STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

ILLINOIS-AMERICAN WATER COMPANY	)	
	)	Docket No. 07-0507
Proposed general increase in water and sewer rates.	)	

REPLY BRIEF OF ILLINOIS-AMERICAN WATER COMPANY

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I. INTRODUCTION

This Reply Brief of Illinois-American Water Company ("IAWC" or "Company") responds to the Initial Briefs of: (1) the Staff ("Staff") of the Illinois Commerce Commission ("Commission"); (2) the People of the State of Illinois, by the Attorney General of the State of Illinois ("AG"); (3) the Citizens Utility Board ("CUB"); (4) the Illinois Industrial Water Consumers ("IIWC"); Fosterburg Water District; Jersey County Rural Water Co., Inc.; and Bond Madison Water Company (collectively, the "Large Water Consumers" or "LWC")[1]; (5) the City of Champaign, 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 (collectively, the "Municipalities"); and (6) the Village of Bolingbrook.[2] For ease of reference between this Reply Brief and the Company's Initial Brief, the Reply Brief utilizes the same section numbering and captions as are used in the Initial Brief.

As in IAWC's Initial Brief, IAWC refers in this Reply Brief to its service districts, grouped into seven rate areas (each a "Rate Area"), as follows: (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.

Staff's Initial Brief contains an appendix ("Staff Appendix") showing Staff's proposed operating income statement and rate base for each Rate Area. IAWC has prepared an appendix

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[1] Because IIWC has filed a joint Initial Brief with the other members of the LWC group, references in this Reply Brief to positions taken by LWC or IIWC apply to all LWC parties.

[2] The Village of Bolingbrook filed an Initial Brief on April 23, 2008. The Village of Bolingbrook's Initial Brief adopts the Initial Brief of the Municipalities in its entirety and Section III.C.6 of the AG's Initial Brief, and does not otherwise present substantive argument. Where IAWC's Reply Brief responds to the Municipalities' Initial Brief and Section III.C.6 of the AG's Initial Brief, it also responds to the Village of Bolingbrook's Initial Brief.

("Appendix A") to this Reply Brief that sets forth IAWC's position with respect to the operating income and rate base for each Rate Area and for the Total Company, showing the necessary adjustments to the operating income statement and rate base shown in the Staff Appendix. Appendix A, Schedule 1 shows the Company's Statement of Operating Income with adjustments (from Staff Pro Forma Present as shown on the Staff Appendix). Appendix A, Schedule 2 shows adjustments to Staff's proposed operating income statement for each item where the Company either opposes a Staff adjustment or proposes a change to Staff's position, to arrive at the Company's position at present and proposed rates. Appendix A, Schedule 3 shows the Company's rate base for each Rate Area and Total Company. Appendix A, Schedule 4 shows adjustments to Staff's proposed rate base. For each adjustment shown, Appendix A references the relevant Schedule of Appendix A or portion of the Company's briefs that addresses the adjustment. Appendix A, Schedules 5 through 7, shows the calculations supporting the Interest Synchronization Adjustment, Cash Working Capital Adjustment and Competitive Tariff Adjustment, respectively.[3]

II. RATE BASE

A. Introduction

The proposed Total Company rate base is $532,541,528, as shown on Appendix A, Schedule 3 (Total Company). Rate base for each of the Rate Areas individually is shown on the respective designated sheet of Appendix A, Schedule 3.

[3] Concurrently with this Reply Brief, IAWC is also filing a Draft Order. Appendix A to this Reply Brief is identical to Appendix A referenced in the Draft Order.

B. Resolved Issues

1. Original Cost Determination

As discussed in Staff's Initial Brief (p. 6), Staff witness Jones recommended that the Commission find that the Company's June 30, 2007 plant balance reflected on Company Schedule B-5 First Revised be approved for purposes of an original cost determination, subject to any adjustments ordered by the Commission in this proceeding. (ICC Staff Ex. 1.0, pp. 9-10.) Company witness Grubb indicated that the Company accepts Ms. Jones' recommendation. (IAWC Ex. 4.10 (Grubb Reb.), p. 25.)

C. Contested Issues

1. Impact of Depreciation Expense

The LWC proposes an adjustment to reduce test year depreciation expense by $5.792 million. (LWC Init. Br., p. 10; IIWC Ex. 2.0, p. 2.) Such an adjustment would also require an adjustment to the rate base component for accumulated deferred depreciation. The Company and Staff have demonstrated that such an adjustment is unwarranted. (IAWC Init. Br., pp. 26-35; Staff Init. Br., pp. 28-31). LWC'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 the accumulated balance of deferred depreciation, which is 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 Costs

In its Initial Brief, Staff 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, including certain rate base adjustments related to the deferred tank painting charges. (Staff Init. Br., pp. 17-21; Staff Exs. 12.0-C, p. 2; Sched. 12.1

(Corrected)). The Company discussed this issue in its Initial Brief (pp. 35-38), and responds to the discussion in Staff's Initial Brief in Section III.C.4 of this Reply Brief. As discussed below, Staff's proposed tank painting expense adjustment should be rejected, and therefore Staff's rate base adjustment for deferred tank painting costs should be eliminated as shown in Appendix A, Schedules 3 & 4.

3. Other

[IAWC is not addressing any "Other" issues with respect to rate base in this Reply Brief.]

4. Recommended Rate Base

The proposed Total Company rate base is $532,541,528, as shown on Appendix A, Schedule 3 (Total Company). Rate base for each of the Rate Areas individually is shown on the respective designated sheet of Appendix A, Schedule 3.

III. OPERATING REVENUES AND EXPENSES

A. Introduction

The Company's proposed operating income statement for the Total Company is shown on Appendix A, Schedule 1. The operating income statement for each Rate Area is shown on the respective designated sheet of Appendix A, Schedule 1.

B. Resolved Issues

1. State Deferred Tax Expense

As Staff stated in its Initial Brief (p. 26), AG witness Effron proposed an adjustment to use the Company's unitary tax rate to calculate deferred state income tax expense. (See AG Ex. 1.0, pp. 21-22.) Mr. Effron stated that the Company had used the statutory state income tax rate of 7.30% to calculate its deferred state income tax expense, but should have calculated this expense with the same rate that was used in calculating its current state income tax expense, i.e., the Company's unitary state income tax rate of 4.27%. (Id.) Staff found Mr. Effron's

adjustment appropriate, and the adjustment was accepted by the Company. (IAWC Ex. 4.10 (Grubb Reb.), p. 20.)

C. Contested Issues

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

Response to AG

In its discussion of sale for resale revenue, the AG asserts that IAWC has "predicted" less sale for resale revenues in the SPSPSB, Champaign and Chicago Metro – Water Districts, by "relying on old data or averaging data that ignores well established trends." (AG Init. Br., p. 6.) AG further asserts that IAWC has mismatched test year revenues and test year expenses. (Id.) These assertions, however, disregard the basis for the Company's test year sale for resale revenue projection. The discussion below first addresses certain matters related to the revenue projections for all three rate areas involved, and then discusses in separate sections certain matters specific to each respective Rate Area.

As IAWC explained in its Initial Brief (p. 20), the Company's initial projections of sale for resale revenues for the SPSPSB, Champaign and the Chicago Metro District-Water Rate Areas were based on the historical average water usage per customer in each Rate Area for a four year period (from 2001 to 2004). Based on the historical per customer usage data, for each Rate Area, in projecting sale for resale customer usage for the test year, IAWC adjusted the average data to reflect an expected decline in usage per customer. (IAWC Ex. 20.00, Scheds. G-2, G-5, p. 1; IAWC Ex. 4.20 (Grubb Sur.), p. 15; Tr. 107.) To project test year revenue at present rates, the current rates were applied to test year usage developed in accordance with this methodology. (Tr. 113.) This projection methodology was developed in accordance with the guidelines for presentation of projected information set forth in the "Guide for Prospective Financial

Information (2006)" ("AICPA Guide"), issued by the American Institute of Certified Public Accountants. (See IAWC Ex. 20.00, Scheds. G-2, G-5, p. 1.) By contrast, the AG does not demonstrate that Mr. Effron's single year projection method discussed in AG's Initial Brief meets the requirements of the AICPA Guide.

As Mr. Grubb explained, the methodology used to develop the initial sale for resale revenue projection for the SPSPSB and Chicago Metro District-Water Rate Areas is appropriate and does not require adjustment. (IAWC Exs. 4.20 (Grubb Sur.), pp. 13-15; 4.12.) As discussed below, the multi-year projection methodology used to develop the sale for resale revenue projections for SPSPSB and Chicago Metro District-Water is a more reasonable approach than the approach used for these Rate Areas by AG witness Effron, who relies on revenue data from a single time period, the year ended June 2007, as the test year level of sale for resale revenue (thereby disregarding the historical decline in per customer usage).

As discussed in IAWC's Initial Brief (pp. 23-24), the Company determined after a review of Mr. Effron's position that an alternate projection methodology for sale for resale revenues in the Champaign District was warranted. (IAWC Exs. 4.10 (Grubb Reb.), p. 13; 4.12.) The adjustment was deemed appropriate due to the addition of a sale for resale customer in Champaign, which would alter the usage per customer. (Tr. 107-09.) Using an average of revenues for the last three years, the Company proposed an adjusted level of sale for resale revenues for the Champaign District of $568,000. As also explained in IAWC's Initial Brief (p. 24), Mr. Effron's proposal for the Champaign District relies again on a single data point, using the actual year ended June 2007 revenues of $684,000 as the basis for his adjustment. This approach should be rejected, because, as discussed below, certain months during that one-year period were also hotter and drier than normal in the Champaign District. (Tr. 108-09.)

AG's assertion that IAWC's approach creates a "mismatch" is incorrect. IAWC's use of averaged per customer usage data in developing the revenue projections is appropriate to account for fluctuations in usage that can affect single year data of the type used by Mr. Effron (due to factors such as weather). The sale for resale revenue projections for SPSPSB and Chicago Metro District - Water and the alternative method used for the Champaign District rely on average data for multi-year periods. Many factors affect usage (and therefore revenue), including weather, and an appropriate projection method recognizes such factors and accounts for the fact that they vary and can have an abnormal impact on data for a given year. (Tr. 107; IAWC Ex. 4.20 (Grubb Sur.), pp. 13-14.) Thus, historical averaged data are more likely to be representative because the average smooths out the variations in usage. (IAWC Ex. 4.20 (Grubb Sur.), pp. 13.) Mr. Effron's proposed revenue level for each Rate Area, on the other hand, relies on revenue data for a single year ended June 30, 2007, and thus does not account for the abnormal weather that occurred that year. Likewise, for SPSPSB and Chicago Metro - Water, the Company's method takes into account the annual decline in usage shown by the multi-year data, while Mr. Effron's method does not.

The AG asserts that the Company is arguing inconsistently that increasing trends in sale for resale revenue will not continue (apparently referring to the fact that sale for resale revenues increased in the SPSPSB and Champaign Rate Areas for the twelve month period ended June 2007), but that declining trends in usage will continue (apparently referring to the annual decline in usage in Chicago Metro District-Water). (AG Init. Br., pp. 7-8, 10.) This assertion is not correct. As discussed above, the projected decline in usage per customer for the test year is supported by data for the historical period examined. The decline in projected sale for resale usage from the year ended June 2007 to the test year in Chicago Metro District-Water (and

SPSPSB) is consistent with this projection of an overall decline in usage per customer. (IAWC Ex. 4.20 (Grubb Sur.), p. 15.) As stated in IAWC's Initial Brief (p. 22), in light of the declining usage, 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 for the test year. Further, the year-ended June 2007 sale for resale revenue, as a single data point, does not constitute a "trend."

Moreover, as Mr. Grubb explained, Mr. Effron's one year period included 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 District, thus causing increased water usage per customer during that time period (and therefore increased usage and revenues). (IAWC Ex. 4.20 (Grubb Sur.), p. 13.) Similarly, hotter weather in Champaign also caused revenues to increase for the year ended June 2007. (Tr. 107-09.) Thus, the hotter and drier weather during the year ended June 2007, rather than being a "trend," is an anomalous event. Use of revenue for the year ended June 2007, therefore, as the basis for the test year sale for resale revenues projection in SPSPSB and Champaign is unreasonable because it reflects an unusual level of water use and would result in an overstatement of the projected level of revenue. (Id., IAWC Ex. 4.10 (Grubb Reb.), pp. 11-12.)

The AG asserts (AG Init. Br., p. 9) that the Company's position regarding hotter and drier weather in the year ended June 2007 for the SPSPSB and Champaign Rate Areas is not supported by sufficient evidence. This, however, is not the case. Mr. Grubb testified that for the year ended June 2007, the months July through September 2006 and the months May and June 2007 were hotter and drier than the than average in the SPSPSB District, and that revenues increased in Champaign due to hotter weather. (IAWC Ex. 4.20 (Grubb Sur.), pp. 13, 16; Tr.

108-09.) No party, however, conducted cross-examination regarding this portion of Mr. Grubb's testimony or submitted rebuttal evidence showing that Mr. Grubb's testimony concerning the weather in the months July through September 2006 and May and June 2007 is inaccurate. Thus, there is no basis for the AG's assertions.

The AG also asserts (AG Init. Br., p. 10) that IAWC witness Paul Herbert's testimony that, "[t]he degree of weather, how hot it is, doesn't necessarily equate directly to the amount of water used" is inconsistent with IAWC's position regarding sale for resale revenues. But there is no inconsistency between the testimonies of Mr. Grubb and Mr. Herbert. Mr. Herbert stated that weather "doesn't <u>necessarily equate directly</u> to the amount of water used." (Tr. 185 (Emphasis added).) IAWC never asserted that weather is the only factor that affects water usage and/or revenue. As discussed above, Mr. Grubb testified that there are a variety of factors that affect water usage, including customer growth, usage per customer, demographic changes or changes in the plumbing code. (Tr. 106-07.) Moreover, the AG's assertion ignores the context of Mr. Herbert's statement, which related to a line of questioning regarding water use by industrial customers, whose usage patterns tend not to vary with weather. (Tr. 172-73.) Thus, Mr. Grubb's testimony supports the view that abnormal weather conditions can affect usage data and revenue for a given year, and that, as a result, a projection of usage and revenue data should be based on historical usage data for more than just one year. Mr. Herbert's testimony does not call this position into question.

a. SPSPSB Sale For Resale Water Revenue

With specific reference to SPSPSB sale for resale water revenue, the AG asserts that the Company has failed to take into account an increasing trend in sale for resale revenue. (AG Init. Br., pp. 9-10.) As Mr. Grubb explained, however, the "trend" that the AG refers to relates only to data for the twelve month period ended June 2007, which was impacted by unusually hot

weather and does not constitute a "trend." As Mr. Grubb further explained, the Company is projecting a decline in sale for resale volumes for the SPSPSB District from the year ended June 30, 2007 for 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.) As also 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 revenue projection of $9,781,000. (IAWC Ex. 4.20 (Grubb Sur.), p. 14.) Thus, the test year projection of SPSPSB sale for resale revenue is reasonable, and Mr. Effron's proposed adjustment should be rejected.

b. Chicago Metro District-Water Sale for Resale Revenue

As IAWC explained in its Initial Brief, the test year level of revenues, with purchased water cost removed, for 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. 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.) The AG's Brief (p. 11) asserts that IAWC has taken the position that Mr. Effron's adjustment should be rejected "despite the fact that the numbers are close." This is not the case –Mr. Effron's adjustment is unnecessary because the numbers are comparable. The fact that Mr. Effron develops a slightly different number using his one-year projection approach does not support rejection of the projection developed by the Company based on average per customer usage data for more than one time period, as described above.

c. Champaign District Water Sale for Resale Revenues

With respect to sale for resale revenue in the Champaign District, the AG offers similar assertions to those it raises for the SPSPSB District; namely that the Company is minimizing the effect of an increasing revenue trend in Champaign and has not produced evidence to support its claim of hotter and drier weather in the year ended June 2007. (AG Init. Br., p. 13.) Both arguments fail for the reasons stated above.

The AG also asserts that "it is inconsistent for the Company to claim that growth is driving its decision to build a new plant [in the Champaign District], while simultaneously proposing decreasing test year revenues." The AG's assertions, however, demonstrate a fundamental misunderstanding of growth in Champaign. As IAWC's Schedule C-3 shows (consistent with the testimony of IAWC's witness Barry Suits regarding forecast demand growth in Champaign), IAWC is projecting increases in sales volume in the Champaign District both for the "Residential" customer classification and for "Total Water." The projections at issue here relate only to sale for resale revenue (i.e., wholesale water sales), not to residential water revenues or even overall water revenues. As discussed above, there are many factors that may affect total water usage, including customer growth and demographic changes. In addition, the projection at issue is for expected annual water sales, and not for the level of expected peak daily or hourly demand.

Response to Staff

With respect to sale for resale revenue, Staff asserts in its Initial Brief (p. 27) that, "the AG's stated reasons for making the adjustments were valid." The only reason Staff gives for this assertion, however, is that, even with surcharge revenues removed, "2007 historical revenues were larger than the test year revenues for three of the four districts affected by the AG's adjustments." (Id.) As discussed above, IAWC's sale for resale revenue projections for SPSPSB

and Chicago Metro – Water were developed using an historical average of usage per customer and in accordance with the AICPA Guide. The AG's proposed use of the sale for resale revenue for the year ended June 2007 relies on a single data point, which is from a period with unusually hot and dry weather in SPSPSB and Champaign. Thus, as discussed above in response to the AG, use of the Company's projections are appropriate, and Staff has offered no reason why they are not.

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

Response to AG

The AG asserts that IAWC's projection of "other" revenues "fails to accurately reflect the amount of Other Revenues regularly received by the Company." (AG Init. Br., p. 16.) As IAWC explained in its Initial Brief (pp. 24-25), however, the Company's projection of "other" revenues does accurately reflect the amount of "other" revenues received by the Company. 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 variety of factors, including changes in the number of customer activations, forfeited discounts, non-sufficient funds charges and reconnections charges. (IAWC Ex. 4.20 (Grubb Sur.), p. 17.) In his rebuttal testimony, Mr. Grubb further explained that, in light of proposals made by Mr. Effron, averaging more current information is appropriate. The Company therefore proposed a three-year average ended June 2007 for "other" revenues, which produces an adjusted 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 AG argues that IAWC offered no evidence "tending to show significant variations in the amount of other revenue." (AG Init. Br., p. 16) Mr. Grubb, however, explained the variable

nature of "other" revenues. (IAWC Ex. 4.20 (Grubb Sur.), p. 17.) This variability is reflected in the level of "other" revenues shown on Schedule C-3. For example, while the amount of "other" revenues increased in the SPSPSB District from the year ended June 2006 to the year ended June 2007 (IAWC Ex. 17.00, Sched. C-3, p. 2 of 8), the amount of "other" revenues in the Champaign District decreased in that same time period. (IAWC Ex. 17.00, Sched. C-3, p. 5 of 8.) No witness has testified that "other" revenues are not variable. Therefore, the variability of "other" revenues is shown by undisputed evidence.

The AG also asserts that Mr. Effron's proposal to use the "other" revenues for the year ended June 2007 is more appropriate because, the AG claims, it assumes no growth from the period ended June 2007. (AG Init. Br., p. 16.) As Mr. Grubb explained, however, "other" revenues are variable. (IAWC Ex. 4.20 (Grubb Sur.), p. 17.) Thus, assuming no change in "other" revenues from the year ended June 2007 to the test year is not appropriate. Rather, it is appropriate to project "other" revenues based on an average to account for the expected variability. (Id.)

The AG also questions why it is appropriate to use an historical average to project revenues for a test year beginning two years later. (AG Init. Br., p. 15.) The AG's concern in this regard, however, shows a misunderstanding of the process of developing the test year projections. The test year level of "other" revenues was developed based on historical information. This projection methodology was certified as in accordance with the AICPA Guide. (See IAWC Ex. 20.00, Scheds. G-5, p. 1, Sched. G-2.) The Company based its initial projection of "other" revenues for all districts on a five-year average of 2001 – 2005 (IAWC Ex. 4.10 (Grubb Reb.), p. 14), but revised its projection to incorporate more recent data by using a three-year average ended June 2007. (IAWC Exs. 4.10 (Grubb Reb.), p. 14; 4.12.) No witness

has challenged IAWC's projection methodology for "other" revenues. Thus, the Company's projection methodology for "other" revenues, made in accordance with the AICPA Guide, is appropriate.

Response to Staff

Staff suggests that AG's amount of "other" revenues is more reasonable than IAWC's test year projection because, according to Staff: (i) the adjustment proposed by IAWC on IAWC Exhibit 4.12 did not match the amounts for "other" revenues shown on Schedule C-23; and (ii) Mr. Grubb could not explain why $2.286 million of historical "other" revenues for 2006 was reported on Schedule C-23, but the amount of $1.594 million of "other" revenues for 2006 was reported in the Company's response to AG data request 6.7. (Staff Init. Br., pp. 27-28.) Both assertions are wrong. Mr. Grubb explained the difference between the historical "other" revenues for 2006 as reported on Schedule C-23 and the "other" revenue reported in the Company's response to AG data request 6.7. As Mr. Grubb indicates, the $1.594 million figure shown in AG data request 6.7 was for the Company's water Rate Areas, and did not reflect "other" revenues for sewer Rate Areas. (Tr. 129-30.) Likewise, IAWC Exhibit 4.12 makes clear that the adjustment to projected level of "other" revenue is only for those Rate Areas providing water service – there is no adjustment for "other" revenues for the Chicago Metro District – Sewer. (IAWC Ex. 4.12.) Schedule C-23, by contrast, includes "other" sewer revenues. Thus, there is no "discrepancy" between Schedule C-23, IAWC Exhibit 4.12 , and the Company's response to AG data request 6.7. Staff has therefore failed to establish a basis to adopt the AG's proposed level of "other" revenues.

3. Depreciation Expense

LWC argues that the net salvage ratios indicated by the Company's depreciation studies are excessive, thereby requiring the Commission to disregard these studies and to impose net

salvage ratios utilized by IAWC affiliates in Missouri, Kentucky and Indiana. LWC's arguments were addressed in the Company's Initial Brief (pp. 26-35).

Briefly stated, as explained in the Company's Initial Brief, LWC's argument that the Company's net salvage ratios create intergenerational inequities is incorrect. (IAWC Init. Br., pp. 29-35.) The nub of LWC's argument is that including estimates of future inflation in net salvage ratios benefits future customers at the expense of today's customers. LWC does not dispute, however, that while inflation levels will vary from year to year, over time such levels will fall within a general range. In fact, as Mr. Robinson explains, a 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.) Additionally, as explained in the Company's Initial Brief, with respect to LWC's concerns that the value of a dollar is worth less in the future than it is currently, 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 Init. Br., pp. 29-30.) Rate base, rate of return concepts and application have consistently been, with limited exception, based upon nominal dollars. (IAWC Ex. 9.20 (Robinson Sur.), p. 3.) IIWC's witness 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.

Although Mr. Collins would have the Commission disregard the Company's depreciation experience and use net salvage ratios of IAWC's affiliates, he has produced no analysis of the affiliate salvage ratios reviewed, and has produced no evidence that IAWC's depreciation experience bears any relation to the depreciation experience of affiliate companies in other jurisdictions. IIWC merely speculates that the affiliate companies "depreciate similar kinds of investments, and likely have similar operating characteristics" (LWC Init. Br., p. 9), with no citation to any record evidence to support these conclusions. As Staff recognizes, where, as here, in-depth information is available for IAWC's depreciation experience, such IAWC-specific information should be used to develop IAWC's depreciation rates. (ICC Staff Ex. 18.0, pp. 1-4.)

LWC has failed to demonstrate any impropriety in the Company's proposed depreciation rates. LWC has also failed to demonstrate any comparability between IAWC's proposed depreciation rates and the depreciation experience of IAWC's affiliates. LWC's proposal regarding net salvage ratios should therefore be rejected.

4. Tank Painting Expense

In its Initial Brief, the Company explained in detail the record evidence that supports recovery in rates of approximately $2.44 million in tank painting expenditures (IAWC Init. Br., pp. 35-38). Staff not only continues to ignore this evidence, but suggests that the Company's projected tank painting needs during the test year are irrelevant. The sole basis for Staff's proposed adjustment to reduce test year tank painting expense to approximately $1.38 million is that this amount represents "the Company's five year average of actual tank painting expense. . . ." (Staff Init. Br., p. 17.)

Staff goes on to cite numerous Commission orders where various types of expenses were normalized through use of a five year average of historical expenditures (see Staff Init. Br., p. 18), but Staff's mention of these orders misses the point. Averaging historical expenditures is

one of several ways to normalize expenses that fluctuate from year to year. The goal of normalization, however, is to develop a level of expense that is representative of expenses likely to be incurred in the test year, and not simply to develop a mathematical average of expenditures incurred in periods preceding the test year. Where, as here, the Company has demonstrated that Staff's calculation of five year average expenditures is not representative of expenditures that will be incurred in the test year, an alternative normalization method should be considered. The Company developed a detailed tank painting plan that provides a normalized level of tank painting expense, taking into considering factors such as the number of tanks to be painted, interior versus exterior painting and total surface area to be painted. (IAWC Init. Br., pp. 35-36.) As that analysis (IAWC Ex. 7.01) shows, the Company operates several types of structures that require painting. In total there are 200 structures, and for certain structures both interior and exterior surfaces must be painted. For interior surfaces, the average life of a coating of paint is twelve years and, for exterior surfaces, the average coating life is eight years. The number of surfaces that require painting each year varies by type of surface (interior or exterior) and by type of structure. (IAWC Ex. 7.01.) The Company's normalization methodology is a detailed study that takes all applicable factors into account. Staff's five year average method does not. Based on the evidence, there is no basis to believe that the five year historical average calculated by Staff is an appropriate level of tank painting cost for the test year. The Company's method or normalizing tank painting expense is representative of expected future conditions, while Staff's method is not.

The Company explained in testimony and in its Initial Brief why the historical year 2003 and 2005 cost data were not representative of future tank painting expenditures. (IAWC Init. Br., pp. 36-37.) Staff does not refute this evidence, but argues that "the inspection of structures in

order to review or develop a new tank painting plan is likely to reoccur as is another unexpected change in the level of tank painting." (Staff Init. Br., p. 19.) Staff, however, does not and cannot cite any record evidence to support either claim. Although Staff speculates that the Company may develop a new tank painting plan, the only tank painting plan described in the record is the Company's plan as reflected in IAWC Exhibit 7.01. Similarly, while Staff speculates that there may an "unexpected change" in the level of tank painting in the future (Staff Init. Br., p. 19), there is no evidence in the record which supports such a conclusion. To the contrary, the record supports the Company's position that the current tank painting plan (IAWC Ex. 7.01) is being followed. (IAWC Init. Br., p. 37.)

Staff's conclusion that a five-year average is representative of future spending on tank painting is not supported by the evidence. A five-year average of tank painting expense bears no relationship to either recent, actual expenditures or forecasted expenditures. The record shows that $1.9 million was spent on tank painting in calendar year 2006 and $2.3 million in calendar year 2007. (IAWC Init. Br., p. 37.) During the test year, the Company expects to spend $2.48 million. (Id., p. 38.) Allowing recovery in rates of only $1.38 million will not allow the Company to fully recover its demonstrated tank painting expense.

Staff also argues that the Company double-counted certain amounts in calculating tank painting expense. On review of Staff's position, the Company has determined that Staff is correct. While an adjustment for these calculation errors is warranted, the remainder of Staff's tank painting adjustment is not and should therefore be rejected. The difference between the level of test year tank painting cost proposal by Staff and the level proposal by the Company is shown as an adjustment in Appendix A, Schedules 1 & 3.

5. Incentive Compensation Expense

Response to Staff

Staff argues that IAWC's incentive compensation expense should be disallowed. (Staff Init. Br., pp. 32-39.) Staff's primary argument is that the Company's award of incentive compensation under its Annual Incentive Plan ("AIP") is based on an underlying goal that benefits shareholders, not ratepayers. (Id., p. 32.) As IAWC explained in its Initial Brief (pp. 38-44), however, the Commission 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). The Company has demonstrated that the AIP provides tangible ratepayer benefits. 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 Init. Br., pp. 38-44; IAWC Exs. 4.10 (Grubb Reb.), pp. 3-4; 4.20 (Grubb Sur.), pp. 4-6.)

Nevertheless, in its Initial Brief (p. 38), Staff asserts, without record support, that the Company failed to demonstrate any direct ratepayer benefits that result from the AIP. Staff's position, however, ignores the substantial evidence showing that the AIP provides ratepayer benefits. 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; see IAWC Init. Br., pp. 39-41.)

In rebuttal testimony, Mr. Grubb also explained that approximately 60% of the Company's proposed incentive plan expense is related to operational and individual goals that

have net ratepayer benefits. (IAWC Ex. 4.10 (Grubb Reb.), p. 3.) The Company therefore proposed, as an alternative, that if the Commission does not allow 100% recovery of incentive compensation expense, 60% of the incentive plan costs should be allowed. (Id., p. 9.) Staff asserts that Mr. Grubb offered no studies or analyses to support the reasonableness of the 60% proposal. (Staff Init. Br., p. 37.) As discussed above and in IAWC's Initial Brief, however, the Company demonstrated that the operational and individual components of the AIP, as well as the financial component, provide ratepayer benefits. Although Staff also asserts that Staff witness Pearce rejected Mr. Grubb's assertion that 60% of incentive compensation costs are operational or individual (Staff Init. Br., p. 37), this appears to mischaracterize Ms. Pearce's testimony. Ms. Pearce contended that the 60% alternative proposal was not reasonable, but acknowledged that "the operational and individual goals have the potential to benefit ratepayers." (ICC Staff Ex. 13.0, p. 8.) Nevertheless, IAWC provided support for the proposed 60% alternative level of incentive compensation expense. Mr. Grubb explained that under the AIP, compensation paid for the operational and individual components represents approximately 60% of the total incentive compensation. (IAWC Ex. 4.10 (Grubb Reb.), p. 9.) The AIP plan documents set forth the components of the incentive plan, including the operational and individual components. (Id., p. 3.) Staff has reviewed the AIP and its components (ICC Staff Ex. 3.0, p. 4), and Staff witness Pearce did not dispute that the Company's determination that the operational and individual components of the AIP represent 60% of incentive compensation expense. Nor does Staff argue that the operational and individual components do not provide ratepayer benefits. Thus, while IAWC has supported its position that 100% of incentive compensation expense should be recovered, recovery of 60% is a reasonable alternative if the Commission does not

allow IAWC to recover 100% of its incentive compensation expense (as the Company believes the record supports).

Staff's contention that IAWC should be "admonished" for seeking recovery of incentive compensation expense is unwarranted. As IAWC pointed out in its Initial Brief (p. 42), the Commission has 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; see also Aqua Illinois, Inc., Docket 04-0442, Final Order, pp. 14-22 (April 20, 2005). As discussed in IAWC's Initial Brief (pp. 39, 42), the Commission has recognized that, where related customer benefits are shown, incentive compensation cost should be allowed, and IAWC has offered evidence making that showing in this proceeding.

As IAWC explained in its Initial Brief (pp. 42-43), Staff 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.) (Staff asserts (Init. Br., p. 38) that Mr. Grubb raised the possibility that IAWC awards incentive compensation to provide the same level of service as is required by the Act. This point will be addressed below in response to the Municipalities discussion of this issue.) 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.) Thus, IAWC should be allowed to recover the projected level of incentive compensation expense.

Response to the AG

The AG's Initial Brief (pp. 16-22) advances many of the same arguments regarding incentive compensation as are offered by Staff. These arguments were addressed above. In fact, the AG acknowledges that its adjustment is "not based on the assumption that there are no benefits of the program" (AG Init. Br., p. 20), but rather that ratepayers do not benefit if payments are not made under the plan. As discussed above, however, ratepayers receive the benefits of the AIP, through employee efforts to achieve the AIP targets, regardless of whether the AIP "pays out."

The AG also raises several additional concerns about incentive compensation expense. The AG asserts that "there has been no evidence presented by the Company to demonstrate that there is a direct relationship between its earnings success and benefits to delivery services ratepayers." (AG Init. Br., p. 18.) While the Company's financial target is not an earnings target (see IAWC Ex. 4.10 (Grubb Reb.), p. 2), the Company has, as discussed above and in its Initial Brief (pp. 38-44), demonstrated a direct relationship between the AIP and ratepayer benefits. With regard to the financial component of the AIP, Mr. Grubb 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 because it 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 AG also argues (Init. Br., p. 19) that, because American Water has made payouts under the plan in each of the past five years (IAWC Ex. 4.20 (Grubb Sur.), pp. 3-4), IAWC is asking the Commission to recognize a trend in the award of incentive compensation by IAWC. This is not the case. IAWC's projection of incentive compensation expense was made not as an average of a "trend," but based on the methodology set forth in Schedule G-5 (p. 3). IAWC explains that American Water has consistently paid out incentive compensation in each of the past five years to support the conclusion that it is reasonable to project that American and IAWC will incur incentive compensation expense in the test year.

The AG also asserts that IAWC's incentive compensation payments were not "assuring service was reliable and efficient" during some unspecified time period. The AG points to no record evidence in this case regarding IAWC's service levels. Rather, the AG cites to Docket 05-0681/06-0094/06-0095 (cons.) ("Docket 05-0681") as its "evidence." The customer service concerns at issue in Docket 05-0681, however, relate primarily to events in 2005. See Docket 05-0681, Final Order, pp. 15, 22-25, 31-33. The AG offers no evidence showing a connection between the issues addressed in Docket 05-0681 and the terms of the present (or then existing) AIP. In fact, the evidence in this proceeding shows that, in the years 2006 and 2007, during which the inspection of all hydrants and key valves (both regulatory requirements at issue in Docket 05-0681) were specific goals of the AIP, all operating districts of IAWC met the applicable performance requirements. (AG Cross Exam. Exs. 5, 6.)

As will be discussed below, IAWC witnesses Karla Teasley and Fred Ruckman addressed the Docket 05-0681 proceeding, explaining that the Commission's Order in Docket 05-0681, issued April 18, 2007 ("Docket 05-0681 Order"), required IAWC to undertake a number of actions, including, *inter alia*, inspections and maintenance of values and hydrants.

Docket 05-0681 Order, p. 39. IAWC is complying with all requirements established by the Commission in the Docket 05-0681 Order, and has thus addressed the concerns raised in that case. No witness has testified that the payment of incentive compensation awards had a connection to concerns addressed in Docket 05-0681. Further, as will be discussed below, certain components of the current AIP relate to actions required for individual employees to maintain compliance with the requirements established by the Docket 05-0681 Order.

AG also asserts (Init. Br., p. 21) that, with respect to IAWC's proposed alternative to recover 60% of incentive compensation expense, IAWC's 60% split appears arbitrary. But there is nothing arbitrary about how the 60% was calculated. Mr. Grubb explained that, under the AIP, compensation paid out for the operational and individual components represents approximately 60% of the total compensation. (IAWC Ex. 4.10 (Grubb Reb.), p. 9.) Thus, the 60% split represents that portion of the AIP that relates to operational and individual goals. The AG's assertion that the 60% split is "arbitrary" is baseless.

Response to Municipalities

The Municipalities also oppose IAWC's recovery of incentive compensation expense. The Municipalities argue that the Company should not have to provide incentive compensation to accomplish tasks, such as inspecting key valves and hydrants, that are already regulatory requirements. (Munis. Init. Br., pp. 5-6.) As IAWC explained in its Initial Brief (pp. 42-43), however, incentive compensation is actually an important tool by which the Company can ensure that regulatory requirements are met. The AIP, in setting individual and operational goals for each individual employee, helps align the goals of each employee 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.) Company management develops 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 part of the approach used by management to focus each employee on specific actions and targets required for that employee to enable the Company to meet the objectives and requirements of the Company as a whole. (IAWC Ex. 4.20 (Grubb Sur.), p. 5.)

The effectiveness of incentive compensation as a tool to communicate regulatory requirements can be seen in the case of inspection of key valves. The Docket 05-0681 proceeding focused on concerns related to 2005 and earlier. Docket 05-0681, Final Order, pp. 15, 22-25, 31-33. The AIP did not include a performance goal to inspect and operate keys valves in 2004 and 2005. (AG Cross Exam. Ex. 5.) The specific goal to operate and inspect key valves was, however, included in the AIP program as a target for individual incentive compensation awards for the years 2006 and 2007. (Id.) All IAWC's operating districts achieved this performance goal for the years 2006 and 2007. (Id.) Thus, the inclusion of inspection of key valves as a performance target proved to be a useful tool for meeting regulatory requirements.

The Municipalities assert that IAWC witness Grubb admitted that IAWC was awarding incentive compensation to employees who were not ensuring that valve and hydrant inspections were being met. (Munis. Init. Br., p. 6.) This mischaracterizes Mr. Grubb's testimony. Mr. Grubb stated that he did not know specifically if incentive compensation payouts were made with respect to a goal of inspecting 775 key valves. (Tr. 77-78; see IAWC Ex. 4.10 (Grubb Reb.), p. 6.) Mr. Grubb did state that the goal to inspect key valves was set in 2006 and 2007. (Tr. 78) As discussed above, IAWC's operating districts achieved the performance goal to inspect key valves for the years 2006 and 2007. (AG Cross-Exam. Ex. 5.) Likewise, IAWC achieved its incentive plan goal for hydrant inspections in 2006 and 2007. (AG Cross-Exam. Ex.

6; Tr. 78-79.) Thus, the Municipalities concern regarding provision of incentive compensation in connection with meeting regulatory goals is unwarranted; in fact, the Municipalities' concerns illustrate the importance of using incentive compensation targets as a component of the employee compensation package.

6. Management Fees

In its Initial Brief (pp. 45-52), the Company demonstrated that its proposed test year level of management fees was reasonable, and that the AG's proposed adjustment to management fees should be rejected. Staff, in its Initial Brief, notes that Staff witness Kahle reviewed IAWC's management fee projection and determined that no adjustment was necessary. (Staff Init. Br., p. 39.) Staff recommended that the Commission approve IAWC's request for management fees. (Id.)

Response to AG

The AG asserts that $2.667 million of the Company's proposed level of management fees is "unexplained." (AG Init. Br., pp. 22-29.) In particular, the AG asserts that certain increases to IAWC's call center costs (AG Init. Br., pp. 25-26) and provision of "expanded services" (id., pp. 27-28) have not been supported. The AG, however, ignores the substantial and detailed evidence provided by IAWC in support of its test year level of management fee expense.

The discussion in AG's Initial Brief ignores the fact that IAWC's test year level of management fee expense was based on a detailed budgeting process. As Mr. Grubb explained, the Company's forecast for test year management fees was based on a detailed, item by item projection of the level of cost that the Service Company will incur in providing necessary services to IAWC during the test year. (IAWC Exs. 4.10 (Grubb Reb.), p. 19; 4.22.) As discussed in IAWC's Initial Brief (p. 45), the test year management fee projection was audited

and certified as complying with the AICPA Guide. (IAWC Ex. 4.00 (Grubb Dir.), p. 6.) The AG has not challenged the detailed projection of test year management fee expense.

With respect to Customer Service Center ("CSC") costs, the AG incorrectly asserts (AG Init. Br., p. 24) that the management fee expense related to CSC call volume should be eliminated because the CSC call volume in 2003 exceeds the number of calls for the test year. As discussed above, IAWC's test year level of management fee expense was based on a detailed budgeting process. The Company further demonstrated the reasonableness of forecasted management fee expense 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. The increased level of call activity from 2003 to 2006 was one of five factors underlying the change in management fee expense from 2003 through 2006. (IAWC Init. Br., p. 46.) As further explained in IAWC's Initial Brief (pp. 48-49), 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.) In addition, the final call volume for 2007 at the CSC reflected a 20.9% increase over 2003. (Id.)

The AG also asserts, without benefit of record support (and in apparent reference to Docket 05-0681), that "increases in call volume, to the extent that they were the result of poor customer service in the years 2005, 2006, and 2007, should not be used to justify an increased cost to consumers." (AG Init. Br., p. 26.) No witness in this case testified that increases in call volume at the CSC were the result of "poor customer service" in 2005, 2006 and 2007 (or in any other year).

The allegations in the complaints filed in Docket 05-0681 were adjudicated in that case. The Docket 05-0681 Order required IAWC to undertake a number of actions, including, *inter*

alia, to develop and conduct training sessions for customer service representatives. (Docket 05-0681 Order, p. 39.) As already mentioned, the matters addressed in the Docket 05-0681 Order took place primarily during 2005, and there is no basis to assume, as AG proposes, that these matters caused an increase in call volume during 2007. Moreover, there was no finding in Docket 05-0681 that CSC call volumes increased as a result of the "complaints that were raised by consumers in the Chicago Metro area" that the AG now refers to. (AG Init. Br., p. 26.) Nor is an inference that CSC call volumes at issue in this case were impacted by the "complaints" the AG refers to from Docket 05-0681 appropriate: the Docket 05-0681 Order (p. 22) references 466 complaints in 2005, while the CSC handled approximately 500,000 calls in 2005. (See IAWC Ex. 4.10 (Grubb Reb.), p. 17.) Moreover, the AG's assertion that call volumes have returned to 2003 "pre-complaint" levels is incorrect because, as discussed above, the call volume at the CSC has actually increased through 2007.

With respect to the "expanded services" that the AG asserts are "an unexplained increase" in management fees (AG Init. Br., p. 27), the AG has failed to recognize the effect on management fee expense of the shift in services from IAWC to the Service Company. As Mr. Grubb explained in his direct, rebuttal and surrebuttal testimony, and as IAWC explained in its Initial Brief (pp. 49-51), in late 2003, American Water initiated an organizational restructuring, which eliminated 31 positions from the payroll of IAWC and shifted the services performed by those employees to the Service Company. (IAWC Exs. 4.00 (Grubb Dir.), pp. 35-36; 4.10 (Grubb Reb.), pp. 17-19; 4.20 (Grubb Sur.), p. 19; Tr. 122-24.) The effect of this was to increase support services cost charged to IAWC from the Service Company, and at the same time, reduce IAWC's labor and other related costs. (IAWC Ex. 4.20 (Grubb Sur.), pp. 18-19.) Nine of these

31 positions were transferred directly to the Service Company.[4] 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), however, 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.) After shifting these services to the Service Company, the Service Company was able to provide both the services previously provided at IAWC and certain expanded services. (IAWC Ex. 4.10 (Grubb Reb.), p. 10.) These expanded services are distinct from the new services, including the Supply Chain, Environmental Compliance, Network, Maintenance, and Production functions, that are being provided to IAWC, and which Mr. Grubb quantified separately (and Mr. Effron agreed to). (IAWC Ex. 4.00 (Grubb Dir.), p. 34; AG Ex. 3.1, Sched. C-3.1.)) Thus, Mr. Effron 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.)

The AG's reference to the Commission's decision in Central Ill. Light Co. d/b/a AmerenCILCO et al., Dockets 06-0070/06-0071/06-0072 (cons.) ("Docket 06-0070"), regarding management fee expense is unpersuasive. (AG Init. Br., p. 27-28.) As the AG acknowledges, the Commission found in Docket 06-0070 that "Ameren has provided insufficient evidence to demonstrate that the amounts cited constitute reasonable expenditures." (Id., p. 28.) That is not the case here – IAWC has provided substantial evidence supporting its projected test year level of management fee expense. As IAWC explained in its Initial Brief (pp. 45-46), the Company

[4] Mr. Effron acknowledges that the $1.028 million 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.)

has demonstrated that its forecast for management fee expense is reasonable. The test year projection was based on a detailed, item by item forecast, and the Company also explained in detail 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. Thus, the Commission's conclusions in Docket 06-0070 are inapposite under the facts and circumstances of this case.

7. Operations and Maintenance ("O&M") Cost Adjustment and Rate/Cost Comparisons

In their Initial Briefs both AG (AG Init. Br., pp. 29-40) and the Municipalities (Munis. Init. Br., pp. 7-9) support the adjustment proposed by AG Witness Rothstein to the Operation and Maintenance ("O&M") expense of the Chicago Metro District – Water. For the reasons discussed in the Company's Initial Brief (IAWC Init. Br., pp. 53-85), the adjustment proposed by Mr. Rothstein (and reflected in AG Exhibit 1.1 sponsored by Mr. Effron) should be rejected.

Response To AG

In its Initial Brief (AG Init. Br., p. 29), AG refers to statements of the Commission in the Final Order (p. 67) and Order on Rehearing (p. 36) in Docket 06-0070 (identified in this Brief, respectively, as the "Ameren Final Order" and "Ameren Order on Rehearing"). Specifically, AG refers to the discussion of comparisons between the amount paid by a utility for certain services provided to it by an affiliate and the respective market price for each service. The Ameren Order on Rehearing states that such comparisons were "perhaps the most important" piece of evidence for evaluating the reasonableness of the amount paid by the utility for service provided by the affiliate. Ameren Order on Rehearing, p. 36. According to AG, this discussion supports AG's position with regard to the O&M cost adjustment proposed by Mr. Rothstein. (AG Init. Br., p. 36.)

In this proceeding, however, Mr. Rothstein did not discuss a comparison of the type referred to in the portions of the Ameren Final Order and Ameren Order on Rehearing that are referenced by AG (i.e., a comparison of the price paid by the utility for a given service and the market price for the same service). Nor are such comparisons the type of "benchmarking" that Mr. Rothstein utilized. Indeed, as will be discussed, the Ameren Order on Rehearing, in language overlooked by AG, criticizes comparisons of the type utilized by Mr. Rothstein in this proceeding, finding that such comparisons are flawed and of no "probative value." Ameren Order on Rehearing, p. 27. Thus, far from supporting Mr. Rothstein's comparisons, the principles stated in the Ameren Order on Rehearing confirm their irrelevance.

As discussed in the Company's Initial Brief, in connection with efforts to review and minimize costs, IAWC considers comparative cost and operating data in appropriate circumstances. (IAWC Init. Br., p. 73.) IAWC, for example, uses median salary information from industry surveys as guidance in setting compensation ranges for employees. (AG Cross-Exam. Ex. 16.) In addition, where certain regulated utilities report customer account service function cost data in a standardized, regulatory accounting framework, American Water operating subsidiaries have compared their customer accounting cost data to the reported data. (AG Cross-Exam. Ex. 16, 17.) Thus, IAWC does not maintain that there are no circumstances in which cost comparisons can provide useful information. As IAWC Witness Schmitt explained, it is 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 recording practices and no demonstrated similarity of service area characteristics, operating practices or processes, facilities or applicable service and regulatory standards) that does not provide useful information. (AG Cross-Exam. Ex. 17.)

As discussed in IAWC's Initial Brief (IAWC Init. Br., pp. 67-79), Mr. Rothstein proposes to compare IAWC's rates and/or costs to those of: (i) certain municipally owned utilities ("MOUs") in the vicinity of IAWC's Chicago Metro District (shown on AG Exhibits 2.0, 2.2., EPR-1, and EPR-3); (ii) certain other MOUs shown on AG Exhibit EPR-4; and (iii) those of 193 entities (188 of which are MOUs (see IAWC Ex. 10.30 (Uffelman Reb.), p. 11)) that provided data for years ending in 2004 or 2005 for a benchmarking survey ("Survey") conducted by the American Water Works Association ("AWWA") in 2006 (shown on AG Exhibit EPR-2). As discussed in IAWC's Initial Brief, however, Mr. Rothstein did not offer evidence showing that any of the data he utilized was properly comparable to cost and/or rate data for IAWC. (IAWC Init. Br. 70-71.)

As explained in IAWC's Initial Brief, IAWC Witnesses Uffelman and Kane submitted in this proceeding the "Analysis of Water Rates, Fees and Charges for Selected Cities in the Vicinity of the Chicago Metro District" ("Report"), which is marked for identification as IAWC Exhibit 10.20. The Report explains in detail differences between the cost structures and rate setting practices of IAWC as compared to those of MOUs, and explains why, as a result of these differences, no conclusion can be drawn from comparisons of IAWC's costs or rates to those of MOUs (and, as indicated above, nearly all of Mr. Rothstein's comparison data is derived from MOUs). (IAWC Ex. 10.20, p. 1.) As explained in IAWC's Initial Brief, Mr. Rothstein submitted no evidence showing that any of the MOUs or entities participating in the Survey should be deemed comparable to IAWC. (IAWC Init. Br., pp. 70-71.) As is the case with regard to Mr. Rothstein's testimony, AG's Initial Brief fails to provide a basis for the position that rates or costs of the referenced MOUs can properly be compared to those of IAWC.

With regard to the rate comparisons, AG's Initial Brief also disregards the fact that Mr. Rothstein failed to include in his Table 1 (AG Exs. 2.0, p. 6, EPR-1) all amounts paid for utility service by MOU customers, although all such amounts are reflected in the charges shown for IAWC. As discussed in IAWC's Initial Brief, the rate comparisons addressed by AG are incomplete, misleading and provide no basis to question the reasonableness of IAWC's rates. (IAWC Init. Br., pp. 67-69.)

In its Initial Brief, AG makes reference to AG Exhibit 2.2, and notes that this Exhibit fills in certain notes that appeared in Table 1 set forth on page 6 of AG Exhibit 2.0. (AG Init. Br., p. 31.) It is correct that, in AG Exhibit 2.2, certain areas left blank in Table 1's "Notes" column were filled in. As AG points out, however, the rates shown in AG Exhibit 2.2 are the same as those shown in Table 1 (which is developed from AG Exhibits 2.0 and EPR-1). (AG Init. Br., p. 31, n. 5.) Thus, the discussion of Mr. Rothstein's Table 1 in IAWC's Initial Brief (IAWC Init. Br., pp. 67-69) applies equally to AG Exhibit 2.2, which shows the same flawed rate comparisons.

With regard to the O&M cost comparisons relied on by the AG (AG Init. Br., pp. 33-38), Mr. Rothstein, as IAWC's Initial Brief points out, prepared no analyses or studies that provide a basis for the comparisons he sets forth. (IAWC Init. Br., p. 70 (citing IAWC Ex. 10.30 (Uffelman Reb.), p. 2).) Mr. Rothstein did not review or analyze the cost structure of any of the MOUs shown on Exhibit EPR-3 or of the Survey participants. (IAWC Ex. 10.30 (Uffelman Reb.), 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 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 discussed above, the reference in AG's Initial Brief to the discussion of comparisons of affiliate service pricing and market prices in the Ameren Order on Rehearing is not relevant in connection with Mr. Rothstein's comparisons. Other discussion in the Ameren Order on Rehearing, however, is relevant. In a section of the Ameren Order on Rehearing that AG overlooks (pp. 20-27), the Commission discusses a "Peer Group Study" submitted by a utility witness in support of the utility's Administrative and General ("A&G") expenses. With regard to that study, the Commission states that the utility's witness had, "not shown that the [comparison] companies are truly comparable." Ameren Order on Rehearing, p. 27. The Commission refers to demonstrated differences between the subject utility and the comparison group as a "glaring flaw" in the Peer Group Study that, "clearly undermines the applicability and indeed probative value of the cost data to the instant case." Id. Because the witness supporting the comparisons provided no "testimony or analysis that would make these peer group costs relevant…," the Commission concluded that it, "[was] not compelled to afford any appreciable

weight or reliance" on the peer group comparisons. Id. In this regard, the conclusion stated in the Ameren Order on Rehearing is fully consistent with the principles applied in the other Commission Order and case law discussed in IAWC's Initial Brief, which confirm that Mr. Rothstein's unsupported cost comparisons should be disregarded.[5] (IAWC Init. Br., p. 73.)

In its Initial Brief, AG notes that the Report identified MOU tax subsidies, differences in funding mechanisms for plant, differences in cost rates for capital, different approaches for recovery of depreciation expense, the failure of MOUs to accrue pension and OPEB expense, as well as differences in service area characteristics and the applicability of taxes. (AG Init. Br., p. 38.) In its Initial Brief, however, AG offers nothing to explain why these (or the other differences detailed in the Report) do not render Mr. Rothstein's comparisons meaningless. AG suggests, however, that as compared to the detailed analysis of the Report, "Mr. Rothstein took a different approach," isolating "O&M cost, which could be expected to be similar among efficient utilities in unexceptional operating environments." (Id.) According to AG, Mr. Rothstein's focus on O&M cost, "avoided the obstacles that IAWC witnesses identified." (Id., p. 39.)

As the record shows, however, Mr. Rothstein's "different approach" does not "avoid the obstacles." As discussed above and in IAWC's Initial Brief (pp. 33-38), Mr. Rothstein conducted no analysis to determine whether the "operating environments"(or factors such as the respective accounting approaches, facilities, service area characteristics or service standards) of IAWC and the MOUs could properly be compared. In addition, IAWC Witness Uffelman detailed five principal categories of cost structure/operating differences between IAWC and MOUs that directly impact O&M cost: (1) Utility (or cost-of-service) v. Cash Needs Approach;

[5] IAWC's Initial Brief also cited the language in the Ameren Order on Rehearing that indicates that the Commission will not place any weight on a comparison of a utility to other companies that are not "truly comparable." (IAWC Init. Br., p. 73 (quoting Ameren Order on Rehearing, p. 27)). IAWC's Initial Brief inadvertently referred to the Ameren Order on Rehearing as the Final Order.

(2) Other Accounting Differences; (3) Shared Resource Utilization; (4) Service Area Characteristics; and (5) Service and Regulatory Standards. (IAWC Init. Br., pp. 75-79.) Further, as explained in IAWC's Initial Brief, the lack of comparability of Mr. Rothstein's "O&M" cost data is plain on the face of AG Exhibit EPR-3, which shows the computation of Mr. Rothstein's proposed O&M adjustment. (IAWC Init. Br., pp. 75-78.) As that Exhibit illustrates, none of the four comparison MOUs utilized by Mr. Rothstein report the same "O&M" cost categories as does IAWC. Three of the four MOUs record no "Maintenance and Repair" expense; two report no cost for "Personnel"; and none report any "Customer Service/Accounting" expense. Thus, AG's assertion that the identified "obstacles" do not affect O&M cost is baseless. Indeed, AG's Initial Brief simply ignores the evidence proving that the differences identified by IAWC affect O&M cost.

As discussed in IAWC's Initial Brief, AG Witness Rothstein showed on Exhibit EPR-3 a proposed adjustment to Chicago Metro District – Water O&M expense of $2,050,000, which is adopted by AG Witness Effron in AG Exhibit 1.1 ($977,000 after the adjustments shown on AG Exhibit 1.1, Schedule C-4). (IAWC Init. Br., pp. 69-70.) As IAWC's Initial Brief points out, Mr. Rothstein's Exhibit EPR-3 also shows an alternative O&M cost adjustment of $750,000, which purports to relate to Chicago Metro District – Water O&M cost other than "Purchased Water" and "Maintenance and Repair" cost. (IAWC Init. Br., p. 70.) For the reasons explained in IAWC's Initial Brief, neither of these proposed adjustments is appropriate. (Id., pp. 69-79.)

In its Initial Brief, AG mischaracterizes Mr. Rothstein's $750,000 alternative adjustment by suggesting that $270,000 should be added to Mr. Effron's adjustment to reflect the alternative adjustment. (AG Init. Br., p. 39.) In support of this assertion, AG cites AG Exhibit 1.1, Schedule C-4. (Id.) With regard to this, IAWC notes that AG Exhibit 1.1, Schedule C-4, cited

by AG, does not refer at all to this adjustment and, so far as it is aware, the $270,000 figure given in AG's Initial Brief does not appear anywhere in the evidentiary record.

Moreover, Mr. Effron reflects Mr. Rothstein's $2,050,000 adjustment (revised by Mr. Effron to $977,000) in his adjustments, as detailed on AG Exhibit 1.1, Schedule A-1. Accordingly, if Mr. Rothstein's alternative $750,000 adjustment were accepted (which it should not be), it would not be added to Mr. Effron's adjustments, which already include the larger $2,050,000 adjustment (as revised by Mr. Effron). As shown on AG Exhibit EPR-3, to develop the $2,050,000 adjustment (for which Mr. Rothstein includes "Maintenance and Repair" cost), Mr. Rothstein adds the amount of $1,300,000 to the $750,000 adjustment, which, according to Mr. Rothstein, excludes "Maintenance and Repair" cost. As explained in IAWC's Initial Brief, the effect of this calculation is to disallow nearly all of IAWC's Chicago Metro District – Water "Maintenance and Repair" cost (due to the fact that the reported O&M costs for three of his four comparison MOUs shown on Exhibit EPR-3 do not record "Maintenance and Repair" cost). (IAWC Init. Br., pp. 75-76.) In any event, because Mr. Effron's adjustments shown in AG Exhibit 1.1 reflect Mr. Rothstein's larger adjustment that subsumes the $750,000 adjustment, it would be inappropriate to add the alternative adjustment to Mr. Effron's total.

For the reasons discussed above and in IAWC's Initial Brief, both of Mr. Rothstein's alternative O&M cost adjustments are baseless and should be rejected.

Response To Municipalities

The Municipalities suggest that IAWC cannot "get its costs and rates in line" with those of MOUs. (Munis. Init. Br., p. 7.) The Report, however, explains in detail significant reasons for the cost structure/rate differences between IAWC and MOUs, and the Municipalities point to no cost structure or rate setting difference that IAWC could somehow change. Except with

regard to IAWC's efficiency programs (which serve to minimize IAWC's costs), the cost structure differences discussed in the Report relate to such factors as: MOU accounting principles and policies; legal and governmental policy differences, such as MOU use of tax supported resources and subsidies; differences in service area characteristics; and/or the effects of differing regulatory practices and policies. The Municipalities point to none of these factors as being within the control of IAWC, and no witness demonstrated that any are.

The Municipalities suggest that IAWC should be required to provide an "independent analysis" comparing its rates in the Champaign District with those charged by MOUs, "so that the Champaign District's rates can be appropriately adjusted to bring them in line with other communities." (Munis. Init. Br., p. 9.) This proposal (which no witness addressed) should be rejected for the reasons discussed in IAWC's Initial Brief with regard to the additional analysis proposed by Mr. Rothstein. (IAWC Init. Br., pp. 79-83.) As explained in IAWC's Initial Brief, IAWC has in this proceeding submitted a thorough and well-supported Report explaining in detail IAWC/MOU cost structure and rate setting differences and, where reasonably possible, the Report quantifies the effect of those differences. (Id., p. 83.) IAWC should not be required to expend resources for an additional analysis in this regard.

Moreover, there is no legal basis for an "adjustment" to set the rates of a public utility based on those of another entity with an entirely different cost structure. Under Illinois law, rates set by the Commission must produce revenues sufficient to cover the utility's operating expenses and provide a reasonable return on the utility's investment in property devoted to the provision of utility service. Illinois Cent. R.R. Co. v. Ill. Commerce Comm'n, 387 Ill. 256, 281 (1944); Ill. Bell Tel. Co. v. Illinois Commerce Comm'n, 414 Ill. 275, 286 (1953); Busisness & Prof. People for the Pub. Interest v. Illinois Commerce Comm'n, 146 Ill. 2d 175, 195-96 (1991). The

Commission is required, by law, to approve rates that provide a reasonable rate of return on rate base, and cannot properly set rates for a public utility based on the rates of another entity. The Illinois Supreme Court has said as much. See Union Elec. Co. v. Illinois Commerce Comm'n, 77 Ill. 2d 364, 383-84 (1979) (holding that, for a utility serving customers in both Missouri and Illinois, the Commission could not order Missouri rates applied in Illinois, but must set rates that produce a reasonable return on the value of the utility's property as required by Illinois law, even if Missouri rates were lower); Alton & S.R. Co. v. Illinois Commerce Comm'n, 316 Ill. 625, 628-29 (1925) (finding that rate comparisons not based on evidence showing "similarity of conditions" have "no probative value and were therefore incompetent"); see also Complaint by Home Depot, USA, Inc., and LNT, Inc., N.Y. Pub. Serv. Comm'n Case Nos. 05-W-0707, 06-W-1080, 2006 N.Y. PUC LEXIS 276, *10-13 (Sept. 11, 2006) (dismissing retailers' complaint that alleged that, inter alia, water rates were excessive compared to the rates in other locations, and stating: "Comparing [the water utility's] rates to those paid by Complainants' stores in other locations is inappropriate. Rates are set on a case-by-case basis, and are based on reasonable costs of the company.").

As discussed in IAWC's Initial Brief, the fact that further analysis of IAWC/MOU rate and cost differences is not warranted does not mean that IAWC's costs have not been reviewed and minimized. (IAWC Init. Br., pp. 83-85.) As the record shows, IAWC regularly reviews all aspects of it specific costs and, as discussed above, IAWC utilizes appropriate cost comparisons as a part of that effort. (IAWC Ex. 10.20 (Teasley Sur.), pp. 3-6.) As is also discussed in IAWC's Initial Brief, the Staff and parties to this rate case conducted their respective reviews of IAWC's specific costs. (IAWC Init. Br., p. 84.) Neither Mr. Rothstein nor the witnesses

testifying for certain of the Municipalities offered evidence disputing the reasonableness of any specific component of IAWC's costs.

For the reasons discussed above and in IAWC's Initial Brief, the O&M cost adjustment proposed by AG witness Rothstein and the additional proposals of AG and the Municipalities with regard to rate/cost comparisons should be rejected.

D. Recommended Operating Income/Revenue Requirement

On a Total Company basis, additional annual revenue of $30,944,883 is needed to afford the Company the opportunity to earn a reasonable rate of return, as shown on Appendix A, Schedule 1. The operating income statement for each Rate Area is shown on the respective designated sheet of Appendix A, Schedule 1.

IV. COST OF CAPITAL/RATE OF RETURN

A. Capital Structure

IAWC's requested capital structure and cost of capital is shown in its Initial Brief (p. 86), and is unchanged.

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

General Response to LWC, Staff and CUB

In its Initial Brief, the Company demonstrated that its proposed return on equity of 11.24% is reasonable and should be adopted, while also explaining why the return on equity recommendations of Staff [10.38%], LWC [9.9%] and CUB [8.58%] are unreasonable and should be rejected. (IAWC Init. Br., pp. 86-111.) In their respective Initial Briefs, Staff, LWC and CUB criticisms of the Company's rate of return recommendation focus primarily on two

areas: (1) a proposed 10 basis point (.10%) business risk adjustment; and (2) use of analysts' forecasted growth rates as a sustainable growth rate in a single-stage DCF calculation. Because Staff, LWC and CUB each raise these issues, their arguments will be addressed collectively. The Company will respond separately to the remaining issues raised by each of the parties.

1. A business risk adjustment is appropriate

The Company's Initial Brief explained the basis for a business risk adjustment of 10 basis points (.10%). (IAWC Init. Br., pp. 89-91.) No party has rebutted the evidence supporting such an adjustment.

As indicated in IAWC's Initial Brief and confirmed by Staff's Initial Brief, Staff continues to confuse the proposed business risk adjustment with a "size" adjustment. (Staff Init. Br., pp. 56-57.) The Docket 03-0403 Order cited in Staff's brief (p. 56) draws a clear distinction between these two types of adjustments. (Docket 03-0403 Order, p. 43.) Ms. Ahern explained the various factors that cause IAWC to have greater risk relative to the proxy group companies. (IAWC Ex. 12.00 (Ahern Dir.), pp. 8-15.) These factors include size, but considering size in the context of a business risk adjustment does not make a business risk adjustment a size adjustment. For example, even if the Commission were to agree that IAWC's size does not cause the Company to incur greater risk, there are other factors, such as lower depreciation rates relative to gas and electric companies and the ongoing need for substantial capital investments, that do result in increased risk. (IAWC Init. Br., pp. 89-90.) Staff does not dispute the evidence that IAWC faces increased risk because of these factors.

LWC also mistakenly characterizes the Company's proposed adjustment as a "size" adjustment" (see, e.g., LWC Init. Br., pp. 19-20) and argues that such an adjustment is inappropriate for at least two reasons. First, LWC argues that by selecting a group of proxy companies with similar total risks to IAWC, the estimate of a proxy group rate of return

produces fair compensation to IAWC investors for IAWC's total investment risk. (LWC Init. Br., p. 20.) The Company's Initial Brief explained why this assertion is incorrect. As discussed in Ms. Ahern's rebuttal testimony (see IAWC Ex. 12.10, 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. 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. (IAWC Ex. 12.30 (Ahern Sur.), pp. 6-7.) Moreover, as explained in the Company's Initial Brief, bond and credit ratings and business risk profiles of the proxy companies reflect the size of those companies, not IAWC. (IAWC Init. Br., p. 94.)

LWC next argues that the "small size return add-on proposal" ignores the fact that IAWC is a subsidiary of American Water. (LWC Init. Br., p. 20.) This argument was also addressed in the Company's Initial Brief. 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 Init. Br., p. 94.) None of these lower costs or benefits reflect the risk of investing in the common stock of IAWC. Moreover, it is the rate base of IAWC, and IAWC alone, to which the overall rate of return set in this proceeding will be applied. Therefore, IAWC should be evaluated as a stand alone utility.

The Company also addressed CUB's arguments regarding a business risk adjustment, which CUB also characterizes as a "size" adjustment. (See CUB Init. Br., p. 3.) CUB first

argues that Ms. Ahern improperly measures the difference in size between IAWC and the proxy companies based on market value instead of book value. (CUB Init. Br., p. 3.) CUB is simply mistaken on this issue. As IAWC indicated in its Initial Brief, 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. (IAWC Init. Br., p. 96.)

Moreover, as also addressed in the Company's Initial Brief, 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 investments," is precisely Ms. Ahern's point. (See IAWC Init. Br., pp. 96-97.) 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, 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.) 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.)

As stated in the Company's Initial Brief, the cost rate for common equity investment in IAWC must be determined without regard to the source of capital and must reflect the risk to

which such capital is put. (IAWC Init. Br., p. 97.) 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. The Commission should, therefore, accept Ms. Ahern's proposed 10 basis point business risk adjustment.

2. The use of analysts' growth rates is appropriate

Staff, LWC and CUB criticize Ms. Ahern's use of analysts' projected growth rates as a sustainable growth rate in a single-stage DCF calculation. Each of these parties argues that such growth rates are unrealistically high or otherwise upwardly biased. Staff and LWC claim that long term GDP growth is the appropriate sustainable growth rate, while CUB's Mr. Thomas proposes an "internal" growth rate a proxy of sustainable growth.

There are two fundamental flaws in the criticisms of Ms. Ahern's selection of a sustainable growth rate, both of which were addressed in the Company's Initial Brief. (IAWC Init. Br., pp. 98-101.) First, Staff and LWC ignore the fact that investors look to analysts' growth rates in forming their expectation of future dividend growth. 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. Prices will therefore 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, a point that LWC concedes. It is, therefore, appropriate to rely upon such forecasts in a DCF analysis, and analysts' forecasts of EPS growth should be used to estimate the current market cost of capital. 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 LWC suggest. (IAWC Ex. 12.10 (Ahern Reb.), pp. 30-32.)

Second, neither Staff nor LWC has established that the projected GDP growth rate is a proper growth rate to use in a non-constant DCF analysis. Specifically, as Ms. Ahern explained, no party 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.) Moreover, 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. Likewise, no party has 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.

CUB's use of an "internal" growth rate in its DCF analysis is also inappropriate. As explained in the Company's Initial Brief, Mr. Thomas's approach is inconsistent with the prospective nature of both ratemaking and the cost of capital. (IAWC Init. Br., p. 109.) By ignoring projections of earnings per share expected three to five years in the future, Mr. Thomas ignores valuable information that influences investors. Additionally, as also explained in the Company's Initial Brief (p. 110), 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. Thus, 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 historical ROEs give rise to internal growth rates, such as those derived by Mr. Thomas, those historical internal growth rates are inherently circular.

Response To Remaining Staff Issues

Staff acknowledges that its rate of return witness, Ms. Kight-Garlisch, originally recommended a return on equity of 11.24%. (Staff Init. Br., pp. 47-48.) Ms. Kight-Garlisch later "changed her recommended cost of common equity from 11.24% to 10.38%." (Id., p. 48.) The reason for this change, according to Staff, is that the growth rates used in her original analysis were "not sustainable," thereby warranting a multi-stage DCF approach with lower sustainable growth rates. (See id., pp. 47-48.)

Staff has failed to justify its change in position for its return on equity recommendation. In particular, Staff has failed to support the use of a multi-stage or non-constant DCF ("NCDCF") approach to arriving at a recommended cost of equity. Ms. Kight-Garlisch acknowledges that the NCDCF approach "necessitates greater reliance on rate of return analysts' judgment than the constant-growth DCF analysis." (ICC Staff Ex. 14.0, p. 5) The apparent rationale for her change in position is that "under certain circumstances, measurement error associated with a constant-growth DCF analysis exceeds that associated with a NCDCF model." (Id.) Staff fails, however, to specifically identify any "certain circumstances" that result in measurement error in this case.

In rebuttal testimony, Ms. Ahern criticized IIWC's return on equity recommendation because the NCDCF analysis upon which that recommendation is based leads to results that are inconsistent with recently authorized returns ranging from 9.1% to 11.5%, as shown on IAWC

Exhibit 12.10, Schedule 12.20. Staff claims that this logic would require exclusion of Ms. Kight-Garlisch's CAPM estimates (11.75% for the Utility Sample and 12.11% for the Water Sample) because these estimates are in excess of the returns shown on Schedule 12.20. Excluding the CAPM results would leave only Ms. Kight-Garlisch's NCDCF estimate of 9.34% for a return on equity recommendation. (Staff Init. Br., p. 57.) Staff is mistaken, however, because Ms. Ahern's criticisms centered on the fact that Mr. Janous's recommendations fell below the authorized range of returns shown on Schedule 12.20. (IAWC Ex. 12.30 (Ahern Sur.), p. 4.)

Staff also claims that Ms. Ahern failed to specify "critical factors" that influenced the allowed returns shown on her Schedule 12.20, such as relative risk (as measured by credit ratings or other metrics) and the amount of common stock flotation cost adjustment. (Staff Init. Br., p. 58.) As Ms. Ahern explained, these factors are irrelevant. Schedule 12.20 presents the authorized ROEs and related common equity ratios. The average authorized common equity ratio of all litigated cases shown on page 2 of Schedule 12.20, 48.21%, indicates that these companies have slightly less financial risk than IAWC based upon IAWC's common equity ratio of 43.77% shown on IAWC Exhibit No. 2.22. The companies shown in Schedule 12.20 are among the companies with which IAWC, through American Water Capital Corp. (AWCC) must compete for capital in the capital markets. Consequently, Staff's comments are misplaced. (IAWC Ex. 12.30 (Ahern Sur.), p. 5.)

Response To Remaining LWC Issues

Contrary to LWC's position, a return on equity of 9.9% is insufficient for IAWC to maintain its financial integrity. As indicated in IAWC's Initial Brief, the Standard & Poor's ("S&P") report that IIWC cites for its conclusion is silent relative to any specific utility subsidiary of American Water. (IAWC Init. Br., p. 102.) 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.) Nowhere does S&P provide a credit rating, bond rating, rating rationale, business risk profile or financial risk profile. Therefore, there is no support for the conclusion that S&P would view an authorized ROE for IAWC of 9.9% as supportive of IAWC's credit standing.

LWC's criticism of Ms. Ahern's CAPM analysis is also misplaced. LWC argues that a equity market risk premium ("EMRP") of 8.13% is too high, and that a 7.2% market risk premium, derived from a risk-free rate of 4.2%, is more appropriate. (LWC Init. Br., p. 18.) As explained in the Company's Initial Brief, 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 Init. Br., pp. 104-05.) Using this approach with recent data from Value Line Investment Survey results in an expected total market return of 15.44%, significantly higher than the 13.46% Ms. Ahern relied upon based upon a DCF analysis for the S&P 500.

In conclusion, while LWC continues to claim that its return on equity recommendation is sufficient for IAWC to maintain its financial integrity, the record evidence in this proceeding demonstrates otherwise. Mr. Janous's average two-stage DCF result of 8.4% for his water group and 9.0% for his 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%. IAWC is more risky than the companies in either of Mr. Janous's proxy groups. (IAWC Ex. 12.10 (Ahern Reb.), pp. 32-33.) Thus, LWC's recommended cost of equity is inadequate relative to recently authorized ROEs for electric and gas utilities against which IAWC must compete for capital in the capital markets.

Response To Remaining CUB Issues

CUB's recommended return on equity of 8.58% – approximately 132 basis points (1.32%) below the next lowest return on equity recommendation presented in this case – is unreasonable and should be rejected. As CUB itself acknowledges, the Commission cannot authorize such a return without substantially changing accepted approaches to estimating the cost of equity in Illinois.

CUB continues to argue that the Commission should reject the CAPM model, claiming that it contains "such substantial bias that it is unreasonable to rely on it to estimate a utility's cost of equity." (CUB Init. Br., p. 9.) CUB has yet to explain why, if the CAPM contains such inherent, substantial bias, it is appropriate to use this model as a "check" on DCF results, as Mr. Thomas did in his own analysis. (CUB Init. Br., pp. 9, 13.) CUB cannot have it both ways. If the CAPM is unreliable, it cannot have utility as a "check" to "verify" the results produced by other models. As explained in the Company's Initial Brief, an analyst should not rely on a single common equity cost rate model in determining a cost rate of common equity. The results of multiple cost of common equity models should be taken into account as primary, not corroborating, methods. 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. (IAWC Init. Br., p. 106.)

The so-called "Nagel Paper" does not support CUB's assertion that the CAPM is unreliable. (CUB Init. Br., pp. 9-10.) Although CUB would have the Commission disregard the CAPM model based on this single article, CUB ignores the myriad evidence that in general, betas revert to 1.00. (See IAWC Ex. 12.10 (Ahern Reb.), pp. 8-11.) Moreover, as Staff explains, the Nagel Paper did not evaluate a CAPM that uses adjusted betas. (Staff Init. Br., pp. 58-59.)

In fact, the Nagel Paper merely found that a CAPM using raw betas (as advocated by CUB) was less accurate in predicting realized rates of return than a forecast model that used adjusted betas (as applied by IAWC). (Id., p. 59.) The Nagel Paper rejects, rather than supports, CUB's conclusion.

CUB next claims that it is inappropriate to recognize quarterly compounding of dividend payments in a DCF analysis. (CUB Init. Br., p. 7-8.) As the Company has previously explained, quarterly compounding recognizes that dividends are paid quarterly, not annually. (IAWC Init. Br., p. 87.) And, as Staff points out, CUB's criticism of a quarterly-compounding DCF methodology raises a working capital issue, not a cost of equity issue. (Staff Init. Br., pp. 61-62.) The annual DCF methodology advocated by CUB was rejected in the numerous cases cited in Staff's brief and should also be rejected here. (See Staff Init. Br., p. 62.)

CUB is also mistaken to suggest that an EMRP of 5% is appropriate to use in a CAPM analysis. (CUB Init. Br., p. 10.) As explained in IAWC's Initial Brief, the Commission has consistently used a DCF analysis for the S&P 500 to derive the EMRP. (IAWC Init. Br., p. 109.) This is the technique which both Staff witness Kight-Garlisch and Ms. Ahern utilized in this case. Although CUB claims that this approach results in a "biased EMRP," CUB fails to explain how any "financial research" support this assertion. Because the ratemaking process and estimating the cost of capital is prospective, it is appropriate to develop a prospective EMRP, rather than a historical EMRP as advocated by CUB. The same holds true for determination of a risk free rate to use in a CAPM analysis. While CUB argues that the Commission should adopt a risk free rate of 4.5%, based on current bond rate data, CUB's argument ignores the fact that the cost of capital must be estimated prospectively for the period when rates will be in effect.

CUB also asserts that the Commission should reject the use of adjusted betas in a CAPM analysis. (CUB Init. Br., pp. 11-12.) CUB's argument appears to stem from Mr. Thomas's apparent confusion over the difference between systematic risk (market or non-diversifiable risk) and non-systematic risk (non-market or diversifiable risk). As the Company explained in its Initial Brief (pp. 107-08), while it is true that companies can reduce their exposure to risk, they cannot reduce their exposure to systematic risk as measured by beta. Beta, as a measure of systematic risk, is largely out of the control of management. 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. 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. (IAWC Ex. 12.10 (Ahern Reb.), p. 9.) 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. The Company's Initial Brief also explained how Mr. Thomas's own analysis demonstrates the reasonableness of using adjusted betas in a CAPM analysis. (IAWC Init. Br., p. 108.)

The Company has supported its cost of equity recommendation of 11.24%. Staff and intervenors have failed to support their alternative recommendations. The Commission should therefore adopt the Company's recommendation.

D. Recommended Overall Rate of Return

For the reasons explained above, the Commission should authorized a return on common equity of 11.24% which, when applied to IAWC's capital structure, yields an overall return of 8.23%. (IAWC Ex. 2.22.)

V. RATE DESIGN; TARIFF TERMS AND CONDITIONS

A. Introduction

In this proceeding, the Company proposed an across-the-board rate increase. An across-the-board rate increase also is supported by the AG and LWC.

B. Resolved Issues

1. Cost of Service Study

As discussed in Staff's Initial Brief (p. 64), Staff and AG proposed that the Company be required to provide a cost of service study in its next rate case. (ICC Staff Ex. 6.0, pp. 21-22; AG Ex. 3.10, p. 17.) The Company agreed to prepare a cost of service study before filing its next rate case. (IAWC Ex. 4.0 (Grubb Reb.), p. 30.)

2. Single Tariff Pricing

As indicated by Staff (Staff Init. Br., p. 74), the Company supports single tariff pricing ("STP") where appropriate. (IAWC Ex. 4.10 (Grubb Reb.), p. 30.) In this proceeding, the Company proposes to combine the revenue requirement for the South Beloit district with the revenue requirement of the Southern District, effectively moving South Beloit into the existing SPSPSB District STP area. Staff agrees with this approach. (ICC Staff Ex. 6.0, p. 35; Staff Init. Br., p. 73.) Staff also recommends that the final order in this proceeding require IAWC, in its next rate case, to address whether the Sterling district should also be included in the STP group. (Staff Init. Br., p. 74.) The Company does not object to this recommendation. (IAWC Ex. 4.10 (Grubb Reb.), p. 30.)

Staff also asserts (Init. Br., pp. 73-74) that IAWC did not respond to Mr. Luth's proposals for moving toward common customer charges, block structures and usage charges for IAWC's downstate districts. In Mr. Grubb's surrebuttal, however, he stated that the Company will prepare a cost of service study in its next rate case, and that it would be appropriate for the

Company to conduct an analysis of moving the downstate districts towards a uniform rate structure prior to the next rate case. (IAWC Ex. 4.10 (Grubb Sur.), p. 8.) Subject to the findings in that analysis, the Company will propose moving towards a uniform rate structure if warranted on the basis of that analysis. (Id.) Thus, the Company has no objection to an order which requires the Company to: (i) conduct an analysis of moving the downstate districts towards a uniform rate structure prior to the next rate case, and (ii) address the results of that analysis in the Company's next rate case.

3. Home Inspection Fee

As discussed in Staff's Initial Brief (p. 79), Staff recommended the $25 Home Inspection Fee be made applicable to all IAWC's Rate Areas, if supporting documentation and analysis could be provided, in the next rate case, or that the Home Inspection Fee be eliminated in all Rate Areas. (ICC Staff Ex. 5.0, pp. 31-32.) The Company stated that it would propose to make the Home Inspection Fee applicable to all Rate Areas in the next rate case. (IAWC Ex. 4.10 (Grubb Reb.), p. 22.)

4. Lincoln District Private Fire Protection Charge

As discussed in Staff's Initial Brief (p. 77), the Company indicated that a change should be made to the private fire protection charge in the Lincoln District. The Company pointed out that in all other Rate Areas, besides Lincoln, where a private fire protection charge is in place, the lowest meter charge is for "Size of Service" (meter size) "2 1/2-inch diameter and smaller." Therefore, the Company proposed, as a compliance filing following the issuance of a final order in this docket, filing a revised tariff for Lincoln's Private Fire Protection charge substantially in the form of IAWC Exhibit 4.15, so that the lowest meter charge refers to under "Size of Service", "Two and One-Half Inch and smaller." (IAWC Ex. 4.10 (Grubb Reb.), pp. 26-27.) This revision will make the tariff language for private fire protection charges consistent across all

Rate Areas, as Mr. Luth recommends. In its Initial Brief, Staff agrees with the Company's proposal. (Staff Init. Br., p. 77.)

5. Number of Days for an Effective Date after Filing Compliance Tariffs

As discussed in Staff's Initial Brief (p. 77), Staff proposed an effective date of five working days after IAWC files its compliance rates. (Staff Ex. 17.0-C, p. 4.) The Company accepted Staff's proposal. (IAWC Ex. 4.20 (Grubb Sur.), p. 8.)

C. Contested Issues

1. $10 Activation Charge

In its Initial Brief (pp. 80-81), Staff opposes implementation of a $10 Customer Activation Charge in all IAWC's Rate Areas because, Staff asserts, IAWC did not explain why the Customer Activation Charge should be recovered in all Rate Areas, and Staff could not find a similar charge in effect for other Commission-regulated utilities in Illinois. As explained in IAWC's Initial Brief (pp. 115-116), however, IAWC has provided support for the costs underlying the Customer Activation Charge. Moreover, 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.) The fact that other regulated utilities in Illinois do not have a similar charge does not mean such a charge, properly supported (as it is here), is not appropriate. In fact, the Company's proposal to implement the charge in all districts is 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)

Response to AG and Staff

Both the AG (Init. Br., pp. 40-43) and Staff (Init. Br., pp. 83-84) assert that IAWC, under the terms of Section 8-306(h) of the Act, 220 ILCS 5/-8-306(h) ("Section 8-306(h)"), must provide a unit sewer rate for collection-only sewer customers who use less than 1,000 gallons of water a month. As IAWC explained in its Initial Brief (pp. 116-18), the Company is proposing a new rate structure in the Chicago Metro District-Sewer, which would apply a combination fixed and volumetric rate for residential sewer collection and treatment customers. (IAWC Ex. 4.00 (Grubb Dir.), p. 40.) The Company's proposed fixed charge of $26.07 for collection and treatment customers, coupled with a usage allowance of 1,000 gallons per month, represents a "unit sewer rate," subject to Commission review, that applies only to those customers who use less than 1,000 gallons of water pursuant to Section 8-306(h). As the AG acknowledges, Section 8-306(h) does not differentiate between sewer collection-only and collection and treatment services (AG Init. Br., p. 42), nor does it specify which, or how many, sewer customers the Section applies to. Nor does Section 8-306(h) require, as the AG suggests (Init. Br., p. 41), that the unit sewer rate be a "consumption-based rate." Thus, IAWC has properly proposed "a unit sewer rate," as required by Section 8-306(h).

Staff and the AG recommend that the unit sewer rate be expanded to cover collection-only customers. As Mr. Grubb explained, however, the Company determined that a separate rate for sewer collection-only customers who use less than 1,000 gallons would not be practical. (IAWC Ex. 4.20 (Grubb Sur.), pp. 20-21.) As Mr. Grubb indicated, the cost of serving collection-only customers consists primarily of fixed costs, and 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.)

If the Commission determines that Staff's and the AG's proposal should be accepted (which it should not), based on the variable cost of $0.01 per ccf referenced above, the Company has proposed a fixed plus volumetric charge with an allowance for low-volume users. (See IAWC Init. Br., p. 118.) This fixed plus volumetric charge is supported by the record in this case, rendering Staff's recommendation "that the Commission order IAWC to make a 45-day filing, for a rate pursuant to Section 8-306(h) of the Act, within 30 days of the Final Order in this docket" (Staff Init. Br., p. 84), unnecessary.

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

The Company proposes an across-the-board rate increase, which is supported by the AG (Init. Br., p. 43) and the LWC (Init. Br., pp. 21-30). Staff proposes that rates be set in accordance with Staff's Cost of Service Study ("COSS"). (Staff Init. Br., pp. 84-97.) As stated in its Initial Brief (p. 119), the Company's position with respect to Staff's COSS is that, although the Commission could reasonably establish rates based on moving toward the Staff COSS, 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, of IAWC's Initial Brief and below.

4. Pontiac District Rate Design

Response to AG

The AG (Init. Br., pp. 52-53) proposes that the rates for Pontiac should not be changed to match the rest of the SPSPSB District rates in the "interest of rate moderation." The AG recommends rejecting IAWC's proposal that the SPSPSB District rate for the third consumption block be adopted with in Pontiac. In Docket 02-0690, the Commission stated that it "does believe that further movement toward STP in the future should be considered," and that the Commission would evaluate the "propriety of moving the Pontiac district more fully into the [SPSPSB District] group." Docket 02-0690 Order, pp. 121-22. Consistent with this conclusion, the Company supports moving Pontiac rates towards the rates of the other portions of the SPSPSB District as a continued effort to consolidate rates. (IAWC Ex. 11.10 (Herbert Reb.), p. 5.) The overall increase in revenue in Pontiac under the Company's proposal is 12.5%. (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.

Response to Staff

Staff recommends that Pontiac's rates not be the same as the SPSPSB District. (Staff Init. Br., p. 99.) As IAWC explained in its Initial Brief (p. 120), however, 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%. IAWC's proposal represents a reasonable approach to continue rate consolidation and move Pontiac's rates to the SPSPSB District rates. (IAWC Ex. 11.10 (Herbert Reb.), p. 6.)

5. South Beloit District Rate Design

Staff asserts that rates should be set in South Beloit based on the COSS, and rejects both an across-the-board increase and Mr. Grubb's proposal that, if Staff's COSS is used, final rate

design reflect the rate increases to South Beloit so 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. (Staff Init. Br., pp. 99-101.) Under the Staff COSS, however, rates for South Beloit would increase by 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. (IAWC Ex. 4.10 (Grubb Reb.), p. 31.) The Company believes that combining service districts will mitigate the rate impact on South Beloit customers, with only a small impact to the average Southern, Peoria, Streator and Pontiac residential customer's bill. (IAWC Ex. 4.00 (Grubb Dir.), pp. 40-41.) Therefore, an across-the-board approach is the most reasonable choice with respect to rate impacts on South Beloit.

The AG supports an across-the-board increase for South Beloit. (AG Init. Br., p. 54.) The Company agrees that an across-the-board increase is the most reasonable option. Mr. Grubb's alternate proposal, however, 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

Response to Staff

With respect those customers with Competitive Service Tariffs in IAWC's SPSPSB District (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")), Staff and the Company are in agreement that the projected change in revenue resulting from test year changes in rates under the Competitive Service Tariffs should be reflected. (See Staff Init. Br., pp. 102-03; IAWC Init. Br., pp. 121-26; IAWC Ex. 4.20 (Grubb Sur.), p. 10.) The disagreement is with

regard to the level of the respective changes in rates during the year 2009, and the portion of the test year for which such changes should be reflected. (Staff Init. Br., p. 101.)

Staff proposes that the rates for each of the SIWC, SOWC, and MEMJAWA Competitive Service Tariff Customers be increased on January 1, 2009 by the same percentages, respectively, that they were increased on January 1, 2008. (ICC Staff Ex. 17.0-C, pp. 6-7.) Staff also asserts that Mr. Grubb's proposal to only reflect the rate change for one-half of 2009 for these Competitive Service Tariff Customers (as the test year ends in June 2009) is not reasonable, and that the Commission should consider that the rates established on January 1, 2009 will continue in effect for 12 months until January 1, 2010, and will (according to Staff) likely increase at that time. (Staff Init. Br., pp. 102-03.) Staff therefore proposes that the expected revenue level for the year ended December 31, 2009 for SIWC, SOWC, and MEMJAWA should be used for developing the test year revenue requirement for the SPSPSB District. (Id., p. 103.) Staff also proposes that revenues attributed to O'Fallon should reflect the annual amount that is projected to occur for the 12 months of August 15, 2008, through August 14, 2009. (Id.) Thus, Staff proposes to reflect for the future test year ended June 30, 2009, an annual revenue level that it calculates for a time period ending after the end of the test year.

There are two flaws with Staff's position. First, Staff's proposal assumes that the January 1, 2009 rate increases for SIWC, SOWC and MEMJAWA and August 2008 rate increase for O'Fallon would be in effect for a full twelve-month period, which, of course, would not be the case until several months after the test year in this proceeding has ended. As Mr. Grubb points out, the referenced increases would be in effect for only a portion of the test year, which ends on June 30, 2009. (IAWC Ex. 4.20 (Grubb Sur.), p. 10.) Thus, Staff's proposal would adjust the test year to reflect post-test year revenue. The test year ended June 30, 2009 concludes within 24

months of the date on which the proposed tariffs were filed in this proceeding, and therefore is consistent with the requirements of a future test year as set forth in 83 Ill. Adm. Code Part 287 ("Part 287"). Also, under Part 287, while adjustments may be made to an historical test year in certain circumstances to reflect certain post-test year changes, no such adjustments are allowed in connection with use of a future test year. 83 Ill. Adm. Code §§ 287.20, 287.40. Thus, Staff's proposal to reflect a post-test year revenue level is a violation of the Commission's test year rules, and is improper single-issue ratemaking. Business & Prof. People for the Public Interest v. Illinois Commerce Comm'n, 146 Ill. 2d 175, 237-38 (1991). Staff proposes to reflect post-test year revenue with no post-test year adjustments to reflect cost changes or other post-test year items. Therefore, Staff's proposal with regard to Competitive Service Tariff Customers should be rejected.

Second, as IAWC explained in its Initial Brief (pp. 124-25), the Competitive Service Tariff rates are variable. (IAWC Ex. 4.20 (Grubb Sur.), p. 10.) 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 cause the Competitive Service Tariff rate to go down. As Mr. Grubb explained, it is therefore appropriate to project test year Competitive Service Tariff rates for MEMJAWA, SIWC and SOWC based on a three-year historical average, rather than the percentage increase from 2007 to 2008 as Staff proposes. (Id., p. 11; see IAWC Init. Br., p. 124-25.) IAWC's proposal for MEMJAWA, SIWC and SOWC, as explained in its Initial Brief (pp. 124-25), represents a reasonable projected increase in Competitive Service Tariff rates effective January 1, 2009, and properly reflects that increase for one-half the test year. Therefore, IAWC's

proposal for SIWC, SOWC and MEMJAWA, which is reflected in the final operating income statement attached as Appendix A, Schedule 1, hereto, should be adopted.

With respect to O'Fallon, as IAWC explained in its Initial Brief (pp. 125-26), 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 (under which O'Fallon currently receives service) that exceeds the level it would experience under the Competitive Service Tariff, O'Fallon is expected to elect to be served under the Competitive Service Tariff. (IAWC Ex. 4.20 (Grubb Sur.), p. 12.) As Mr. Grubb explained, such an election by O'Fallon is projected to occur under both IAWC's and Staff's proposed rate increases and 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.)

Staff agrees that the revenues attributed to O'Fallon should reflect the amount projected to occur. (Staff Init. Br., p. 103.) As discussed above, however, Staff proposes to reflect revenues attributed to O'Fallon from August 15, 2008, through August 14, 2009. As also discussed above, reflecting revenues from O'Fallon beyond the test year, which ends June 30, 2009, violates the test year rules and represents single-issue ratemaking. IAWC's proposal, which reflects revenues attributed to O'Fallon's switch to the Competitive Service Tariff from August 15, 2008, through June 30, 2009, as shown on IAWC Exhibit 4.21 and on the final operating income statement (Appendix A, Schedules 1 & 2), properly reflects the revenue

received from O'Fallon during the test year in light of O'Fallon's expected switch back to the Competitive Service Tariff.

7. Fire Protection Charges

With respect to private fire protection charges, Staff recommends that the Commission set private fire protection rates at current levels. (Staff Init. Br., p. 105.) 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. Staff's proposal with respect to private fire protection charges, however, is consistent with IAWC's proposal that, if Staff's COSS is adopted, fire protection rates should remain at present rates. (IAWC Init. Br., pp. 126-27.)

With respect to public fire protection rates, IAWC also proposed that, if Staff's COSS is adopted, fire protection rates should remain at present rates. (IAWC Init. Br., pp. 126-27.) Staff asserts, however, that in setting public fire protection rates, it is "bound by the provisions of [Section 9-223 of the Act], which does not provide any leeway on this issue." (Staff Init. Br., p. 105.) The Commission, however, does have "leeway" in setting fire protection charges. As IAWC discussed in its Initial Brief (p. 127), the cost of providing fire protection service is not the sole consideration for the Commission. 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%, should be accepted.

8. Other

a. Tariff Harmonization

As IAWC explained in its Brief (pp. 127-28), Staff witness Luth recommended that the Commission order the Company to create "streamlined uniform tariffs." In its Brief (p. 128), the Company agreed with Mr. Luth's recommendation and indicated that it 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. The Company also proposed that it would file the final version of the revised tariffs within 90 days after Staff completes its review. (IAWC Ex. 4.20 (Grubb Sur.), p. 8.) Staff agreed with the Company's proposal to provide a first complete version of its revised tariffs for Staff's review by April 30, 2009, and to file the final version of the revised tariffs within 90 days after Staff completes its review. (Staff Init. Br., p. 75.) In its Order, the Commission should make clear that the filing of standardized tariffs with the Commission, other than in a general rate case, should not preclude the filing by the Company of a proposed general increase in rates during the period in which the Commission is reviewing the standardized tariffs

Staff notes, in its Initial Brief (p. 76), that the AG seeks "input" into the tariff harmonization process. IAWC shares Staff's concerns that involvement of additional parties might make the project cumbersome, but does not object to the AG's reasonable participation. IAWC supports Staff's recommendation that the AG provide general comments regarding tariff consistency and specific proposals for revisions by October 31, 2008.

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 Appendix A hereto, implementing the increase across-the-board as proposed by the Company.

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Respectfully submitted,

ILLINOIS-AMERICAN WATER COMPANY

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