rates in line with surrounding municipalities is vital to the communities in which IAW provides service. As Jim Daley, the mayor of Homer Glen, and Mary Niemiec, one of Homer Glen's village trustees, testified: "As public officials for Homer Glen, we know the residents of our community compare their water rates to those of surrounding communities." Homer Glen Exhibit 1.0 at 5/105-106. When IAW's water rates are out of line,

as they are now and will be even more if the rate increase is approved, “Homer Glen will be at a disadvantage in attracting residents and development into our community,” noted Mayor Daley and Trustee Niemiec.

AG witness Mr. Rothstein calculated that the O & M expense for the Chicago Metro District needs to be reduced by \$2.05 million to reach the benchmark O & M per account cost of \$225. AG Ex. 2.0 at 24/589. This adjustment is reflected in the recommendation of AG witness David Effron, AG Ex. 1.1 at Schedule C-4. This adjustment should be adopted for the Chicago Metro water O & M.

In light of the evidence that IAW’s cost structure and rates are in excess of the costs and charges of municipally-owned water utilities in the Chicago Metro District, it would be appropriate for the Commission to require IAW to provide the Commission with an independent analysis of IAW’s rates in the Champaign District in comparison to what municipal systems charge their customers so that the Champaign District’s rates can be appropriately adjusted to bring them in line with other communities.

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CERTIFICATE OF SERVICE

I, Richard C. Balough, hereby certify that a copy of the foregoing Initial Hearings Brief of the Municipalities was served upon all parties on the ICC eDocket Service List by electronic means on this 22nd day of April 2008.

_____/rcb/_____
Richard C. Balough