

**STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION**

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

**BRIEF ON EXCEPTIONS
WITH PROPOSED SUBSTITUTE LANGUAGE
OF THE CITIES OF CHAMPAIGN AND URBANA, AND
THE VILLAGES OF HOMER GLEN, ORLAND HILLS,
ST. JOSEPH AND SAVOY**

I. Introduction.

This Brief on Exceptions with proposed substitute language is filed on behalf of the Cities of Champaign and Urbana and the Villages of St. Joseph and Savoy in the Champaign District and the Villages of Homer Glen and Orland Hills in the Chicago Metro District (Municipalities).

Illinois-American Water Company (IAW or Company) filed this rate case seeking increases in water revenues that varied by district. For the Champaign District, the filed increase was 59.83 per cent and for the Chicago Metro District the filed increase was 5.80 per cent. The Proposed Order would grant the Company an increase of 47.20 per cent in the Champaign District and 5.29 per cent for the Chicago Metro District.

The Municipalities will address four items in this Brief on Exceptions:

- The Proposed Order errs by not recalculating the net salvage value to be used to establish depreciation rates as proposed by the Illinois Large Water Consumers.
- The Proposed Order errs in not reducing the amount of management fees charged to IAW as recommended by the Illinois Attorney General.

- The Proposed Order errs by not reducing the Company's operations and maintenance expenses for the Chicago Metro District to bring IAW's rates in line with what municipally-owed water utilities charge.
- The Proposed Order errs by not requiring the Company to conduct a rate comparison study in the Champaign District to determine if that district's rates are higher than what municipally-owned utilities charge.

EXCEPTION NO. 1.

II. The Company's proposed net salvage ratio should be rejected.¹

In this case, IAW presented a depreciation study to support its increase in depreciation expense for each district. The Proposed Order concludes that since IAW has supplied company-specific data, it is not necessary or appropriate to rely upon affiliate information to determine the proper depreciation expenses in this docket. Proposed Order at 19. While it is generally reasonable that a specific study should trump a comparison to what affiliates are charging, the Commission should not blindly accept a study that shows what the Company proposes in this case is excessive.

The Proposed Order accepts the \$8.153 million in net salvage value proposed by the Company based solely on the fact that it is company-specific. However, the amount of net salvage value is 6.5 times larger than IAW's actual net salvage expense adjusted for inflation. IWC Ex. 2.0 at 2/31-32. The Proposed Order fails to explain how the Company's own study produces such a huge increase or why such an increase is justified. The shocking nature of the increase is further underscored by the example cited in the Proposed Order itself for Account

¹ Original outline number III. C. 3. Depreciation Expenses.

334.20. The Company is requesting a net salvage ratio of negative 250.00 per cent while the net salvage values for IAW affiliates in Missouri, Kentucky and Indiana range from a positive 3.00 per cent to a negative 40.00 per cent, or negative 16.00 per cent on average. Proposed Order at 17. The Order accepts without question the Company's ratio and ignores the fundamental question of why is IAW's rate so out of line? As IIAW's witness Mr. Collins stated:

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

IIRC Ex. 5.0 at 3/52-59.

This Commission should not accept a study from the Company that on its face produces an inequitable result. Instead, a reasonable alternative is to use the average of the net salvage ratios adopted by other American Water affiliates. By doing so, it would still be 2.5 times greater than IAW's actual net salvage expenses adjusted for inflation. IIRC Ex. 2.0 at 2/44-45.

The Proposed Order should be amended to reflect this result.

EXCEPTION NO. 2.

III. IAW has not justified the excessive level of the management fees it pays to its affiliate.²

The Proposed Order, while finding that the Company may not be “doing everything possible to ensure low costs for ratepayers,” nonetheless approves all of the management

² Original outline No. III, C. 6. Management Expenses.

expenses that IAW requested. Proposed Order at 30. Instead, the Commission should adjust IAW's expenses as recommended by Attorney General witness Mr. Effron.

The Proposed Order should not allow the Company to collect money from ratepayers for questionable expenses now and then in the next rate case require the Company to justify the amount. This Commission cannot grant refunds. Allowing a utility to collect questionable funds from ratepayers and then allow the company to keep the money sends the wrong signal to utilities—they can overcharge with no fear of consequences.

This Commission notes later in the Proposed Order that IAW “disregarded the Commission’s directive” as to what to file in this case. Proposed Order at 119. The consequence of disregarding a specific Commission order was to tell them to do it the next time and then, maybe, the Commission will do something. This is the same approach the Commission took in Docket Nos. 05-0681, 06-0094 and 06-0095, the Village of Homer Glen’s complaint case against IAW. In Docket No. 06-0095, the Commission found that IAW was not in compliance with numerous rules and regulations of the Commission but forgave IAW and told it that maybe the next time the Commission would assess penalties against IAW for violating rules that endangered the safety of its customers. The history of IAW’s actions is that it disregards the Commission’s rules and orders to the detriment of ratepayers. The Commission has the ability to change the Company’s approach and should do so in the order in this docket.

The Proposed Order gives IAW the full amount of its \$18.5 million request for management fees; that is, payments it makes to its affiliated service company. The payments cover, in part, services now performed by the service company that were formerly provided by employees of IAW. This transfer of employees and responsibilities to the affiliate was described

as a cost savings initiative. However, AG witness Effron found that the company did not justify all of its expenses and that an adjustment of \$2.667 million was necessary. It is up to the Company to justify its costs. As the Proposed Order indicates, IAW has failed to do so in this case. Rather than give the company its full request and ask for justification later, the Commission should make the adjustment as recommended by AG witness Effron.

EXCEPTION NO. 3.

IV. An adjustment to reflect IAW's high rates in comparison to municipally-owned utilities is appropriate for the Chicago Metro District.³

As a result of Docket No. 05-0681, 06-0094 and 06-0095 (Consol.), the Company was required to file this rate case or reopen its previous case because the evidence in the complaint case “suggests that the rates charged by IAWC in the Chicago Metro service may not be just and reasonable because they are disproportionately high relative to the rates charged in other nearby communities.” Docket Nos. 05-0681, 06-0094 and 06-0095 (Consol.) Final Order at 45.

In this Docket, the Company attempted to side-step the fact that the rates it charges customers are higher than the rates charged by municipally-owned utilities. The testimony of the Company, in essence, is that it agrees it charges its customers more than what customers of municipally-owned utilities pay, but that's because IAW's costs are higher. IAWC Ex. 1.0 at 13/287-289. The Proposed Order simply throws up its hands by stating “a comparison of IAWC's rates and costs to those of MOUs is a difficult, if not impossible, undertaking.” Proposed Order at 41. This is the precise reaction IAW wants the Commission to have, but it is wrong.

³ Original Outline No. C. 7. Chicago-Metro Division Operations and Maintenance (“O&M”) Cost Adjustment and Rate/Cost Comparisons.

AG witness Rothstein presented a clean, clear and simple analysis. His analysis dealt only with the costs and expenses that are common to both IOUs and MOUs. He studied the operating and maintenance expenses of several surrounding MOUs. He also went one step further. He compared IAW to an industry benchmark that surveyed 193 water and wastewater systems throughout the United States. By conducting the study in this manner, he was able to eliminate the items that do vary by whether the entity is an IOU or a MOU. His results showed that the Chicago Metro District's adjusted operations and maintenance expense per account is \$240.21 (or \$266 including an adjusted maintenance expense) compared with \$208 for the national average. The median benchmark for O&M costs for water utilities is \$1,360 per MG processed versus \$1,990 for the Chicago Metro District. AG Ex. 2.0 at 18/409-19/432. These results clearly show that IAW's operations are inefficient when compared to other utilities. Mr. Rothstein concluded that the "disparity in charges between municipally owned systems and investor owned systems raises the question of whether the costs and rates of the investor owned system are reasonable." AG Ex. 2.0 at 7/129-131.

Of course, it is the bottom line that customers compare. It is that bottom line comparison that has municipalities such as Homer Glen worried. As the Village Mayor testified, "If IAW's water rates are not in line with the water rates in other communities, Homer Glen will be at a disadvantage in attracting residents and development in our community." HG Ex. 1.0 at 5/108-111.

AG witness Efron developed an adjustment only to IAW's O&M expenses for the Chicago Metro District that would help bring IAW's rates in line with those charged by MOUs

in the area. This adjustment is both reasonable and necessary. The Proposed Order should be amended to incorporate this adjustment.

EXCEPTION NO. 4.

V. The Commission should require IAW to perform an analysis comparing IAW's rates in the Champaign District to MOUs in the Champaign area.⁴

Having erroneously found that there should be no adjustment in the revenue requirements for the Chicago Metro District due to the fact that IAW's rates are disproportionately too high when compared to MOU rates, the Proposed Order also erroneously finds that it is unnecessary for IAW to perform an analysis of its rates in the Champaign District. Proposed Order at 42.

The Proposed Order should be modified to require IAW to file a new study comparing rates in the Champaign District when it files its next rate case.

VI. Conclusion.

The Municipalities request that the Proposed Order be modified as set forth in this Brief on Exceptions and the attached proposed substitute language.

By: _____/rcb/_____
Richard C. Balough

Richard C. Balough
Attorney at Law
53 W. Jackson Blvd. Ste. 936
Chicago IL 60604
Telephone: 312-834-0400
Fax: 312.834.0526
rbalough@balough.com

⁴ Original Outline No. C. 7. Chicago-Metro Division Operations and Maintenance ("O&M") Cost Adjustment and Rate/Cost Comparisons.

CERTIFICATE OF SERVICE

I, Richard C. Balough, hereby certify that a copy of the foregoing Brief on Exceptions with Proposed Substitute Language of the Municipalities was served upon all parties on the ICC eDocket Service List by electronic means on this 19th day of June 2008.

_____/rcb/_____
Richard C. Balough

EXCEPTION NO. 1 PROPOSED LANGUAGE

e. Commission Conclusion

The Commission ~~rejects~~accepts LWC's and CLGI's proposal that in determining IAWC's depreciation expense, information for the average net salvage ratios of IAWC's affiliates should be used. In preparing the depreciation studies, Mr. Robinson investigated and analyzed IAWC's historical plant data, as well as reviewed IAWC's past experience and future expectations to determine the remaining lives of IAWC's water and sewer plant assets. It has not been established to the Commission's satisfaction that the study was proper in scope, reviewed appropriate data, and the method of analysis was reasonable. ~~It appears to the Commission that Mr. Robinson's depreciation studies justify IAWC's proposed test year depreciation expense~~The results produced are, as LWC demonstrated, out of line with historic numbers and the ratios used by IAW affiliates in surrounding states.

~~Specifically, the study analyzed historical net salvage for the periods of 1980-2005 and a three-year rolling band analysis that was also based on historical data. It was then established after further analysis of the information that IAWC's proposed net salvage ratios were in line with the net salvage ratios historically experienced by IAWC; and when applied to the original cost of existing plant, reflect what can reasonably be expected to be the end-of-life cost of removal and salvage for plant still in service.~~

The Commission agrees that absent an in-depth study it may be appropriate in some circumstances to make a depreciation rate comparison to IAWC's affiliates in determining a proposed net salvage ratio. However, just because IAWC has supplied the Commission with a study that specifically includes company-specific data, it ~~does not mean that the Commission can ignore other evidence that demonstrates the unreasonableness of the company-specific numbers. is not necessary or appropriate to rely upon affiliate information in determining IAWC's depreciation rates.~~ Thus, the Commission concludes that the record does not support IAWC's proposed depreciation rates and associated test year depreciation expense based on its depreciation studies. The more reasonable approach is to use the net salvage values determined by IAW in this case. This issue is discussed in conjunction with rate base below.

EXCEPTION NO. 2 PROPOSED LANGUAGE

d. Commission Conclusion

IAWC seeks to recover in rates \$18,523,751 in management fees. AG witness Effron recommends an adjustment reducing the management fees expense by \$2,667,000 to remove what the AG argues has not been explained or justified as reasonable. Mr. Effron's recommendation adjusts the management fees to only include the expenses associated with IAWC employees that were transferred to the Service Company, an inflation factor which he recalculated for 2006, pension expense, an inflation factor from 2006 to the test year, IAWC's quantification of the cost of "new functions," and the costs associated with the restructuring.

The Commission ~~does not agree~~s with Mr. Effron's analysis. Mr. Grubb ~~explains~~ that the change in management fees expense from 2003 through 2006 was based on a re-categorization of certain costs from the prior test year and five additional factors, including general inflation, new functions being performed that resulted in new services being provided to IAWC by the Service Company, increased call activity at the CSC, increased pension expense, and a restructuring that shifted services from IAWC to the Service Company. IAWC explains that American Water initiated an organizational restructuring in 2004 that ultimately eliminated 31 positions from the payroll of IAWC is not convincing. The services performed by these 31 employees were subsequently provided by the Service Company. According to IAWC, the reduction of costs to IAWC as a result of this restructuring exceeded the amount of service costs shifted to the Service Company and charged back to IAWC after the restructuring by at least \$312,969. IAW has not justified its level of management fees in this case and therefore, the analysis of Mr. Effron is more reasonable.

The lack of sufficient evidence from IAWC makes the Commission ~~points out that it does~~ question whether IAWC is doing everything possible to be as efficient in controlling its management fees to avoid passing unnecessary costs to ratepayers. ~~Although the Commission holds that the expense requested is not unreasonable, it does so only in the absence of specific and adequately justified adjustments. The Commission acknowledges that it is possible that CSC expense has increased due to complaints and unhappy customers.~~ If IAWC plans to continue to utilize the Service Company because doing so arguably benefits ratepayers by reducing IAWC's labor and other related costs, then at some point the lower costs must be more evident. When IAWC can demonstrate those savings, then the Commission will allow full recovery.

Based on the evidence, the Commission adopts the management expense as recommended by ~~IAWC~~Mr. Effron. The ~~Commission, however, has a continuing obligation to ensure just and reasonable rates. Because the Commission questions whether IAWC is doing everything possible to ensure low costs for ratepayers, the~~ Commission directs IAWC to conduct a study comparing the cost of each service obtained from the Service Company to the costs of such services had they been obtained through competitive bidding on the open market. As part

of the study, IAWC must also provide an analysis of the services provided by the Service Company to all IAWC's affiliates. The analysis must provide details on how costs are allocated among affiliates of IAWC. IAWC shall include the study in its next rate filing.

EXCEPTION NOS. 3 AND 4 PROPOSED SUBSTITUTE LANGUAGE

e. Commission Conclusion

The Commission ~~rejects~~accepts both the AG's and CLGI's recommendation to reduce IAWC's O&M expense for the Chicago-Metro Division because its cost and rates are ~~allegedly~~ higher than those for municipal utilities. IAWC retained two companies to gather information to determine whether a comparison of IAWC's rates to those of MOUs would indicate whether IAWC's rates are reasonable. The Report resulting from the two companies' efforts outlines numerous differences between MOUs and IOUs, such as IAWC. ~~However, the Report fails to explain and justify why IAWC's operations and maintenance expenses are significantly higher than the expenses for MOUs in the area and the benchmark survey. Due to the fundamental differences between MOUs and IAWC, it is the opinion of the Commission that a comparison of IAWC's rates and costs to those of MOUs is a difficult, if not impossible, undertaking. In this instance, the results of the Report do not support a conclusion that IAWC's rates and costs in the Chicago-Metro Division are unreasonable.~~

~~As the Report notes, MOU operations receive significant tax subsidies and have other sources of revenue, thus reducing the extent to which MOUs are required to recover utility-related costs in rates. For instance, the imposition of non-resident surcharges, a common practice of MOUs, is unknown in IAWC's Chicago-Metro Division. MOUs utilize sources of funding for capital projects that are not available to IAWC, due to applicable regulatory requirements such as Part 600. Also, unlike MOUs, IAWC is subject to service standards imposed by the Commission. The Commission also recognizes that MOUs do not incur certain costs that IAWC must incur, such as property and franchise taxes paid to local authorities, income and franchise taxes paid to state and local authorities, and income taxes and payroll taxes paid to the federal government. While the Commission recognizes that there are differences between IOUs and MOUs, the Rothstein study eliminates those differences and finds IAWC's rates for the Chicago Metro District are unreasonably high. As a result, Mr. Efron's revenue adjustment is appropriate and will be made in this docket. In light of this finding, the Commission In the Commission's view, the record demonstrates that there are significant differences between IAWC's cost structure and those of MOUs which supports the conclusion that comparisons of IAWC's rates to those of MOUs are not practical for ratemaking purposes. In the absence of better evidence of unreasonable costs, the Commission finds that the AG's and CLGI's proposed adjustment to IAWC's O&M expense should be rejected. The Commission further finds that requiring IAWC to provide this Commission with a comparison of rates in the Champaign District to rates in nearby municipal systems is ~~not~~ appropriate given the significant~~

differences between MOUs and IOUs discussed above. The report shall be prepared and filed with IAWC's next rate case.