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REPLY BRIEF ON EXCEPTIONS OF ILLINOIS-AMERICAN WATER COMPANY

I. INTRODUCTION

This Reply Brief on Exceptions of Illinois-American Water Company (“IAWC” or the “Company”) responds to the Briefs on Exceptions 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, “LWC”)¹; (5) the Cities of Champaign and Urbana and the Villages of Homer Glen (“Homer Glen”), Orland Hills, St. Joseph and Savoy (collectively, the “Municipalities”); and (6) the Village of Bolingbrook² with regard to the Administrative Law Judges’ Proposed Order (“ALJPO”) issued in this proceeding on June 2, 2008.

IAWC’s Reply Brief on Exceptions is organized by section of the ALJPO. Where a party or parties take exception to a section of the ALJPO, IAWC’s reply to those exceptions is provided under the respective ALJPO section heading. The sub-headings identify the party and exception number to which IAWC’s reply is directed. Where two or more parties take exception to language in the same section of the ALJPO, IAWC’s reply to the exceptions of each party is provided under the relevant ALJPO section heading, and the party and exception number to which the reply is directed is identified by sub-heading.

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

² The Village of Bolingbrook’s Brief on Exceptions adopts the three exceptions of the Municipalities in their entirety, and does not otherwise present substantive argument. Where IAWC’s Reply Brief on Exceptions responds to the Municipalities’ Brief on Exceptions, it also responds to the Village of Bolingbrook’s Brief on Exceptions.

II. ARGUMENT

A. ALJPO Section II, “Nature of IAWC’s Operations” (ALJPO, pp. 4-6)

Response to Staff Exception 1

Staff proposes (Staff BOE, pp. 3-5) certain changes to the descriptions of IAWC’s service areas and operations. IAWC does not object to the changes as proposed by Staff.

B. ALJPO Section IV.A.4, “Water Meter Depreciation Expense,” (ALJPO, pp. 8-9)

Response to Staff Exception 2

Staff notes in its Brief on Exceptions (pp. 4-5) that to correctly reflect the change in depreciation rates for water meters, an adjustment must be made to both depreciation expense and accumulated depreciation. As IAWC explained in its Initial Brief (pp. 19-20), Staff witness Jones proposed an adjustment to depreciation expense for meters in each Rate Area based on Staff witness Johnson’s proposed changes. (ICC Staff Ex. 1.0, p. 12; Sched. 1.8.) Staff witness Jones also proposed a related adjustment to accumulated depreciation based on Mr. Johnson’s recommendation. (Id.) The Company accepted Ms. Jones’s proposed adjustments. (See Staff Ex. 11.0, p. 8.) Therefore, IAWC agrees with Staff Exception 2.

C. ALJPO Section IV.B.3, “Water and Sewer Plant Depreciation Expense,” (ALJPO, pp. 14-19)

Response to LWC Exception No. 1 and Municipalities Exception No. 1

LWC, the Municipalities and Bollingbrook take exception to the ALJPO’s conclusion that depreciation rates should be determined in accordance with depreciation studies prepared by the Company’s depreciation expert, Mr. Earl Robinson. None of these parties have provided persuasive evidence that the ALJPO erred in its conclusions regarding depreciation expense.

LWC argues that the Commission should disregard IAWC’s depreciation study because it “results in a situation of intergenerational inequities.” (LWC BOE, p. 3.) LWC contends that

these “intergenerational inequities” arise from including an inflation component in the calculation of net salvage ratios. This argument was thoroughly addressed and refuted in IAWC’s Initial (pp. 26-35) and Reply (pp. 14-16) Briefs. LWC does not dispute 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, 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.) LWC’s proposal to selectively alter the rate case process by treating a single component (negative net salvage recovery) differently than the remaining items was properly rejected.

LWC also argues that it is improper to use IAWC-specific data to determine IAWC’s depreciation expense because “it fails to explain the reasoning why the net salvage ratios of other IAWC affiliates are so much lower than those developed by IAWC.” (LWC BOE, p. 4.) The Municipalities similarly contend that because certain IAWC affiliates have lower net salvage ratios than IAWC, the Commission should adopt the affiliates’ net salvage ratios for IAWC and

ignore IAWC-specific data. (Munis. BOE, p. 2.) None of these parties, however, have produced evidence that IAWC's depreciation experience bears any relation to the depreciation experience of affiliate companies in other jurisdictions. As Mr. Robinson explained, it is unknown just what levels of actual net salvage IAWC affiliates may have historically experienced as compared to what levels were incorporated in the affiliates' request in various dockets. (IAWC Ex. 9.10 (Robinson Reb.), p. 16.) Not only may there be variances between net salvage experience levels and requested levels, but reasons such as the size of the service territory versus the number of operations centers, the density of the customer base, the current age of plant in service, and other similar factors, could explain the differences in net salvage ratios among various operating entities. (*Id.*, pp. 16-17.) Moreover, the net salvage ratios and depreciation rates of IAWC affiliates are not at issue in this proceeding. The issue in this proceeding is whether IAWC's net salvage ratios and overall depreciation rates are reasonable. IAWC has produced detailed, company-specific studies to support its proposed depreciation rates. That certain parties do not like the results of the depreciation studies is not a reason to disregard the studies. The exceptions of LWC, Municipalities and Bolingbrook should be rejected.

D. ALJPO Section IV.B.6, "Management Expense," (ALJPO, pp. 26-30)

Response to AG Exceptions II and III

In its Brief on Exceptions, the AG argues (pp. 3-5) that IAWC's management fee expense is "double counting" the cost of new functions provided by American Water Works Service Company, Inc. ("Service Company") and expanded services provided by the Service Company following the restructuring that shifted services from IAWC to the Service Company. This is not correct: the testimony of IAWC witness Grubb makes clear that the new functions provided by the Service Company are separate from expanded services provided by the Service Company to IAWC after the restructuring. Moreover, the AG's arguments in its Brief on Exceptions continue

to overlook the fact that Mr. Effron's proposed \$2.667 million adjustment failed to account for (among other things) the shift of services performed by 31 employees of IAWC to the Service Company. (See IAWC Init. Br., pp. 47-53.)

In its evidence in this case, IAWC explained that American Water initiated an organizational restructuring in 2004 that ultimately eliminated a number of positions from the payroll of IAWC. (IAWC Ex. 4.00 (Grubb Dir.), p. 35.) The services performed by these 31 employees were subsequently provided by the Service Company. (IAWC Ex. 4.20 (Grubb Sur.), p. 18.) The evidence makes clear that following this restructuring, the Service Company provided both new and expanded services to IAWC. In his Direct Testimony, Mr. Grubb set forth the component of management fee expense attributable to new services provided to IAWC by the Service Company, and described in detail the new functions provided. Mr. Grubb explained that the new services included the Supply Chain, Environmental Compliance, Network, Maintenance, and Production functions. (IAWC Ex. 4.00 (Grubb Dir.), p. 34.) The total cost associated with these five functions was \$1,178,187. (Id.) Mr. Effron "accepted the Company's quantification of the expenses associated with these new functions." (AG Ex. 1.0, p. 19.)

In Rebuttal Testimony, Mr. Grubb also explained that as a result of the 2004 restructuring, the Company began receiving expanded services from the Service Company. (IAWC Ex. 4.10 (Grubb Reb.), pp. 17-18.) Mr. Grubb described the types of services that were provided by the Service Company after the restructuring, and how those services were expanded when provided by the Service Company. (Id., p. 18.) For example, Mr. Grubb explained that the types of services shifted to the Service Company included the Legal Function, which was expanded to include seven lawyers, a contract administrator, a paralegal and two administrative personnel who provide IAWC with services as needed and appropriate. (Id.) Similarly, he explained that

the Finance Function was expanded to include a Manager of Compliance and three staff individuals who also provide IAWC with services as needed and appropriate. (Id.) At hearing, Mr. Grubb confirmed that the new functions described in his Direct Testimony and the expanded existing functions described in his Rebuttal Testimony were two different services and “are not the same.” (Tr. 121.)

Neither Mr. Effron nor any other witness in this proceeding asserted that the new functions and expanded services were the same or were being double counted. Instead, Mr. Effron’s adjustment of \$2.667 million was based on what he referred to as an “unexplained increase in management fees.” (AG Ex. 1.2, pp. 9-10.) As IAWC explained at length in its Initial Brief (pp. 45-53) and Reply Brief (pp. 26-30), and as the ALJPO acknowledges (p. 30), however, IAWC has fully supported the level of management fee expense proposed in this case. With respect to the 2004 restructuring, Mr. Grubb explained in testimony that the restructuring removed 31 employee positions from the Company. (IAWC Ex. 4.00 (Grubb Dir.), p. 36.) The services performed by these 31 employees were shifted to the Service Company. (IAWC Ex. 4.20 (Grubb Sur.), p. 19.) As Mr. Grubb further explained, Mr. Effron’s proposed adjustment failed to recognize that, as a result of the restructuring, IAWC began receiving expanded services from the Service Company in 2004 that replaced the services provided by the 31 eliminated IAWC employees. Mr. Effron acknowledges that the cost associated with nine employees transferred directly from IAWC to the Service Company should be included in management fee expense. (AG Ex. 1.3, Sched. C-3.1.) Mr. Effron’s analysis, however, did not account for the shift in services performed by the remaining 22 employees to the Service Company. (IAWC Exs. 4.10 (Grubb Reb.), pp. 17-19; 4.20 (Grubb Sur.), pp. 18-19.) As Mr. Grubb explained, because Mr. Effron has failed to include these shifts in services, he understated management fee

expense by approximately \$2.757 million (the cost of the services formerly provided by the 22 employees eliminated from IAWC and of related expanded services). (IAWC Ex. 4.10 (Grubb Reb.), p. 19.) With respect to new and expanded services therefore, Mr. Effron's analysis: (i) accepted the \$1,178,187 in costs for new services, but (ii) overlooked the costs associated with the services provided by the 31 employees eliminated from IAWC as a result of the restructuring. As a result, the evidence in this proceeding demonstrates that the new functions and expanded services were addressed separately by both IAWC and Mr. Effron and there was no "double counting" of services. Thus, there is no basis for the AG's position in its Brief on Exceptions.

The AG's Brief on Exceptions (p. 2) also asserts that Mr. Grubb relies on his "representation that the management fee expense was based on a 'detailed, item by item development of the budgeted costs'" (emphasis added), and also refers (p. 4) to IAWC's "purported" detailed budget. These statements ignore the fact that, not only did Mr. Grubb testify that the "Company's forecast for the test year Management fees was based on a detailed, item by item development of the budgeted costs that the Service Company anticipates to incur to provide the necessary services to Illinois American in the test year" (IAWC Ex. 4.10 (Grubb Reb.), p. 19), IAWC also provided the detailed, item by item development of the budgeted costs. (See IAWC Ex. 4.22.) Thus, IAWC's management fee expense forecast was not "purported," but was available to the parties for review. No party cross-examined Mr. Grubb on the issue of the management fee forecast, however, nor did any party challenge that forecast as inaccurate or insufficient.

The AG also asserts (AG BOE, p. 5) that the cost of new functions and expanded services provided to IAWC by the Service Company "dwarf" the savings from the restructuring. This assertion also ignores the fact that IAWC's proposed management fee expense was based on a

detailed budget of costs that the Service Company projects it will incur to provide the necessary services to IAWC in the test year. (IAWC Ex. 4.22.) IAWC has shown that the services covered by IAWC's management fee expense are services projected to be necessary in the test year, and no witness has testified otherwise. Moreover, the AG's assertion assumes that it is appropriate to compare savings to ratepayers to the cost of new (or expanded services), which it is not. IAWC has explained that the restructuring resulted in savings to rate payers (IAWC Init. Br., p. 47), so that IAWC's operating expenses are lower than they would have been without the restructuring. The fact that IAWC will receive necessary services in the test year at a cost greater than that savings is irrelevant, as IAWC has demonstrated that the services are necessary and that the Service Company will provide them, due to the efficiencies generated by the Service Company, at a lower cost than would be incurred had they been performed by IAWC. (IAWC Ex. 4.20 (Grubb Sur.), p, p. 19.)

With respect to the study that the ALJPO (p. 30) directs IAWC to prepare on the costs of services obtained from the Service Company, as noted in IAWC's Brief on Exceptions (pp. 16-17), IAWC does not take exception to the study requirement. The AG's Brief on Exceptions (p. 6) requests that the study, "should include an itemization of the services provided by the Service Company." IAWC does not object to identifying the services provided to IAWC by the Service Company, and, in fact, the language proposed in IAWC's Exceptions (IAWC BOE, App. A, pp. 13-14) addresses the AG's concerns. IAWC proposed in its Brief on Exceptions that the Commission's order state: "As part of the study, for each service provided by the Service Company to IAWC and other affiliates, where costs of such service are allocated in part to IAWC, the study will provide details on how such costs are allocated to IAWC." Thus, under

IAWC's proposed language, the study will identify and provide details for each service provided by the Service Company to IAWC, where costs of such service are allocated in part to IAWC.

Response to Municipalities Exception 2

The Municipalities argue in their Brief on Exceptions (pp. 4-5) that IAWC has not justified its costs with respect to management fees, that such expenses are "questionable," and therefore AG witness Effron's adjustment to management fee expense should be adopted. As IAWC explained in its Initial (pp. 45-53) and Reply (pp. 26-30) Briefs, IAWC provided substantial evidence supporting its management fee expense, including evidence that refuted the position of AG witness Mr. Effron. As discussed in IAWC's Initial and Reply Briefs and above, there is no basis for Mr. Effron's adjustment. As a result, the ALJPO correctly concludes (p. 29) that, "Based on the evidence, the Commission adopts the management expense as recommended by IAWC." As IAWC explained in its Brief on Exceptions (p. 14), to the extent the ALJPO could be read to suggest that IAWC has not met its burden of proof with respect to the recovery of management expense, it is inconsistent with the ALJPO's conclusion that, based on the evidence, IAWC's management expense should be adopted.

The Municipalities' Brief on Exceptions (pp. 3-4) also refers to the ALJPO's suggestion (p. 30) that IAWC is not doing "everything possible" to control costs. As IAWC explained in its Brief on Exceptions (pp. 14-16), the suggestion that IAWC is not doing everything it can to control costs is not supported by the record. The Company provided substantial evidence (which no party contested) regarding measures taken to control costs. Mr. Grubb explained (IAWC Ex. 4.00, pp. 5-6) that the Company assures that costs are maintained within approved projections through a variety of measures. Similarly, Ms. Teasley (IAWC Ex. 1.20 (Teasley Sur.), pp. 3-6) provided specific examples of how IAWC manages costs on an ongoing basis. Moreover, IAWC

demonstrated actual savings to ratepayers as the result of restructuring of Service Company operations. (IAWC Init. Br., pp. 46-47.) Thus, the Municipalities' concern that IAWC may not be controlling costs is not supported by the record and should be rejected.

The Municipalities' Brief on Exceptions (p. 4) also points to the ALJPO's statement (p. 119) that the Company "disregarded" a Commission directive in its last rate proceeding, Docket 02-0690, to provide updated demand factors for each district. As IAWC explained in its Brief on Exceptions (pp. 19-20), IAWC's decision to use a representative demand study to develop updated demand factors in this proceeding does not constitute a "disregard" of the Commission's Order in Docket 02-0690. The Docket 02-0690 Order did not specifically direct IAWC to conduct any particular type of demand study in each rate area, and there is no basis to conclude any type of penalty is warranted.

The Municipalities go on to refer to the proceedings in Dockets 05-0691/06-0094/06-0095 ("Docket 05-0681"), and assert (Munis. BOE, p. 4) that, "The Commission has the ability to change the Company's approach and should do so in the order in this docket." The Municipalities do not specify either what approach should be changed or how the Commission should make such a change. To the extent that the Municipalities are referring to the Commission's approach towards management fees, as discussed above, IAWC has shown its management fees are reasonable, and does not take exception to the ALJPO's requirement that IAWC prepare for its next rate case a study of services provided by the Service Company to IAWC for which costs are allocated to IAWC. (IAWC BOE, p. 16.) Moreover, pursuant to the Commission's directive in IAWC's last rate case (Docket 02-0690), IAWC filed the operating agreement between it and the Service Company with the Commission for reapproval. In Docket 02-0690, the Commission ordered that, "to facilitate the review of management fees in the next

rate case and to ensure that ratepayers are being adequately protected by the terms of the current agreements,” IAWC should be required to file a petition seeking approval of IAWC’s operating agreements with the Service Company. Docket 02-0690, Final Order, p. 28. IAWC filed a petition for review of the operating agreement with the Service Company in Docket 04-0595, and the Commission reviewed the operating agreement and re-approved it in that proceeding. Docket 04-0595, Final Order, p. 3. In that case, the Commission found that, “the Service Agreement is reasonable and in the public interest and should be re-approved, and consented to, by this Commission” and granted reapproval of the operating agreement. Id. Thus, there is no basis for the Municipalities to conclude some other unspecified “approach” is needed for management fees.

With respect to Docket 05-0681, no connection has been shown between that proceeding and the level of management fee expense proposed by IAWC in this proceeding. (See IAWC Reply Br., pp. 27-28.) The issues in Docket 05-0681 relate primarily to events in 2005, and the allegations in the complaints filed in Docket 05-0681 were adjudicated in that case. See Docket 05-0681, Final Order, pp. 15, 22-25, 31-33. IAWC witness Teasley addressed the Docket 05-0681 proceeding in her testimony (IAWC Ex. 1.00 (Teasley Dir.), pp. 12-14), explaining that the Docket 05-0681 Order required IAWC to undertake a number of actions, including, *inter alia*, increase the monitoring and reporting of high bills, estimates and zero-use bills, improve bill format, develop and conduct training sessions for customer service representatives, conduct inspections and maintenance of valves and hydrants, and take certain steps with regard to recordkeeping and reporting. Thus, in contrast to the Municipalities’ assertion in their Brief on Exceptions (p. 4) that the Commission “forgave” IAWC in that case, IAWC committed to, and the Commission so ordered, extensive actions in response to concerns raised in Docket 05-0681.

IAWC is in the process of complying with all requirements established by the Commission pursuant to the Docket 05-0681 Order. (Id.) Thus, there is no basis to draw the connection the Municipalities suggest between the outcome of Docket 05-0681 and the Commission's determinations in this case.

E. ALJPO Section IV.B.7, "Chicago-Metro Division Operations and Maintenance ('O&M') Cost Adjustment and Rate/Cost Comparisons" (ALPO pp. 30-42)

In their respective Briefs on Exceptions, both AG (AG BOE, pp. 8-35) and the Municipalities (Munis. BOE, pp. 5-7, 11-12) challenge the ALJPO's rejection of the adjustment proposed by AG Witness Rothstein (and reflected by AG Witness Effron) which would reduce Operations and Maintenance ("O&M") expense for IAWC's Chicago Metro District – Water in the amount of \$2,050,000, based on a comparison of IAWC's O&M cost per customer with certain costs recorded by four municipally owned utilities ("MOUs"). For the reasons discussed in IAWC's Initial and Reply Briefs (IAWC Init. Br., pp. 53-85; IAWC Reply Br., pp. 30-41), the ALJPO (pp. 41-42) recognizes correctly that the O&M adjustment addressed in the Briefs on Exceptions of AG and the Municipalities, and the alternative adjustment proposed by AG witness Rothstein (but not referenced in the Briefs on Exceptions), are baseless and should be rejected.

The Municipalities (Munis. BOE, pp. 7, 11-12) also seek to overturn the ALJPO's rejection of their proposal that IAWC be required to provide the, "Commission with a comparison of rates in the Champaign District to rates in nearby municipal systems." (ALJPO, p. 42.) As will be discussed, the ALJPO properly rejects this proposal.

Response to AG Exception IV

As discussed in IAWC's Initial Brief (IAWC Init. Br., pp. 53-54), in response to the Commission's Order in Docket 05-0681, IAWC presented extensive evidence through several

witnesses (including the detailed Schedules of the “Standard Filing Requirements” set forth in 83 Ill. Admin. Code Part 285) demonstrating the reasonableness of the rates proposed in this proceeding. In addition, in response to the concern expressed in Docket 05-0681 with regard to a comparison of IAWC’s rates with those of certain MOUs, IAWC retained Stifel, Nicolaus & Company (“Stifel”) and Deloitte & Touche, LLP (“Deloitte & Touche”) to gather available information, and to analyze that information to determine whether a comparison of IAWC’s rates to those of MOUs would indicate whether or not IAWC’s rates are reasonable. (IAWC Init. Br., p. 54.) Stifel and Deloitte & Touche assembled information, performed the requested analysis, and summarized their findings and conclusions in a Report (“Report”), which was identified in this proceeding as IAWC Ex. 10.20. The Report is supported by the testimonies of Mr. Uffelman of Deloitte & Touche (IAWC Ex. 10.00) and Ms. Kane of Stifel (IAWC Ex. 10.10). As discussed in the Report, the cost structures on which the rates of investor-owned utilities (“IOUs”), such as IAWC, are based differ in many respects from those of MOUs. As a result, a comparison of IAWC’s rates or costs to those of MOUs does not support a conclusion that IAWC’s rates or costs are unreasonable. (IAWC Init. Br., p. 54.)

In its Brief on Exceptions (AG BOE, p. 8), AG suggests that testimony of IAWC witness Teasley supports the view that IAWC’s rates are unreasonable. This assertion, however, misstates Ms. Teasley’s testimony. At the referenced point of her testimony, Ms. Teasley noted that the level of IAWC’s rates relative to those of certain MOUs has been a source of customer concern. (IAWC Ex. 1.20 (Teasley Sur.), p. 2.) Ms. Teasley went on to explain that IAWC has responded to this concern with extensive efforts (which Ms. Teasley’s testimony describes) to review and minimize its specific costs and rates. (Id., pp. 2-6.) Ms. Teasley also noted that IAWC cannot address this concern by setting its rates to match those of MOUs which, as shown

by the Report, are subject to different cost and accounting structures as compared to those applicable to IAWC. (Id., p. 2; IAWC Ex. 1.0 (Teasley Dir.), p. 13.)

As discussed in IAWC’s Initial Brief (IAWC Init. Br., pp. 54-67), the Report and the testimonies of Mr. Uffelman and Ms. Kane identify numerous differences between IAWC and MOUs that affect their rates. Most MOUs, including the three studied, set rates on the basis of “cash needs”, whereas IAWC is required by applicable rules to use the “utility” or “cost of service” approach. Under the cost of service approach, IAWC recovers the costs of non-cash accrued items – including depreciation expense and the cost of providing pensions or other post-employment benefits (“OPEBs”) – in rates in the accounting period when the costs are accrued. MOUs, on the other hand, do not recover such costs in rates in this manner. (Id., pp. 55-56.) Unlike IAWC, MOUs also receive significant tax subsidies. Two of the MOUs studied in the Report, for example, obtain all their water from the DuPage Water Commission (“DWC”), which has the lowest wholesale cost of water of all regional providers because of a significant sales tax subsidy. (Id., pp. 57-59.) In addition, the service area characteristics of each of the MOUs studied in the Report differ significantly from those of IAWC’s Chicago Metro District, with the result that the MOUs exhibit different cost characteristics. (Id., p. 59.) MOUs, moreover, utilize sources of funding for capital projects – including tax exempt general obligation bonds (“GO bonds”) and connection fees or impact charges – that are not available to the same extent for IOUs, such as IAWC. (Id., pp. 60-61.) IAWC must also follow comprehensive operational and regulatory service standards promulgated by the Commission that do not apply to the MOUs. As the Report further indicates, IAWC must pay a variety of different taxes not applicable to MOUs, including property and franchise taxes to local authorities; income and franchise taxes to state authorities; and income and payroll taxes to the

federal government. (Id., pp. 61-63.) Due to the numerous differences addressed in the Report (which are quantified where reasonably possible), the ALJPO's conclusion on this issue is firmly supported by the evidence in this case.

The record does not support AG's assertion (AG BOE, p. 33) that a comparison of IAWC's rates and those of MOUs "raises serious questions" about the reasonableness of IAWC's rates. Mr. Uffelman noted that Mr. Rothstein prepared no analyses or studies that provide a basis for the comparisons he set forth. (IAWC Ex. 10.30 (Uffelman Reb.), p. 2.) As Mr. Uffelman explained, Mr. Rothstein's responses to IAWC's Data Requests confirm that he did not review or analyze the cost structure of any of the MOUs shown on Exhibit EPR-3 or of the Survey participants. (Id., p. 3.) Mr. Rothstein conducted, "no separate analysis of the comparability of utility systems, facilities or operating practices" of the MOUs or Survey participants in the 2006 Benchmarking Survey ("Survey") referenced by AG (AG BOE, p. 15) to those of IAWC. (IAWC Ex. 10.30 (Uffelman Reb.), p. 3 (quoting Data Response IAWC-AG 1.42).) In addition, Mr. Rothstein admits in a data response that he did not examine individual components of IAWC's operating expenses. (IAWC Ex. 10.30 (Uffelman Reb.), p. 3 (citing Data Response IAWC-AG 1.68, marked as IAWC Ex. 10.31).) In fact, Mr. Rothstein acknowledges that there are, "some significant differences between the cost structures of IAWC" and the MOUs and Survey participants. (IAWC Ex. 10.30 (Uffelman Reb.), p. 3 (quoting Data Response IAWC-AG 1.44).) Mr. Rothstein also admits that he did not review the accounting assumptions and methodologies of any Survey participant to determine their comparability to the accounting assumptions and methodologies of IAWC. (IAWC Ex. 10.30 (Uffelman Reb.), p. 3 (citing Data Response IAWC-AG 1.64, marked as IAWC Ex. 10.61).) Under these circumstances, as Mr. Uffelman testified, comparisons of the costs recorded by the

MOUs or Survey participants (or their rates) to those of IAWC are meaningless for ratemaking purposes. (IAWC Ex. 10.30 (Uffelman Reb.), p. 3.)

Moreover, as Mr. Rothstein admits, the comparisons he sets forth focus only on monthly bills and, therefore, do not consider all amounts paid for utility service by MOU customers, although the comparisons do reflect all such amounts for customers of IAWC. (IAWC Init. Br., pp. 68-69.) For example, Mr. Rothstein's comparisons disregard amounts paid by MOU customers for utility service through their tax payments or payments to other entities that provide a portion of their utility service. (*Id.*, p. 68.) As Ms. Kane explained, at least two of the MOUs, Lemont and Downers Grove, have their wastewater treated by other governmental entities, which impose additional charges and property taxes (not reflected in MOU rates or Mr. Rothstein's comparisons) for their services. (IAWC Ex. 10.40 (Kane Reb.), p. 3.) Also, in a data response, Mr. Rothstein notes that Woodridge receives "Connection Fees/Other Income" that, "may include some tax revenues." (IAWC Ex. 10.40 (Kane Reb.), p. 3.) As Ms. Kane explained, the failure to identify these additional charges to the MOU user significantly distorts Mr. Rothstein's rate comparisons. (IAWC Init. Br., p. 69.)

AG criticizes ALJPO's statement that "MOU operations receive significant tax subsidies and have other sources of revenues, thus reducing the extent to which MOUs are required to recover utility-related costs in rates." (AG BOE, p. 10 (quoting ALJPO, p. 42).) In this regard, AG refers (AG BOE, p. 10) specifically to the Report's discussion of the under-allocation of cost to MOUs for municipal resources that MOUs share with other municipal departments. The Report, however, identifies numerous tax subsidies and MOU sources of revenue other than rates, in addition to use by MOUs of shared resources (the only form of subsidy referenced by AG). For example, two of the studied MOUs purchase their water solely from the DWC and

thus take advantage of the DWC's sales tax subsidy to a much greater degree than does IAWC. (IAWC's Init. Br. 57-59.) In addition, MOUs rely on tax exempt GO bonds and connection fees or impact charges as sources of funding for capital projects. (Id., pp. 60-61.) In criticizing the ALJPO's language, the AG fails to address any of the subsidies other than MOU resource sharing that are identified in the Report.

With regard to shared resource subsidization, AG's Brief on Exceptions further disregards the evidence. AG claims that the Report does not contain studies or data to support its discussion of shared resource subsidization. The Report, however, provides specific examples for each of the three studied municipalities of use by the MOU of tax-supported municipal resources without an allocation of costs to the MOU (e.g., Downers Grove – MOU utilizes space in municipal buildings for personnel without an allocation of cost to the MOU; Lemont – municipality does not allocate to the MOU the cost of certain tax-supported resources used; Woodridge – MOU utilizes tax-supported municipal buildings, including a public works garage, for utility functions without paying the full cost; the Woodridge MOU also does not pay full cost for municipal human resource and data processing functions). (IAWC Init. Br., pp. 57, 66.) AG did not present evidence disputing the existence of the identified examples of sharing.

Furthermore, Ms. Kane testified with regard to Stifel's experience that many Illinois municipalities (like the three MOUs studied in detail) do not allocate to their MOU Enterprise Funds all MOU cost for shared resources. (Id., p. 66.) While AG criticizes the Report's reliance on Ms. Kane's expert experience, AG witness Rothstein concedes that he conducted no studies or analyses whatever to support AG's position that certain MOU operations are not subsidized in this manner. (IAWC Init. Br. pp. 66-67 (citing IAWC Rothstein Cross-Exam Ex. 1, Data Response IAWC-AG 1.54).)

In its Brief on Exceptions, AG quotes an Illinois statute requiring county-owned governmental utilities to charge rates that provide sufficient revenue to “pay the cost of maintenance and operation,” “pay the principal and interest” on certain bonds and provide a “reasonable depreciation fund.” (AG BOE, p. 10-11 (quoting 55 ILCS 5/5-15020).) AG also cites, but does not quote, 65 ILCS 5/11-117-12, which provides, in part, that MOUs should charge rates sufficient to “bear” the cost of maintenance and operation and “meet” interest charges. AG suggests (AG BOE, p. 10) that this language requires MOU rates to cover all “costs of operation.” The statutes referenced by AG, however, refer to requirements that MOU rates provide revenue to “pay” or “bear” certain costs. AG cites no authority for the view that the statute should be interpreted to require municipalities to “accrue” non-cash costs of the type accrued by IOUs subject to “cost of service” accounting requirements. Nor does AG cite authority for the view that the referenced statutes preclude MOUs from using tax subsidization or from sharing municipal buildings and other municipal resources without a full allocation of the associated cost, as the Report in uncontested evidence shows that they do. In addition, despite the statutory language, AG did not present evidence disputing the Report’s finding that none of the MOUs studied recover depreciation expense in rates. (IAWC Ex. 10.20, pp. 3, 25.) Under AG’s interpretation of the referenced statutes, the demonstrated practices of MOUs would presumably be deemed contrary to law. AG, however, cites no case authority to support its position in this regard and, in any event, it is not the responsibility of IAWC to enforce the statutes that AG cites.

AG notes (AG BOE, p. 11) that, even if the Report’s estimate of the under-allocation of costs to MOUs is accurate, an adjustment for this factor would increase MOU costs by only a small margin. AG, however, overlooks the fact that shared resource subsidization is only one of

many MOU/IAWC cost structure differences that are identified in the Report. As the record shows, it is not reasonably possible to quantify the myriad of IOU/MOU cost structure differences related to such factors as differing service area characteristics, IAWC efficiencies, applicability of tax laws and/or cost of capital variances. (IAWC Ex. 10.20, p. 32.) The Report, however, does provide quantifications of differences where reasonably possible. (Id.; IAWC Init. Br., p. 63.)

AG also criticizes the ALJPO's statement that, "[t]he imposition of non-resident surcharges, a common practice of MOUs, is unknown in IAWC's Chicago-Metro Division." (AG BOE, p. 11 (quoting ALJPO, p. 42).) AG suggests that the MOUs' non-resident rates are lower than IAWC's rates. (AG BOE, pp. 11-12.) Yet, AG again misconstrues the ALJPO. In reaching its conclusion, the ALJPO does not rely solely on the imposition of non-resident surcharges. Rather, like the Report, the ALJPO notes that non-resident surcharges are one factor that results in a rate subsidy for residents of the municipality, in part explaining a differential between IAWC's rates and the rates that MOUs charge municipal residents.

Conceding that there are many cost structure differences between IAWC and the MOUs, AG nonetheless announces that "none are relevant to the Operations and Maintenance adjustment recommended by the People." (AG BOE, p. 12.) AG bases this claim on Mr. Rothstein's speculation that O&M expense is "largely unaffected" by the cost structure differences. (Id.) AG asserts that the only operational factor cited by the ALJPO (and thus by IAWC) that relates to O&M expense is "IAWC's argument that it serves 25 separate water areas, whereas each municipality serves a contiguous area of more than 10,000 people." (Id., pp. 12-13.) Nothing could be further from the truth. IAWC's Initial Brief identified five principal categories of cost structure/operating differences between IOUs and MOUs that

directly impact O&M cost. (IAWC Init. Br., pp. 75-79.) Within each broad category, IAWC also identified numerous individual examples that would cause IAWC's O&M expenses to diverge from MOU expenses. (Id.) To rebut the extensive evidence of differences, AG criticizes one example in one category (the number of geographically dispersed separate areas IAWC serves as compared to the contiguous MOU service areas). AG's Brief on Exceptions ignores the other differences that affect O&M expense that are detailed in evidence that is in large part uncontested.

As the record (IAWC Ex. 10.60 (Uffelman Sur.), pp. 7-12) shows, the five categories of cost structure differences that directly impact O&M expense are as follows:

1. Utility (or COS) v. Cash Needs Approach – The difference in approach in setting rates with respect to such factors as accounting for pension and OPEB costs will affect the O&M cost category. (IAWC Init. Br., p. 75 (citing IAWC Ex. 10.60 (Uffelman Sur.), pp. 7-8).) AG's Brief on Exceptions ignores this difference.

2. Other Accounting Differences – As noted in the Report, IOUs, such as IAWC, are required to utilize a Uniform System of Accounts (“USOA”) with specific instructions related to the accounting and reporting of costs, including O&M expense, while MOUs are not. Thus, in Exhibit EPR-3, Mr. Rothstein compares IAWC's O&M expenses—recorded in accordance with the USOA—to what he characterizes as O&M expenses for the MOUs of Downers Grove, Lemont, Woodridge, and Wheaton. Yet, as IAWC explained in its Initial Brief, Mr. Rothstein performed no review at all of the comparability of IAWC and MOU accounting practices. (IAWC Init. Br., p. 74 (citing IAWC Ex. 10.60 (Uffelman Sur.), p. 7).) Since none of the MOUs utilize the USOA, it is impossible to confirm what MOU functions that the cost data in Exhibit EPR-3 relates to. Mr. Rothstein, himself, “recognizes that ‘municipal utility financial reporting

is formatted differently,’ and thus that he relies on ‘a number of assumptions and supporting calculations due to differences in reporting and available detail in the financial statements’ for the MOUs.” (IAWC Init. Br., p. 70 (quoting AG Ex. 2.0, p. 20).)

As an example, Mr. Rothstein’s \$2,050,000 adjustment shown on Exhibit EPR-3 and adopted by Mr. Effron is based, in part, on a comparison of a component of IAWC’s expense for “Maintenance & Repair” and that same component for each of his four comparison MOUs. Yet, as Exhibit EPR-3 shows, three of the four MOUs show no expense at all in the cost category of “Maintenance & Repair.” Mr. Rothstein speculates in his Rebuttal Testimony that the MOUs may “capitalize” maintenance expense, but he at no point explains the complete absence of specific cost data for this category for the three MOUs. (IAWC Init. Br., p. 75 (citing Ex. 10.60 (Uffelman Sur.), p. 8).) Thus, Mr. Rothstein is comparing IAWC’s expense for this category to that of MOU entities that record none. As a result, as Mr. Uffelman testified, Mr. Rothstein’s O&M adjustment in the amount of \$2,050,000 disallows almost all of IAWC’s Chicago Metro District-Water “Maintenance & Repair” cost shown on the Exhibit EPR-3. The Chicago Metro District-Water amount shown on Exhibit EPR-3 for this cost is \$1,324,357. Mr. Rothstein’s adjustment for maintenance cost is \$1,300,000 (\$2,050,000 (with maintenance cost) less \$750,000 (without)). Thus, as Mr. Uffelman indicated, Mr. Rothstein would disallow rate recovery of nearly all of the Chicago Metro District-Water maintenance cost despite his admission that he has not reviewed the reasonableness of this (or any other specific) IAWC cost. (IAWC Init. Br., p. 75-76 (citing IAWC Ex. 10.60 (Uffelman Sur.), pp. 8-9).)

As Mr. Uffelman also pointed out, the only MOU that recorded any “maintenance and repair” cost is Lemont. When Lemont’s recorded maintenance and repair cost was added, Lemont’s O&M cost per customer (as calculated by Mr. Rothstein on Exhibit EPR-3) increased

by approximately 37% (from \$186.99 to \$255.36). As Mr. Uffelman noted, this is the only data Mr. Rothstein provides about the effect of including maintenance cost in MOU O&M expense. (IAWC Init. Br., p. 76 (citing IAWC Ex. 10.60 (Uffelman Sur.), p. 9).) Yet, when Mr. Rothstein calculated the change in overall O&M cost for the MOUs to include maintenance cost, he added almost nothing (adjusting the cost from \$225.23 per customer to \$225.72 per customer), which is why his procedure disallows nearly all of IAWC's Maintenance & Repair cost. Had he instead increased the MOU O&M cost per customer by 37% to reflect maintenance cost (based on the only available data), his O&M cost per customer would have increased to \$309.23, which is 16% above IAWC's O&M cost (including maintenance). As Mr. Uffelman indicated, this cost per customer figure is based on a more reasonable assumption than Mr. Rothstein's assumption that maintenance cost has almost no effect on MOU O&M expense. Applying this assumption, the Exhibit EPR-3 approach suggests that, to increase IAWC's O&M expense (including maintenance) to that of MOUs, an increase in IAWC's expense of \$411,890 is required (\$13,761,044 (which is \$309.23 times 44,501 customers) less IAWC's Chicago Metro District-Water O&M cost of \$13,349,154). As Mr. Uffelman explained, this benchmarking adjustment would have more support than Mr. Rothstein's adjustment. Mr. Uffelman, however, did not recommend such an increase in recoverable cost based on benchmarking in light of his belief that the amount of cost recoverable in rates should reflect the costs of the specific utility involved. This data demonstrates, however, that, contrary to the assertion in AG's BOE, the accounting differences discussed in IAWC Exhibit 10.20 have a direct and significant bearing on O&M expense. (IAWC Init. Br., pp. 76-77 (citing IAWC Ex. 10.60 (Uffelman Sur.), p. 10).)

As another component of the O&M expense adjustment calculated on Exhibit EPR-3, Mr. Rothstein compares IAWC's "Customer Service/Accounting" expense to that of the MOUs.

Yet, none of the MOUs on Exhibit EPR-3 show any cost at all in this category. Thus, the effect of Mr. Rothstein's proposal could be also to disallow entirely IAWC's expense for "Customer Service/Accounting," because the MOUs apparently do not record this cost either. Mr. Rothstein has done nothing to show that the O&M expense recorded by IAWC reflects a comparable approach to that of the MOUs with respect to the expensing or capitalization of O&M costs (including such costs as those for "Personnel" and "Maintenance & Repair") or the categorization of such costs into the applicable accounts as the MOUs are not subject, as is IAWC, to the USOA. (IAWC Init. Br., p. 77 (citing IAWC Ex. 10.60 (Uffelman Sur.), pp. 10-11).)

In response to this demonstration of accounting differences that affect O&M cost, AG's Brief on Exceptions claims that "the O&M expense calculated for the municipal utilities . . . included a maintenance expense, although only Lemont broke it out." (AG BOE, pp. 13-14.) To justify this view, AG cites Mr. Rothstein's speculative assumption that "[s]everal of the municipalities do not break down their expenses into the categories shown for the Chicago Metro District, but the totals include all [operating] expenses." (AG Ex. 2.0, p. 22.) As AG would have it, despite Mr. Rothstein's inability to identify "Maintenance and Repair" cost for three of the four MOUs shown on Exhibit EPR-3, such costs must be in the data somewhere in some unidentified amount. Mr. Rothstein, however, introduced no evidence to support an assumption that the IAWC's O&M costs and the MOU costs in the categories shown on Exhibit EPR-3 covered comparable items. Rather, as explained above, Mr. Rothstein compares IAWC's O&M expenses to what he characterizes as O&M expenses for the MOUs without any review of the comparability of IAWC and MOU accounting practices. (IAWC Init. Br., p. 74 (citing IAWC Ex. 10.60 (Uffelman Sur.), p. 7).) As a result, there is no basis to believe—as AG suggests in its

BOE—that the Exhibit EPR-3 cost data for MOUs other than Lemont includes “Maintenance and Repair” costs. (IAWC Init. Br. p. 70 (citing IAWC Ex. 10.60 (Uffelman Sur.), p. 8).)

Indeed, Mr. Rothstein himself noted that there may be “potential objections [to his \$2,050,000 adjustment] on the basis of accounting approaches related to maintenance costs.” (AG Ex. 2.1, p. 12.)

In this regard, AG does not deny that the effect of Mr. Rothstein’s adjustment would be to disallow nearly all of IAWC’s “Maintenance and Repair” cost. In its Reply Brief, AG dismisses this fact as being “coincidental, but irrelevant.” (AG Reply Br., p. 39.) In light of Mr. Rothstein’s lack of review of any specific component of IAWC’s cost (IAWC Ex. 10.30 (Uffelman Reb.), p. 3 (citing IAWC Ex. 10.31)), AG’s proposal to disallow this expense is baseless and unsupported.

3. Shared Resource Utilization –As discussed above, the Report demonstrates that the MOUs use tax-supported resources in their utility operations, and there is no data available from the MOUs (despite Stifel’s effort to obtain it) to quantify precisely the extent of this practice. For example, the MOUs shown on Exhibit EPR-3 do not record “Customer Service/Accounting,” perhaps because municipal personnel not directly assigned to the MOU perform this function. (IAWC Ex. 10.60 (Uffelman Sur.), p. 11.) The absence of “Maintenance & Repair” cost for three of the MOUs also may relate, in whole or in part, to the performance of such functions by other municipal employees, such as municipal public works department employees. (Id.) As Mr. Uffelman noted, despite Mr. Rothstein’s data, it does not seem possible that three of the four MOUs perform no maintenance and make no repairs. Further, although two of the four MOUs on Exhibit EPR-3 record no “Personnel Expense,” it is also difficult to believe that no municipal personnel are used in connection with the utility function. (IAWC Init. Br., p.

78.) While AG's Brief on Exceptions argues that no shared resource utilization occurs (AG BOE, pp. 10-11), its claim is not supported by the record for the reasons outlined above.

Furthermore, shared resource subsidization directly affects O&M costs.

4. Service Area Characteristics – As IAWC's Report and the Testimony of Mr. Stephen Schmitt, Vice President of Operations for the Service Company, discuss, there are differences in service area characteristics and these also affect O&M costs. (IAWC Init. Br., p. 78 (citing IAWC Exs. 10.60 (Uffelman Sur.), p. 11; 10.80 (Schmitt Sur.), p. 3).) The service area characteristics of each of the MOUs studied differ significantly from those of IAWC's Chicago Metro District. (IAWC Init. Br., p. 59 (citing IAWC Ex. 10.20, p. 5).) Each of the MOUs serves concentrated service areas of approximately seven to ten square miles. As a result, their personnel, facilities and infrastructure are focused in a relatively compact area. In contrast, IAWC's Metro District operations serve multiple municipalities and wholesalers across a wide geographic area. As Mr. Schmitt explained, IAWC's Chicago Metro District comprises 25 separate water service areas, 11 of which also provide wastewater service. As Mr. Schmitt indicated, the need for IAWC's maintenance personnel to travel long distances in populated areas through heavy traffic has a significant impact on IAWC's cost of service as compared to that of the more compact MOUs. Also, as Mr. Schmitt testified, IAWC experiences the effect of spreading the cost of a fixed asset base over the relatively small population of each of twenty two separate medium and small systems (each serving a population below 10,000), which represent 88% of the twenty-five IAWC Metro District systems. (IAWC Exs. 10.80 (Schmitt Sur.), p. 3; 10.50 (Schmitt Reb.), pp. 6-7.) As Mr. Schmitt explained, on an individual system basis, each of the MOU systems referenced by AG Witness Rothstein serves a customer base that is relatively large (over 10,000 people) as compared to that of the multiple small and medium systems served

by IAWC. (IAWC Init. Br., p. 59 (citing IAWC Exs. 10.50 (Schmitt Reb.), pp. 6-7; 10.80 (Schmitt Sur.), p. 3).)

AG witness Rothstein's testimony supports Mr. Schmitt's analysis. He notes that "[i]t is undoubtedly true that systems of different sizes with varying geographic and other characteristics exhibit different cost characteristics." (IAWC Init. Br., p. 74 (quoting AG Ex. 2.1, p. 17).) He also testifies that "there are undoubtedly important differences among utility systems, labor pools, and operating environments" (IAWC Init. Br., p. 74 (quoting AG Ex. 2.1, p. 5), and that "[s]ystems may require different water treatment processes, have different age distributions and deterioration curves, and have different arrangements for field operations, administration and customer service." (IAWC Init. Br., p. 74 (quoting AG Ex. 2, p. 15).) "For utilities in the Chicago region," Mr. Rothstein admits that O&M "functions (and associated costs) may be particularly impacted by weather factors, labor unionization, system densities and geographic dispersion." (IAWC Init. Br., p. 74 (quoting AG Ex. 2.1, p. 4).) Mr. Rothstein's own testimony, therefore, suggests that service-area characteristics impact O&M costs.

Without the benefit of testimony from its witness, AG suggests in its Brief on Exceptions (AG BOE, pp. 12-13) that certain factors, such as IAWC's economies of scale and the number of customers in the combined area, could offset the cost of impact of the factors referenced by Mr. Schmitt. AG is correct that IAWC's "consolidated management approach" provides IAWC's service areas with economies of scale that lower their costs from what they would be without this consolidation. But that does nothing to respond to IAWC's position that, as Mr. Schmitt explained, "[t]he IAWC Chicago Metro area, even with all the positive aspects achieved through a consolidated management approach, is significantly different than the service areas of Mr. Rothstein's comparison MOUs and Survey participants." (IAWC Ex. 10.80

(Schmitt Sur.), p. 3 (emphasis added).) In other words, AG makes the wrong comparison. The fact that IAWC's economies reduce costs to a level below the level that IAWC would otherwise incur indicates nothing about the relative level of IAWC's rates as compared to those of one or more MOUs. AG's speculation about the effect of service area differences in its Brief on Exceptions is unsupported by evidence and should be disregarded.

5. Service and Regulatory Standards – Mr. Schmitt demonstrated that IAWC must follow different service and regulatory standards as compared to the MOUs. (IAWC Init. Br., p. 78 (citing IAWC Exs. 10.60 (Uffelman Sur.), p. 12; 10.80 (Schmitt Sur.), pp. 5-6).) Particularly at the state level, IOUs, such as IAWC, are subject to extensive regulatory responsibilities that do not apply to MOUs, and which do affect relative O&M cost levels. (IAWC Init. Br., p. 78 (citing IAWC Ex. 10.80 (Schmitt Sur.), pp. 5-6).) As Mr. Schmitt indicated, for IAWC, certain of those differences relate to the applicability to IAWC of the provisions of 83 Ill. Admin. Code, Part 600 "Standards of Service for Water Utilities," which are not applicable to MOUs. MOUs are not subject to the regulatory requirements established by the Act, or other rules and regulations promulgated by the Commission (in addition to Part 600). (IAWC Init. Br., p. 78 (citing IAWC Ex. 10.80 (Schmitt Sur.), p. 5).)

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

billing and bill information provision; provision of emergency customer notification systems and customer hot lines; handling and reporting of customer complaints; and specific requirements relative to extending water service to new customers and financial dealings with developers. Illinois MOUs are not subject to any of the requirements established by the Commission in these areas, which are applicable to IAWC and affect the level of O&M cost incurred. (IAWC Init. Br., pp. 78-79 (citing IAWC Ex. 10.80 (Schmitt Sur.), pp. 5-6).)

In response to this evidence, AG's Brief on Exceptions concedes that "Commission regulation . . . is different" in that it applies to IAWC, but not MOUs. (AG BOE, p. 14.) Yet, AG fails to reconcile this concession with its belief that the O&M costs of IAWC and the MOUs are comparable. Rather, it seeks to minimize the impact of the Commission's regulations by suggesting that "[t]here is no dispute that MOUs and IAWC are subject to the same federal and state water quality and environmental rules." (Id.) AG's argument is a non sequitur. The fact that certain regulations apply to both types of entities does nothing to minimize the fact that the O&M costs of IAWC, and not the MOUs, are affected by a number of other regulations. Mr. Schmitt's testimony demonstrates that the regulations applicable to IAWC, and not MOUs, are extensive and have an impact on O&M costs.

In sum, AG's assertion (AG BOE, p. 12) that the IAWC/MOU O&M costs must somehow be comparable is unsupported by the record. As the entity that seeks to set rates based on a comparison with other entities, AG bears the burden of demonstrating that the entities involved are, in fact, "comparable" to IAWC. AG's repeated reliance on speculation to meet this burden does not suffice, and thus the ALJPO properly disregarded AG's proposed O&M cost adjustment. See Central Ill. Light Co., et al., Docket Nos. 06-0070, 06-0071, 06-0072 (Cons.) Order on Rehearing, p. 27 (May 16, 2007). Consistent with longstanding Illinois law, the

Commission does not “afford any appreciable weight or reliance on” a comparison of utility rates or costs to those of entities not shown to be “comparable.” Id.; see also Antioch Milling Co. v. Public Serv. Co. of N. Ill., 4 Ill.2d 200, 210 (1954) (holding that evidence on the rates charged by other utilities should be disregarded where the party proffering the evidence failed to show “that the [utilities’] conditions of service were comparable”); 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”). The evidence submitted by IAWC in this case demonstrates conclusively that, for rate/cost comparison purposes, MOUs are not comparable to IAWC, and AG offers nothing that demonstrates otherwise.

AG also contends that “benchmarking has been used extensively by water utilities since the 1980s to assess their performance.” (AG BOE, p. 31.) AG fails to acknowledge, however, that no one has ever used benchmarking in the manner that AG seeks to use it, namely, to adjust IAWC’s rates based solely on the cost benchmarks for entities not shown to be comparable. In fact, AG’s own witness, Mr. Rothstein, unambiguously, “agree[s] that [his] referenced benchmarking data and cost comparisons alone do not enable one to propose specific adjustments to individual cost categories.” (AG Ex. 2.1, p. 7.) In addition, Mr. Rothstein acknowledged in a data response that the ratemaking allowance for O&M expenses should not be based on ““averages or benchmarks”” without analysis of individual expense components. (IAWC Ex. 10.30 (Uffelman Reb.), p. 10 (quoting Data Response IAWC-AG 1.73).) Thus, AG’s particular use of the benchmarking data is inappropriate and unprecedented.

AG also argues for the first time in its Brief on Exceptions “that IAWC uses the rates of another local municipal water system – the City of St. Louis – to set the rate for consumers” and

that “this demonstrates that it is reasonable . . . to use the performance of neighboring systems as a check on” IOU performance. (AG BOE, p. 31.) The fact that the reference to rates of the City of St. Louis was deemed appropriate in designing a Competitive Service Tariff previously approved by the Commission, however, provides no support for Mr. Rothstein’s O&M cost adjustment. No revision of the referenced Competitive Service Tariff is at issue in this proceeding. AG’s argument that the design of Competitive Service Tariff supports its O&M adjustment is not supported by any evidence.

For all of the reasons discussed above, the replacement language suggested by AG (AG BOE, pp. 15-35) should be rejected. In this regard, the AG argues that the ALJPO “should be amended to provide a more balanced presentation” and that the ALJPO “omits key information”, namely, AG’s “response to IAWC’s arguments.” (AG BOE, p. 12.) As a result, AG proposes a restructuring of the ALJPO so that AG’s position comes after IAWC’s. (*Id.*, p. 14-15.) IAWC submits that the ALJPO properly explains the positions of the parties and (except as discussed in IAWC’s Brief on Exceptions) conclusions reached.

Also, with respect to the Survey, AG proposes to include language in the ALJPO stating that Mr. Rothstein, “applied a generous 4% inflation factor for the period between 2006 and 2009, and that the effect of using 2004-2005 data in the benchmarking survey was minimal and cost differences highlighted in his analysis were not ‘merely a function of the effects of a year or two of inflation.’” (AG BOE, p. 30 (quoting AG Ex. 2.1, p. 14).) The evidence shows, however, that Mr. Rothstein’s 4% inflation factor was far from “generous” because of “significant increases experienced by IAWC and the industry for fuel, chemicals and energy costs.” (IAWC Ex. 10.80 (Schmitt Sur.), p. 4.) The AG's proposed language for the ALJPO acknowledges that

Mr. Rothstein failed to use a four or five year inflation adjustment and so did not fully account for the fact that the Survey data on which he relied was from 2004 and 2005. (AG BOE, p. 30.)

Response To Municipalities' Exceptions 3 & 4

Like AG, the Municipalities claim that Mr. Rothstein's O&M cost comparisons "eliminate the items that do vary by whether the entity is an IOU or a MOU." (Munis. BOE, p. 6.) As explained above, however, the Report, IAWC's Initial Brief, and IAWC's Reply Brief all explain in detail why the Municipalities' argument is wrong. As discussed in detail above, the cost structure differences identified in the evidence do impact O&M expense, making Mr. Rothstein's O&M cost comparisons meaningless. Nothing in the Municipalities' Brief on Exceptions calls into question the ALJPO's conclusion that the "comparisons of IAWC's rates to those of MOUs are not practical for ratemaking purposes." (ALJPO, p. 42.)

Second, the Municipalities' Brief on Exceptions claims that the ALJPO "erroneously finds that it is unnecessary for [IAWC] to perform an analysis of its rates in the Champaign District." (Munis. BOE, p. 7.) The Municipalities, however, provide no reasoning to support their call for further rate/cost comparisons other than their erroneous suggestion that the ALJPO wrongly rejected Mr. Rothstein's O&M cost adjustment. The ALJPO properly rejects the Municipalities' proposal (which no witness addressed) for the reasons discussed in IAWC's Initial Brief with regard to the additional comparisons 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.) As explained in IAWC's Initial Brief, the development of additional quantifications of the many factors responsible for differences between the rates and costs of

IAWC and MOUs, if possible at all, would be a costly and involved effort. (IAWC Ex. 10.60 (Uffelman Sur.), pp. 13-17; IAWC Ex. 10.70 (Kane Sur.), pp. 3-5); IAWC Init. Br., pp. 79-83.) IAWC should not be required to expend additional resources for more analysis that will do nothing other than further confirm the conclusions of the detailed Report already prepared.

For the reasons discussed above and in IAWC's prior Briefs, the ALJPO correctly rejected 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. The replacement language suggested by AG and the Municipalities should be rejected.

F. ALJPO Section V.D, "Original Cost Determination" (new section)

Response to Staff Exception 3

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.) As IAWC stated in its Reply Brief (p. 3), Company witness Grubb indicated that the Company accepts Ms. Jones' recommendation. (IAWC Ex. 4.10 (Grubb Reb.), p. 25.) Therefore, IAWC agrees with Staff's proposed language as set forth in Staff Exception 3.

G. ALJPO Section VI.B.5, "Rate of Return," (ALJPO, pp. 52-91)

LWC and CUB take exception to the findings in the ALJPO concerning rate of return. Except as noted in IAWC's Exception No. 7, the ALJPO's findings and conclusions regarding rate of return are appropriate and supported by the record. As discussed below, the exceptions filed by LWC and CUB are inappropriate and unsupported, and should therefore be rejected.

Response to LWC Exception 2

LWC argues that the ALJPO should be modified “so that the Commission uses only the Company’s and Staff’s low-end CAPM return estimates of 11.16% and 11.71%, respectively, (PO at 91) to determine IAWC’s return on common equity in this case.” (LWC BOE, p. 6.) This change, if adopted, would reduce the midpoint of Staff’s DCF and CAPM results to 10.2%.

Both the Company and Staff derived an equity market risk premium (“EMRP”) based on a DCF return of the S&P 500, which is a proxy group intended to represent the market. LWC alleges that the growth rates used by the Company and Staff to determine an EMRP are unsustainable, thereby inflating the CAPM results. According to LWC, the “deficiencies” in the Company and Staff’s approach “must be considered in arriving at an appropriate return on equity for the Company and, unfortunately, the Proposed Order does not consider them.” (LWC Br., p. 5.)

LWC is incorrect to suggest that the Commission did not consider its arguments. The ALJPO fully considered LWC’s argument that the Staff and Company EMRP are based on unsustainable growth rates. (See, e.g., ALJPO, pp. 76, 86, 90.) The ALJPO ultimately concludes that “the CAPM analyses of the IAWC and Staff witnesses, 11.16-12.22% and 11.75-12.11%, respectively, are without material flaws and should be considered in establishing IAWC’s cost of common equity.” This finding is correct and supported by the record. As IAWC explained in its Initial (pp. 104-105) and Reply (p. 48) Briefs, Ms. Ahern developed a forward looking EMRP consistent with the methodology used by Commission Staff and historically relied on by the Commission. Using this approach with recent data from Value Line Investment Survey results in an expected total market return of 15.44%, which is significantly higher than the 13.46% Ms. Ahern relied upon based on her DCF analysis for the S&P 500, or

the 13.55% relied upon by Staff. (See also IAWC Ex. 12.10 (Ahern Reb.) pp. 37-38.) Thus, the record demonstrates that the Company and Staff DCF analyses of the S&P 500 (which were used to determine the EMRP for the CAPM analyses) are conservative when compared to the most recent data available at the time testimony was filed. To disregard the high end of the Staff and Company CAPM estimates would produce results that are unrealistically low and not reflective of investor expectations, as demonstrated by the Staff and IAWC analyses. Moreover, to suggest that the Commission should consider the low range of the CAPM estimates, while disregarding the high range, is plainly a results-oriented approach. If the Commission is to consider evidence of the CAPM analyses in determining a rate of return, it should consider all of the evidence.

The CAPM analyses of the Company and Staff are reasonable and supported by the record. LWC's Exception No. 2 should be rejected.

Response to CUB Exceptions 1 - 5

CUB argues that the ALJPO is flawed in five respects. Because none of CUBs arguments have merit, all of its exceptions should be rejected.

First, CUB argues that the ALJPO improperly relied on the CAPM analyses performed in this case. According to CUB, the "Nagel Paper" proves that the CAPM consistently overstates the cost of capital. As the ALJPO correctly notes, the Nagel Paper is not part of the record in this proceeding. (ALJPO, p.85.) Nevertheless, pages 79 through 85 of the ALJPO analyze CUB's arguments in significant detail. The ALJPO notes that the issues raised by CUB were "discussed extensively in the parties' testimony and briefs." (ALJPO, p. 85.) The ALJPO properly reflects the fact that CUB has provided no record support for its assertion that the Nagel Paper excluded adjusted betas because of forecast error. (Id.) If anything, the Nagel Paper demonstrates that the use of adjusted betas is preferable to raw or unadjusted betas. (Id.) The

ALJs gave full and fair consideration to CUB's arguments concerning alleged flaws in the CAPM and rejected those arguments. The ALJPO's conclusions concerning the Nagel Paper are more than adequately supported by the record.

Second, CUB argues that if the Commission determines to utilize the CAPM in its determination of ROE, the ALJPO should be modified to adopt CUB's methodology for calculating the EMRP. The ALJPO properly rejects this argument. As explained in IAWC's Initial Brief (pp. 108-09), the Commission has consistently used a DCF analysis for the S&P 500 to derive the EMRP. This forward-looking approach is consistent with the prospective nature of estimating the cost of capital and the ratemaking process. (IAWC Initial Br. at 109.) CUB's approach ignores forecasted data and relies instead on "empirical research" from "independent academics." (CUB BOE, p. 5.) The problem with this approach, as pointed out in the ALJPO, is that "It is not clear that the EMRP of members of financial and academic arena are intended to be used for the same purposes faced by the Commission in this proceeding." (ALJPO at 87.) Moreover, as noted in the ALJPO, CUB's proposal does not allow the EMRP to change with time, and its EMRP of 5% is far below the EMRP calculated by the other rate of return witnesses in this proceeding. (See id.)

Third, CUB argues that the ALJPO should be modified to adopt CUB's recommended growth rate in the DCF analysis. CUB agrees that a single-stage DCF analysis is appropriate. The problem with CUB's approach is that the growth rate used in its analysis is unrealistically low. CUB's growth rate is based on an average of an internal growth rate calculated by Mr. Thomas and analysts' forecasted growth rates. (CUB BOE, p. 7.) CUB argues that this approach "can be reasonably assumed to be accurate." (CUB BOE, p. 8.) CUB is mistaken, and its conclusion unsupported. As Ms. Ahern explained, Mr. Thomas's use of historic returns in his

internal growth analysis results in a problem of circularity. The returns earned by utilities each year are the product of rates set in the most recent rate proceeding, based upon the authorized ROE, which then gives rise to the realized ROE in each subsequent year until a new rate proceeding sets new rates and a new ROE. Consequently, realized ROEs each year are a function of the then-authorized ROE. Since historical realized ROEs give rise to internal growth rates, using internal growth rates to predict future growth rates is inherently circular.

Additionally, relying on historical growth rates ignores both the prospective nature of ratemaking and information from analysts that is valuable to investors, as Ms. Ahern also explained. (IAWC Initial Br. at 109-110.) The ALJPO correctly characterizes the approach of averaging internal growth rates with analysts' expected growth rates as a "results oriented" exercise. (ALJPO, p. 88.)

Fourth, CUB argues that the ALJPO erroneously adopted use of a quarterly DCF model. CUB is again mistaken. As explained in IAWC's Initial (p. 87) and Reply (p. 50) briefs, quarterly compounding recognizes that dividends are paid quarterly, not annually. Also, Staff has correctly pointed out that CUB's criticism of quarterly compounding raises a working capital issue, not a cost of equity issues. (Staff Initial Br., p. 62.) The ALJPO is correct to conclude that "the quarterly model accurately recognizes the timing of cash flows to investors that is necessary to estimate the investor required rate of return." (ALJPO, p. 87.)

In its fifth exception, CUB argues that, based on its first four exceptions, the ALJPO should be modified to reflect an ROE of 8.58%. Because CUB has failed to support its exceptions 1 through 4, there is no basis to adopt its fifth exception.

H. ALJPO Section VII.B.1, “Activation Charge” (ALJPO, pp. 99-100)

Response to Staff Exception 5

Staff argues in its Brief on Exceptions that, with respect to the \$10 Activation Charge, the ALJPO’s statement (p. 100) that IAWC’s response to Staff Data Request CLH-2.04 could have provided more information means that IAWC has not met its burden of proof in this proceeding. To suggest that the ALJs have determined that IAWC should prevail on this issue despite not meeting its burden of proof is not a fair reading of the ALJPO. Staff’s position ignores the fact that the ALJPO (p. 100) states that, “While IAWC’s response to Staff Data Request CLH-2.04 could have provided more information, the Commission is nevertheless persuaded by IAWC’s response.” (Emphasis added.) The ALJPO also states (p. 100), “As for the amount of the fee, the Commission finds that \$10 is not unreasonable.” Thus, the ALJPO makes clear that IAWC has met its burden of proof on this issue.

As IAWC explained in its Initial Brief (pp. 115-16), the Company has provided support for the implementation of the \$10 Activation Charge for all service areas. As Mr. Grubb explained, the costs to be recovered in the fee include labor, overhead and transportation costs. (IAWC Ex. 4.10 (Grubb Reb.), p. 21.) In response to Staff data request CLH 2.04, the Company provided a discussion and cost breakdown analysis supporting the \$10 charge. (See IAWC Ex. 4.13.) Mr. Grubb explained that the cost breakdown shown on CLH 2.04 reflects the overhead, transportation, and labor costs related to the \$10 activation charge on a Company-wide basis. (IAWC Ex. 4.20 (Grubb Sur.), p. 7.) In addition, the \$10 charge is reflected in the Company’s E Schedules, the amount of revenue that would be collected from this charge is incorporated in the Company’s revenues at proposed rates in Schedule C-1, and the revenues from the charge are specifically included in Schedule E-5 (Other Operating Revenues) for the Rate Areas. (IAWC Ex. 4.10 (Grubb Reb.), pp. 21-22.) Based on this evidence, the ALJPO (p. 100) concluded that

the \$10 Activation Charge was reasonable, and that it would avoid imposing the cost of activating new customers on all existing customers.

Although Staff characterizes the ALJPO's language as supportive of its position that the Company has not met its burden of proof, the ALJPO expressly states that the Commission is "persuaded by IAWC's response." To meet its burden of proof, IAWC must provide sufficient evidence that its proposal for the \$10 Activation Charge is reasonable, which IAWC has done in this case. Therefore, Staff's proposed Exception 5 should be rejected.

I. ALJPO Section VII.B.3, "Across-the-Board' Increases vs. Staff COSS and Rate Design Proposals" (ALJPO, pp. 105-121)

Response to Staff Exception 6

In its Brief on Exceptions (pp. 8-10), Staff takes exception to the across-the-board rate increase proposed by the ALJPO. Staff's main concern in its Exceptions (p. 9) appears to be that by adopting an across-the-board increase, the Commission would be basing rates on the cost of service study used in IAWC's last rate case, Docket 02-0690, and so would be basing rates on "out of date" costs. As IAWC witness Grubb explained (IAWC Ex. 4.00, pp. 39-41), however, there is no change in circumstances since Docket 02-0690 that would warrant a change in the design of the Company's rates, with two exceptions. Those exceptions are the new rate structure in the Chicago Metro Sewer District for residential customers, and the combination of the South Beloit system into the SPSPSB District. No witness challenged Mr. Grubb's assertion that circumstances have not changed, and issues relating to Chicago Metro District Sewer rate design and South Beloit have been fully addressed in this case.

In addition, as IAWC explained in its Initial (p. 119) and Reply (pp. 56-57) Briefs, 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 about 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 Reply Brief. Thus, there are other important reasons for adopting an across-the-board increase that outweigh Staff's concern with using the costs established in Docket 02-0690 as the underlying basis for the rates set in this proceeding.

With respect to fire protection charges, Staff acknowledges (Staff BOE, p. 10) that it would be preferable for the Commission to take other factors besides only costs into consideration when setting fire protection charges. Nevertheless, Staff continues to believe (Staff BOE, p. 11) that the language of Section 9-223 of the Act "constricts the Commission's flexibility in this area." As IAWC points out in its Initial (pp. 126-127) and Reply (p. 62) Briefs, and as the ALJPO correctly concludes (pp. 120-121), the cost of providing fire protection service is not the sole consideration for the Commission; rather it is appropriate to set fire protection charges at a level which, while considering the cost of service, also will mitigate ratepayer impacts. Thus, Staff's Exception 6 should be rejected.

J. ALJPO Section VII.B.4, "Pontiac District Rate Design" (ALJPO, pp. 121-123)

Response to AG Exception IV

The AG (AG BOE, pp. 35-36) proposes that the rates for Pontiac should not be changed to match the rest of the SPSPSB District rates because there should be a "more moderate change." The AG recommends rejecting IAWC's proposal that the SPSPSB District rate for the third consumption block be adopted for Pontiac and adopting AG witness Rubin's "moderated rate recommendation." (AG BOE, p. 36). As IAWC explained in its Initial (pp. 119-120) and Reply (pp. 57-58) Briefs, the AG's proposal is unwarranted. 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.

K. Response to AG Request for Oral Argument

In its Brief on Exceptions (p. 37), the AG requests oral argument in this proceeding. IAWC believes that, because all of the issues in the this proceeding have been extensively and thoroughly briefed, oral argument should not be necessary.

L. Staff’s Technical Corrections to Appendices

With respect to Technical Correction A, IAWC has undertaken a further review of the ALJPO and its Appendices and agrees with Staff’s proposed corrections.

With respect to Technical Correction B, IAWC agrees with Staff’s proposed correction.

With respect to Technical Correction C, IAWC agrees with Staff’s proposed corrections. Technical Correction C.2 is the same Technical Correction 4 set forth in IAWC’s Brief on Exceptions (pp. 21-22).

With respect to Technical Correction D, IAWC agrees with Staff’s proposed correction.

With respect to Technical Correction E, IAWC agrees with Staff’s proposed correction. Technical Correction E is the same Technical Correction 3 set forth in IAWC’s Brief on Exceptions (p. 21).

III. CONCLUSION

For the reasons set forth above and in its Brief on Exceptions, the Company requests the Commission adopt the Exceptions set forth in Appendix A to IAWC's Brief on Exceptions.

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Respectfully submitted,

ILLINOIS-AMERICAN WATER
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