

TABLE OF CONTENTS

	Page
I. Introduction.....	1
A. Executive Summary	1
B. Procedural History	7
C. Nature of Operations.....	9
D. Proposed Test Year and Revenues.....	9
1. Future Test Year	9
2. Proposed Tariffs.....	10
II. Rate Base	11
A. Resolved Issues.....	11
1. Cash Working Capital Issues	11
2. Plant-in-Service Adjustment.....	13
3. Business Systems Planning Study	14
4. Tank Painting.....	14
5. Original Cost Determination.....	15
B. Contested Issues.....	15
1. Cash Working Capital.....	15
C. Proposed Rate Base.....	25
III. Operating Revenues and Expenses	25
A. Resolved Issues.....	25
1. Tank-painting Charges and Amortization Expense	25
2. Adjustments to Depreciation Expense	26
3. Advertising Expense	26
4. Lobbying Expense	26
B. Contested Issues.....	27
1. Residential Sales Volumes and Revenues	27
2. Commercial Sales Volumes and Revenues.....	28
3. Industrial Sales Volumes and Revenues.....	31
4. General Inflation Adjustment for Non-labor O&M Expenses.....	33
5. Prior Rate Case Expense.....	35
6. Current Rate Case Expense.....	36
7. Proposed “Normalization” of Rate Case Expense	46

TABLE OF CONTENTS

(continued)

	Page
8. Purchased Power and Fuel Expense	48
9. Chemicals Expense	53
10. Insurance Other Than Group Expense	55
11. Management Fees	57
12. Gross Revenue Conversion Factor Adjustment	71
C. Proposed Operating Income & Revenue Requirement	72
IV. Cost of Capital & Rate of Return	73
A. Capital Structure	73
1. Overview	74
2. IAWC's Proposed Capital Structure Is Reasonable	76
3. IAWC's Short-term Debt Ratio Is Appropriate	78
4. IAWC's Common Equity Ratio Is Appropriate	80
B. Cost of Debt	84
1. Short-term Debt	84
2. Long-term Debt	84
C. Cost of Common Equity	85
1. IAWC Has Proposed a Reasonable Rate of Return on Common Equity of 10.90%	85
2. IAWC's Return on Common Equity Must Be Adjusted for Business Risk	87
3. IAWC's Return on Common Equity Must Be Adjusted for Financial Risk	89
4. Adjustments to the Return on Common Equity Analyses of Staff and IAWC Produce a Reasonable Range of Return on Common Equity for IAWC	90
5. CUB's Proposed Return on Common Equity Should Be Rejected	98
6. Criticism of IAWC's Business Risk Adjustment Should Be Rejected	101
7. Criticism of IAWC's Financial Risk Premium Should Be Rejected	103
D. Proposed Rate of Return	104
V. Cost of Service	105
A. Demand Study	105

TABLE OF CONTENTS
(continued)

	Page
1. Background.....	105
2. Staff’s Concerns with the Demand Study Have Been Addressed	110
3. Staff’s Recommendation for a Direct Measurement Demand Study Should Be Rejected.....	115
4. IIRC’s Objections to the Demand Study Should Be Rejected.....	119
B. Cost-of-Service Study	121
1. IIRC’s Cost of Service Study Is Reasonable.....	121
2. Staff’s Proposal For a Future Study Using Coincident Peaks Should Be Rejected.....	123
3. IIRC’s Concerns About Rate Area Specific Demand Factors Are Unwarranted.....	126
4. IIRC’s Allocation of Purchased Power Costs Is Incorrect	126
VI. Rate Design & Tariff Terms And Conditions.....	128
A. Introduction.....	128
B. Resolved Issues	131
1. Public Fire Charges by Meter Size – Chicago Metro	131
2. Public Fire Charges – Lincoln and Pekin	131
3. Champaign & Sterling Consolidation with Zone 1.....	131
4. Tinley Park Wholesale/Westbury	132
5. Champaign/Lincoln Monthly Billing.....	132
6. Non-residential Declining Block Structures	133
7. Pekin Industrial Class	133
8. Pekin 5/8” Customer Charge	134
9. Lincoln 3”+ Meter Charges	134
10. University of Illinois Current Rate Structure.....	134
11. Customer Count	135
12. Non-residential demand charges.....	135
13. Reconnection Charges	135
14. Home Inspection Fee	136
15. Tariff Language Changes.....	136
C. Contested Issues.....	136

TABLE OF CONTENTS
(continued)

		Page
	1.	Proposed Customer Charge..... 136
	2.	Single Block Residential Rate Structure..... 143
	3.	Multi-unit Residential Building Classification 146
	4.	Across-the-board Adjustment 147
	5.	Recovery of Uncollectible Accounts Expense..... 148
	6.	Chicago Metro Sewer Rate Increase..... 149
	7.	Public Fire Service Revenue Recovery – Zone 1 151
	8.	Private Fire Charge 152
	9.	Rates for the Competitive Industrial, Large Sales for Resale and Large Other Public Authority classes 152
	10.	Recovery of Overall Revenue Requirement 153
VII.	Other Issues.....	154
	1.	Municipal Rate Comparisons..... 154
	2.	Pension / OPEB Accounting Proposal in Docket 09-0400..... 169
	3.	Service Concerns in Homer Glen 171
	4.	Sewage Treatment Planning 176
VIII.	CONCLUSION.....	179

I. INTRODUCTION

A. Executive Summary

In this proceeding, Illinois-American Water Company (“IAWC” or the “Company”) requests an increase of \$50,008,924¹ in base water and sewer rates for the Company’s Illinois rate areas. The Company’s last rate increase was authorized on July 30, 2008 in Docket 07-0507 based on a forecasted test year ending on June 30, 2009. Subsequent to the test year of Docket 07-0507, the Company’s rate areas experienced increased operating expenses and increased rate bases. The proposed rate increases reflect the increased cost associated with capital additions necessary to meet customer service needs and the implementation of operational changes. As IAWC’s President, Karla O. Teasley, explains, the Company seeks an increase in rates to provide an opportunity for IAWC to recover operating expenses that it is required to incur in order to maintain a high level of customer service, and to earn a reasonable return on rate base. (IAWC Ex. 1.00 (Teasley Dir.), p. 9.) In this proceeding, IAWC proposed a future test year ending December 31, 2010.

IAWC recognizes that the current economic climate has caused customer concern over rate levels. IAWC, however, cannot address those concerns by proposing rates insufficient to cover the costs incurred in meeting its obligations as a regulated public utility. In this regard, the Illinois Public Utilities Act (220 ILCS 5/101 et seq.) requires that, in all economic circumstances, a public utility such as IAWC “shall provide service and facilities which are in all respects adequate, efficient, reliable and environmentally safe and which, consistent with these obligations, constitute the least-cost means of meeting the utility’s service obligations.” 220

¹ The requested increase reflects IAWC’s updated weighted average cost of capital of 8.50% as discussed in Section IV. An updated operating income statement, for Total Company and each Rate Area, reflecting the updated weighted average cost of capital, is attached as Appendix A to this Initial Brief.

ILCS 5/8-401. IAWC also has extensive regulatory responsibilities related to drinking water standards (Safe Drinking Water Act (42 U.S.C. §300f et seq.)) and wastewater standards (Clean Water Act (33 U.S.C. §1251 et seq.)), which the Illinois Environmental Protection Agency (“IEPA”) has responsibility to enforce. (IAWC Ex. 1.00R (Teasley Reb.), p. 2.) As discussed below in Sections IV.A, public utilities must meet service requirements, even in difficult economic times, by investing in infrastructure and required capital projects, and by taking such steps as are reasonably necessary to maintain the financial ratios, levels of interest coverage and rates of return sufficient to attract capital in order to finance required capital projects. At the same time, however, public utilities are required to minimize the level of cost incurred to provide service and, thereby, minimize the level of required rate increases. As Ms. Teasley explained, IAWC has put in place extensive measures to assure that costs and rate levels are minimized. (IAWC Ex. 1.00 (Teasley Dir.), pp. 24-26.)

As discussed by Ms. Teasley, cost control begins with careful budgeting and management. (IAWC Ex. 1.00 (Teasley Dir.), p. 22.) Management continuously monitors operating expenses and capital expenditures to ensure that the Company purchases necessary, cost-effective goods and services, and incurs capital expenditures that are cost-effective and necessary to provide high quality and reliable service. To this end, the Company is able to engage in strategic supply sourcing through the use of the American Water Service Company, Inc. (“Service Company”), which achieves economies of scale that IAWC could not obtain on its own. IAWC also implements extensive internal reviews aimed at monitoring and maintaining efficient levels of productivity among its employees. (*Id.*, pp. 22-24.) Further, as discussed below, the Company has also implemented a number of programs designed to help control cost through preventative

measures and careful planning. Specific examples include (IAWC Ex. 1.00SR (Rev.) (Teasley Sur.), pp. 2-3.):

1. Utilizing national purchasing power to obtain the most reasonable power costs possible. Recent contract negotiations for 2010 and 2011 power costs resulted in a substantial reduction in the contracted price from the previous price. This reduction was reflected in the earlier case update;

2. Utilizing national purchasing power to obtain the most reasonable chemical costs possible. Careful monitoring of market conditions has allowed the Company to pursue updated contracts for reduced costs related to some treatment chemicals for the remainder of 2009, as well as negotiating competitive chemical costs for 2010;

3. Treatment optimization to minimize chemical usage. In most locations, chemical usage is minimized by utilizing flow pacing techniques based on source water conditions and plant performance. In addition, lower-cost alternative treatment techniques are evaluated to determine effectiveness. The Company is currently evaluating an ultra-sonic probe in two locations for algae control and alternative corrosion inhibitors in the Interurban District;

4. Reviewing power consumption of large pumps. Several older electric pump motors have been replaced with variable frequency drive controlled pump motors which are more effective in matching operational conditions, as well as being significantly more energy efficient; and

5. Reduction in insurance premiums (other than group). Due to an extensive safety training and awareness program, workers compensation and auto liability insurance premiums have been reduced.

In addition, the Company routinely reviews, in all economic conditions, opportunities to increase productivity within the business. Specific examples include (IAWC Ex. 1.00SR (Rev.) (Teasley Sur.), pp. 3-4):

1. Reviewing staffing levels to ensure that the most efficient structure is in place.

Operational reviews determined that utilizing existing staff to create an additional shift would eliminate a substantial amount of overtime for one district. Where needed, additional supervisory personnel were added to improve oversight including employee performance, prioritization of work assignments and overtime utilization analyses;

2. Review of work processes to ensure that the most efficient processes are in place.

Process reviews revealed that in some areas crew sizes could be reduced and processes could be modified to improve overall productivity; and

3. Planning for repair and maintenance projects. Several projects have been combined to reduce construction overhead and management costs and limit service disruptions to customers. Examples include obtaining multiple project bids for contracted work, simultaneous valve replacements and working with municipal officials to combine main replacement programs with other planned work such as street and/or sewer replacements in order to reduce restoration costs.

In furtherance of the effort to maintain efficient, high-quality service, IAWC has undertaken a number of Company improvement programs which have contributed to an increase in operating expenses. IAWC witness Cheryl Norton described three such programs in particular. (IAWC Ex. 2.00 (Rev.) (Norton Dir.), pp. 3-4.) First, a reliability-centered maintenance program, including reactive, preventative and predictive/condition-based maintenance is being implemented by IAWC throughout the state. This program will benefit IAWC and its consumers by improving resource management, preserving asset reliability and will generate valuable

information regarding asset performance and generally will encourage efficient maintenance and repair/replacement of assets. Second, in the Chicago Metro District, IAWC is in the process of designing and implementing a Capacity Management Operations Maintenance program for IAWC's wastewater systems. (*Id.*, p. 4.) The program will improve collection systems performance, reduce sanitary sewer overflows, reduce equipment and operational failures, extend the life of systems and equipment, and will improve measures to correct problem areas. Third, the Company has devoted significant resources to identifying and, where economically justified, mitigating levels of unaccounted-for water. (*Id.*)

With regard to capital planning, as discussed by Mr. Kaiser (IAWC Ex. 3.00) (Kaiser Dir.) pp. 3-4), the Company engages in a comprehensive planning process that assesses capital investment needs for all aspects of operations and assigns funding to capital projects on a prioritized basis. A key component of this planning technique is that it is flexible and can be adjusted as needed to address new priorities, such as equipment failures, large or sudden growth of a service area, or new regulatory requirements. For example, as Mr. Kaiser explains (IAWC Ex. 3.00SUPP), the Company has determined that, consistent with service obligations, it can defer certain capital projects until after 2010.

The Company has also invested and will continue to invest a significant level of capital in required facility additions and infrastructure replacement projects. As discussed by Mr. Kaiser, for the 2007-2010 period, the Company projects that it will invest over \$366 million in needed capital projects, approximately \$84 million of which represent planned necessary projects in the 2010 test year. (IAWC Ex. 3.00 (Kaiser Dir.), pp. 5-20.) These test year capital projects include a \$3 million upgrade of the Champaign Mattis Ave. Water Treatment Facility ("WTF") plant to meet regulatory requirements related to the rating of the WTF, as well as several other major

projects in Alton, Cairo, Champaign, Chicago Metro, Interurban, Pekin, Peoria and Pontiac. (*Id.*, pp. 15-20.)

As also described by IAWC witness Mr. Kaiser, the Company has completed over 30 major capital investment projects between the last rate case and 2009. (IAWC Ex. 3.00 (Kaiser Dir.), pp. 6-15.) The major capital projects recently completed include construction of the Champaign County Water Treatment Facility and related facilities, entailing an investment of over \$50 million, as well as various transmission mains, and improvements and upgrades to water and wastewater treatment facilities. (*Id.*, pp. 8, 12.) These capital projects are all intended to enhance and maintain the quality of service IAWC provides to customers. The Company has also invested in many smaller projects, such as those relating to replacement of mains, minor plant and pump station improvements, and installation or replacement of services, hydrants and meters. These projects are also critical to enhancing and maintaining current levels of service quality, reliability and efficiency. (*Id.*, p. 5.)

As in the Company's last rate case, Docket 07-0507, certain witnesses in this proceeding testified with regard to differences between IAWC's rates and those of various municipally-owned utilities ("MOUs"). As Ms. Teasley explained (in this proceeding and in Docket 07-0507), the Company understands these concerns, but cannot address them by proposing that IAWC adopt rates applied by entities with cost and rate structures that differ significantly from those of IAWC. (IAWC Ex. 1.00R (Teasley Reb.), p. 3.) In Docket 07-0507, IAWC submitted the *Analysis Of Water Rates, Fees And Charges For Selected Cities In The Vicinity Of The Chicago Metro District Of Illinois-American Water Company* ("Municipal Rate Study"), which quantified, to the extent possible, differences in MOU and investor-owned utility ("IOU") costs and rates. The Commission found in Docket 07-0507 that the Municipal Rate Study, "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." Docket 07-0507, Final Order, p. 44. Moreover, the Final Order in Docket 07-0507 ("Docket 07-0507 Order") noted that the Commission establishes water and sewer rates based upon the cost of service, not upon a comparison of adjacent or regional utility rates. (*Id.* at 43.) As IAWC witness Bernard Uffelman explained again in this proceeding, a comparison of IAWC's rates to those of MOUs does not support a conclusion that IAWC's rates are unreasonable. Therefore, as Mr. Uffelman explains in detail, and in view of the Docket 07-0507 Order with regard to this issue, IAWC submits that comparisons of IAWC's rates to those of MOUs are not meaningful in ratemaking proceedings.

B. Procedural History

On May 29, 2009, IAWC filed its new and/or revised tariff sheets for water and sewer service. The tariff sheets reflect a proposed rate increase for the following "Rate Areas" of the Company: Zone 1 (consisting of Southern, Peoria, Streator, Pontiac and South Beloit Districts), Chicago Metro Water District, the Chicago Metro Sewer District, the Champaign, Sterling District, the Lincoln District and the Pekin District. In conjunction with the filing of these tariffs, the Company filed the schedules and other materials required under 83 Illinois Administrative Code Part 285. (83 Ill. Adm. Code § 285.) On July 1, 2009, the Company received a deficiency letter from the Administrative Law Judge ("ALJ"), requiring additional filings under the same provision. On July 28, 2009, the Company filed its responses to the deficiencies.

Notice of the filing of the proposed rate increase was posted in IAWC's service district business offices and was published twice in newspapers of general circulation within each service district, in accordance with the requirements of Section 9-201(a) of the Public Utilities

Act (220 ILCS 5/9-201(a)) and the provisions of 83 Ill. Adm. Code 255. In addition, the Company sent notice of the filing to its customers with the first billing issued after the filing.

The Company's proposed rates were suspended on July 8, 2009 and resuspended on October 7, 2009.

Leave to intervene in the proceeding was granted to: the People of the State of Illinois, by the Attorney General of the State of Illinois ("AG"); the Citizens Utility Board ("CUB"); the Illinois Industrial Water Consumers ("IIWC"); the City of Des Plaines ("Des Plaines"); the Village of Homer Glen ("Homer Glen"); the Village of Mount Prospect ("Mt. Prospect"); the City of Elmhurst; the Village of Bolingbrook ("Bolingbrook"); the Village of Lemont; the City of Pekin; the Village of Woodridge; the Village of Prairie Grove; the City of Champaign; and the Village of Tinley Park. Des Plaines, Homer Glen, Mt. Prospect, Bolingbrook, the Village of Lemont and the Village of Woodridge jointly sponsored testimony with the AG as the "Joint Municipalities."

Public forums were held for the purpose of receiving public comment concerning the proposed general increase in water and sewer rates proposed by the Company at: Parkland Community College (Champaign) on October 1, 2009; the Mt. Prospect City Council Chambers on October 8, 2009; the Homer Jr. High School on October 19, 2009; the Wheaton Community Center on November 4, 2009; Alton Square Mall on November 9, 2009.

Evidentiary hearings were held in this matter on December 8-10, 2009. Appearances were entered by counsel on behalf of IAWC, Staff, AG, CUB, IIWC, the Bolingbrook, the City of Champaign, the City of Urbana, Des Plaines, the Homer Glen, the Village of St. Joseph, the Village of Savoy, and the Village of Sidney.

C. Nature of Operations

IAWC is a corporation organized and existing under the laws of the State of Illinois with its principal office in the City of Belleville, Illinois. IAWC currently owns, operates and maintains potable water production, treatment, storage, transmission and distribution systems, and wastewater collection, pumping, and/or treatment systems for the purpose of furnishing water and wastewater service for residential, commercial, industrial and governmental users in various districts. IAWC's service districts include Alton, Cairo, Champaign, Chicago Metro, Interurban, Lincoln, Pekin, Peoria, Pontiac, South Beloit, Sterling and Streator. In total, IAWC serves approximately 308,000 customers in 129 communities in Illinois. IAWC is a wholly-owned subsidiary of American Water Works Company, Inc. ("American Water"), a holding company that owns the stock of water and sewer utility subsidiaries operating in 23 states.

(IAWC Ex. 2.00 (Rev.) (Norton Dir.), pp. 2-3.)

D. Proposed Test Year and Revenues

1. Future Test Year

The test year in this proceeding is a future test year consisting of the twelve month period ending December 31, 2010. No party has opposed use of this future test year. IAWC witness Kerckhove explained how the Company developed its test year projections. (IAWC Ex. 6.00 (Rev.) (Kerckhove Dir.), pp. 4-5.) Mr. Kerckhove further explained that the Company developed the test year projections in accordance with the "Guide for Prospective Financial Information" (2008) issued by the American Institute of Certified Public Accountants ("2008 Guide"). (*Id.*, p. 6.) In Schedule G-2 and G-2 Supplemental, the Company submitted the opinion of Kerber, Eck & Braeckel LLP, certified public accountants, that the preparation and presentation of the projections (as adjusted) comply with the 2008 Guide. (*Id.*, p. 7.) Mr. Kerckhove stated that the projections are reasonable, reliable, and were made in good faith, and

that all of the basic assumptions used in preparing the projections are reasonable, evaluated and justified in the exhibits, testimony and workpapers supporting this filing, allowing Staff and any interveners to test the appropriateness of the projections. (*Id.*)

2. Proposed Tariffs

The Company's initial filing in this case showed, for all Rate Areas, that operating expenses since the test year in the last rate case have increased by approximately \$19 million and rate base has increased by over \$78 million, thus requiring an additional annual revenue of approximately \$59 million to afford the Company the opportunity to earn a reasonable rate of return. (IAWC Ex. 1.00 (Teasley Dir.), p. 10.) As a result of various adjustments discussed below, the record shows that, as of the Company's surrebuttal filing, for all service districts in the aggregate, additional annual revenue of \$50,008,924 is needed to afford the Company the opportunity to earn a reasonable rate of return. (*See* Appendix A.) The Company has proposed rate increases for each of its Rate Areas. For each Rate Area, the final proposed operating income statement and rate base are shown on the designated sheet of Appendix A and IAWC Exhibit 6.03SR, respectively.

The Company proposes an overall rate of return of 8.50%, which includes a common equity cost of 10.90%. As explained by IAWC witness Ahern, such a return on common equity is reasonable, based on her assessment of the market-based cost rates of proxy companies of relatively similar risk, with an appropriate adjustment for IAWC's business risk relative to the proxy groups (because IAWC's common stock is not publicly traded, a market-based common equity cost rate cannot be determined directly for IAWC). (IAWC Ex. 8.00 (Ahern Dir.), pp. 17-20.)

II. RATE BASE

A. Resolved Issues

1. Cash Working Capital Issues

(a) Adjustments to Chemical and Waste-disposal Lead/Lags for CWC

In direct testimony, Staff indicated that the Company's calculation of chemical expense lead days in its initial workpaper WPB-8f did not include a component for service period mid-point. (Staff Ex. 1.0, p. 11.) Similarly, the Company did not initially include lead-lag days for its waste disposal expense for the Lincoln area. (*Id.*, p. 12.) In order to complete the cash working capital requirements and ensure conformity with the Company's methodology as used in Docket 07-0507, Staff witness Mr. Kahle adjusted the chemical and waste disposal expenses to include service period mid-points. (*Id.*, pp. 11-12.) The Company agreed with Mr. Kahle's adjustments. (IAWC Ex. 6.00R1 (Kerckhove Reb.), p. 6.) The Company qualified its acceptance of Mr. Kahle's adjustment by recommending that the cash working capital calculation reflect the values in the accounts included in the working capital calculation that are included in the revenue requirement provided in the Commission's final order to this case. (*Id.*) Staff in turn agreed with this recommendation. (Staff Ex. 8.0, p. 5.)

(b) Equity Return Amount

In direct testimony, Attorney General/Joint Municipalities ("AG/JM") witness Mr. Smith objected to the Company's initial calculation of the equity return in its cash working capital calculation. The Company had determined equity return by multiplying the overall return on rate base by the equity proportion of its capital structure. (AG/JM Ex. 1.0, pp. 26-27.) Mr. Smith stated that the correct method of calculating equity return is to multiply the weighted cost of equity by the base rate, and that in the present case this leads to an equity return in cash working

capital of \$37,179,695. (*Id.*, p. 27.) The Company agreed with Mr. Smith's correction. (IAWC Ex. 6.00R2 (Kerckhove Reb.), p. 7.)

(c) Adjusted Uncollectibles

In his direct testimony, AG/JM witness Mr. Smith recommended that the total amount of adjusted uncollectibles be removed from the cash working capital revenue calculation. (AG/JM Ex. 1.0, p. 28.) The Company agreed and adjusted its cash working capital calculation accordingly. (IAWC Ex. 6.00R2 (Kerckhove Reb.), p. 7.)

(d) Adjustment to Interest Expense

In his direct testimony, AG/JM witness Mr. Smith recommended that the interest expense of cash working capital be calculated by multiplying the adjusted rate base by the weighted cost of debt. (AG/JM Ex. 1.0, p. 28.) The Company replied that it believes the amount of interest expense in cash working capital should be the amount of interest included in the interest synchronization calculation included by the Commission in the revenue requirement. (IAWC Ex. 6.00R2 (Kerckhove Reb.), p. 7.) Mr. Smith agreed with this, as these represent the same amount. (AG/JM Ex. 5.0, p. 26.)

(e) Adjustment to Champaign and Lincoln Lags

In his direct testimony, AG/JM witness Mr. Smith recommended that the service period used to determine the revenue lag in the Champaign and Lincoln districts be adjusted in the Company's lead-lag study to reflect the transition from bi-monthly to monthly billing, if that transition is approved. (AG/JM Ex. 1.0, p. 28.) The Company pointed out that its lead-lag study already reflects this transition, and that because it does not have actual history for lags associated with monthly billing in these districts, it used the weighted average of lags from all other districts, or 47.13 days. (IAWC Ex. 6.00R2 (Kerckhove Reb.), p. 8.) After reviewing Mr. Kerckhove's rebuttal testimony, Mr. Smith determined that the Company's lead-lag study already reflects the

transition from bi-monthly to monthly billing for the Champaign and Lincoln districts, and concluded that no further adjustment is necessary. (AG/JM Ex. 5.0, p. 25.)

(f) CWC: Component Synchronicity

Mr. Smith proposed that components of the cash working capital calculation affected by the amount of revenue increase be synchronized with the adjusted revenue amounts, where practical and material, to reflect the Commission's final approved revenue requirement. (AG/JM Ex. 1.0, p. 29.) The Company agreed with this recommendation, and similarly proposes that all components of cash working capital be based on and synchronized with the revenue requirement approved by the Commission in this docket. (IAWC Ex. 6.00R2 (Kerckhove Reb.), p. 10.)

2. Plant-in-Service Adjustment

Staff proposed to adjust the Company's expenditures for additions to plant-in-service for years 2009 and 2010. (Staff Ex. 1.0, p. 8.) Staff's proposed reduction was calculated by applying the ratio of actual to planned capital spending on plant-in-service for the years 2006, 2007 and 2008 to the projected capital spending in 2009 and 2010. (IAWC Ex. 6.00R1 (Kerckhove Reb.), pp. 3-4.) AG/JM witness Smith also recommended that the Company's plant-in-service expenditure projection be reduced in consideration of historical budget to actual capital spending. (AG/JM Ex. 1.0, pp. 17-22.) The Company accepted Staff's reduction to projected 2009 and 2010 expenditures by application of the resulting Average Planned Capital Expenditures Expended ratio of 94.34%. (IAWC Ex. 6.00R1 (Kerckhove Reb.), p. 4.) However, the Company also applied this ratio to test year customer advances, which are deducted from the base rate, as well as each of the Company's forecasted additions and resulting retirements. (*Id.*) Staff in turn agreed with the Company's adjustments, as reflected in Column (b) of Staff Schedules 8.1 (Operating Statement) and 8.3 (Rate Base). (Staff Ex. 8.0, p. 7.) AG/JM witness Smith also agreed. (AG/JM Ex. 5.0, pp. 17-18.)

3. Business Systems Planning Study

AG/Joint Municipalities witness Smith initially expressed concern regarding the Company's inclusion of its Comprehensive Planning Study ("CPS") expenses in rate base. Mr. Smith also suggested that the item was being double-counted. (AG/JM Ex. 1.0, pp. 24-25.) Mr. Kerckhove responded the double-counting error was corrected in the Company's Errata filing on September 22, 2009, and the correction is reflected in IAWC's Schedule B-5 Second Revised. (IAWC Ex. 6.00R2 (Kerckhove Reb.), p. 6.) Mr. Grubb explained that the study aims to identify the investment needed to replace aging business systems and to streamline and automate processes across American Water affiliates. The new systems and processes are intended to meet customer expectation of service and allow the Company to continue delivering high quality water and wastewater services. (IAWC Ex. 5.00R2 (Rev.) (Grubb Reb.), pp. 6-8.) In light of these explanations, Mr. Smith dropped his objection to its cost's inclusion in rate base. (AG/JM Ex. 5.0, pp. 17-18.)

4. Tank Painting

Staff witness Kahle proposed an adjustment to tank painting costs based on the percentage by which the cost of actual tank painting differed from the budget for tank painting for the years 2007 and 2008. (Staff Ex. 1.0, p. 12.) The Company agreed to accept Mr. Kahle's adjustments with certain modifications, detailed in IAWC Ex. 6.07R1. Mr. Kerckhove recalculated the adjustments by applying Mr. Kahle's Actual Additions as a Percentage of Planned Additions of 81.84% to each of the planned tank paintings for 2009 and 2010. In addition, amortization was recalculated to reflect the reduction in proposed tank painting proposed by Mr. Kahle. The results were lower current and test year amortizations than Mr. Kahle's determination. Finally, Mr. Kerckhove recalculated the deferred income taxes

associated with tank painting. Subject to these modifications, the Company accepted Mr. Kahle's adjustments. (IAWC Ex. 6.00R1 (Kerckhove Reb.), pp. 6-7.)

5. Original Cost Determination

Staff recommends, and IAWC does not oppose, that the Commission conclude and make a finding in the Order in this proceeding that the Company's December 31, 2008 plant balance reflected on Company Schedule B-5 Second Revised, p. 3 of 24, is approved for purposes of an original cost determination, subject to any adjustments ordered by the Commission in this proceeding. (Staff Ex. 1.0, p. 8.); (IAWC Ex. 6.00R1 (Kerckhove Reb.), p. 3.)

B. Contested Issues

1. Cash Working Capital

The purpose of including cash working capital ("CWC") in a utility's rate base is to compensate the utility's investors for providing the funds required for those day-to-day business operations which require a cash outlay during the lag time between the provision of service and the receipt of revenues associated with that service. (IAWC Ex. 6.00SR (Kerckhove Sur.), pp. 2-3.) The compensation provided to the investors through the cash working capital allowance is similar to the compensation provided to the investors for any other non-depreciable capital outlay. Thus, the important consideration in determining cash working capital is the extent that the utility's investors are supplying the utility with funds to meet its operational needs while customer revenues are outstanding. (*Id.*, p. 3.)

The amount of required cash working capital can be determined in various ways. In Illinois, under 83 Illinois Administrative Code Part 285, the cash working capital calculation may be based on a lead-lag study. 83 Ill. Adm. Code § 285.2070. The cash working capital amount may also be calculated using a formula based on operating expenses. *See Aqua Illinois, Inc.*, Docket 03-0403 (cash working capital amount calculated as 1/8 of operating expenses, less

certain adjustments). In this case IAWC chose to perform a lead-lag study to support the proposed cash working capital allowance. IAWC's lead-lag study was based on the lead-lag study performed by IAWC in Docket 07-0507 (which had been required by the Commission in Docket 02-0690). (IAWC Ex. 6.00SR (Kerckhove Sur.), p. 3) In order to minimize rate case expense, the Company used the same fiscal year 2005 data for the lead-lag study that it used in the prior rate case, Docket 07-0507, which was the most recent total fiscal year data available at the time that the prior rate case was being prepared. (*Id.*, pp. 18-19.) The lead-lag study revenue collection analysis utilized in Docket 07-0507 was accepted by the Commission in that proceeding. In addition, the Commission's rules regarding payment, including the late payment fee amount and late payment rules, have not changed between 2005 and the present. (*Id.*, p. 19.)

The lead/lag study analyzed the lag time between the date customers receive service and the date that customers' payments are available to the Company, offset by a lead time during which a company receives goods and services, but pays for them at a later date (except for certain services that result in an expense lag due to pre-funding requirements, such as insurance, operating and facilities leases, IT support services, maintenance agreements, trade organization dues, and certain taxes and fees). (IAWC Ex. 6.00SR (Kerckhove Sur.), pp. 3-4.) The "lead" and the "lag" are both measured in days. These lead days and lag days (based on the 2005 study) are applied to test year revenues and expenses to determine the level of CWC. (Schedule B-8.) The projected annual test year cash expenses are divided by 365 days to determine a daily cash working capital. (*Id.*, p. 4.) The daily amount is then multiplied by the dollar-weighted lead and lag days to determine the amount of CWC required for operations. (*Id.*) The resulting amount of CWC is then included as part of a Company's rate base.

In the present case, IWC witness Mr. Gorman (IWC Ex. 1.0, pp. 66-72) and AG witness Mr. Smith (AG/JM Ex. 5.0, pp. 25-29) both recommend adjustments to cash working capital based on: (i) an assertion that the Company's revenue collection lag should not be more than 21 days (which is the minimum amount of time a residential bill can be due after its issue date); and (ii) an assertion that IAWC's prepayment of Service Company fees is commercially unreasonable and should not be reflected in the cash working capital amount. Both contentions of each witness should be rejected, for the reasons set forth below. Of note, Staff witness Kahle, in his rebuttal testimony, also supported both these adjustments. (Staff Ex. 8.0, pp. 8-11.) However, at hearing, Mr. Kahle withdrew both adjustments, stating: "After reviewing the surrebuttal testimony of the company witness Kerckhove, I am no longer sponsoring my proposed adjustments to cash working capital that appear from lines 153 through 230 of my revised rebuttal testimony." (Tr. 574.)

(a) Revenue Collection Lag

In this case, IAWC calculated the revenue collection lag by dividing the 2005 average daily accounts receivable by the 2005 daily revenue to produce district-specific collection lags between 24.09 days and 34.71 days, excluding Champaign and Lincoln, which use the weighted-average of the total revenue lag for the rest of the districts because the Company is proposing to move Champaign and Lincoln from bimonthly billing to monthly billing in this case. (IAWC Ex. 6.00SR (Kerckhove Sur.), pp. 3-4.)

Collection day lags are calculated as a weighted average of days between the bill date and the date that payment is received (not a simple average as Mr. Smith and Mr. Gorman propose), and can be affected by several factors. (IAWC Ex. 6.00SR (Kerckhove Sur.), p. 14.) The collection lag can be affected by the length of time that a customer takes to pay his or her bill. It can also be affected by the amount of the customer outstanding balance. Thus, in one example

provided by Mr. Kerkchove, the collection lag exceeds 22 days even though 80% of the customers paid in 22 days or less. (*Id.*, p. 15.) This is because both the outstanding balance and the length in payment days affect the collection lag calculation. (*Id.*) As Mr. Kerckhove explained, a significant portion of IAWC's outstanding accounts receivable in excess of 21 days is represented by state government agencies, such as the Illinois Department of Corrections and the Logan Correctional Facility. Other governmental entities, including neighboring municipalities that purchase water from the Company such as the Caseyville Water Company, maintain large outstanding balances in excess of 21 days that drive the collection period day lag up. (*Id.*, p. 11.)

Both Mr. Gorman and Mr. Smith believe that the Company's collection lag should be limited to 21 days because the Commission's rules and Company tariffs require that the due date for residential customer payments be "at least" 21 days after the date printed on the bill. (IWC Ex. 1.0, p. 69; AG/JM Ex. 1.0, p. 29.) Their position, however, is not based on a calculation of collection lags. Rather, it improperly seeks to replace IAWC's detailed projection of its revenue collection lag days, which is based on the lead/lag study and reflects the Company's projection of the lag between issuance of bills and receipt of customer revenues, with an arbitrary projection of collection lag days based solely on the Commission's rules regarding payment terms for one customer class, the residential class. Their proposal ignores the effect of collection from classes other than the residential class and the effect of payment lags from large government or institutional customers as discussed above. In addition, their proposal ignores the fact that IAWC incurs costs related to customer late payment and is entitled to recover those costs.

As the Company's lead-lag study demonstrates, the projected collection lag is 24.09 to 34.71 days (excluding Champaign and Lincoln) for all customers at IAWC. (IAWC Ex. 6.00SR

(Kerckhove Sur.), p. 9.) This projected collection lag reflects IAWC's historical collection experience, including late payments. (*Id.*, pp. 9, 11.) Because IAWC's projected collection lag is based on a detailed calculation using IAWC's actual collection lag experience, Mr. Smith and Mr. Gorman's arbitrary substitution of a 21 day collection lag should be rejected.

Moreover, Messrs. Smith and Gorman's position is based on the premise that a collection lag of more than 21 days indicates IAWC's customers are, on average, paying their bills late. As Mr. Gorman asserted, the "collection lag portion of the revenue lag should be reviewed to conform with the payment terms provided for in the Company's tariff and adjusted as necessary to avoid the use of an unreasonable assumption that customers on-average are paying late, which appears to have been presumed in IAWC's calculation of the revenue collection lag." (AG/JM Ex. 1.0, p. 29.) The implication of their proposal is that IAWC's collection practices could somehow be improved, thereby reducing collection lag. (AG/JM Ex. 5.0, p. 19.)

Mr. Smith and Mr. Gorman's position ignores the comprehensive practices and procedures, established by the Commission in Part 280 of the Commission's rules, 83 Ill. Adm. Code Part 280 ("Part 280"), through which IAWC and other Illinois utilities may collect amounts due from residential and non-residential customers. (IAWC Ex. 6.00SR (Kerckhove Sur.), pp. 9-10.) Part 280 sets forth the terms under which IAWC may pursue the collection of overdue bills and the amount of the late payment charge. For example, Part 280 (83 Ill. Adm. Code §280.90) sets the amount of a late fee that a utility may charge: "such charge shall be set at an amount equal to 1 ½% per month on any amount, including amounts previously past due, for utility service which is considered past due under this Section." The Commission's rules also state, "For Residential Service, the due date printed on the bill *may not be less than* twenty-one (21) days after the date of the postmark, if mailed. . ." (83 Ill. Adm. Code § 280.90 (b).) (emphasis

added). As the language indicates, the due date can be more than 21 days. Part 280.90 (a) also provides a grace period for payment: “When a customer mails any payment in the net amount of a bill for service, and such payment is received at the utility’s office not more than two full business days after the due date printed on the bill, the customer shall be deemed to have made timely payment.” In addition, Section 280.90 (h) sets forth rules regarding payment rules for government agencies. Section 280.90 (h) states, in part, “No late payment charges shall be assessed on the amounts owing on units of Federal, State, County, and local government (including, but not limited to, townships, municipalities and school districts) until 45 days from the date of the issuance of the bill for utility service. . .” These rules were established by the Commission in a rulemaking proceeding, in which the Commission determined, as a policy matter, what the procedures and policies relating to late payments would be. (IAWC Ex. 6.00SR (Kerckhove Sur.), p. 10)

Moreover, Mr. Gorman and Mr. Smith’s proposed limitation of the collection lag overlooks IAWC’s projected test year cost for late payments from all customer classes, and seeks to replace it with a cost arbitrarily limited by the payment period set forth for residential customers in Part 280. There is a cost to IAWC associated with late payments. (IAWC Ex. 6.00SR (Kerckhove Sur.), p. 11.) The costs related to late payments represent an operating expense of the Company (and when past due bills become uncollectible, the Company recovers the cost of related to uncollectible bills as an operating expense – uncollectible expense). (*Id.*) When a customer pays late, IAWC does not timely receive the revenues from that customer to provide service and must obtain the equivalent funds necessary for working capital from some source of funds. A portion of the cost of late payments is the cost associated with having to obtain cash working capital to fund necessary service when payments are not made on time. The

Company incurs the cost related to obtaining the needed funds, and this cost is reflected in rates through inclusion of a cash working capital allowance, based on the lead/lag study, in rate base. The Company may also incur administrative costs related to collections. (*Id.*) These costs associated with late payment are costs incurred by IAWC in providing service and are properly recoverable in rates.

Rates set by the Commission provide an opportunity to recover operating expenses that are prudently incurred in providing service, including the cost related to late payment. The Commission-established late payment charge and other miscellaneous charges provide a portion of the revenue required to meet the Company's total revenue requirement. (IAWC Ex. 6.00SR (Kerckhove Sur.), p. 12.) The forecasted amount of these charges is reflected in the test year income statement as "other operating revenue." The remainder of the revenue requirement is recovered through the Company's base rates. The cost associated with late payments is thus recovered, in part, through inclusion of a properly calculated cash working capital allowance in rate base. Related administrative costs are recovered as customer accounting and business support services expenses. (*Id.*, pp. 16-17.) Because the rates approved by the Commission take into account the level of revenue provided by miscellaneous charges (including the amounts received from the Commission established late payment charge) and in total are designed to recover the revenue requirement (and no more), there is no double recovery of cost as a result of the late payment charge or other miscellaneous charges. (*Id.*, p. 12.) To the extent that customers do not pay bills on time, IAWC is entitled to recover the associated costs in rates. (IAWC Ex. 6.00SR (Kerckhove Sur.), pp. 12-13.)

Mr. Smith and Mr. Gorman's proposal would have the effect of imposing an arbitrary limitation on the collection lag, which would prevent the Company from recovering the full

operating cost associated with late payments. The Company's collection lag properly represents the projected test year lag in the Company's receipt of revenues from its customers. Therefore, Mr. Gorman and Mr. Smith's proposal should be rejected.

(b) The CWC Calculation Should Not be Adjusted to Reflect Prepayment of Service Company Fees

Mr. Smith and Mr. Gorman both assert that IAWC's prepayment to the Service Company for services is not commercially reasonable and that the CWC calculation should be adjusted to remove this calculation. Mr. Gorman asserts that a 15-day payment lag is reasonable. (IWC Ex. 1.0, p. 67.) Mr. Smith and Mr. Gorman's assertions, however, do not recognize that the Commission-approved agreement between IAWC and the Service Company ("Service Company Agreement") requires prepayment of Service Company fees, and that this approach eliminates a Service Company overhead cost that IAWC would otherwise be required to pay as a part of the cost for services provided. (IAWC Ex. 6.00SR (Kerckhove Sur.), pp. 4-5.)

Unlike other vendors, the Service Company provides services at cost. It has no retained earnings or other internally generated funds with which to provide working capital to fund the services it provides to IAWC prior to receipt of payment for those services. (IAWC Ex. 6.00SR (Kerckhove Sur.), p. 5.) Thus, in preparing the Service Company Agreement, there were essentially two options for addressing the Service Company's need to obtain funds in order to provide the necessary funds to finance required services used by IAWC. (*Id.*) One option was to have the operating utilities, such as IAWC, prepay for Service Company services. The other option would have been to require the Service Company to obtain cash working capital and include the related cost in the overheads added to the cost for services provided to IAWC and other operating subsidiaries. (*Id.*) In the Service Company Agreement, the option to have the operating utilities, including IAWC, prepay for Service Company services was used.

As the Service Company is an affiliate of IAWC, the Company was required to obtain Commission approval for the Service Company Agreement. The current Service Company Agreement, which includes a provision for pre-payment for monthly services, has been approved by the Commission twice: on July 19, 1989, in Docket 88-0303 and again on October 25, 2005, in Docket 04-0595. In approving the Service Company Agreement, including the prepayment provision, the Commission found that the Service Company Agreement was reasonable and in the public interest. If the approved Service Company Agreement had not required prepayment for services, IAWC's cost to obtain services from the Service Company would have been different. (IAWC Ex. 6.00SR (Kerckhove Sur.), p. 6.) As noted above, modification of the prepayment terms of the Service Company Agreement would have required that IAWC pay as an overhead the cost incurred by the Service Company to obtain working capital needed to provide services. (*Id.*) Thus, the prepayment terms are reasonable and should not be modified.

The terms of the Service Company Agreement determine the actual method by which IAWC pays the Service Company. (IAWC Ex. 6.00SR (Kerckhove Sur.), pp. 6-7.) As Mr. Kerckhove explained, IAWC does in fact prepay Service Company charges, and this prepayment is reflected in IAWC's lead-lag study and cash working capital calculation. As discussed above, the Commission has expressly found that the Service Company Agreement is reasonable and in the public interest. This determination demonstrates that the Commission considers the prepayment provision reasonable (as compared to, for example, inclusion of the cost to the Service Company to fund its own cash working capital as overhead in the Service Company's charges). Because IAWC's prepayment of Service Company fees represents its actual, Commission-approved practice, Mr. Smith's recommendation is nothing more than a request to impose an

arbitrary and theoretical 15-day lead period on IAWC that does not reflect IAWC's actual circumstances.

Prepaying Service Company costs is also a prudent business practice. IAWC commonly prepays certain types of vendors, such as lessors, taxing authorities, insurers, trade organizations (dues), and providers of IT support services and maintenance agreements. These prepayments are in accord with industry practice related to the particular service involved. (*See* IAWC Exs. 6.00SR (Kerckhove Sur.), pp. 7-8; 6.07SR; 6.08SR.) Thus, in addition to the fact that the Service Company Agreement was approved by the Commission, there is no commercial basis to support the argument that the prepayment terms are unreasonable.

Mr. Smith also cites a West Virginia Public Service Commission ("PSC") Order that he alleges finds, with respect to the Service Company Agreement, "there is no provision for advance payments of the next monthly bill." (AG/JM Ex. 5.0, p. 24.) The West Virginia PSC order appears to misinterpret the terms of the Service Company Agreement. The Service Company Agreement provides: "As soon as practicable after the last day of each month, Service Company shall render a bill to Water Company *for all amounts due* from Water Company for services and expenses for such month *plus an amount equal to the estimated cost of such services and expenses for the current month.*" (Emphasis added). The quoted language provides that the bill from the Service Company include two amounts: (i) amounts due; and (ii) an amount equal to the estimated cost of such services and expenses for the current month. Thus, the Service Company Agreement clearly requires prepayment, and IAWC does in fact pay the current month's estimated Service Company fees in advance. (IAWC Ex. 6.00SR (Kerckhove Sur.), pp. 23-24.)

As a result, the record in this case demonstrates that it is appropriate for IAWC's cash working capital calculation to reflect its actual payment practices with respect to Service Company fees. IAWC is contractually required to prepay the Service Company for services, and the Commission has determined that the provision of funds to support services provided by the Service Company is more appropriately met through the prepayment terms. (IAWC Ex. 6.00SR (Kerckhove Sur.), pp. 6-7.) If a 15-day lead period for payments was imposed, IAWC would continue to be required to prepay the Service Company for services. Thus, the effect of this proposal would be to deny IAWC a reasonable opportunity to recover a cost prudently incurred in providing service in accord with an agreement previously approved by the Commission. (*Id.* p. 8.)

C. Proposed Rate Base

The Company's recommended Total Company rate base is \$613,076,601, as shown on IAWC Exhibit 6.03SR. The rate bases for each Rate Area are shown on the designated sheets of IAWC Exhibit 6.03SR.

III. OPERATING REVENUES AND EXPENSES

A. Resolved Issues

1. Tank-painting Charges and Amortization Expense

Staff witness Kahle proposed an adjustment to disallow a part of the test year deferred tank painting charges and the related amortization expense. (Staff Ex. 1.0, p. 12.) Mr. Kerckhove accepted these changes, after correcting Mr. Kahle's inclusion of two years of painting which he had calculated as being done in one year, and recalculating deferred income taxes to reflect the reduction in tank painting cost and amortization. (IAWC Ex. 6.00R1 (Kerckhove Reb.), pp. 6-7.) Mr. Kahle in turn accepted Mr. Kerckhove's corrections. (Staff Ex. 8.0, p. 6.)

2. Adjustments to Depreciation Expense

Mr. Kahle proposed certain changes to depreciation expense, accumulated depreciation expense and accumulated deferred federal and state income taxes. (Staff Ex. 1.0, Schedule 1.7.) The Company generally accepted these changes, with certain modifications. In particular, the Company corrected adjustments which increased rather than decreased the reserve for depreciation for all areas other than Zone 1 (including for retirements, removal, salvage and depreciation expense associated with each forecasted 2009 and 2010 plant addition). The Company also adjusted accumulated deferred income taxes related to the resulting difference between book and tax depreciation resulting from use of the Average Planned Capital Expenditures Expended rate. (IAWC Ex. 6.00R1 (Kerckhove Reb.), p. 5.) Staff agreed with the Company's corrections. (Staff Ex. 8.0, pp. 5-6.)

3. Advertising Expense

Mr. Kahle proposed to remove certain advertising expenses of a promotional, goodwill or institutional nature from the Company's proposed level of operating expense. (Staff Ex. 1.0, pp. 15-16.) For purposes of this proceeding, the Company accepted Mr. Kahle's adjustment. (IAWC Ex. 7.00R1 (Rev.) (Bernsen Reb.), p. 4.)

4. Lobbying Expense

Staff witness Mr. Kahle and AG/JM witness Mr. Smith both proposed that the Company remove lobbying expenses initially included in its proposed test year expenses, including 17% of the Company's NAWC dues attributable to lobbying. (Staff Ex. 1.0, p. 17; AG/JM Ex. 1.0, pp. 30-31.) However, Mr. Kahle's adjustment to remove lobbying associated with NAWC dues used the incorrect amount of \$96,009 for total dues, and incorrectly allocated the adjustment based on the percentage of total Miscellaneous Expense by district. (IAWC Ex. 7.00R1 (Rev.) (Bernsen Reb.), p. 5.) The Company agreed to remove lobbying expenses, but using a figure of

\$101,887.25 for NAWC total dues, and allocating the adjustment based on district customer counts. (*Id.*) Mr. Smith and Staff both accepted the Company's adjustments. (Staff Ex. 8.0, pp. 7-8; AG/JM Ex. 5.0, p. 29.)

B. Contested Issues

1. Residential Sales Volumes and Revenues

IIRC initially challenged IAWC's projection of the number of residential customers in the test year and resulting test year revenue. (IIRC Ex. 2.0, p. 8.) As explained by Mr. Grubb, as a result of its ongoing efforts to review customer data for accuracy and completeness (a process that includes the Company's periodic reporting to the Commission on zero use bills, consecutive estimates and high usage bills), IAWC determined in early 2009 that the billing system was double counting some residential customers throughout the Company. (IAWC Ex. 5.00R2 (Rev.) (Grubb Reb.), pp. 15-16.) The issue did not cause the customer to be billed incorrectly. The customer count has been corrected in the customer service system. (*Id.*, p. 16.) Mr. Collins accepted Mr. Grubb's actual September 2009 residential customer count and adjusted it for 0.4% annualized growth to get a final projected test year customer count of 254,952 from which to determine projected test year revenue. (IIRC Ex. 4.0, p. 7.)

IAWC agrees in principle with Mr. Collins' approach of using the most current level of customers to project the level of residential customer for 2010, but his actual calculation contains an error. He utilized the total number of residential customer at September 2009 of 254,189, but determined the level of residential customers by district based on each districts percentage of residential customers as of March 2009. Thus, his calculation does not properly reflect the actual residential customers by district as of September or October, 2009 and so misallocates residential revenue. (IAWC Ex. 5.00SR (Grubb Sur.), pp. 4-5.) The actual number of residential customers at October 2009 is 253,660. The level of residential customers is consistent with the Company's

updated projection of residential customers at the end of December 2009 of 253,641, from which the test year projection was calculated using an annualized growth level of 0.4%. Because the Company's test year projection is consistent with its recent actual residential customer count, and to avoid the concerns with Mr. Collins' allocation of residential customers to the districts, an adjustment to IAWC's test year residential revenues should not be adopted.

2. Commercial Sales Volumes and Revenues

The Company's projection of test year sales for the commercial class was based on a detailed projection. The Company first analyzed historical data to derive average usage per customer per day. (IAWC Ex. 5.00R2 (Rev.) (Grubb Reb.), p. 18.) This data incorporates usage trends where appropriate, and was thoroughly examined to ensure that usage variances were consistent throughout the year. (*Id.*) The resulting number was then multiplied by the projected customer count, discussed below, of 19,950. (*Id.*) The Company's projection is consistent with historical data. The Company's test year projection produced a commercial sales volume of 6,594,607,000 gallons. (*Id.*) The projection matches recent historical data—the sales volumes for years 2003 through 2008 are, respectively, 6.3 billion gallons, 6.5 billion gallons, 6.8 billion gallons, 7.1 billion gallons, 6.7 billion gallons and 6.2 billion gallons. (IAWC Ex. 5.00SR (Grubb Sur.), p. 8.)

IWC witness Mr. Collins proposes an adjustment to commercial sales volume based on an assumed test year commercial customer count of 19,403. Mr. Collins increased the Company's total projected commercial sales volume by 2,900,039 CCF. (IWC Ex. 2.0, p. 11.) His proposal, however, is based on a misunderstanding of the Company billing data that he used to derive a new customer count, as discussed below. Because the Company's sales volume projection is accurate, and because Mr. Collins' adjustment to it is based on a misunderstanding

the Company's projections, there is no reason for the Commission to reject the Company's test year projection.

Mr. Collins bases his criticism of the Company's customer count on a mistaken reading of the Company's annual billings. Mr. Collins divided the number of yearly customer billings in the E-4 and E-5 Schedules by twelve to derive what he believed was the Company's current commercial customer count (16,420). (IWC Ex. 4.0, p. 8.) He projected an increase in commercial customers to 19,403 in the test year, and an accompanying increase in Commercial revenues. Mr. Collins' then asserted that the Company has understated commercial revenues by \$7.2 million. In assuming this, however, Mr. Collins disregards the Company's actual commercial customer counts of 19,088 on October 31, 2009 and 19,250 in September 2009. (IWC Exs. 5.00R2 (Grubb Reb.), p. 18; 5.00SR (Grubb Sur.), p. 7.) In fact, Mr. Collins' recommendation for a total test year commercial customer count of 19,403 is consistent with the Company's current projection of 19,950. (IWC Exs. 5.00R2 (Grubb Reb.), p. 19.) The Company's projection of test year commercial revenues in the amount of \$24.4 million, using a customer count of 19,950, is more accurate than the recommendation of Mr. Collins, who is recommending commercial revenues of \$31.6 million based on a customer count increase from 16,420 to 19,403.

As Mr. Grubb explained, IWC uses a Microsoft Excel based model ("revenue model") to calculate its budgeted revenues used by management. (IWC Exs. 5.00R2 (Grubb Reb.), p. 19.) This same model was used to populate the E-4 and E-5 Schedules in this rate case. This model has been used since 2003. In the model, the Company used the 2003 historical distribution of customer charges (by size of meter) in preparing its 2009 revenue budget. (*Id.*, p. 20.) Since 2003, IWC's distribution of customer charges by meter size has evolved and

changed. When the Company prepared this case, it noted that the number of 5/8" meters had declined while the number of 1" meters, 1-1/2" meters, 2" meters, 3" meters and 4" meters had increased. (*Id.*) Due to the shift of the distribution of meters, and in order to properly reflect the level of revenues contained in the 2009 revenue budget, the Company adjusted the number of commercial customer charges by meter size to reflect the percentage distribution of the customer charges by meter sizes based on the actual 2008 historical customer charges by meter size. (*Id.*) When this was done, however, IAWC maintained the same level of revenues generated by the commercial customer charge at a level to match the 2009 projection. IAWC also adjusted the commercial consumption charges to reflect actual 2008 historical distribution of sales through the blocks, so that the revenues generated by the commercial consumption charge would be the same as reflected in the 2009 revenue budget. (*Id.*; IAWC Exhibit 5.02R2). This adjustment of the revenue model resulted in customer meter billing information that incorrectly appeared to show a lower level of commercial customers than the level of commercial customers IAWC actually has at present. (IAWC Ex. 5.00R2 (Rev.) (Grubb Reb.), p. 19.) As discussed above, however, IAWC's test year projected commercial customer count was based on historical data and is consistent with the current actual customer count. Therefore, IAWC's commercial customer count projection remains reasonable. Because Mr. Collins' adjustment of the Company's test year customer count is based on incorrect assumptions, the Commission should disregard it.

Mr. Collins' use of an incorrectly low current customer count leads him to project test year commercial revenues that deviate significantly from IAWC's historical and current experience. Mr. Collins incorrectly asserts that the Company understated commercial revenue by \$7.2 million. (IIWC Ex. 2.0, p. 11.) He therefore proposes a test year level of commercial

revenues at present rates in the amount of \$31.6 million. This number, however, is not consistent with IAWC's recent actual and budget commercial revenue amounts. (IAWC Ex. 5.00R2 (Rev.) (Grubb Reb.), p. 21.) The Company is proposing test year commercial revenues at present rates of \$24.4 million. Commercial revenues for 2008 (annualized using present rates) are \$24.4 million. The Company's 2009 budget for commercial revenues at present rates is \$24.5 million. Actual billed commercial revenues for the twelve months ended September 2009 is \$23.6 million. And finally, the amount of authorized commercial revenues from Docket 07-0507 was \$24.3 million. Thus, Mr. Collins proposed adjustment overstates commercial revenues by nearly 30%. (*Id.*) Mr. Collins' commercial revenue adjustment should therefore be rejected.

3. Industrial Sales Volumes and Revenues

In its direct case and update, the Company's projection of industrial sales for Zone 1 was based on the most current information available at that time. Sales to the sole customer of the Large Industrial class in Zone 1, U.S. Steel Granite City Works, fell significantly between December 2008 and the time of the initial projection, due to the economic downturn and a the facility entering "hot idle mode," during which production ceases but a lower level of water is still consumed. (IAWC Ex. 5.00R2 (Rev.) (Grubb Reb.), p. 9; IAWC Ex. 5.0, p. 2.) As a result, the initial projection of 500,000 CCF was the annualization of actual sales during the months of April, May and June 2009. (IAWC Ex. 5.00R2 (Rev.) (Grubb Reb.), p. 9.) Because U.S. Steel was unable to provide a projection of 2010 water usage, the Company's projection used the April through June consumption as its projection basis, given that there was no more current information available. (IAWC Ex. 5.0, p. 4; IAWC Ex. 5.00R2 (Rev.) (Grubb Reb.), pp. 9, 12.)

Subsequently, the Company received additional information regarding U.S. Steel's water usage, including the actual November sales for U. S. Steel and the rebuttal testimony of the IAWC witness Goossens, which was filed on November 13, 2009, and stated that U.S. Steel had

left “Hot idle” mode. (IAWC Ex. 5.00SR (Grubb Sur.), p. 2.) Based on this additional information, the Company concluded that its August 24th update projection of water sales to U. S. Steel should be adjusted to a higher level of projected sales for 2010. (*Id.*) The Company therefore proposes to annualize U.S. Steel’s actual water usage for July through November 2009 to project IAWC’s 2010 level of large industrial class usage. (*Id.*) During the July to November period, average monthly usage by U.S. Steel was 135,908 CCF, which equates to an annualized usage of 1,630,896 CCF. Utilizing this level of annual sales to U.S. Steel would increase the Company’s present rate revenues by \$1,702,681 from the August 24th update and increase fuel and power expense and chemical expense by a total of \$407,123. Use of this current information is reasonable in light of the recent shift of U.S. Steel out of hot idle mode. In addition, in IAWC’s recent prior rate case, Docket 07-0507, the Commission found that the use of recent revenue data was an appropriate basis for projected future water sales than an historical average. Docket 07-0507 order, pp. 12, 14. Because the Company’s current estimate is accurate based on recent actual usage data, the Commission should accept it as a reliable indicator of expected test year usage.

IIRC witness Collins proposes a test year level of industrial sales of 1,879,879 CCF. (IIRC Ex. 4.0, p. 5.) Mr. Collins’ test year industrial consumption projection for Zone 1 is based on historical information—specifically the four-year average of annual sales for the period from 2004 through 2008. However, the historical data on which Mr. Collins relies is not a reliable indicator of test year usage, as U.S. Steel Granite City Works (the sole customer in the class) is currently just now returning to higher levels of production, and therefore water usage capacity, from its hot idle period. (IIRC Ex. 2.0, p. 6; IAWC Ex. 5.00R2 (Rev.) (Grubb Reb.), pp. 9-10.) Furthermore, this projection fails to include the most recent available actual data,

which, as discussed above, the Commission has indicated is an appropriate basis for determining projected future levels of revenue. (IAWC Ex. 5.00R2 (Rev.) (Grubb Reb.), pp. 12-13.) U.S. Steel witness Goossens also indicated that the test year projection should include the most recent available data. (IAWC Ex. 5.00SR (Grubb Sur.), pp. 2-3; IWC Ex. 5.0, p. 4.) Because Mr. Collins' projection is based on historical data which does not reflect recent economic conditions affecting water usage at U.S. Steel and does not incorporate the most recent available actual data, the Commission should reject it.

4. General Inflation Adjustment for Non-labor O&M Expenses

The Company's test year forecast was prepared using a 2.5% general inflation adjustment for certain non-labor O&M expenses in 2009 and 2010 to arrive at the test year level of expense. At the time that the forecast was prepared, the 2.5% general inflation adjustor was appropriate and was primarily based upon expected inflation as provided in the Budget of the U. S. Government for Fiscal Year 2009. (IAWC Ex. 6.00R2 (Kerckhove Reb.), p. 11.)

AG/JM witness Smith recommend an adjustment to the Company's projected test year level of non-labor O&M expenses based on elimination of the Company's initial O&M inflation estimate of 2.5%. Mr. Smith asserted that non-labor inflation is expected to be negative in 2010. (AG/JM Ex. 1.0, p. 33.) Mr. Smith's sole support for his projected deflation factor is a memo written by the staff of the California Public Utilities Commission. (IAWC Ex. 6.00R2 (Kerckhove Reb.), p. 10.)

The Company realizes that economic conditions are not the same now as when the fiscal year 2009 U. S. Government Budget was prepared. As a result, the Company proposed to apply to certain non-labor expenses a 1.7% general inflation adjustor to forecast the respective test year expenses. The 1.7% inflator was obtained from the Livingston Survey sponsored by the Federal Reserve Bank of Philadelphia. The Livingston Survey, conducted June 2009, contains forecasts

of economic information from a survey of 33 forecasters.. (IAWC Exs. 6.00R2 (Kerckhove Reb.), p. 11; 6.01R2.) The 1.7% inflation projection is reasonable, and, as discussed below, is supported by the fact that actual inflation in 2009 is positive and above 2%.

In response to the Company's replacement of its 2.5% inflation estimate with an estimate of 1.7%, Mr. Smith asserted that the Livingston Survey also contains information on the Producer Price Index ("PPI"). He claimed it did not seem reasonable for IAWC to rely exclusively on Consumer Price Index ("CPI") based inflation, and to entirely ignore the PPI measure. (AG/JM Ex. 5.0, p. 30.) He further asserted that the Livingston Survey shows that the 2008 to 2009 estimates of both CPI and PPI inflation are now both negative (i.e., deflation). He therefore recommended that the inflation adjustment to non-labor O&M expenses should be 0%. (*Id.*)

As Mr. Kerckhove explained, however, Mr. Smith's reference to projected inflation for 2009 is not relevant for projecting inflation in 2010. (IAWC Ex. 6.00SR (Kerckhove Sur.), p. 26.) What is relevant is actual inflation in 2009. (*Id.*) In fact, actual inflation for 2009 is positive. According to the U. S. Government's Bureau of Labor Statistics, the CPI for the ten months ended October 31, 2009, is 2.3%. (*Id.*) According to the U. S. Government's Bureau of Labor Statistics, the PPI for the ten months ended October 31, 2009, is 2.6%.

The Company's original projection of a 2.5% inflation rate for certain 2008 non-labor expenses to arrive at the 2009 amount is supported by the 2009 year-to-date CPI of 2.3% and compares favorably with the PPI of 2.6%. (IAWC Ex. 6.00SR (Kerckhove Sur.), p. 27.) The 2009 level of expenses that is used as the base to forecast 2010 expenses through the application of an inflation factor is appropriate and supported by the 2009 inflation indices published by the

U. S. Bureau of Labor Statistics. (*Id.*) Therefore the Company's reasonable 1.7% 2010 non-labor O&M inflation factor should be adopted.

5. Prior Rate Case Expense

IAWC requests the inclusion of expenses incurred in generating the Commission-ordered Municipal Rate Study performed by IAWC in the prior rate case, Docket 07-0507. As a component of rate case cost, the Company is seeking recovery of \$187,047, which represents the unamortized balance of the actual cost of the Municipal Rate Study (*see* Staff Ex. 2.0, Schedule 2.1). In Docket 07-0507, the Company projected a cost for the Municipal Rate Study of \$37,000, which was the cost level allowed by the Commission. That amount was amortized over five years. (*Id.*) The actual cost of the Municipal Rate Study was \$224,047, which exceeded the amount projected. (*See* Schedule C-10.1.) In this proceeding, IAWC proposes to recover the unamortized balance of the actual cost, amortized over the three year period remaining of the original five year amortization of the Municipal Rate Study (resulting in a test year amount of \$62,349. (Staff Ex. 2.0, Schedule 2.1; Schedule C-10.)

In accord with the Commission's Order in Docket 07-0507, IAWC has recovered the cost of the Municipal Rate Study to date based on the initial cost estimate. IAWC, believes, however, with respect to the Municipal Rate Study, the proposal to recover cost going forward for the remainder of the amortization period based on the actual cost incurred is reasonable. (IAWC Ex. 7.00R2 (Rev.) (Bernsen Reb.), p. 2.) Owing to the unique nature of the Study, its cost was difficult to predict at the time the Company filed Docket 07-0507. Further, as the final order in Docket 07-0507 shows, the issue of the comparability of municipal rates was extensively litigated in that case, leading to costs higher than anticipated. (IAWC Ex. 7.00SR (Bernsen Sur.), p. 2.) Additionally, the Commission upheld the Municipal Rate Study's conclusions. (IAWC Ex. 7.00R2 (Bernsen Reb.), pp. 2-3.)

Moreover, as Mr. Uffelman's testimony makes clear (IAWC Ex. 10.00R (Uffelman Reb.), pp. 5-21.), the issue of municipal rate comparisons, previously addressed by the Municipal Rate Study, is again an issue in this proceeding. As will be discussed later in this Brief, Mr. Uffelman draws on the analysis in the Municipal Rate Study in responding to the testimony and information regarding municipal rates produced in this proceeding. Due its continuing application, it is appropriate to recover the full cost of the Study.

AG witness Mr. Smith and Staff witness Mr. Wilcox object to the inclusion of this amount in the current case. (AG/JM Ex. 5.0, p. 35; Staff Ex. 20, p. 3.) Due to these factors and the continuing reference to the study in the present rate case, it is appropriate to permit IAWC to recover the full cost of this Commission-directed study. Because IAWC has shown the propriety of such recovery, Mr. Smith's and Mr. Wilcox's adjustments should be rejected.

6. Current Rate Case Expense

(a) Current Rate Case Expense Is a Reasonable and Accurate Projection

The Company's requested level of rate case expense for the current case is a reasonable and accurate projection of necessary costs required to prosecute the current case, and should be recovered in rates. *Du Page Utility Co. v. Illinois Commerce Comm'n*, 47 Ill.2d 550, 561 (1971) (costs incurred by a utility to prepare and present a rate case are properly recoverable as an ordinary and reasonable cost of doing business). The Company is requesting a total rate case expense of \$2,339,496. (IAWC Schedule C-10.1.) As IAWC witness Mr. Bernsen explains, the litigation process, required studies, and staffing needed to file and litigate a rate case are reflected in the Company's proposed rate case expense. The proposed rate case expense does not contain any expenses above and beyond what is projected to be necessary to go through the rate case process. (IAWC Ex. 7.00R2 (Rev.) (Bernsen Reb.), p. 3.) Of this total, \$930,000 consists

of legal expenses, which as discussed below represents a reasonable cost incurred to for attorneys with experience in representing Illinois public utilities, and which is subject to cost-control measures including a not-to-exceed limit. Other components of the total include the cost of Commission-required studies such as the Demand Study, Cost of Service Study and Service Company Cost Study, all of which the Commission ordered the Company to undertake in Docket 07-0507. Cost control measures are in place with respect to these studies as well. The projected level of rate case expense reflects careful analysis of prior case costs and incorporates cost-control measures implemented to minimize expenses. Commission Staff agrees that the Company's requested level of rate case expense is appropriate. (Staff Ex. 2.0, p. 4.) Therefore, the Company's requested rate case expense should be approved.

The reasonableness of the Company's proposed level of rate case expenses in the current case is demonstrated by a comparison of current rate case expenses to the actual level of rate case expense incurred in Docket 07-0507. The actual rate case expense of Docket 07-0507 was \$2,347,164, which is \$7,668 more than the projected cost of the current case. (IAWC Schedule C-10.1.) However, the current case includes expenses of \$106,540 and \$422,900 for a Cost of Service Study and Service Company Study, respectively, neither of which was undertaken by the Company in the prior rate case. The projected costs of Legal Fees and Expenses, Revenue Requirement and CPA Review saw cost decreases from actual amounts in the prior case of 7%, 51% and 47%, respectively. (IAWC Schedule C-10.1.) The total level of rate case expense also includes the \$143,000 cost of the Demand Study, which was performed in accordance with a Commission-approved methodology. (IAWC Ex. 13.00 (McKinley Dir., p. 4). While the cost of the Demand Study undertaken in the current docket is higher than that undertaken in the prior docket, the cost increase is attributable to a different methodology used in the current case, as

discussed below. Furthermore, the Company selected the Demand Study consultant through a competitive bidding process in which the lowest bidder received the contract. (IAWC Ex. 7.00R2 (Bernsen Reb.), p. 6.)

The Company has demonstrated commitment to keeping rate case expense as low as possible through implementation of various cost control measures. (IAWC Ex. 7.00R2 (Rev.) (Bernsen Reb.), p. 4.). As IAWC witness Mr. Bernsen explained, these cost-control measures include the use of fixed fees for certain aspects of rate case expense, as well as contractual agreements for “not-to-exceed” amounts, or ceilings for certain expense categories, such as legal expense. (IAWC Ex. 7.00R2 (Rev.) (Bernsen Reb.), pp. 4, 9.) The Company has also utilized in-house legal counsel (whose hourly rates, as discussed below, are lower) where appropriate. (IAWC Ex. 5.00SR (Grubb Sur.). p. 12). Moreover, the Company’s proposed level of rate-case legal expense is similar to, and generally below, such expenses in other rate cases. North Shore Gas Company’s approved rate case legal expense in its 2007 rate case (07-0241 (cons.)) was \$1,382,000. Nicor Gas Company’s approved rate case legal expense for its 2004 rate case (Docket 04-0779) was \$2,300,000. Commonwealth Edison Company’s actual rate case legal expense for its 2005 rate case (Docket 05-0597) was \$6,385,000. In contrast, IAWC’s estimated rate case legal expense is under \$1 million. (IAWC Ex. 7.00R2 (Rev.) (Bernsen Reb.), p. 4.)

With specific reference to the level of rate case legal expense, as Ms. Teasley explains in her Direct Testimony, in procuring services, IAWC’s practice is to provide support for utility operations based on considerations of cost-effectiveness, timeliness, reliability and adequacy. (IAWC Ex. 1.00 (Teasley Dir.), p. 17.) The field of regulatory law is a very specialized field, and prosecuting a rate case requires knowledge in not only the area of law, but also in the areas of accounting, finance, economics and engineering. (IAWC Ex. 5.00R2 (Rev.) (Grubb Reb.), p.

2.) Outside counsel can bring substantial regulatory law experience to bear in the rate case context. In addition, the use of outside legal counsel provides efficiencies that could not be achieved by having the legal aspects of a rate case performed entirely within the Company. Therefore, while the Company has concluded that, for legal services, the hourly billing rates for the Service Company are lower than non-affiliated third party billing rates (IAWC Ex. 11.01), there are instances where it is more appropriate to use outside legal counsel. (IAWC Ex. 5.00R2 (Rev.) (Grubb Reb.), p. 2.)

As Mr. Grubb explains, the Company has concluded that use of outside counsel is more cost-efficient than use of Service Company attorneys for rate cases. (IAWC Ex. 5.00R2 (Rev.) (Grubb Reb.), p. 2.) In order for the Company to use in-house attorneys for rate cases, it would first have to hire appropriate attorneys, and therefore “would incur expenses related to those lawyers on an on-going basis, despite the fact that rate cases occur every two to three years.” (IAWC Ex. 5.00R2 (Rev.) (Grubb Reb.), pp. 2-3.) Furthermore, the Company has saved \$6.2 million over the past nine years by using outside counsel rather than Service Company lawyers. (IAWC Ex. 5.00SR (Grubb Sur.), p. 13.) Based on this conservative analysis, it is apparent that the Company’s use of outside attorneys for rate cases is the least cost approach. (IAWC Ex. 5.00SR (Grubb Sur.), p. 13.)

The reasonableness of IAWC’s cost of legal representation is further supported by data from the Service Fee Study, which provides information regarding the market pricing of legal services. The hourly billing rates for the Company’s outside legal counsel are, in fact, consistent with or lower than the hourly rates for lawyers in Midwestern cities, including Chicago and St. Louis. (IAWC Ex. 7.00R2 (Bernsen Reb.), p. 5.) IAWC is paying \$300-\$525/hr for partner-level lawyers and \$250-\$360/hr for associate-level lawyers. (*Id.*) The Midwest market average

rates for those same services are \$435/hr and \$264/hr respectively. (IAWC Exhibit 11.01, Schedules 4.2 and 4.3.) Rates for partner-level legal services in the Midwest run as high as \$1000. (IAWC Exhibit 11.01 Schedule 4.2.) Similarly, rates for Midwest associate-level lawyers run as high as \$625. Thus, the data show that IAWC is paying legal-service rates comparable to market averages. Midwest-region top hourly rates, in contrast, are nearly double what IAWC is paying. (IAWC Ex. 7.00R2 (Bernsen Reb.), p. 5.)

(b) AG/JM Witness Smith's Arbitrary Reduction to Legal Rate Case Expense Should Be Rejected

Citing concerns about the poor state of the economy, the hourly rates charged by attorneys retained by the Company, and the magnitude of increase over the approved level from the prior rate case, AG/Joint Municipality witness Mr. Smith's proposes to limit IAWC to a 10% increase over the approved level of rate case legal expense in the Company's prior rate case. (AG/JM Ex. 1.0, p. 44.) His proposal, however, should be rejected because it is arbitrary, ignores the Company's detailed projection of rate case expense for this case, and does not allow the Company to recover its prudent expenses.

When setting utility rates, the Commission must determine that the rates accurately reflect the cost of service delivery and must allow the utility to recover its prudent and reasonable costs. *Citizens Utility Bd. v. Illinois Commerce Com'n*, 166 Ill.2d 111 (Ill. 1995); *see also Illinois Bell Telephone Co. v. Illinois Commerce Comm'n* (1953), 414 Ill. 275, 286 (rates fixed by the Commission must be adequate to recover reasonable operating expenses and for an adequate rate of return and operating expenses). The Commission may not simply disregard the level of a utility operating expense as shown by evidence in a rate proceeding in favor of an arbitrary lower amount. *Peoples Gas Light & Coke Co. v. Slattery*, 373 Ill. 31, 25 N.E.2d 482, 497 (1940) ("Where amounts of operating expenses are capable of definite proof, they may not

be reduced by estimates of what the maintenance should have cost unless there is a further showing that, for some reason, the amount was improperly increased over a legitimate cost.”)

Nevertheless, in developing his \$715,000 fee proposal, Mr. Smith simply adds 10% to the amount authorized in the prior rate case. (AG/JM Ex. 1.0, p. 44.) Smith does not contest the need for legal services in this case, or contend that the projected level of rate case legal expense is inaccurate. Rather, Mr. Smith’s proposal amounts to nothing more than substitution of an arbitrarily determined amount for prudent and necessary projected cost levels supported by detailed evidence. IAWC submits that, in the context of the future test year utilized in this proceeding, Mr. Smith’s proposal contravenes the principles referenced above.

Apart from being arbitrary, moreover, Mr. Smith’s 10% figure is based on data that does not reflect the *actual* amount spent by the Company in the previous rate case. (IAWC Ex. 7.00R2 (Bernsen Reb.), p. 3.) The amount of rate case expense approved by the Commission represents IAWC’s projection of rate case legal expense. The actual figure for rate case legal expense from that case is \$997,904. (*Id.*) Based on this number, the Company’s projection actually *reduces* legal costs by 7% in the present rate case as compared to the actual costs required for the prior case. (IAWC Ex. 7.00R2 (Bernsen Reb.), p. 3.) Furthermore, when one considers the projected approximate 5.7% increase in the market rates for legal services estimated for 2010 in the Service Company Cost Study, the savings achieved by the Company amounts to nearly 14% over the previous rate case, considering the higher rates expected in 2010. (IAWC Ex. 11.01, Schedule 4.)

At most, although it is unclear from his testimony, Mr. Smith suggests without analysis that Service Company attorneys would be a cheaper alternative and that IAWC’s counsel are charging “rack rates.” (AG/JM Exs. 1.0, p. 40; 5.0, pp. 39-40.) As discussed above, the hourly

rates charged by IAWC' outside counsel are consistent with Midwest hourly rates for legal services. Contrary to Mr. Smith's assertions, moreover, the Company does make economical use of in house legal staff in Illinois rate cases - in-house legal staff are actively involved in rate cases in a variety of areas (for example, coordinating discovery and planning for an attending public hearings). (IAWC Ex. 5.00SR (Grubb Sur.). p. 12). As explained by Mr. Grubb, the use of outside counsel is appropriate and allows the Company to save on the costs that would otherwise be incurred during the intervening periods between rate cases. (IAWC Ex. 5.00R2 (Rev.) (Grubb Reb.), pp. 2-3.).

Mr. Smith also ignores IAWC's efforts to control costs, discussed above, including "not to exceed" ceilings on legal fees. (IAWC Ex. 7.00R2 (Rev.) (Bernsen Reb.), p. 4.) Furthermore, as discussed above, the record indicates that counsel for the Company are charging rates competitive in the Midwestern market, and far from the "rack rates" Mr. Smith suggests. (IAWC Ex. 11.01, Schedules 4.2 and 4.3.) Mr. Smith does not dispute Mr. Grubb's study, nor the rate analysis contained in IAWC Exhibit 11.01. Mr. Smith simply chooses to ignore these figures in his testimony. It appears that he would deny the Company its right to recover prudently and reasonably incurred costs, for no other reason than he would prefer that legal fees be lower. Under Illinois law, such an argument is unavailing. *See Citizen Util. Bd. v. Illinois Commerce Comm'n*, 166 Ill.2d at 121.

In summary, Mr. Smith's proposed adjustment is arbitrary and denies IAWC recovery of its costs. As discussed above, the Commission must allow a utility to recover costs prudently and reasonably incurred. In suggesting that IAWC be limited to an arbitrary 10% increase over the prior case, Mr. Smith provides no basis to dispute the reasonableness or prudence of the Company's legal fees. (IAWC Ex. 7.00SR (Bernsen Sur.), p. 7.) The Company has shown that

its current rate case legal expense projection is based on a careful consideration of alternatives with cost in mind, reasonable when compared to market rates, and that it is in fact lower than the actual legal expense incurred in the prior case. Mr. Smith's adjustment should be rejected.

(c) AG witness Smith's Arbitrary Reduction to the Service Fee Study Cost Should Be Rejected

Mr. Smith recommends that recovery for the Service Company Fee Study be limited to \$366,000, which he acknowledges is less than its cost, because of his objection to the study's consultant's hourly billing rate. (AG/JM Exs. 1.0 (Smith), pp. 44-45; 5.0 (Smith Reb.), p. 43.) Because this adjustment focuses too narrowly on the hourly rate of certain consultants, and ignores the "not to exceed" ceilings and competitive bid process utilized to select the consultants, this recommendation should be rejected. Moreover, his proposal represents another example of an arbitrary limit on IAWC's expenses, which, as discussed above, is inconsistent with Illinois law and Commission policy.

Although Mr. Smith is correct that *some* of the services required to prepare the Service Fee Study were performed at an hourly rate in excess of \$400, he fails to note that there are multiple levels of employees, billing out at a range of hourly rates, some as low as \$250/hour. (AG/JM Exhibit 1.2, p. 30.) Citation only to the highest rate charged by a single consultant, as Mr. Smith does in his testimony, is misleading and paints a distorted picture. (AG/JM Ex. 5.0 (Smith Reb.), p. 40.) Furthermore, as discussed below, the single consultant to which Mr. Smith points is both highly qualified and experienced. Moreover, Mr. Smith's concerns about hourly rates ignore IAWC's overall approach to ensuring that the cost of the Service Fee Study is reasonable.

The Service Company Fee Study consultant was selected as a result of a competitive bidding process. (IAWC Ex. 7.00R2 (Bernsen Reb.), p. 6.) The Service Company Fee Study

consultant's bid was the lowest bid. (*Id.*) The Service Company Fee Study consultant was also selected due to the fact that the Service Company Fee Study consultant had superior expertise and experience related to the scope of the Service Company Fee Study, and the Service Company Fee Study consultant (both Deloitte & Touche and Mr. Uffelman) had the necessary resources to perform the service company study in the Company's time frame. (*Id.*) Mr. Uffelman, in particular, has extensive experience working in the Illinois regulatory field, and had recently worked on IAWC's Municipal Rate Study in Docket 07-0507.

In addition to being the product of a reasonable bidding process, the Service Fee Cost Study is subject to measured cost control efforts. At IAWC's request, the consultant agreed to a "not-to-exceed" amount for the production of the Service Company Cost Study and related direct testimony, which was intended in part to ensure that the projection of the expense is reliable and that the amounts actually incurred for the Service Company Cost Study are consistent with the projection. (IAWC Ex. 7.00R2 (Bernsen Reb.), pp. 6-7.) Moreover, as of September 30, 2009, the Company had already incurred \$357,371 for the Service Company Study. (*Id.*, p. 7.) It is unreasonable to estimate that the Company would incur less than \$9,000 from that date until the conclusion of this case in Service Company Study-related costs, as Mr. Smith would propose. Mr. Smith's unsupported adjustment, which would prevent IAWC from recovering these costs, should be rejected.

(d) IAWC's Proposed Two-Year Amortization Period For Rate Case Expense Is Appropriate

Because rate case expenses do not routinely occur every year, such expenses are ordinarily amortized over an appropriate period of time. *Central Illinois Public Service Co. v. Illinois Commerce Comm'n*, 243 Ill. App. 3d 421, 432 (4th Dist. 1993). The Company is proposing to amortize the majority of its rate case expense (\$1,667,056, which includes rate case

legal expense) over two years, while the costs of certain studies (\$672,440 for the demand study, cost of service study, and service company study) are amortized over five years, as these studies are not expected to be presented in the Company's next rate case filing. (IAWC Ex. 7.00 (Bernsen Dir.), pp. 3-4.) The proposed two-year amortization is appropriate because the Company has projected a rate case cycle of two years given the need for capital investment in its facilities. (IAWC Ex. 7.00R2 (Bernsen Reb.), p. 8.) Specifically, as discussed by Mr. Kaiser, for the 2007-2010 period, IAWC projects that it will invest over \$366 million in needed capital projects. (IAWC Ex. 3.00 (Kaiser Dir.), pp. 3-20.) Mr. Kaiser's projection is the result in part of the development of demand projections for IAWC's systems, the identification of improvements needed to meet those demands and the adoption of strategies designed to bring about the correct prioritization and distribution of capital spending for the various needs of the business. (IAWC Ex. 3.00 (Kaiser Dir.), p. 3.) It is the Company's position that the amortization period should be set to match the period of time that rates will be in effect. Given the Company's expectation of filing a subsequent rate case in two years, IAWC proposes in this proceeding that some rate case expenses be amortized over two years. (IAWC Ex. 7.00R2 (Bernsen Reb.), p. 8.)

In addition to prospective rate filings anticipated by the Company, the Company's historical rate case filings schedule also supports a two-year amortization period. Since 1990, the Company has filed rate cases in 1990, 1992, 1995, 1997, 2000, 2002, 2007 and 2009. (IAWC Exs. 7.00R2 (Bernsen Reb.), p. 9; 7.00SR (Bernsen Sur.), p. 7.) Even with the five-year gap between 2002 and 2007, the average time between the Company's rate cases over the past 19 years is less than three years. Coupled with IAWC's forward-looking expectation of filing on two year cycles, this historical evidence provides ample reason to adopt IAWC's proposed two year period.

Mr. Smith proposed in his testimony that the Company adjust its proposed two-year amortization period for certain expenses to a three year period. Driving this suggestion is a concern that the Company will over-recover amortization expenses, should the amortization period be set at too short a term. (AG/JM Ex. 1.0, p. 41.) For the reasons discussed above, the amortization period is appropriate and Mr. Smith's adjustment should be rejected. Moreover, Mr. Smith's concerns ignore the fact that the Company may under recover rate case expense. As Mr. Bernsen explained, if actual rate case expense ends up higher than the Commission-approved amount, the Company would not recover the difference (absent unusual circumstances like those with respect to the unrecovered balance of the Municipal Rate Study). (IAWC Ex. 7.00SR (Bernsen Sur.), p. 5.) (This provides the Company with an incentive to maintain rate case costs within the projected budget.) Further, Mr. Smith ignores the fact that, under current Commission policy, the utility does not recover the full cost of rate case expense: rate case expense is "shared" between the utility's shareholders and ratepayers because the unamortized balance of rate case expense is not included in rate base and so the utility does not earn a return on it. Thus, utility shareholders already bear the carrying costs (the time value of money) associated with the unamortized rate case expense. *See Central Illinois Public Service Co. v. Illinois Commerce Comm'n*, 243 Ill. App. at 433-34.

7. Proposed "Normalization" of Rate Case Expense

Mr. Smith proposes that the Commission reject the "amortization" approach to rate case expense that it has long used, and instead adopt what he calls a "normalization" approach. Mr. Smith prefaces his argument by testifying that "rate case costs do not meet the criteria for a regulatory asset of volatility and materiality and should not be afforded regulatory asset treatment." (AG/JM Ex. 1.00 (Smith), p. 42.) Mr. Smith, however, does not explain what his "normalization" proposal is or how it would work, and his contentions fail on several grounds.

Mr. Smith acknowledges that rate case costs fluctuate from year to year. (IAWC Ex. 7.00SR (Bernsen Sur.), p. 6.) Because rate case expenses do not routinely occur every year, such expenses are ordinarily amortized over an appropriate period of time and the Commission has routinely and for many years approved the deferral and amortization of rate case expense. *Central Illinois Public Service Co. v. Illinois Commerce Comm'n*, 243 Ill. App. 3d at 432; see, e.g. Dockets 92-0116, 95-0076, 02-0690, 06-0070 (cons.), 07-0507, 07-0585 (cons). Moreover, Mr. Smith's "normalization" suggestion ignores the fact that deferral and amortization of rate case expense is itself a form of "normalizing" the level of expense. (IAWC Ex. 7.00SR (Bernsen Reb.), p. 6.) Specifically, amortization of the total projected level of rate case expense over the expected life of the rates results in a normalized test year level of rate case expense. (*Id.*)

The Commission has stated that "[f]or ratemaking purposes, the Commission has allowed the deferral and amortization of fluctuating expenses." *Illinois-American Water Co.*, Docket 95-0076, Final Order, p. 12. In making this determination, the Commission looks to the "pattern of expenditures made by the Company" for a particular expense category, and allows amortization and deferral where these costs "fluctuate significantly from year to year." (*Id.*) The Commission has explained that where there are wide annual fluctuations in an expense, "the amount projected to be expended in any given test year may not be representative of a normal year. Therefore, deferred amounts may be used to help arrive at a more normal or representative test year allowance as an alternative to unrepresentative test year projections. . ." *Illinois-American Water Co.*, Docket 02-0690, Final Order, pp. 16-17.

As Mr. Bernsen explained, where a future test year is utilized, some portion, but not all, of rate case expense may be incurred in the test year (for example, in Docket 09-0319, a small portion of rate case expense will be incurred in the 2010 test year). Amortization of the total

projected level of rate case expense over the expected life of the rates results in a normalized test year level of rate case expense. (IAWC Ex. 7.00SR (Bernsen Sur.), p. 6.) The Commission has recognized that amortization is a proper way to “normalize” costs which would otherwise fluctuate greatly. *See Illinois-American Water Co.*, Docket 07-0507 (tank painting); *Illinois American Water Co.*, Docket 02-0690 (tank painting); *Illinois-American Water Co.*, Docket 95-0076 (well and pump maintenance.) Rate case expense receives similar treatment.

As noted by Mr. Bernsen, Mr. Smith did not explain in any detail how his normalization approach would work, and so he established no basis for claiming it is superior to (or even different from) the present amortization approach. (IAWC Ex. 7.00R2 (Bernsen Reb.), p. 10.) Furthermore, no evidence produced in this case indicates that normalization, as described by Mr. Smith, is used by any utility regulatory commission for rate case expense recovery. Mr. Smith failed to identify even one order of the Commission in which it treated annual rate case expense recovery using a normalization method different from amortization. (IAWC Ex. 7.00R2 (Bernsen Reb.), p. 10.) Mr. Smith’s vague normalization proposal is therefore not consistent with Illinois ratemaking practice. (*Id.*) Because Mr. Smith’s normalization proposal runs counter to long-established practice in Illinois, and because it is entirely unsupported by any evidence of record, the Commission must reject it in favor of continued use of amortization for rate case expense.

8. Purchased Power and Fuel Expense

(a) IAWC’s Projections are Accurate and Reasonable

As Ms. Norton described, IAWC performed a detailed analysis to project purchased fuel and power (“PPF”) expense in the test year, “based upon unit costs and updated usage patterns (including water sales projections) for all facilities.” (IAWC Ex. 2.00R (Rev.) (Norton Reb.), p. 1; Schedule G-5 First Revised, p. 5.) As discussed by Mr. Kerckhove (IAWC Ex. 6.00SUPP

(Kerckhove Supp.), p. 8.), at the time of IAWC's update, the Company's projected test year PPF expense was reduced from the level of the initial filing. This reduction was a result of reduced water sales and, as also discussed by Ms. Teasley, lower PPF costs per unit based on recently negotiated power contracts. (IAWC Ex. 1.00SUPP (Rev.) (Teasley Supp.), pp. 1-2.) After IAWC's initial filing, expiring contracts were renegotiated at lower-than-anticipated cost rates (the new contracts reflect per unit power supply costs approximately 10% lower than the prior contracts). In addition, water sales projections were calculated based on updated actual levels and were found to be below previous projections. The cost savings from renegotiated contracts and reduced sales were included in the update previously submitted for a total reduction of \$872,800

To meet the needs of its customers, IAWC negotiates contract pricing when possible through use of the energy management group within the Service Company that works with local operations staff and third party electric providers to enter into long-term contracts that lock in rates for large consumption locations. (IAWC Ex. 1.00SUPP (Rev.) (Teasley Supp.), p. 2.) This cost control effort enabled by the energy management group has secured approximately 80% of the Company's test year electric power supply requirements at contract rates per unit of power for the test year that are 10% lower than the contract rates in the prior rate case. (IAWC Ex. 2.00R (Rev.) (Norton Reb.), p. 2.) Due to the favorable contract rates in place, IAWC is able to project its per unit electric power expense in the test year. (*Id.*)

Based on its detailed analysis of demand, contract and market PPF pricing, IAWC has determined that PPF expense will be higher in the test year than in 2007-2009. This increase is due in large part to the demands of new facilities, increasing delivery charges, and weather

conditions which caused depressed demand in the years prior to the test year. (IAWC Ex. 2.00SR (Norton Sur.), pp. 2-4.)

New facilities include expansions in the Champaign district, the Oak Valley Treatment Plant, as well as new tank and booster stations in Streator and Sterling. (IAWC Exs. 2.00SR (Norton Sur.), p. 3; 2.02SR; 2.03SR). The new Champaign plant went online in late December 2008, and the electric power costs per million gallons for the Champaign district before and after the new plant went on-line were \$191.88 and \$224.82, respectively. (IAWC Ex. 2.02SR.) The expansion of the Oak Valley treatment plant was put into service in December 2008. In addition, there were two new tank and booster stations that went online in Streator and Sterling in June 2008 and August 2008, which contributed to increased power demands and costs. (IAWC Ex. 2.00SR (Norton Sur.), p. 3.)

Moreover, delivery charges are projected to increase in the test year. Based on a weighted calculation for a sample of large power bills, the distribution or delivery service portion of the bills received from the electric suppliers is approximately 20.1%. (IAWC Ex. 2.00SR (Norton Sur.), p. 4.) Thus, delivery service charges represent a significant portion of IAWC's electric power cost.

Both 2008 and 2009 were abnormally wet years and so system delivery was unusually low. (IAWC Ex. 2.00SR (Norton Sur.), p. 2.) In 2008, Illinois experienced its second wettest year on record with precipitation levels of 50.7 inches (11.4 inches above normal). Only 1993 was wetter with 51.2 inches. At the end of October, 2009, the average state rainfall for the year was over 46 inches, compared to an average expected amount of just over 33 inches. Additionally, the average temperature through October was cooler than normal. IAWC is projecting that 2010 will be a normal year and system delivery will increase to normal levels.

(*Id.*, p. 4.) As a result, PPF will increase with the increase in system delivery. Thus, based on IAWC's detailed demand projections, the Company's test year level of PPF expense is reasonable.

(b) IWC's Criticisms Should Be Disregarded

IWC has expressed concerns that IAWC's requested PPF expense increase does not reflect drops in per unit power costs. (IWC Ex. 2.0, p. 13.) IWC further suggests that IAWC cannot explain the increase in PPF expense per CCF because delivery charges represent too small a portion of PPF expense to meaningfully impact total expense, and per unit power costs should be low in the test year. (*Id.*, p. 10.) Finally, IWC witness Collins suggests that sales volume will be down in the test year, which should lead to lower PPF needs. (*Id.*)

Mr. Collins' analysis fails on several grounds. As a preliminary matter, PPF expense has been revised since IAWC's initial filing. The revision was submitted by IAWC in its updated filing, reflecting reductions in projected consumer sales and the effect at renegotiated contracts, as discussed above. Total cost savings from IAWC's recomputation amount to a reduction in the test year level of PPF expense of \$872,800. (IAWC Ex. 2.00R (Rev.) (Norton Reb.), p. 2.)

Further, Mr. Collins' analysis inappropriately focuses on the difference between the amount of fuel and power expense included in IAWC's rates in the prior rate case and its current projection for the test year. As the prior case was a future test year, the amount of fuel and power expense set in the last case was based on the projection for that test year. (IAWC Ex. 2.00SR (Norton Sur.), p. 1.) Comparing the Company's actual fuel and power expense data for the period 2007-2009 to the test year in this case, however, shows that the Company's test year fuel and power expense is, on a cost per 1000 gallons of water produced basis, consistent with 2007-2009 levels (and is slightly below 2009). (*Id.*, p. 2.) As Ms. Norton explains, and is discussed above, the decrease in the electric supply charges that resulted from IAWC's

negotiation of new power contracts for 2010 is partially offset by increased usage requirements and a projected increase in delivery charges. As shown on IAWC Exhibit 2.01SR, however, the Company's fuel and power cost per 1000 gallons of system delivery increased from \$0.17 per 1000 gallons in 2007 to \$0.20 per 1000 gallons in 2009, and is projected to decline to \$0.19 per 1000 gallons in 2010. As IAWC Exhibit 2.01SR also shows, the Company's overall total amount of fuel and power expense increased from approximately \$8.1 million in both 2008 and 2009 to a projected amount of approximately \$8.8 million in the test year. (*Id.*) This increase is explained, however, by the fact that 2008 and 2009 were both abnormally wet years (as discussed above) and so system delivery was unusually low. The Company's test year projection of system delivery reflects more normal weather conditions, with resulting higher fuel and power expense. As indicated on IAWC Exhibit 2.01SR, however, despite the higher level of expense in 2010, the per unit cost is lower than 2009. This demonstrates that the test year projection is reasonable. (*Id.*)

Another flaw with Mr. Collins' analysis is his methodology in calculating the adjustments proposed in IAWC Exhibit 2.4. As explained by Mr. Kerckhove, Mr. Collins "calculates PPF costs per CCF for Zone 1 and Total Company and proposes adjustments to Zone 1 and to Total Company, which latter adjustment must be assigned to all rate areas other than Zone 1." (IAWC Ex. 6.00R2 (Kerckhove Reb.), p. 16.) Mr. Collins errs by failing to individually calculate test year PPF amounts for the Chicago Metro, Pekin, and Lincoln rate areas, and instead groups them into the result of Total Company less Zone 1 by default. (*Id.*) The effect of this error is to understate the PPF cost per CCF from the prior rate case by artificially applying a "fallout" rate to all non-Zone 1 rate areas and overstates the PPF adjustment for the total company by \$80,221. (*Id.*) In order for Mr. Collins' adjustment to be

equitable, Mr. Collins would have to apply the respective rate to each of the districts. Selecting only one district rate and the Total rate yields incorrect results. (*Id.*, pp. 16-17.)

Because Mr. Collins's per CCF price comparison does not take into account IAWC's updated price information, nor the actual data available from the intervening years since the last rate case, it should be disregarded by the Commission. (IAWC Ex. 2.00R (Rev.) (Norton Reb.), p. 4.)

9. Chemicals Expense

(a) IAWC's Projections are Accurate and Reasonable

In projecting chemical expense in the test year, IAWC "included anticipated system delivery, projected chemical unit costs, and historical treatment requirements. Projected total delivered water and internal plant usage by month were combined to determine the total treated water requirement." (IAWC Ex. 2.00R (Rev.) (Norton Reb.), p. 5.) IAWC then reviewed the projection, considering possible changes resulting from new regulations or possible efficiency or technology improvements. (*Id.*) Historical chemical usage, adjusted (where necessary) to reflect changes in treatment requirements discussed above, was used to establish the usage for each chemical required in the treatment process. (*Id.*) Based on these estimates IAWC engaged in a competitive bidding process to obtain optimal prices, and projected overall cost based on pounds per million gallons per month required to treat projected needs at projected prices. (*Id.*)

As part of its bidding process, IAWC continuously monitors supplier markets. Due to this vigilance, IAWC was able to seize upon the opportunity presented by the recent economic downturn to negotiate more favorable prices to meet the needs of its customers. (IAWC Ex. 2.00R (Rev.) (Norton Reb.), p. 6.) Through this process IAWC was able to achieve an overall 6% reduction from budgeted pricing for 2009. This reduction of test level of chemical expense has been included in the current rate case. (*Id.*) In addition to seeking optimal pricing for

chemicals in the bidding process, IAWC continually examines, and where appropriate, implements alternative treatment techniques including corrosion and algal control chemicals and the use of higher quality source water. IAWC continues to identify approaches to minimize costs, while ensuring that production of high quality water is not jeopardized. (IAWC Ex. 2.00 (Rev.) (Norton Dir.), p. 7.)

Although there has been a recent decline in chemical expense in 2009, chemicals saw substantial increases in pricing in 2008. These chemicals include coagulants, potassium permanganate and fluoride. (IAWC Ex. 2.00R (Rev.) (Norton Reb.), p. 7.) For example, in Interurban, the per unit cost of “PolyAlum SulfClarionA410P Bulk” (a coagulant) increased from \$0.13 to \$0.22. (IAWC Ex. 2.00SR (Norton Sur.), p. 5.) While prices have declined, and IAWC has been able to obtain lower prices on chemicals for the test year as described by Ms. Norton, prices have not declined to the level they were at prior to the steep increases in 2007. (*Id.*) Thus, projected chemical expense is higher in the test year in this case when compared to the amount allowed in rates in the last case. (*Id.*)

(b) IAWC’s Concerns Regarding Chemical Expenses Should Be Rejected

IAWC witness Mr. Collins suggests that IAWC’s requested chemical expense is too high and should be held to present levels. (IAWC Ex. 2.0, p. 16.) The basis of Mr. Collins’ conclusion is a comparison between the projected chemical expense and the chemical expense allowed in the previous rate case. He suggests that IAWC has failed to account for the increase over the prior rate case levels. (*Id.*, pp. 15-16.)

Although Mr. Collins correctly points out that chemical prices are presently declining, the recent declines in costs have not brought prices down to their 2007 levels. Ms. Norton explained in her testimony that chemical cost per 1,000 gallons in 2007 was \$0.120. In 2008 and 2009,

chemical prices increased year over year by 17.5% and 29.08%, respectively, putting the cost per 1,000 gallons in 2009 at \$0.182. (IAWC Ex. 2.00SR (Norton Sur.), p. 5.) Although prices have recently fallen, this still does not bring costs back to 2007 levels. (*Id.*) IAWC has projected a 8.95% reduction in chemical costs in the test year to \$0.166 per 1,000 gallons. (*Id.*)

Additionally, as explained by Mr. Kerckhove and discussed in Section III.C.8(b) above, Mr. Collins repeats the same error he made in calculating chemical expense as he did in his PPF calculations. Specifically, “he understates total company chemical expense cost per CCF from the prior rate case and overstates the chemical adjustment for the total company by \$72,389.” (IAWC Ex. 6.00R2 (Kerckhove Reb.), p. 17.)

Therefore, as indicated by the detailed analysis provided by IAWC in this case, the Company’s test year level of chemical expense is appropriate and should be accepted by the Commission. (IAWC Ex. 2.00R (Rev.) (Norton Reb.), p. 7.)

10. Insurance Other Than Group Expense

IAWC’s proposed level of insurance other than group (“IOTG”) expense (for general liability, workman’s compensation, property, excess casualty, directors and officers, errors and omission, executive risk, etc.) was based on projections of premium costs for the various insurance policies protecting the Company and its assets. (*See* Schedule G-5 First Revised, p. 12.) The test year IOTG projection was based on the actual 2009 premium/loss and the percentage change per insurance type. The analysis and report was prepared by a broker, Marsh USA, Inc., working with 50+ years of detailed claim history. The analysis also utilized the key economic data, including inflation, health care, salary increases, and return on investment and indemnification paid to an injured person under workers compensation, general and auto liability. (*Id.*)

A part of the Company's IOTG expense is the "Retrospective Accrual". The Retrospective Accrual is a prospective review of expected future insurance claims cost based upon current IOTG premiums for General Liability, Auto Liability, and Workers Compensation, utilizing the most recent available loss information and claims experience, and is a proper test year expense. (IAWC Ex. 7.00R1 (Rev.) (Bernsen Reb.), p. 3.) This review results in an adjustment to annual IOTG expense that represents insurance costs for current claims in excess of premium costs. (An insurance premium is based on historical data including historical claims.) (*Id.*)

In the present case, IAWC is projecting that a Retrospective Accrual adjustment, representing an additional expense above projected IOTG premiums, will be required in the test year. (IAWC Ex. 7.00R1 (Rev.) (Bernsen Reb.), p. 3.) The Retrospective Accrual amount was included in the Company's original filing under the "Annual Premium" column of Schedule C-17. In IAWC's update filing, the Retrospective Accrual amount was listed separately on Schedule C-17 First Revised for clarity. (*Id.*) As Mr. Bernsen explained, the Retrospective Accrual is IOTG expense that represents insurance costs for current claims in excess of premium costs. (*Id.*) The Company calculates this amount in a "prospective review of expected future insurance claims cost" based on current IOTG premiums, and "utilize[es] the most recent available loss information and claims experience." (*Id.*)

Staff and AG/JM witnesses objected to the Company's insurance cost calculations for test year 2010 expense. Initially, both Staff and the AG/JM objected to the inclusion of the Retrospective Accrual as a test year expense, based on the presumption that it was "based on costs incurred during previous accounting periods" and therefore not appropriate as a test year expense. (*See* Staff Ex. 2.0, p. 4.) Similarly, AG/JM witness Smith argued that the amount

should not be included as a test year expense because, it “was not listed on IAWC Schedule C-17 First Revised for 2007, 2008 or 2009, was not included in IAWC’s original filing, and has not been justified for inclusion in operating expenses.” (AG/JM Ex. 1.0, p. 47.)

As discussed above, the Retrospective Accrual is a proper test year expense. The Company’s explanation in this regard fully resolved Staff’s concerns with Retrospective Accrual. Staff witness Wilcox stated that, “I withdraw my adjustment as relates to Insurance Expense. When I first proposed the adjustment I was working under the erroneous assumption that “Retrospective Adjustment” referred to expenses incurred during previous accounting periods. Retrospective Accrual, in that it represents additional expense for insurance premiums, would be a valid test year expense.” (Staff Ex. 9.0, p. 5.)

11. Management Fees

(a) Introduction

IAWC’s practice is to provide or procure the services needed to support utility operations based on considerations of service quality, cost effectiveness, timeliness, reliability and adequacy of alternative suppliers. (IAWC Ex. 1.00 (Teasley Dir.), p. 17.) Based on these considerations, for certain functions IAWC maintains its own full-time staff of employees to provide needed services. For other services, however, IAWC is able to both maintain high service quality and achieve efficiencies through the use of qualified outside service providers, including the Service Company. The terms related to IAWC’s use of services provided by the Service Company are set out in the approved Services Company Agreement. (*Id.*) Under the Service Company Agreement, the Service Company provides services for IAWC at its cost. (*Id.*) As IAWC witness Mr. John Young indicates, the Service Company maintains a highly capable staff of employees who are expert in all aspects of the water utility business, and who have detailed knowledge and

experience specifically with the operations and facilities of IAWC (and other American Water operating companies). (IAWC Ex. 12.00 (J. Young Dir.))

Where appropriate, however IAWC obtains services from outside providers other than the Service Company. (IAWC Ex. 1.00 (Teasley Dir.), pp. 17-18.) As will be discussed, the Service Company is, in most cases, the most cost-effective and qualified source for required services. In certain circumstances, however, the Service Company is unable to provide specialized services needed to address specific situations. Where that occurs, or where use of a non-affiliate provider is appropriate based on cost or other considerations, IAWC utilizes non-affiliate service providers. (*Id.*, p. 18.) As the evidence in this proceeding shows, however, the expected level of savings for 2010 that results from the procurement by IAWC of services through the Service Company as compared to the level of cost that IAWC would incur to procure services from non-affiliate providers is significant.

The Company's requested level of management fee expense reflects the cost of the services IAWC is projected to receive from the Service Company in the test year. As discussed below, IAWC witness Mr. John Young provides a detailed description of the services that the Service Company provides and the benefit of those services to IAWC. As Mr. Grubb explained, the Company's requested level of management fee expense is based on a detailed, bottoms-up approach to budgeting of the costs for the Service Company to provide services to IAWC in the test year. As the following discussion makes clear, the Company's requested level of management fee expense is reasonable and should be allowed.

(b) The Commission Order in Docket 07-0507

In Docket 07-0507, the Commission directed IAWC to, in its next rate filing:

[C]onduct 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 of IAWC's affiliates. The analysis must provide details on the specific services provided to IAWC and how costs are allocated among affiliates of IAWC.

As Ms. Teasley explains in her testimony, IAWC has addressed this requirement through a comprehensive set of studies and the testimony of five witnesses in the current case (collectively, the "SC Cost Evidence"): IAWC's President, Ms. Teasley; Mr. Mark Young of Deloitte & Touche; Mr. Uffelman of Uffelman Advisory Services; Mr. John Young, President of AWWSC; and Mr. Grubb. (IAWC Ex. 1.00 (Teasley Dir.), p. 15.) The discussion that follows demonstrates that the SC Cost Evidence is fully responsive to the requirements of the Order in Docket 07-0507. The SC Cost Evidence also shows that for those services that: (i) IAWC obtains from the Service Company; and (ii) can be obtained from an affiliate or non-affiliate source, the amount paid by IAWC to the Service Company (which is the Services Company's cost ("SC Cost")) is well below the cost that IAWC would be required to pay a non-affiliate provider based on market prices for services. (*Id.*) As IAWC Exhibit 11.01 indicates, the expected level of savings for 2010 that results from the procurement by IAWC of services through the Service Company as compared to the level of cost that IAWC would incur to procure services from non-affiliate providers is approximately \$7.69 million. For these services, the SC Cost is also below the cost that IAWC would incur to retain its own employees to provide the services on a stand-alone basis (to "Self Provide"). (IAWC Exs. 1.04; 5.00 (Grubb Dir.), p. 4.)

As part of the SC Cost Evidence addressing the requirements that IAWC "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," the Company produced the Service Company Cost Study (IAWC Ex. 11.01), which provides a comparative study of Service Company cost and market prices for certain services based on hourly rates; the

Self-Provision Study (IAWC Ex. 1.04), provided by Ms. Teasley, which compares the cost that IAWC incurs in obtaining services through the Service Company to the cost that IAWC would incur to provide those services with its own personnel; and the Belleville Lab Study (“Belleville Study”) (IAWC Ex. 5.04), provided by Mr. Grubb, which supplements the Service Company Cost Study by comparing the cost of performing over 55,000 water quality tests for the American Water system to the cost of obtaining the same tests from three separate independent labs on a per-test fee basis. Mr. John Young describes the services provided to IAWC and other American Water affiliates. (IAWC Ex. 12.00 (John Young Dir.), pp. 2-26.) Mr. Grubb discusses the allocation of Service Company costs between regulated and non-regulated affiliates of the Service Company and discusses the Belleville Lab Study. (IAWC Ex. 5.00 (Rev.) (Grubb Dir.), pp. 4-11.) Mr. Grubb also discusses the basis for IAWC’s test year projection of management fee expense. (IAWC Ex. 5.00R2 (Rev.) (Grubb Reb.), pp. 4-6.)

(i) Service Company Cost Study

As IAWC witness Uffelman explains (IAWC Ex. 10.00 (Uffelman Dir.), pp. 4-5), the Service Company Cost Study provides the required market comparison for services that IAWC can effectively outsource to either an affiliate or non-affiliate provider. As Ms. Teasley explains, not all services can be effectively obtained through non-affiliated providers. (IAWC Ex. 1.00 (Teasley Dir.), p. 20.) These Services include corporate governance, employee benefits management, and customer service center services. (*Id.*) Consequently, a market for such services is not included in the Service Company Cost Study, but is instead addressed in the Self-Provision Study (which compares the “market” cost that IAWC would incur to retain additional IAWC employees to provide services to the cost of obtaining such services from the Service Company), IAWC Exhibit 1.04. (IAWC Ex. 1.00 (Teasley Dir.), p. 21.)

As the Service Company Cost Study explains (IAWC Ex. 11.01, p. 2.), the Service Company Cost Study's methodology compares "the cost of each service expected to be obtained from the Service Company that can be performed by a non-affiliate to the costs of such services that would be incurred if such services were obtained through competitive bidding on the open market." The Service Company Cost Study relies on market comparison survey data of hourly rates for various services, as well as actual hourly rates charged by third party vendors to IAWC or its affiliates, that represent the cost of those services in the market, i.e., the cost had they been obtained through competitive bidding. As the Service Company Cost Study describes (*id.*, pp. 10-13), the market surveys contain 2008 information (the most recent annual information available at the time the Service Company Cost Study was prepared) relating to the compensation, fee and billing practices for the five categories of professional services firms. For services like accounting, engineering and legal services, market survey data focused on the Midwest region was used. (*Id.*) The market surveys were identified by Deloitte & Touche through research based on certain selection criteria. Based on the research conducted, Deloitte & Touche concluded that the surveys selected each provide a reliable indication of a market price for services covered by the survey. In addition to market survey data, the Service Company Cost Study utilized what is referred to as "Supplemental Data", which is market price data specifically applicable to non-affiliate services utilized by IAWC and/or other American Water entities. As the Service Company Cost Study explains, IAWC and American Water utilize a wide variety of services provided by unaffiliated vendors. As a result, Deloitte & Touche had available for the Service Company Cost Study market pricing data specifically applicable to IAWC or American Water for all service categories (Accounting, Engineering, IT, Legal and Management Consulting) of services studied. The Supplemental Data (*see, e.g.*, IAWC Exhibit 11.01,

Schedules 1.2, 2.2, 3.3, 4.4 and 5.2), represents actual hourly rates for services such as accounting, legal and engineering services, charged to IAWC or its affiliates by non-affiliated vendors. Many of these hourly rates were the product of competitive bidding conducted by IAWC or American Water or request for proposal (“RFP”) processes. (IAWC Ex. 12.00 (J. Young Dir.), pp. 27-28.)

Based on the market survey data and Supplemental Data, the Service Company Cost Study projects market costs for services in 2010. Based on these projections, the Service Company Cost Study demonstrates for those services that: (i) IAWC obtains from the Service Company; and (ii) can be obtained from an affiliate or non-affiliate source, the amount paid by IAWC to the Service Company is well below the amount that IAWC would be required to pay a non-affiliate provider based on market hourly prices for services that would result from competitive bidding. (IAWC Ex. 1.00 (Teasley Dir.), p. 18.) As IAWC Exhibit 11.01 indicates, the expected level of savings for 2010 that results from the procurement by IAWC of services through the Service Company as compared to the level of cost that IAWC would incur to procure services from non-affiliate providers is approximately \$7.69 million. No witness in this proceeding has challenged the methodology or results of the Service Company Cost Study.

(ii) Belleville Lab Study

The Service Company Cost Study is supplemented by the Belleville Lab Study provided by Mr. Grubb. The Service Company Cost Study demonstrated that, based on the expected per hour market price for laboratory employee services, IAWC’s use of Service Company laboratory personnel is the lower cost approach. Laboratory services, however, can also be obtained in the market at a “per test” price. Accordingly, IAWC supplemented the Service Company Cost Study approach for laboratory services, with the Belleville Lab Study which compared the Service

Company's projected "per test" laboratory cost to the expected market "per test" cost for the test year. (IAWC Exs. 5.00 (Rev.) (Grubb Dir.), pp. 8-12; 5.04.)

The Belleville Lab Study utilized per test price data from three outside water quality testing labs for twenty-eight different water quality tests currently being performed by the Belleville Lab. (IAWC Ex. 5.00 (Rev.) (Grubb Dir.), p. 9.) The per test prices of the outside vendors were adjusted for turnaround surcharges, the electronic data requirements of the tests, the need for limited receipt days for microbial analyses, the need for multiple microbial slides and for sample disposal containers. (*Id.*) The study concluded that, on a per-test basis (as opposed to the hourly rate basis examined in the Service Company Cost Study), the American Water system would realize a total savings of \$2,305,374 in water quality testing costs in 2010 by performing necessary tests at the Service Company's Belleville Lab, rather than having an outside water quality testing lab perform the tests. Of this savings, IAWC would realize \$207,253 in 2010, as shown on Exhibit 5.04, page 1 of 3. (*Id.*)

(iii) Self-Provision Study

For those services that: (i) IAWC obtains from the Service Company; and (ii) can be obtained from an affiliate or non-affiliate source, the amount paid by IAWC to the Service Company, the SC Cost is also below the cost that IAWC would incur to retain additional IAWC employees to provide the services on a stand-alone basis (to "Self Provide"). (IAWC Exs. 1.00 (Teasley Dir.), p. 18; 1.04.) The Self-Provision Study utilized the compensation levels paid by the Service Company for comparable employee positions. These compensation levels are based on detailed surveys of market compensation levels applicable to each position, and therefore represent a market-based level of compensation. (IAWC Ex. 1.00 (Teasley Dir.), p. 19.) The overhead cost data utilized for each position is also the same as that incurred by the Service Company in connection with comparable employee positions. (*Id.*)

To Self Provide all services provided by the Service Company, IAWC would be required to retain 182.5 additional employees (on an FTE basis), and also would incur increased one time costs for (i) the hiring of new employees; (ii) training and orientation; and (iii) relocation cost. (IAWC Ex. 1.00 (Teasley Dir.), p. 19.) The increased cost (including applicable overheads) for all services (including corporate governance, customer service and the employee benefits service center which are discussed below) would amount to approximately \$6.25 million. (IAWC Ex. 1.00SUPP (Rev.) (Teasley Supp.), p. 3.)

As indicated by the testimony of Ms. Teasley, certain services cannot be feasibly outsourced to non-affiliates. (IAWC Ex. 1.00 (Teasley Dir.), p. 16.) These services include: (1) corporate governance, due to the need to ensure appropriate accountability and to protect the confidentiality of certain information in accordance with securities laws; (2) customer service functions, to assure proper management of customer communication and the billing process, as well as compliance with applicable regulatory requirements; and (3) the employee benefits service center, due to the complex and confidential nature of employee benefits and need to maintain an appropriate relationship between IAWC and its employees. (*Id.*, p. 20.) For these functions, the Self Provision Study shows that use of the Service Company approach, which allows IAWC to “share” the cost of the functions with other American Water operating companies rather than retaining all required employees on its own, results in a significant level of savings for Illinois ratepayers. For the Governance, CSC and BSC functions, the savings are approximately \$1.7 million. (IAWC Ex. 1.04, Schedule 3.)

(iv) Resources and Benefits of the Service Company

As Mr. John Young explained, IAWC receives a wide range of services from the Service Company to support the provision of utility service to IAWC’s customers. (IAWC Ex. 12.00 (J. Young Dir.), p. 2.) The Service Company benefits IAWC by maintaining an organization whose

officers and employees are familiar with all facets of the water utility business and are knowledgeable and experienced in the efficient management, financing, accounting and operation of water utility assets and the particular business of IAWC. The primary areas of service provided to IAWC by the Service Company are:

- *Communications and External Affairs.* Providing comprehensive coordination, standardization and support for information sharing within IAWC and externally with governmental agencies and customers. (IAWC Ex. 12.00 (J. Young Dir.), p. 3.)
- *Corporate Finance.* Providing coordination with IAWC employees, and support for rate activities, budget preparation and analysis, and other regulatory and financial analysis as requested by the management of IAWC. (IAWC Ex. 12.00 (J. Young Dir.), pp. 3-4.)
- *Customer Service.* Providing call center operations, education and training of new employees, quality control, centralized billing, collection activities, and other support functions. The Service Company handles “virtually all customer inquiries.” (IAWC Ex. 12.00 (J. Young Dir.), pp. 5-8.)
- *Divisional Operations Support and Regulated Operations.* Providing support for IAWC customer relations, such as bill and service order reviews, and engineering related services. (IAWC Ex. 12.00 (J. Young Dir.), pp. 8-9.)
- *Human Resources.* Providing support for management of employees throughout their tenure with IAWC, and handling areas of compensation and benefits, employee and labor relations, HR systems and processes, business center and corporate staffing, and organizational and talent development. (IAWC Ex. 12.00 (J. Young Dir.), pp. 9-12.)
- *Information Technology Services.* Providing support under six divisions: Enterprise Architecture, Security Architecture, Infrastructure and Operations, Business Application Development, Client Services and Support, and the Project Management Office. (IAWC Ex. 12.00 (J. Young Dir.), pp. 12-14.)
- *Legal.* Providing legal support for many IAWC functions, including corporate governance functions and decisions regarding hiring and management of specialized outside counsel. (IAWC Ex. 12.00 (J. Young Dir.), pp. 15-16.)
- *Operations Services.* Providing technical, operations and business professional services in the areas of: engineering, maintenance & supervisory control and data acquisition services, innovation and environmental stewardship, central laboratory services, supply chain, best operating practices, operational risk management.” (IAWC Ex. 12.00 (J. Young Dir.), pp. 16-24.)

- *Shared Services.* Providing services in the areas of business development, regulatory programs, internal audits, and investor relations. (IAWC Ex. 12.00 (J. Young Dir.), p. 25.)

These services are of a high quality and save IAWC the need of replicating them in-house. (IAWC Ex. 12.00 (J. Young Dir.), pp. 2-26.) No witness in this proceeding has questioned IAWC's need for the specific services described by Mr. John Young.

(v) Cost Allocation

The Service Company performs services for American Water affiliates nationwide. Certain services are provided for the benefit of individual affiliates, while other services provide common benefit to all or a group of affiliates. (IAWC Ex. 5.00 (Rev.) (Grubb Dir.), p. 4.) Records are maintained by Service Company employees, who complete weekly electronic time sheets, showing the time spent by the employee. (Tr. 471-72.) The employees also identify the affiliate for which the service or activity was performed, whether the affiliate is a regulated or non-regulated affiliate, and whether the work was performed for the benefit of a single or multiple affiliates. (IAWC Ex. 5.00 (Rev.) (Grubb Dir.) p. 4.)

As Mr. Grubb explains, where possible, the Service Company employee identifies the specific affiliate that a service benefits, so that the cost of that service may be charged to that specific affiliate directly ("Direct Charge"). (IAWC Ex. 5.00 (Rev.) (Grubb Dir.), p. 5.) Where the work benefits multiple affiliates, the Service Company has established a system of allocating costs between the various served affiliates. (*Id.*) Where services benefit both regulated and non-regulated entities, the costs for services to the non-regulated entities are allocated to them based on Tier 1 formulas. The Tier 1 formulas are based on cost causative factors and reflect the costs of the services provided to the non-regulated entities, with the balance allocated to the benefited regulated affiliates as a group. (*Id.*, pp. 5-6.) Common costs that benefit regulated affiliates are

allocated in direct proportion to each affiliate's customer count, in accord with the Service Company Agreement. (*Id.*, p. 6.) This is referred to as the Tier 2 allocation.

Overhead costs are allocated by the Service Company based on two broad categories: labor benefits (i.e. employee benefits costs such as payroll taxes, medical coverage, pensions, and disability insurance) and general building overhead (i.e. office rent equipment leases, telephone expenses, electricity charges, office supply costs, property taxes, and office maintenance costs). These expenses are allocated in proportion to the labor costs assessed to each affiliate (either under Direct Charge, or Tier 1 and Tier 2 formulas). For regulated affiliates, this allocation methodology is in accord with their respective agreements. (IAWC Ex. 5.00 (Rev.) (Grubb Dir.), p. 7.)

(c) IAWC's Proposed Level of Management Fees Is Reasonable and Appropriate

The Company's requested level of management fee expense reflects the cost of the services IAWC is projected to receive from the Service Company in the test year. As discussed above, IAWC witness Mr. John Young provides a detailed description of the services that the Service Company provides and the benefit of those services to IAWC. As Mr. Grubb explained, the Company's requested level of management fee expense is based on a detailed, bottoms-up approach to budgeting of the costs for the Service Company to provide services to IAWC in the test year. (IAWC Ex. 5.00R2 (Rev.) (Grubb Reb.), pp. 4-5.) As shown on IAWC Exhibit 5.01R2, the Service Company prepares a detailed budget, which includes details not only by account but also by functional group. For example, it provides the budgeted costs for the Call Center (CSC), Finance, HR, ITS and Legal. (*Id.*, p. 5.) (These functional groups were described by Mr. John Young in his direct testimony (IAWC Ex. 12.00), which supported the Service Fee Study that was presented to the Commission in accordance with the Order in Docket 07-0507.)

The budget process evaluates the operating needs of the Service Company and the level of costs needed to meet the service expectations of IAWC, as well as other American Water affiliates who use the services of the Service Company. (IAWC Ex. 5.00SR (Grubb Sur.), p. 10.) This evaluation includes a review of employee levels, the benefits for the employees, contract services, rents, transportation costs, travel costs, building costs, depreciation, capital needs and other miscellaneous operating costs. This process is performed each year and is critical in determining the appropriate cost to include in the business plan. (*Id.*) No witness has challenged any specific aspect of this detailed budget, or any specific aspect of IAWC's Service Company fees.

In addition, Schedules 1, 2, 3, 4, and 5 to the Service Company Cost Study, described above, provide detailed descriptions of the projected hours and hourly rates for services to be provided by the Service Company to IAWC in the test year, for each functional area of the Service Company, as well as comparisons to market rates. (IAWC Ex. 11.01.) For example, in the area of accounting services, the Service Company Cost Study indicates that Service Company hourly rates are below market rates for every functional accounting position. (IAWC Ex. 11.01 (Schedule 1), p. 1.) Similar data is shown for Engineering, Information Technology, Legal and Management Consulting Services. (IAWC Ex. 11.01, Schedules 2, 3, 4, 5) No witness challenged the detail forecast data presented in these schedules.

As Ms. Teasley explained, IAWC takes affirmative steps to both monitor and control the costs incurred by IAWC from the Service Company. IAWC reserves the right to review and approve Service Company budgets before they take effect. It also conducts detailed reviews of Service Company bills and cost allocations under the formulas described by Mr. Grubb, including monthly comparisons of budgeted costs with bottom line actual costs. (IAWC Ex.

1.00 (Teasley Dir.), p. 22.) IAWC uses this information to conduct internal reviews aimed at identifying “areas for further focus” and to make adjustments in a “continuous improvement approach to cost control.” (*Id.*)

Other efforts of IAWC cost control include a reliability-centered maintenance program, and strategic sourcing of supply needs. By consolidating the purchasing needs of the Service Company’s operating companies on both a national and regional basis, economies of scale are achieved which IAWC could not achieve on its own. (IAWC Ex. 1.00 (Teasley Dir.), p. 24.) IAWC also seeks to promote efficiencies through use of a national call center, support from the American Water Laboratory in Belleville, Illinois, and consolidation of services in such areas as human resources, legal, corporate finance, environmental safety, engineering, communications and information technology systems. (*Id.*)

IAWC also secures necessary financing through the Service Company, which achieves economies of scale by consolidating the financing requirements of all the operating utilities in the American Water system. In this way, IAWC has access to reliable sources of debt capital at cost effective rates and in a manner that minimizes transactional and management costs. IAWC also utilizes the energy management group within the Service Company to help lock in favorable long-term rates for large consumption locations. (IAWC Ex. 1.00 (Teasley Dir.), p. 25.) In short, IAWC and the Service Company expend a great deal of effort on controlling costs and promoting efficiencies.

(d) AG and Joint Municipality Witness Smith’s Adjustment to Management Fees Should Be Rejected

AG and Joint Municipality Witness Mr. Smith has recommended that IAWC be limited to a 5% increase over the affiliate management fee charges from Docket 07-0507. (AG/JM Ex. 5.0, p. 50.) Mr. Smith’s 5% recommendation appears however to be an arbitrary limit that is not

based on any specific analysis of IAWC's management fees, and ignores real increases in Service Company costs. As discussed above, it is well established under Illinois law that, in setting rates, the Commission may not simply disregard the level of a utility operating expense as shown by evidence in a rate proceeding in favor of an arbitrary lower amount. *Slattery*, 373 Ill. 31, 25 N.E.2d at 497. That, however, is precisely what AG witness Smith proposes with respect to management fee expense in this case. As discussed above, evidence presented by IAWC regarding management fees discusses in detail: the Company's service procurement strategy and procedure (IAWC Ex. 1.00 (Teasley Dir.), p. 17); the need for each service expected to be required in connection with IAWC's operations (IAWC Ex. 12.00 (J. Young Dir.)); and the projected IAWC cost of each service to be acquired from the Service Company during the test year (IAWC Exs. 5.00 (Rev.) (Grubb Dir.), pp. 4-11; 5.00R2 (Rev.) (Grubb Reb.), pp. 4-6.). IAWC also presents detailed evidence showing that, for each service expected to be acquired, the Service Company is the least cost provider of the service. (IAWC Exs. 11.01; 1.04; 5.04.)

In response to this evidence, Mr. Smith proposes that IAWC's detailed projection of Service Company cost be disregarded, and that, in its place, the Commission substitute the level of cost approved in Docket 07-0507 increased by 5%. In offering this proposal, Mr. Smith does not contest the need for any given service. Mr. Smith also does not contend that the projected cost of any required service is inaccurate or that the Service Company is not the least cost source of the service. Thus, Mr. Smith's proposal amounts to nothing more than substitution of an arbitrary amount for prudent and necessary projected cost levels supported by detailed evidence. As discussed above with respect to rate case expense, Mr. Smith's proposal contravenes the principles established in *Slattery* and other caselaw referenced above.

The adjustment offered by Mr. Smith fails on two additional grounds. First, Mr. Smith relies on the level of management fees from the previous rate case in setting his 5% cap. (AG/JM Ex. 5.0, p. 50.) This methodology is problematic because this number represents expense levels that were first projected by the Service Company over three years ago. Since then, the Service Company has seen increases in its costs for labor, pension, OPEB, maintenance and depreciation, such that that number no longer reflects an accurate measure of current real costs. (IAWC Ex. 5.00SR (Grubb Sur.), p. 9.) Second, Mr. Smith's 5% inflation factor, which he connects into his discussion of a survey conducted by Hewitt for a U.S. Salary Increase Survey, offers no support for its use for increases in other non-labor expenses. In fact, as Mr. Grubb explains, rising management fees are not attributed only to increasing salaries, as Mr. Smith's testimony implies. Mr. Grubb provided detailed information explaining a number of factors that resulted in increased Service Company costs, including: increased pension and OPEB costs, increased depreciation expenses, caused by capital investments, increased maintenance costs for information technology systems, and increases in labor and group insurance costs. (*Id.*, pp. 10-11.) For example, IAWC has determined that costs for Pensions and OPEB have increased by approximately 64% and 32% respectively from the 2008 actual cost to the 2010 projected costs. Mr. Smith's adjustment ignores these real cost increases factors in "computing" his arbitrary proposed 5% cap. (IAWC Ex. 5.00R2 (Rev.) (Grubb Reb.), p. 4.)

12. Gross Revenue Conversion Factor Adjustment

The Company maintains uncollectibles on its books at the state corporate level. (IAWC Ex. 6.00R2 (Kerkchove Reb.), p. 2.) The Company calculated a Company-wide uncollectible factor of 1.2% of revenues, based upon the Company's actual uncollectible experience for the 12-month period ended May 2009. (*Id.*, p. 3.) The calculation of the monthly uncollectible provision is performed at the state corporate level, and not at the Rate Area level. (IAWC Ex.

6.00SR (Kerkchove Sur.), p. 24.) For historic years 2007 and 2008, the Company allocated uncollectibles to each of the rate areas based upon their relative portion of the total number of customers. (IAWC Ex. 6.00R2 (Kerkchove Reb.), p. 2.) However, for the current year (2009) and the test year, the Company revised its allocation method to allocate uncollectibles to each rate area based upon each rate area's relative portion of water and wastewater revenues, exclusive of miscellaneous revenues, to total water and wastewater revenues.

AG witness Mr. Smith asserts that there should be Rate Area specific uncollectible factors. He develops his proposed Rate-Area specific factors by dividing uncollectible expense amounts, allocated using the customer count by Rate Area for 2007 and 2008, by the respective rate area historic revenues. Because the Company projects test year uncollectible expense as a percentage of revenue, Mr. Smith's calculation distorts the uncollectibles rate for individual districts by allocating the uncollectibles expense based on customer counts in 2007 and 2008, rather than based on revenue. (IAWC Ex. 6.00SR (Kerkchove Sur.), pp. 24-25.) Moreover, as Mr. Grubb explained, the distribution of customers in the Company's Rate Areas has changed recently (due to the elimination of double counted residential customers) (IAWC Ex. 5.00SR (Grubb Sur.), p. 4), thereby rendering Mr. Smith's 2007 and 2008 customer count allocations outdated. In addition, use of a uniform uncollectible rate for all rate areas is consistent with the practice approved in the Company's last three rate cases. (IAWC Ex. 6.00SR (Kerckhove Sur.), p. 25.)

C. Proposed Operating Income & Revenue Requirement

On a Total Company basis, additional annual revenue of \$50,008,924 is needed to afford the Company the opportunity to earn a reasonable rate of return, as shown on Appendix A. The operating income statement for each Rate Area is shown on the respective designated sheet of Appendix A.

IV. COST OF CAPITAL & RATE OF RETURN

A. Capital Structure

The Commission should adopt the following capital structure and associated cost of capital (*see* IAWC Ex. 4.01SR; Tr. 297-98, 324-25):

Capital Structure & Cost of Capital

	<u>Ratio</u>	<u>Cost</u>	<u>Weighted Cost</u>
Short-term Debt	0.15%	1.97%	0.00%
Long-term Debt	51.22%	6.24%	3.20%
Preferred Stock	0.00%	0.00%	0.00%
Common Equity	48.63%	10.90%	5.30%
Weighted Average Cost of Capital			<u>8.50%</u>

This proposed capital structure is explained in the testimony of Scott Rungren (IAWC Ex. 4.00 (Rungren Dir.), 4.00SUPP (Rungren Supp.), 4.00R1 (Rungren Reb.), 4.00R2 (Rungren Reb.), 4.00SR (Rungren Sur.); Tr. 297-98, 324-25 (accepting Staff's proposed cost of long-term debt based on IAWC's December 4, 2009 debt issuance)). This capital structure, which was developed using average capital component balances over the period beginning January 1, 2010 and ending December 31, 2010, is fully consistent with IAWC's test year in this proceeding, with the use of 13-month average balances for rate-base items, and with the stipulation entered in Docket 06-0336, as well as with IAWC's target capitalization ratios. (IAWC Ex. 4.00 (Rungren Dir.), pp. 9-10.) Staff agrees with the capital structure detailed above, which matches Staff's own projections. (Staff Ex. 10.0, p. 2.)

1. Overview

As a public utility, IAWC is required to maintain the ability to obtain capital on reasonable terms in order to provide adequate and reliable service in all economic conditions. Thus, it is essential that IAWC maintain a capital structure that will allow it to attract necessary capital in the market: IAWC must ensure that it is able, in all possible economic conditions, to attract debt and equity capital at the lowest weighted average cost of capital (“WACC”). This requires that IAWC maintain a balanced capital structure and a favorable “rating” for debt. (IAWC Ex. 20.00SR (Kalinovich Sur.), pp. 2-3.)

IAWC is responsible for raising debt capital on its own behalf. (IAWC Ex. 20.00SR (Kalinovich Sur.), pp. 2, 8.) IAWC has the ability to issue debt capital on its own through public or private issuances. Under an affiliated interest agreement approved by the Commission in Docket 04-0852, IAWC also has the ability to issue both short- and long-term debt through American Water Capital Corp. (“AWCC”), provided that AWCC is determined to be the least cost source of debt capital. This allows IAWC to benefit from the economies of scale associated with system-wide debt financing and decreased administrative costs such as bank fees, legal fees, bond rating costs, SEC registration fees, and other costs.

In the recent past, IAWC has determined that AWCC was the least cost source of capital for several issuances of debt. (IAWC Ex. 20.00SR (Kalinovich Sur.), p. 3.) Thus, IAWC has gained access through AWCC to the public markets without a need to issue debt on its own through public or private issuances. Using this approach, IAWC has reduced the cost related to the issuance of debt. By issuing larger debt packages that meet the capital requirements of more than one American Water Works Company, Inc. (“American Water” or “AWW”) subsidiary, AWCC is able to significantly reduce the cost for debt issuances, relative to the cost that subsidiaries such as IAWC would incur by issuing debt on its own.

By the terms of the approved agreement between IAWC and AWCC, however, IAWC can and must review the cost of debt capital available in the market when it requires additional capital. The agreement permits IAWC to obtain debt capital from AWCC, but only if AWCC represents the least-cost available source. Recently, the lowest cost source of debt financing has been AWCC; however, if AWCC is unable or unwilling to provide the lowest cost debt financing, IAWC must independently access the debt markets via public or private debt issues. (IAWC Ex. 20.00SR (Kalinovich Sur.), pp. 8-9.) For instance, Pennsylvania American Water and New Jersey American Water, affiliates of IAWC, have accessed the debt markets directly during 2009, since the cost was lower than the cost offered by AWCC. (*Id.*)

To date, IAWC has not chosen to obtain debt capital through public issuances due to the higher issuance costs related to such placements. (IAWC Ex. 20.00SR (Kalinovich Sur.), p. 2.) Thus, IAWC has not been required to obtain an agency rating for its bonds, and as such, does not have a stand-alone bond rating. IAWC has, however, issued debt through private offerings, primarily to institutional investors. Although these offerings (unlike public offerings) do not require a “bond rating”, the private investor (usually an institution such as insurance company) examines the same types of financial data that a rating agency would examine. In effect, the private investor assigns its own “rating,” developed in a manner similar to that used by the rating agencies for public debt. IAWC must maintain a certain rating in order to issue capital on reasonable terms as it is required to maintain adequate and reliable service. (*Id.*)

American Water and AWCC are rated BBB+ by S&P. Although IAWC is not currently rated by the S&P, based on its current financial condition, the Company estimated that its rating would be between B+ and BBB-, which is significantly lower than American Water’s rating. IAWC has a strong business risk profile, although not as strong as AWW owing to its small size.

Additionally, IAWC's financial risk profile is between "highly-leveraged" and "aggressive," primarily because of its relatively high debt to capitalization ratio. IAWC's capital structure and cash flows should be designed to maintain at least a BBB+ credit rating, and the proposed common equity ratio of 48.63% would provide an opportunity to obtain a BBB+ rating if IAWC were rated by S&P. (IAWC Ex. 20.00SR (Kalinovich Sur.), p. 4.)

IAWC is also responsible for raising common equity capital on its own behalf. Currently, AWW holds 100% of IAWC's common equity, and IAWC anticipates that in 2010, AWW will remain the source of common equity capital for IAWC. (IAWC Ex. 20.00SR (Kalinovich Sur.), p. 8.) IAWC's December 2009 and planned May 2010 common equity infusions will ensure that IAWC maintains an appropriate common equity ratio, which will enable IAWC to continue to attract debt at reasonable rates and to maintain the lowest weighted average cost of capital. (*Id.*, p. 6.) IAWC's capital structure and cash flows should be designed to maintain at least a BBB+ credit rating, and IAWC's proposed common equity ratio of 48.63% will provide an opportunity to obtain a BBB+ rating if it were rated by S&P.

2. IAWC's Proposed Capital Structure Is Reasonable

The proposed capital structure will enable IAWC to attract debt and equity capital at the lowest weighted average cost of capital. (IAWC Ex. 20.00SR (Kalinovich Sur.), p. 2.) The cost of debt is directly correlated to the common equity ratio. As the common equity ratio drops, the cost of debt rises. Therefore, the proposed common equity ratio of 48.63% appropriately balances IAWC's higher cost of common equity with the rising cost of IAWC's debt as the common equity ratio declines. (*Id.*, p. 14.)

To determine whether the pro-forma December 31, 2010 capital structure is reasonable for ratemaking purposes, IAWC examined the average common equity ratios of the two proxy groups of utility companies discussed in the direct testimony of IAWC witness Pauline Ahern.

Specifically, Mr. Rungren compared the proposed common equity ratio for IAWC to that of Ms. Ahern's proxy group of six AUS Utility Reports water companies and her proxy group of 26 comparable utility companies. These utilities and their corresponding financial data are shown on Schedules 8.06 and 8.07, respectively, attached to the direct testimony of Ms. Ahern (IAWC Ex. 8.00 (Ahern Dir.)). For the year ended 2007, the average common equity ratio of Ms. Ahern's proxy group of six AUS Utility Reports water companies was 49.45%, with a standard deviation of 4.16%. For the same period, the average common equity ratio of Ms. Ahern's twenty six utility-company sample was 44.54%, with a standard deviation of 6.67%. Thus, IAWC's forecasted average common equity ratio for the twelve-month period ending December 31, 2010 of 48.63% is within one standard deviation of the average common equity ratio of both Ms. Ahern's six AUS Utility Reports water companies and her 26 utility company sample. (IAWC Ex. 4.00 (Rungren Dir.), pp. 10-11; IAWC Ex. 4.00R1 (Rungren Reb.), p. 2.)

To further check the reasonableness of the proposed capital structure, Mr. Rungren also considered projected common equity ratios from Value Line Investment Survey. (IAWC Ex. 4.00 (Rungren Dir.), p. 11.) Value Line estimates that the composite common equity ratio for the water utility industry will be 48.0% in 2008, 49.0% in 2009, 50.0% in 2010, and 50% over the 2012-2014 time period. Thus, IAWC's pro-forma average common equity ratio for the twelve-month period ending December 31, 2010 is also relatively close to Value Line's projected common equity ratios for the water utility industry. (*Id.*) Based on these comparisons, IAWC's forecasted average capital structure for the twelve-month period ending December 31, 2010 is reasonable and should be used to compute IAWC's WACC in this proceeding. The WACC is used as the authorized rate of return on rate base.

3. IAWC's Short-term Debt Ratio Is Appropriate

Short-term debt is an acceptable source of financing for short-term investments (that is an investment which will mature in less than one year), or as temporary financing between long-term debt and equity issuances. However, the vast majority of IAWC's investments are long-term in nature. The recent economic crisis highlights the risks of financing long-term investments with short-term debt, as many companies that pursued this strategy required government bailout or faced severe financial distress. For example, if short-term rates were to increase abruptly at a time IAWC was maintaining a large short-term debt balance, IAWC could incur much higher than expected interest costs.

There are two main risks associated with short-term debt. When short-term debt comes due, IAWC must secure replacement financing or else it runs the risk of not being able to meet its short-term debt obligations. This risk is known as liquidity risk. The other risk inherent with a strategy of using short-term borrowing to finance long-term assets is interest rate risk, which is the risk that rates will rise above the level at which IAWC could have initially obtained long-term financing. For this reason, and given the desire to have fixed, predictable financial commitments, it is generally prudent to finance long-lived assets with long-term capital. (IAWC Ex. 20.00SR (Kalinovich Sur.), pp. 12-13.)

In addition, as Mr. Rungren explains, "Short-term debt is largely a function of construction expenditures and the timing and level of long-term financings. The Company's construction expenditures are lower in 2010 than in 2008-2009, due mainly to the Champaign Plant being completed, and in addition, its planned financings are designed to maintain a reasonable debt/equity mix. Thus, the Company requires less short-term debt in its capital structure in 2010 than in 2008 or 2009. (IAWC Ex. 4.00SR (Rungren Sur.), p. 9.)

AG witness Ralph Smith recommends that IAWC switch 3.11% of its capitalization from common equity to short-term debt; Mr. Smith believes that short-term debt financing is more cost-effective, and 3.11% is the difference between the portion of short-term debt in IAWC's last rate case (Docket 07-0507) and the current proceeding. (AG/JM Ex. 5.0, pp. 7-10.) Mr. Smith's reliance on the amount of short-term debt reflected in IAWC's prior rate case, however, is improper, because, as discussed above, short-term debt is largely a function of construction expenditures and the timing of long-term financings, and IAWC's construction expenditures are lower in 2010 than in 2008-2009. (IAWC Ex. 4.00SR (Rungren Sur.), p. 9.) In addition, IAWC's planned financings are designed to maintain a reasonable debt/equity mix. Thus, IAWC requires less short-term debt in its capital structure in 2010 than it did in 2008 or 2009. Further, Mr. Smith's recommendation ignores a fundamental mismatch between the point of short-term debt and the nature of the projects IAWC intends to finance with this capital, which mismatch causes additional liquidity and interest-rate risk, as explained above.

Moreover, Mr. Smith incorrectly focuses on the cost of common equity, rather than the combined cost of debt that results from a chosen capital structure. Mr. Smith is ignoring the high risk associated with financing long-term investments with short-term debt. Mr. Smith can only assume that access to low cost short-term debt will remain unhindered and capital markets will never face severe distress as they did in late 2008. However, financing long-term investments with short-term debt can result in a rapid and unnecessary rise in costs to ratepayers. When capital markets face distress, as they did in late 2008, access to short-term debt is restricted and rates rise rapidly. Additionally, if IAWC is forced to replace such short-term debt with long-term financing during economic crises, it will do so at significantly higher credit spreads and lock in high costs of financing. (IAWC Ex. 20.00SR (Kalinovich Sur.), pp. 13-14.)

Mr. Smith is ignoring the most recent economic crises and the lingering impact on the capital markets. IAWC's proposed capital structure reflects current market conditions, the appropriate capital structure (including lowest-cost financing) and IAWC's need to invest in infrastructure. Additionally, Mr. Smith does not consider the need to maintain a reasonable capital structure. As explained above, the proposed capital structure will enable IAWC to attract debt and equity capital at the lowest cost.

4. IAWC's Common Equity Ratio Is Appropriate

IIRC witness Michael Gorman asserts that the proposed capital structure is not reasonable, owing to its common equity ratio being (in Mr. Gorman's view) significantly higher than the forecasted 2010 common equity ratio for IAWC's parent AWW. (IIRC Ex. 3.0, p. 19.) AG/JM witness Smith makes similar allegations (AG/JM Ex. 5.0, pp. 7-10.) However, as explained above, the proposed capital structure and common equity ratio are reasonable. IAWC's average 2010 test year common equity ratio of 48.63% is within one standard deviation of the average common equity ratio of IAWC witness Ahern's six AUS Utility Reports water companies and her 26-utility company sample. IAWC's test year common equity ratio is relatively close to Value Line's projected common equity ratios for the water utility industry. In addition, Staff witness Sheena Kight-Garlich has reported that for the first quarter of 2009 the mean common equity ratio for the water industry was 48.88%, which is close to IAWC's proposed common equity ratio of 48.63%. (IAWC Ex. 4.00SR (Rungren Sur.), pp. 10-11.)

Significantly, Mr. Gorman's own proxy groups' data support the reasonableness of IAWC's proposed capital structure. The average common equity ratios of the companies in Mr. Gorman's 3 proxy groups – Water Utility, Gas Utility, and Electric Utility – range from 44.60% to 53.90% (by AUS measurement) and 47.10% to 55.50% (by Value Line projection). (IIRC Exhibit 1.3.) Assuming that Mr. Gorman relied on these samples to compute his recommended

cost of common equity in this proceeding, he must consider these groups to be reasonably well-suited for comparison with IAWC. And IAWC's test year common equity ratio of 48.63% is consistent with, and compares very favorably with, these industry averages. (IAWC Ex. 4.00SR (Rungren Sur.), pp. 11-12.) All these facts indicate that Mr. Gorman's concern regarding IAWC's common equity ratio is unwarranted.

Mr. Gorman is also unnecessarily concerned by the fact that a certain portion of the common equity contribution is from AWW. The source of funds invested in the common equity of IAWC (whether by AWW or another investor) is not relevant to the return on equity or the appropriate common equity ratio. The required return on any investment is dependent upon the investment risk profile of the entity in which the investment is made. The investor's source of funds does not affect his required rate of return on the investment. The required, or expected, rate of return on an investment in IAWC's common equity will not move up or down based on the degree of leverage used by a particular investor. For example, an investor using little leverage would not expect a higher return on his investment in IAWC's common equity than that expected by a highly leveraged investor. (IAWC Ex. 20.00SR (Kalinovich Sur.), p. 5.)

Nor is there any substance to Mr. Gorman's concern that there is a conflict of interest by virtue of AWW's contributions. AWW, like any other independent investor, will evaluate the risk and reward profile of common equity contributions to IAWC and make an common equity investment if it expects to earn a reasonable return on its investment. Although AWW is not required to invest in the common equity capital of IAWC or any other specific entity, AWW has supported IAWC in its effort to maintain a balanced capital structure in the past and intends to do so in the future, subject to evaluation of IAWC's risk and reward profile. (IAWC Ex. 20.00SR (Kalinovich Sur.), pp. 5-6.)

Mr. Gorman also incorrectly contends that IAWC should have a capital structure similar to that of AWW because IAWC's bond rating is tied to the financial risk represented by AWW. IAWC's operating risk profile is significantly different than the risk profile of AWW. AWW makes common equity investments in water and water-related businesses, including regulated utilities, in many different states, while IAWC is a regulated water utility operating in the state of Illinois. Since the appropriate capital structure of a business should reflect the risk profile of such business's operations, it is logical that the risk profile of IAWC and AWW are different. The lack of a costly stand-alone bond rating does not change the risk profile of IAWC. IAWC's lack of bond ratings reflects the fact that IAWC has not issued "public offerings" historically (only Pennsylvania and New Jersey American were large enough to support the cost for such offerings). IAWC is now larger, but has been able to obtain access to the public markets through AWCC at a lower cost. This, however, does not mean that IAWC can ignore investor requirements. It must maintain a financial position to attract capital in all possible economic circumstances, irrespective of the capital structure at AWW. Furthermore, if IAWC obtained a credit rating, it would be significantly lower than AWCC's. Therefore, the added cost of obtaining and maintaining a credit rating for IAWC would be unnecessary, especially since it is not a regular issuer of debt, and the minimum cost to rate a company is only appropriate if there is a reasonable expectation to gain a materially higher credit rating. (IAWC Ex. 20.00SR (Kalinovich Sur.), pp. 6-7.)

IIRC mistakenly asserts that an increase in common equity will likely not lower IAWC's cost of debt. (IIRC Ex. 3.0, p. 20.) Absent any other changes in a business's risk profile, a higher common equity ratio lowers the cost of debt. If IAWC lowers its risk profile through a combination of a higher common equity ratio in its capital structure, higher return on common

equity, and lower operating risk, then, like Pennsylvania American Water and New Jersey American Water, IAWC may have access to lower cost debt financing than offered by AWCC. IAWC can and has issued debt to private lenders, as is common with water utilities. IAWC does not need a credit rating to issue debt to an insurance company or pension fund. (IAWC Ex. 20.00SR (Kalinovich Sur.), p. 9.)

The higher common equity ratio in IAWC's capital structure lowers the weighted average cost of common equity for IAWC. (*Id.*, pp. 10-11.) Furthermore, as previously explained, IAWC's most recent historical financial performance is significantly lower than needed to maintain a BBB+ credit rating. The historical returns earned by AWW on its common equity investments in IAWC are well below the theoretical return allowed in previous rate cases. If IAWC does not have a reasonable capital structure, it would not be prudent for it to assume that it will attract common equity contributions from AWW or any other investor, nor can it assume AWCC can and will lend to IAWC. (*Id.*) IAWC must improve its credit ratios to maintain access to debt and equity capital markets.

Mr. Gorman is also incorrect in asserting that IAWC's customers will pay substantially more for this capital than this capital would actually cost AWW, with the difference in capital costs improving earnings and returns on AWW's common equity capital. AWW and IAWC both have access to the same capital markets. It is highly unlikely that two companies with the same risk profile can obtain materially different financing costs. As mentioned earlier, AWW is a portfolio of investments in water and water-related businesses. The risk profile of AWW reflects the risk profile of its investments and the cost of AWW's capital reflects this portfolio of risk. For example, an investor cannot gain a higher return by investing in a company that buys a single Treasury bond versus buying the exact same Treasury bond directly. Therefore, there is

no difference in capital costs for the same investment. (IAWC Ex. 20.00SR (Kalinovich Sur.), p. 11.)

Nor should the Commission focus on any “extra” amount that customers may pay owing to an infusion of common equity. The Commission should instead focus on the appropriate capital structure for IAWC. IAWC’s business plan includes a significant investment in infrastructure which will require additional financing. The Commission should determine the total cost of financing that is required to attract investors. (*Id.*)

B. Cost of Debt

1. Short-term Debt

IAWC’s average projected cost of short-term debt for the 2010 test-year is 1.97%. (IAWC Ex. 4.00R1 (Rungren Reb.), p. 2.) For the purposes of this proceeding, Staff has accepted the use of this proposed interest rate as the cost of short-term debt for the test year 2010. (Staff Ex. 10.0, p. 2.) AG witness Ralph Smith disagrees, proposing that recent actual information should be used to determine the cost rate instead. (AG/JM Ex. 5.0, p. 6.) Mr. Smith’s suggestion that IAWC derive a cost rate by using a multiple-month average of recent actual cost rates is less desirable, because it requires use of monthly data that becomes less relevant to the 2010 test year as more historical months are added. Mr. Smith’s proposal is also vague; he does not specifically recommend a time-period to use for computing this average cost. (IAWC Ex. 4.00SR (Rungren Sur.), p. 7.) Accordingly, IAWC’s and Staff’s proposed cost rate of 1.97% is appropriate.

2. Long-term Debt

IAWC’s initial projection of the cost of long-term debt was 6.77%. (Schedule D-3, p. 1.) Based on lower actual and projected interest rates, IAWC subsequently revised this cost to 6.53% (IAWC Ex. 4.00SUPP (Rungren Sup.), p. 3), and then to 6.28% (IAWC Ex. 4.00R1

(Rungren Reb.), p. 4.). AG witness Smith accepted IAWC's proposed cost of long-term debt, as does IWC witness Gorman. (AG/JM Ex. 5.0, p. 6; IWC Ex. 3.0, p. 25.) IAWC had projected an issuance of debt in November 2009, at an estimated interest rate of 6.64%. However, \$14 million of that debt was issued in December 2009, at an interest rate of 6.00%, with the rest to be issued in May 2010 (at a projected rate of 6.20%). (Tr. 297-98, 324-25.) Given the debt issuance at 6.00%, which occurred just prior to the hearing in this proceeding, IAWC in turn accepted Staff's projected overall embedded cost of long-term debt of 6.24%. (Tr. 324-25.)

C. Cost of Common Equity

1. IAWC Has Proposed a Reasonable Rate of Return on Common Equity of 10.90%

IAWC retained Ms. Pauline Ahern, a Principal with AUS Consultants, to determine the cost of common equity. Ms. Ahern's final recommendation of a reasonable rate of return is a range of 10.70%-11.10% (IAWC Ex. 8.00SR (Rev.) (Ahern Sur.), pp. 18-19), and IAWC has selected the midpoint of this range – 10.90% – as an appropriate and reasonable common equity cost rate. (IAWC Ex. 4.00SR (Rungren Sur.), p. 1.)

As will be discussed, Ms. Ahern's recommendation is based on an assessment of market-based cost rates of publicly-traded companies of relatively similar risk: a proxy group of 6 water companies, and a separate group of 26 utility companies, as well as her review and adjustment of the proposals of Staff witness McNally, IWC witness Gorman, and CUB witness Thomas. (IAWC Exs. 8.00 (Rev.) (Ahern Dir.), pp. 4, 7; 8.00R1 (Rev.) (Ahern Reb.), pp. 3-4; 6-8, 8.00R2 (Rev.) (Ahern Reb.), pp. 17, 26-27, 33-34, 42-43.) As Ms. Ahern states in her surrebuttal testimony, having reviewed all of these data, she finds that a range of common equity cost rates of 10.70%-11.10%, with a midpoint of 10.90%, is not in excess of a reasonable rate of return.

For her initial analysis, Ms. Ahern applied two well-tested market-based cost of common equity models to these data – the single-stage growth Discounted Cash Flow (DCF) Model and the Capital Asset Pricing Model (CAPM). These are models that the Commission has generally relied on in prior proceedings, including Docket Nos. 03-0403, 04-0442, 05-0071/05-0072 (consolidated), 06-0285, and 07-0507. (IAWC Ex. 8.00 (Rev.) (Ahern Dir.), p. 6.) To synthesize the cost rates generated by each model, Ms. Ahern averaged the predicted cost rates generated by each model, giving twice as much weight to the rates predicted for the 6-utility-company proxy group because all members of this proxy group are engaged in the exact same service – provision of water-utility services – as is IAWC. This resulted in a baseline cost rate of 11.80%. (*Id.*, p. 7.)

As Ms. Ahern discusses, using other utilities of relatively comparable risk as proxies is consistent with the principles of fair rate of return (as established in *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) and *Bluefield Water Works & Improvement Co. v. Public Service Comm'n*, 262 U.S. 679 (1923)) and adds reliability to the informed expert judgment used in arriving at a recommended common equity cost rate. However, no proxy group can be selected to be identical in risk to IAWC and therefore, the proxy groups' results must be adjusted to reflect differences in risk profiles. (IAWC Ex. 8.00 (Rev.) (Ahern Dir.), p. 5.) Accordingly, Ms. Ahern accounted for the increased risk profile of IAWC by applying two separate adjustments. She applied a business risk adjustment of 15 basis points to account for IAWC's increased relative business risk owing to: environmental regulatory requirements specific to Illinois; the availability and quality of IAWC's water supply; IAWC's concentration of sale for resale customers; IAWC's small size relative to the two proxy groups; and IAWC's need to replace aging infrastructure. She applied a financial risk adjustment of 30 basis points to

account for IAWC's greater financial risk relative to the two proxy groups. This resulted in an initial recommendation of a 12.25% cost rate. (*Id.*, p. 8.) After reviewing the testimonies of Staff witness McNally, IWC witness Gorman, and CUB witness Thomas, Ms. Ahern revised her recommendation, concluding that a range of common equity costs of 10.70%-11.10% is not in excess of a reasonable rate of return. (IAWC Ex. 8.00SR (Rev.) (Ahern Sur.), pp. 18-19.)

2. IAWC's Return on Common Equity Must Be Adjusted for Business Risk

Business risk incorporates all of the risks of a firm other than financial risk (discussed below). Examples of business risk include the quality of management, the regulatory environment, customer mix, service territory growth and the like, which have a direct bearing on earnings. It is investors' perception of the risk associated with investment in a given utility's common equity that is relevant to estimating the cost of common equity capital. This perception can be assessed, in part, by reviewing information of the type that investors consider with regard to the risk faced by the specific utility involved in the industry in which it operates. Business risk is important to the determination of a fair rate of return because the greater the perceived level of risk, the greater the rate of return investors demand, consistent with the basic financial precept of risk and return. (IAWC Ex. 8.00 (Rev.) (Ahern Dir.), p. 9.)

As Ms. Ahern explains, the water and wastewater utility industry faces significant risks related to replacing aging transmission and distribution systems. In addition, because the water and wastewater industry is much more capital-intensive than the electric, natural gas or telephone industries, the investment required to produce a dollar of revenue is greater. In fact, the National Association of Regulatory Commissioners (NARUC) has highlighted the challenges facing the water and wastewater industry stemming from its capital-intensive nature. IAWC itself is facing an expected "massive capital investment" as it projects gross capital expenditures of \$469.319

million for the years 2008 through 2013, representing an increase of 45% over 2007 gross plant of \$1.044 billion. (IAWC Ex. 8.00 (Ahern Dir.), pp. 9-11.) And both the Congressional Budgeting Office (CBO) and the Environmental Protection Agency (EPA) have addressed the necessary future growth in water and wastewater utility infrastructure. Lastly, the water utility industry, as well as the electric and natural gas utility industries, faces the need for increased funds to finance the increasing security costs required to protect the water supply and infrastructure from potential terrorist attacks in the post-September 11, 2001 world. (*Id.*, pp. 13-14.)

The water and wastewater utility industry also experiences relatively lower depreciation rates. Lower depreciation rates, as one of the principal sources of internal cash flows for all utilities, mean that water and wastewater utility depreciation as a source of internally-generated cash is far less than for electric, natural gas or telephone utilities. Water and wastewater utilities' assets have longer lives and, hence, longer capital recovery periods. As such, water and wastewater utilities face greater risk due to inflation, which results in a higher replacement cost per dollar of net plant than for other types of utilities. (IAWC Ex. 8.00 (Rev.) (Ahern Dir.), pp. 11-12.)

IAWC faces additional extraordinary business risk owing to several factors. IAWC's geographic spread necessitates compliance with a wide range of regulatory requirements in multiple, non-contiguous locations. The fact that it is distributing water (as opposed to energy) also requires regulatory compliance with environmental laws that energy utilities do not account for. Illinois itself has more stringent environmental regulations that impose higher costs of operation, and thereby increase business risk. IAWC faces increased business risk because of the source and quality of its water supply. IAWC's concentration of sale-for-resale customers also

increases its relative business risk, because these customers, who represent 20% of IAWC's sales, can choose to discontinue service whenever their contracts end. IAWC's smaller relative size makes it less able to cope with significant events which affect sales, revenues and earnings, such as the loss of revenue from a few larger customers or extreme weather conditions. Finally, IAWC's smaller size – and corresponding lower market capitalization – creates a market perception of increased risk as compared to the proxy group of 6 water companies, and the larger group of 26 utility companies. (IAWC Ex. 8.00 (Rev.) (Ahern Dir.), pp. 15-20.)

To quantify this additional business risk, Ms. Ahern used data contained in the 2009 Yearbook – Valuation Edition. The determinations are based on the size premia for decile portfolios of New York Stock Exchange (NYSE), American Stock Exchange (AMEX) and NASDAQ-listed companies for the 1926-2007 period, and on related data. Ms. Ahern adjusted the determinations to arrive at an extremely conservative business risk adjustment of 15 basis points. (IAWC Ex. 8.00 (Rev.) (Ahern Dir.), pp. 40-41.)

3. IAWC's Return on Common Equity Must Be Adjusted for Financial Risk

Financial risk is the additional risk created by the introduction of senior capital, i.e., debt and preferred stock, into the capital structure. In other words, the higher the proportion of senior capital in the capital structure, the higher the financial risk. S&P bond or issue credit ratings may be used as an indicator of financial risk. Similar bond ratings/issue credit ratings reflect similar combined business risks, i.e., total risk. Although the specific business or financial risks may differ between companies, the same bond rating indicates that the combined risks are similar as the bond rating process reflects acknowledgment of all diversifiable business and financial risks in order to assess credit quality or credit risk. (IAWC Ex. 8.00 (Rev.) (Ahern Dir.), pp. 20-22.)

Ms. Ahern used predicted S&P and Moody's bond ratings for IAWC's long-term debt as a measure of the financial risk represented by IAWC. She determined that IAWC would be rated at the bottom of the BBB/Baa or the top of the BB/Ba bond rating categories. She also estimated that IAWC's likely S&P credit rating would be at the bottom of the BBB or top of the BB credit rating category. (*Id.*, pp. 41-42.) In contrast, the average S&P and 1090 Moody's bond and / or credit ratings of the proxy groups are in the A bond / credit rating category. Therefore, IAWC has greater financial risk than the average company in either proxy group, and would therefore require an upward adjustment to its cost of common equity.

Ms. Ahern used the bond yield differential between Moody's A and Baa rated public utility bonds to compute the required financial risk adjustment. Rather than relying on the recent 151-point yield differential between Moody's A and Baa rated public utility bonds, which is significantly higher than historical averages, Ms. Ahern based her estimate on the normalized yields differential of approximately 30 basis points over the most recent twenty-year historical period. This also represents a conservative adjustment, not just because it is significantly different from the 151-point recent differential, but also because this is the yield differential between the middle of the A and Baa bond rating categories, while IAWC's debt would likely have a low Baa or high Ba bond rating if they were rated by Moody's (resulting in a larger than 30-point differential). (*Id.*, pp. 42-43.)

4. Adjustments to the Return on Common Equity Analyses of Staff and IWC Produce a Reasonable Range of Return on Common Equity for IAWC

Staff and IWC propose unreasonably low returns on common equity, for two reasons – incorrect methodology in baseline analysis and failure to adjust for IAWC's specific heightened business and financial risk (as compared to the proxy groups used by Staff and IWC). However,

adjustments based on proper methodology and on Ms. Ahern's calculation of IAWC's specific additional risk bring these projections up to a reasonable level of return on common equity.

(a) The DCF Analyses of Staff and IWC Produce an Unreasonably Low Return on Common Equity

Staff's DCF Analysis

Staff witness Mr. McNally's multi-stage DCF analysis, which he offers as an alternative to Ms. Ahern's calculations, contains two flaws, which understate the cost of common equity. His use of recent spot yields of US Treasury securities is inconsistent with the prospective nature of both the cost of capital and ratemaking as well as the Efficient Market Hypothesis ("EMH"), particularly when *forecasts* of U.S. Treasury security yields are readily available. (IAWC Ex. 8.00R1 (Rev.) (Ahern Reb.), pp. 2-3.) Mr. McNally fails to account for the fact that forecasts of the yields on U.S. Treasury securities are readily available based upon a consensus of approximately 50 of the country's leading economists from Blue Chip Financial Forecasts, and as soon as those forecasts are publicly available, under the EMH, they are immediately assimilated by investors. (IAWC Ex. 8.00SR (Rev.) (Ahern Sur.), p. 2.) Mr. McNally also does not utilize readily available GDP growth forecasts, instead relying upon an "implied" growth rate. Mr. McNally's use of improper data results in lower-than-expected DCF estimates. (IAWC Ex. 8.00R1 (Rev.) (Ahern Reb.), pp. 3-4.)

Mr. McNally's DCF analysis also uses an incorrectly calculated 20-year forward US Treasury yield of 5.37%. Ms. Ahern demonstrated that the correct yield, using Mr. McNally's work papers in part, is 5.70%. This makes the corrected DCF result for his Utility Group, upon which he relied exclusively in formulating his recommended 10.38% common equity cost rate for IAWC, 11.55%. Mr. McNally is indeed correct that the DCF based upon the EIA GDP forecast is 10.99% for his Utility Group.

IWC's DCF Analysis

IWC witness Michael Gorman's DCF analysis is also flawed. Mr. Gorman starts out with three versions of the model: a constant-growth model using security analysts' EPS growth; a constant growth model using sustainable, or internal, growth; and a multi-stage growth DCF model. However, he then rejects the results of the constant-growth model because its projected EPS growth rate exceeds projected GDP growth, which Mr. Gorman considers to be a ceiling growth rate. (IWC Ex. 1.0, pp. 59-60.) However, as discussed above, GDP growth rates are average rates, implying that some entities will grow faster than that rate, while others may lag. In addition, Mr. Gorman himself concedes that security analysts' estimates of growth are more accurate predictors of future returns than growth rates derived from historical data. Finally, in a counterintuitive move, Mr. Gorman rejects the constant-growth DCF cost rate (10.61%) while retaining a higher rate (11.74%) for the electric proxy group in his calculations. (IAWC Ex. 8.00R2 (Rev.) (Ahern Reb.), pp. 34-35.)

Mr. Gorman's use of a sustainable-growth DCF model is an exercise in logical circularity. Moreover, the Commission has rejected the use of a sustainable-growth DCF model in IAWC's last rate case (Docket 07-0507). As regards Mr. Gorman's multi-stage DCF model, his use of 10-year forecasts of GDP growth while rejecting the use of security analysts' 5-year projected EPS growth is inconsistent. In fact, the Missouri Commission has recently commented that Mr. Gorman had used these projected GDP growth rates improperly in his multi-stage DCF analysis in that proceeding (Case No. ER-2008-0318), and that there was "no good reason" to ignore the results of his constant-growth DCF model. (IAWC Ex. 8.00R2 (Rev.) (Ahern Reb.), pp. 36-37.)

Averaging the results of Mr. Gorman's constant growth DCF model using security analysts' EPS growth rates with the results of his multi-stage growth DCF model yields average DCF results of 9.86% for his water proxy group, 9.74% for his gas proxy group, and 12.49% for his electric proxy group. However, these common equity cost rates are applicable to the larger and less business-and financially-risky proxy groups, and require adjustment for IAWC's greater business and financial risk.

(b) The CAPM Analyses of Staff and IAWC Produce an Unreasonably Low Return on Common Equity

Staff's CAPM Analysis

Turning to the alternative CAPM analyses presented, IAWC notes that Staff witness McNally's CAPM analysis relies on an improper risk-free rate. Mr. McNally uses a historical spot 30-year U.S. Treasury bond yield as the risk-free rate, rather than an actual projection of the 30-year U.S. Treasury bond yield. As explained above, use of a spot rate is inconsistent with both the prospective nature of the cost of capital and ratemaking as well as the EMH. (IAWC Ex. 8.00R1 (Rev.) (Ahern Reb.), p. 4.) As discussed above, forecasted 30-year U.S. Treasury Bond (note) yields are readily available from the September 1, 2009 Blue Chip Financial Forecasts. From this, a forecasted 30-year U.S. Treasury Bond (note) yield of 4.67% can be derived, based upon the consensus forecast of about 50 economists of the expected yield on 30-year U.S. Treasury Bonds (notes) for the six calendar quarters ending with the fourth calendar quarter of 2010. Utilizing Mr. McNally's average betas for his Water Group and Utility Group of 0.68 and 0.69, respectively, as well as the forecasted 4.67% 30-year U.S. Treasury Bond (note) yield as the risk-free rate, the CAPM cost rates under his model calculate to 10.19% and 10.21% respectively.

The 10.99% and 11.55% corrected DCF results, when coupled with the corrected CAPM analysis of Mr. McNally for his Utility Group of 10.21%, result in a range of common equity cost rate of 10.60% to 10.88%, before any adjustment for IAWC's greater relative financial and business risks.

IWC's CAPM Analysis

IWC witness Gorman's application of the CAPM is flawed for three reasons. First, his derivation of the historical market equity risk premium is incorrect. Second, his "forward-looking" equity risk premium is not truly a prospective equity risk premium. Third, his use of an internal market growth rate estimate and a non-constant growth DCF in determining a market equity risk premium is inconsistent with the methodology adopted by the Commission in IAWC's last rate case, Docket 07-0507, and Staff's analysis in the current proceeding. (IAWC Ex. 8.00R2 (Rev.) (Ahern Reb.), p. 39.)

Mr. Gorman relies on Ibbotson SBBI - 2009 Valuation Yearbook ("SBBI") for his historical market equity risk premium, discussing several variations of the SBBI historical market equity risk premium in his testimony. However, the SBBI publication makes clear that aside from one exception, "the long horizon equity risk premium of 6.5% is the appropriate horizon equity risk premium." Thus, Mr. Gorman's reliance upon any historical equity risk premiums other than SBBI's 6.5% premium should be rejected. (IAWC Ex. 8.00R2 (Rev.) (Ahern Reb.), pp. 40-41.)

Mr. Gorman's derivation of a "forward-looking" equity risk premium is theoretically flawed, and reflects a calculation error. Mr. Gorman applies a single-quarter inflation forecast – 2.1% for 4th quarter 2010, which he incorrectly terms the "current consensus analyst inflation projection" – to the average real market return for the period 1926-2008, a stretch of 82 years.

(IWC Ex. 1.0, p. 44.) This construct does not mimic investor behavior, who would instead more likely be influenced by a forecast such as Value Line, which is widely subscribed to and is available in the business reference section of most libraries. A more appropriate method of deriving the prospective equity market return is based upon Value Line's projected 3-5 year market appreciation potential, which, when converted to an annual rate and added to the market's median expected dividend yield, results in a forecast total annual market return. Mr. Gorman also makes an arithmetic error in calculating the average real market return over the period 1926-2008 period.

Finally, Mr. Gorman's use of a DCF calculation to derive a market equity risk premium is improper. First, it relies upon sustainable, or internal, growth, which is inconsistent with Staff's methodology of developing a market DCF return and which, as discussed above, was rejected by the Commission in IAWC's last rate case Docket 07-0507. Second, Mr. Gorman's use of a non-constant growth DCF model to develop the market DCF return is also inconsistent with Staff's methodology of developing a market DCF return, and inconsistent with the CAPM methodology adopted by the Commission in IAWC's last rate case Docket 07-0507. (IAWC Ex. 8.00R2 (Rev.) (Ahern Reb.), p. 41.)

Had Mr. Gorman calculated a market return consistent with Staff's methodology and consistent with the Commission's Order in Docket 07-0507, CAPM results of 10.70%, 10.16% and 10.31% for Mr. Gorman's water, gas and electric proxy groups, respectively, would result. Combining these rates with the corrected DCF rates discussed above yields a common equity cost rate of 10.54% (average) and 10.68% (midpoint). However, these common equity cost rates reflect the business and financial risks of the proxy groups, and just as the DCF results above,

require adjustment to reflect IAWC's greater business and financial risk. (IAWC Ex. 8.00R2 (Rev.) (Ahern Reb.), pp. 41-42.)

(c) Staff's and IAWC's Proposed Returns on Common Equity Should Be Adjusted for Business and Financial Risk

With regard to financial risk, reliance on the proxy group comparisons in other witnesses' testimony must be tempered, because these groups consist of better-rated, less risky utilities than the Utility Group upon which Mr. McNally relied which has an average S&P and Moody's bond and / or credit ratings of BBB+ and Baa1, at least two notches or more above IAWC's likely bond / credit ratings. Therefore, IAWC has greater financial/credit risk than the average company in Mr. McNally's Utility Group. Because, as explained earlier, recent yield differentials between Moody's A and Baa rated public utility bond yields are high by historical standards, it is more appropriate to rely upon the "normalized" yields differential of approximately 32 basis points, over the most recent twenty-year historical period, between Moody's A and Baa rated public utility bonds. Adjusting for the fact that Mr. McNally's Utility Group has a Moody's bond rating of Baa1 and an S&P bond rating of BBB+, Ms. Ahern demonstrates that a conservative 21 basis-point adjustment to reflect IAWC's greater financial risk is warranted. When a 21 basis-point upward adjustment for financial risk is added to the range of common equity cost rates based upon Mr. McNally's analysis as corrected above, financially risk-adjusted common equity cost rates of 10.81% and 11.09% result. (IAWC Ex. 8.00R1 (Rev.) (Ahern Reb.), pp. 7-8; IAWC Ex. 8.00SR (Rev.) (Ahern Sur.), pp. 5-6.)

As explained above, Ms. Ahern also made a 15 basis point adjustment to her recommended common equity cost rate to account for IAWC's increased relative business risk. Applying this same conservative business risk premium to Staff's range of common equity cost

rates results in final common equity cost rates of 10.96% and 11.24%. (IAWC Ex. 8.00SR (Rev.) (Ahern Sur.), p. 10.)

Similarly, Mr. Gorman's proxy comparison is misleading. His water and gas proxy groups have average S&P corporate credit ratings of A, which he states is slightly higher or equivalent to S&P's corporate credit rating for AWW of BBB+.² However, S&P itself makes a clear risk distinction between its credit-rating categories, and its definitions show that S&P does not consider the default risk of A-rated obligations or companies comparable to that of BBB-rated obligations or companies. BBB-rated obligations or companies have greater default risk than those rated A. Mr. Gorman's proxy group is thus not comparable to IAWC. (IAWC Ex. 8.00R2 (Rev.) (Ahern Reb.), pp. 28-29.)

Mr. Gorman makes an additional error in his testimony, in stating that IAWC has an "Excellent" business risk profile (just as his water proxy group does). In fact, IAWC has not been assigned a business risk profile by S&P: only Pennsylvania American Water Company and New Jersey American Water Company have. (IAWC Ex. 8.00R2 (Rev.) (Ahern Reb.), p. 29.) Moreover, IAWC's financial metrics indicate that it is still riskier than the proxy groups. IAWC is not functionally equivalent to AWW for risk-assessment purposes, and so any credit comparisons between AWW and the proxy group do not capture the full extent of the risk represented by the smaller and more business risky IAWC. (*Id.*, pp. 30-31.)

To adjust IAWC's cost rate for financial risk requires use of the Hamada equation. Based upon the Hamada derivation, financial risk adjustments of 0.17% (17 basis points) relative to the water proxy group, 0.57% (57 basis points) relative to the gas proxy group, and a negative 0.05% (5 basis points) relative to the electric proxy group are warranted, in order to reflect the financial

² Mr. Gorman's electric proxy group has an average S&P corporate credit rating of BBB+, which is identical to that of AWW.

risk inherent in Mr. Gorman's recommended 44.9% common equity ratio for IAWC relative to the common equity ratio maintained by the proxy groups. Thus, financial risk-adjusted common equity cost rates would be 10.45% for the water proxy group, 10.52% for the gas proxy group (9.95% + 0.57%), and 11.35% for the electric proxy group (11.40% - 0.05%). The midpoint of these financially risk-adjusted common equity cost rates is 10.90% and the average is 10.77%. Adding the 15-point business risk adjustment results in financial- and business-risk-adjusted common equity cost rates of 10.60% for the water proxy group, 10.67% for the gas proxy group, and 11.50% for the electric proxy group. The midpoint of these common equity cost rates is 11.05% and the average is 10.92%. (*Id.*, p. 42.)

5. CUB's Proposed Return on Common Equity Should Be Rejected

CUB witness Christopher Thomas also discusses the use of a sustainable-growth DCF model, which suffers from the same weakness of circular reasoning outlined above. In fact, it was Mr. Thomas's sustainable-growth DCF analysis that the Commission rejected in Docket 07-0507. (IAWC Ex. 8.00R2 (Rev.) (Ahern Reb.), pp. 2-7.) In addition, Mr. Thomas states that he performed a multi-stage growth analysis that assumes that for the short-term, the companies in the sample will grow at their average internal growth rate over the last five years. Hence, Mr. Thomas relied solely upon historical retention growth. However, since the cost of capital, as well as ratemaking itself, is prospective, his reliance upon historical, sustainable, fundamental growth is inconsistent with the prospective nature of both ratemaking and the cost of capital. By ignoring projections of earnings per share, dividends per share and common equity such as those provided by Value Line Investment Survey (Value Line) and expected 3-5 years hence, Mr. Thomas has ignored a valuable investor-influencing and widely available source of forecasted information and the very source he utilized in his discussion about declining dividend payout ratios.

Mr. Thomas's other position – that analysts' forecasts cannot be relied upon in the DCF calculation because of a "discontinuity" in the equity markets – ignores the empirical and academic literature alluded to above, which support the superiority of such data in a DCF analysis. Further, growth rates are significantly influenced by this discontinuity. Security analysts are fully aware of the effect this discontinuity has on the credit and equity markets in general, and on specific companies and industries in particular, reflecting this knowledge when they make their forecasts. Thus, there is no need for the Commission to reconsider the use of analyst's forecasts of growth in EPS in the DCF calculation. (IAWC Ex. 8.00R2 (Rev.) (Ahern Reb.), pp. 8-9.)

Mr. Thomas's use of a three-stage DCF model with short-term growth, i.e., internal growth, persisting for five years, followed by a five-year period of transition and a third stage where growth is equivalent to the long-term historic growth in real GDP is unsound. There is no evidence from historical nominal GDP growth rate data that the growth in each individual component of GDP going forward can be expected to converge toward GDP growth as a whole. Thus, even nominal GDP growth is not an appropriate proxy for the long-term growth of utilities. Second, the use of growth in real GDP, i.e., without inflation, results in a mismatch with both the market prices utilized to develop the dividend yield in the DCF and the internal growth rate Mr. Thomas developed for use in the first and second or transitional stage of his three-stage DCF, because both market prices and the return on common equity utilized in the calculation of internal growth have inflation expectations embedded in them. Thus, Mr. Thomas' use of real GDP growth results in an inconsistency in his application of the three-stage DCF. (IAWC Ex. 8.00R2 (Rev.) (Ahern Reb.), p. 11.)

Mr. Thomas objects to the use of adjusted betas in CAPM analysis, but readily acknowledges that the Commission has traditionally relied upon adjusted betas in arriving at a common equity cost rate for utilities under its jurisdiction. In fact, in IAWC's prior rate case, Docket 07-0507 (Order, p. 88), the Commission found, in response to Mr. Thomas's argument that adjusted betas be rejected, that it "has reviewed the testimony and arguments offered by CUB in favor of using unadjusted betas and does not find them convincing. Many of these arguments have been presented in previous proceedings where they were rejected." (IAWC Ex. 8.00R2 (Rev.) (Ahern Reb.), p. 12.) In fact, the Commission concluded in Docket 07-0507 that "adjusted betas are superior to unadjusted betas." (*Id.*, p. 14.)

Mr. Thomas also takes issue with Ms. Ahern's derivation of equity market risk premium (EMRP), once again presenting arguments that the Commission has reviewed and discarded in a prior proceeding. (CUB Ex. 1.0, p. 36.) By rejecting Ms. Ahern's derivation of the EMRP, Mr. Thomas effectively rejects the Commission's derivation of the EMRP, since the Commission relied upon the CAPM analyses of both Ms. Ahern and Staff in IAWC's last rate case, Docket 07-0507. Mr. Thomas relies instead on what he calls "research and analysis performed by unbiased academics over many years." However, such reliance is inconsistent with the discontinuity, turmoil and uncertainty in capital markets due to the recent financial crisis and recession, because each and every one of the studies upon which he relies was published between 2004 and 2005, well before the start of the current recession in late 2007 and the market free fall which began in September 2008. The Commission rejected this very argument in Docket 07-0507, finding that Mr. Thomas's suggestion to be "troubling on many levels." (IAWC Ex. 8.00R2 (Rev.) (Ahern Reb.), pp. 15-16.)

Given Mr. Thomas's use of a circular and fundamentally flawed DCF analysis that ignores relevant data and literature, and his use of CAPM calculations that the Commission has already rejected, Mr. Thomas's proposed return on common equity should be excluded from further consideration.

6. Criticism of IAWC's Business Risk Adjustment Should Be Rejected

Staff criticizes Ms. Ahern's business risk premium for focusing on the difference in size between the market values of her proxy groups and her prediction of IAWC's market value, but in so doing, Staff ignores the fact that Ms. Ahern's adjustment also reflects regulatory risk associated with operating in Illinois, the availability and quality of IAWC's water supply, and IAWC's concentration of sales-for-resale customers, coupled with its need to replace ongoing infrastructure. (IAWC Ex. 8.00R2 (Rev.) (Ahern Reb.), pp. 16-17.) Moreover, estimating IAWC's market capitalization if its common stock were publicly traded, based upon the market-to-book ratios of the companies in the two proxy groups, is entirely appropriate since it is the market data of those companies upon which Ms. Ahern's recommended common equity cost rate is based (before adjustment for IAWC's unique business and financial risks). Nor is this estimation any more hypothetical, as Mr. McNally suggests in rebuttal testimony, than using the market data of that very same proxy group to arrive at a cost rate of common equity applicable to IAWC. In other words, if the market prices of the proxy groups are appropriate for cost of capital estimation, those same market prices are appropriate for estimating IAWC's market capitalization if its common stock were publicly traded. (IAWC Ex. 8.00R2 (Rev.) (Ahern Reb.), pp. 16-17; IAWC Ex. 8.00SR (Rev.) (Ahern Sur.), pp. 7-8.)

Staff witness McNally's view that a size-based risk premium for a utility is contrary to financial theory and empirical studies is contradicted by current academic literature, which discusses the existence and impact of the "small-firm effect," and by data compilations such as

the 2009 Yearbook – Valuation Edition, which Ms. Ahern uses in her calculations. Nor is he correct in assuming that IAWC's size is irrelevant because it is a subsidiary of a larger organization. The cost of common equity and the authorized rate of return on common equity based thereon must reflect the risks which the shareholder/shareholders in the regulated utility bear and thus require in order to invest in that utility, regardless of any parent-company organization. What Mr. McNally appears to ignore is that it is the use of the funds, and not the source of the funds, which gives rise to risk and the risk-appropriate rate of return. (IAWC Ex. 8.00R1 (Rev.) (Ahern Reb.), pp. 17-18.)

IAWC should be evaluated as a stand-alone utility – to do otherwise would be discriminatory and confiscatory. Just as with any other utility under its jurisdiction, the Commission must focus on the risk and return on the common equity investment in IAWC's jurisdictional rate base because it is IAWC's rates alone that will be set in this proceeding and it is IAWC's rate base alone that serves its ratepayers. The risk of investment in IAWC's rate base is independent of ownership or provides of the capital used to finance that rate base. (IAWC Exs. 8.00R1 (Rev.) (Ahern Reb.), pp. 18-19; 8.00SR (Rev.) (Ahern Sur.), p. 9.)

The *Bluefield* decision made clear that a utility is entitled to a rate of return “equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties.” 252 U.S. 679, 692 (1922). Staff's proposal, on the other hand, suggests that if capital is acquired at a theoretical zero cost, then it should be invested with an expectation of a zero rate of return, an illogical proposition. (IAWC Ex. 8.00R1 (Rev.) (Ahern Reb.), pp. 19-20.)

CUB witness Thomas's claim, that in Docket 07-0241/07-0242 (Cons.) the Commission rejected the business risk adjustment that Ms. Ahern is proposing, is incorrect. What the

Commission rejected in that proceeding is “financial leverage adjustment” based analysis of the perceived difference in the financial risk contained in a market-value capital structure relative to a book value capital structure. Ms. Ahern has made no such leverage adjustment in this proceeding, nor any adjustment resembling those criticized by the Commission in its Order in that case. Mr. Thomas’s claim thus relies on a mischaracterization. (IAWC Ex. 8.00R2 (Rev.) (Ahern Reb.), pp. 22-23.)

Nor is Mr. Thomas correct in claiming that when a company is earning precisely its cost of capital, market and book value will be exactly the same. Mr. Thomas appears to believe that a direct relationship exists between market-to-book ratios and the rate of earnings on book common equity, but the academic literature asserts that there is no such relationship. Further, Ms. Ahern’s analysis of the existence of a direct relationship between the market-to-book ratios of unregulated companies and their earned rates of return on book common equity reveals that no such relationship has ever existed in the past, and that in fact, competitive, unregulated companies have never sold below book value, on average, and have sold at book value in only one year since 1947. (IAWC Ex. 8.00R2 (Rev.) (Ahern Reb.), pp. 24-25.) The business risk adjustment is not an adjustment for the differences in market-to-book ratios, and IAWC is not suggesting that the Commission adjust the return to account for market-to-book ratios: it is simply a risk adjustment that accounts for IAWC’s small size relative to the proxy companies regulatory risks specific to Illinois, the availability and quality of IAWC’s water supply, and IAWC’s its concentration of sales-for-resale customers.

7. Criticism of IAWC’s Financial Risk Premium Should Be Rejected

IIWC witness Gorman charges that since credit rating analyses already considers small-company risk, there is no need for an adjustment based on IAWC’s relative size. Mr. Gorman’s charge ignores two salient facts, however: IAWC has no credit or bond rating, and IAWC has

greater financial risk than the proxy groups, including Mr. Gorman's water and gas proxy groups. Were IAWC bonds rated by Moody's and S&P, these instruments would likely be rated in the low Baa/low BBB or upper Ba/upper BB bond rating category (the latter being below investment grade), hence requiring a financial risk adjustment. (IAWC Ex. 8.00R2 (Rev.) (Ahern Reb.), p. 47.)

CUB witness Thomas declares that credit ratings are artificially inflated, causing him to question the use of credit-rating data in this exercise. However, Mr. Thomas is relying on statements regarding CDOs (collateralized debt obligations) and not the long-term debt of utilities (which typically finances utility plant and hence rate base). Additionally, the SEC has put in place rules and regulations on the credit ratings process in response to past artificially inflated credit ratings for residential mortgage-backed securities and CDOs linked to sub-prime mortgage loans, and not utility long-term debt. Finally, if credit ratings are inflated, then they all are inflated, and on a relative basis IAWC is still financially riskier than the rated utilities to which it is being compared, and therefore requires an adjustment to the baseline risk premium. (IAWC Ex. 8.00R2 (Rev.) (Ahern Reb.), pp. 20-22.)

D. Proposed Rate of Return

After correcting DCF and CAPM calculations, and making financial- and business-risk adjustments, Staff's recommended cost rate ranges from 10.96% to 11.24%. IAWC's recommendation has a midpoint of 11.05%, and an average of 10.92%. In rebuttal, AG witness Smith uses a cost rate of 10.19%, which is an average of the uncorrected Staff and IAWC recommendations. (AG/JM Ex. 5.1, p. 8; Schedule D.) As Ms. Ahern states in her surrebuttal testimony, having reviewed all of these data, she finds that a range of common equity cost rates of 10.70%-11.10%, with a midpoint of 10.90%, is not in excess of a reasonable rate of return. IAWC has, therefore, selected the midpoint of this range, 10.90%, as an appropriate and

reasonable common equity cost rate. Based upon a common equity cost rate of 10.90%, IAWC's updated weighted average cost of capital for the 2010 average test year is 8.50%. This reflects the overall cost of long-term debt of 6.24%, recommended by Staff and accepted by IAWC. (Tr. 297-98, 324-25.)

V. COST OF SERVICE

A. Demand Study

1. Background

As discussed by Company witness Mr. Grubb, on July 30, 2008, the Commission entered an Initiating Order in Docket 08-0463 (the "Initiating Order") requiring, among other things, that IAWC provide updated demand factors for each rate area in which a rate increase was proposed in Docket 07-0507. (IAWC Exs. 5.00 (Rev.) (Grubb Dir.), pp. 12-13; 13.00 (McKinley), p. 4.) After the Commission entered the Initiating Order, the parties to Docket 08-0463 (the Company, the AG, the IAWC, the Cities of Champaign and Urbana and the Villages of St. Joseph and Savoy, and the Staff of the Commission) convened a workshop at which they discussed approaches to a demand study. (IAWC Ex. 13.00 (McKinley), p. 5.) At the workshop, the Company presented a proposed methodology for a multi-year demand study, to which the other parties did not object provided the Commission "deemed it consistent with the directives in the Initiating Order." (*Id.*, p. 6.) Therefore, the parties to the workshop filed a Joint Motion for Clarification on October 3, 2008, requesting that the Commission approve the Company's proposed methodology. (*Id.*; IAWC Ex. 13.02.) On October 15, 2008, the Commission granted the Joint Motion for Clarification and expressly approved the use of the Company's proposed methodology for the demand study. (IAWC Ex. 13.00 (McKinley), p. 6;)

IAWC engaged Black & Veatch to prepare a study to produce the required demand factors in accordance with the approved methodology. (IAWC Ex. 13.00 (McKinley), p. 4.) In

accordance with the approved methodology, the Company presented its demand study (“Prior Report”) in Docket 08-0463, as an exhibit to IAWC’s direct testimony filing on January 30, 2009.

(*Id.*)

In the present case, IAWC has submitted a demand study, entitled “*Report on Capacity Factors by Customer Class for the Illinois-American Water Company*” (“Capacity Factors Report”), which provides updated demand factors for all IAWC’s Rate Areas. (IAWC Ex. 13.01R1). The Capacity Factors Report used data from each Rate Area to determine demand factors for that Rate Area. In addition, as set forth in the approved methodology, the Company utilized actual demand data that was available for certain Chicago Metro service areas and data obtained in the Docket 07-0507 demand study to confirm the reasonableness of the results of the Capacity Factors Report where appropriate. The Capacity Factors Report is substantially similar to the Prior Report prepared in accordance with the Commission-approved methodology in Docket 08-0463, and the demand factors provided in the Capacity Factors Report as initially submitted were unchanged from those submitted in the Prior Report. (IAWC Ex. 13.00 (McKinley), pp. 4-5.) These demand factors were utilized in the preparation of a cost of service study (“COSS”) by IAWC’s witness Mr. Herbert, which is provided as IAWC Exhibit 9.01.

The Capacity Factors Report produced reasonable results. As explained by Mr. McKinley, the Capacity Factors Report’s results are “typical of the range of capacity factors that I have observed in other water utilities, and, when compared to system coincidental demands, produce diversity ratios generally in the range considered reasonable by the American Water Works Association Manual M1 (“AWWA Manual”). (IAWC Ex. 13.00 (McKinley Dir.), p. 7.) While the diversity factors produced in the report were generally within the AWWA Manual’s range of reasonableness, the Chicago Metro rate group’s diversity factor was outside the

manual's range. However, "given the primarily residential nature of the customer base in Chicago Metro, the diversity ratio for that area is believed to be reasonable" as well. (*Id.*, p. 8.)

(a) Use of Actual Demand Data in the Capacity Factors Report

The Demand Study developed capacity factors based on system and customer billing data gathered from each IAWC district, so that capacity factors for each district were based on data from that district. (IAWC Ex. 13.00R1 (McKinley Reb.), p. 5.) The approved methodology for the Capacity Factors Report expressly stated that actual demand data would be used "to the extent possible" to develop various adjustment factors. (IAWC Ex. 13.02, pp. 2-3.) Consistent with the approved methodology (*Id.*, pp. 1-3.), therefore, actual data was used where appropriate in developing the demand factors.

A valuable source of actual demand data was identified in four IAWC Chicago Metro service areas. These service areas were almost entirely residential, and so the actual measured demand data from these areas could be used to confirm the reasonableness of daily demand variation estimates that were used to develop the final demand factors in the Capacity Factors Report.

As the Demand Study makes clear, the residential daily variation ("RDV") factors or ratios which were utilized in determining the final capacity factors were first developed as estimates based on a number of considerations, including judgment supported by the reasonableness of the resulting system diversity factors, the relationship of prior and measured residential capacity factors to other customer classes, how resulting capacity factors compared with capacity factors previously used to design IAWC water rates in prior rate cases; and how resulting capacity factors compared with customer class capacity factors determined in other water rate studies. (IAWC Ex. 13.00R1 (McKinley Reb.), p. 5.) As discussed in detail in the Capacity Factors Report (IAWC Ex. 13.01R1, pp. 13-17), one factor (but not the only factor)

considered in determining the RDV factor was actual daily pumpage records of 2,161 residential accounts within four Chicago Metro service areas that serve residential customers either exclusively or with very little influence from other customer classes. This type of residential data is not generally available for other districts operated by the Company. As discussed below, the ability to utilize such actual residential data was considered relevant and significant, as a goal of the demand study methodology was to use actual data where reasonably possible. (*Id.*, p. 6.)

Five districts within the Chicago Metro rate area were identified as isolated systems that were primarily residential and had a master meter for the area that was connected to the SCADA system, and so were selected for analysis. (IAWC Ex. 13.00R1 (McKinley Reb.), p. 6.) One of the districts (Terra Cotta) was removed from consideration when it was discovered that several days of water usage was being met by a new water tank before being refilled, resulting in several days with no indicated pumpage data. Of the four remaining districts, the percentage of July 2005 water usage attributed to residential customers was as follows: Liberty Ridge – 99.1 percent; Arrowhead – 99.6 percent; Liberty Ridge East – 100 percent; and Alpine Heights – 100 percent. These four districts served 2,161 residential customers in 2005. (*Id.*)

Maximum day and average day pumpage for these areas was used to determine a ratio of maximum day pumpage to average day pumpage in the maximum month (the “Residential MD/ADMM”). To determine the RDV factor for each rate area, the Residential MD/ADMM was divided by the ratio of system maximum day to average daily pumpage in the year’s maximum month (the “System MD/ADMM”). (IAWC Ex. 13.00R1 (McKinley Reb.), p. 7.)

The four Chicago Metro districts are primarily residential, and provide data regarding the Residential MD/ADMM. The Residential MD/ADMM is considered indicative of the ratio of residential maximum day to average day water usage in the Midwest. (IAWC Ex. 13.00R1

(McKinley Reb.), p. 7.) Therefore, the Residential MD/ADMM is considered representative of residential customers in IAWC service areas for the purpose of developing the RDV factor for each respective rate area, based on the ratio of Residential MD/ADMM to System MD/ADMM. As described in IAWC Exhibit 13.01R1, the maximum day and maximum hour capacity factors for each IAWC rate area (see Table 19) were developed using rate-area specific system and billing data.

The RDV factor is one component in the calculation of maximum day and maximum hour capacity factors. Where Residential MD/ADMM data is not available, judgment considerations regarding the RDV factor are supported by the reasonableness of the resulting system diversity factors. (IAWC Ex. 13.00R1 (McKinley Reb.), p. 7.) Preliminary RDV factors were developed for each rate area based on a number of considerations. (*Id.*)

As discussed above, however, measured Residential MD/ADMM data was available for the four Chicago Metro districts. In reviewing this data, it was determined that use of measured Residential MD/ADMM data in calculating an RDV factor for each rate area (based on the rate area's System MD/ADMM) corroborated the preliminary RDV calculations. (IAWC Ex. 13.00R1 (McKinley Reb.), p. 7.) The calculated RDV factor for each rate area, with the exception of Chicago Metro, is consistent with the range of diversity factor ratios (1.1 to 1.4) identified as acceptable in AWWA Manual. (*Id.*, p. 8.) Because use of the calculated Residential MD/ADMM for the four Chicago Metro districts corroborated the preliminary RDV factors, it was determined that basing the proposed capacity factors on calculated Residential MD/ADMM was appropriate. (*Id.*) In addition, this is the type of "actual" data that, in accordance with the approved-methodology, was to be used in the Demand Study to the extent it was available. Direct measurement data available from the demand study conducted in 2007 in

Docket 07-0507 (“Docket 07-0507 Study”) also supports the reasonableness of the Residential MD/ADMM results determined from daily usage data of Chicago Metro residential customers. (*Id.*, pp. 8-9.)

2. Staff’s Concerns with the Demand Study Have Been Addressed

(a) Use of Chicago Metro Data

Mr. Lazare objected to the use of the Chicago Metro data described above to derive demand factors for the entire state, claiming that Chicago Metro maximum month ratios are used to produce peak month residential variations for all districts in Illinois. (Staff Ex. 6.0, p. 22.) His objection is unfounded. As discussed above, and consistent with the approved methodology, use of the actual measured Residential MD/ADMM data from the four Chicago Metro service areas in calculating an RDV factor for each rate area (based on the rate area’s System MD/ADMM) corroborated the preliminary RDV calculations. (IAWC Ex. 13.00R1 (McKinley Reb.), p. 7.) The calculated RDV factor for each rate area, with the exception of Chicago Metro, is consistent with the range of diversity factor ratios (1.1 to 1.4) identified as acceptable in AWWA Manual. (*Id.*, p. 8.)

Mr. Lazare also asserted that Chicago Metro usage is more weather sensitive than in other districts, based on his comparison of each district’s ratio of average daily usage for the peak month to residential daily usage for the year. (Staff Ex. 6.0, p. 22.) Because the ratio for Chicago Metro is 147% and the ratios for the state’s other districts range from 110% to 135%, Mr. Lazare reads the results to indicate greater weather-sensitivity in Chicago Metro than in other districts. (*Id.*, pp. 22-23.)

As Mr. McKinley demonstrated, however, Mr. Lazare’s contention that Chicago Metro customers are more weather sensitive than other residents of other parts of the state, and that therefore reliance on any Chicago Metro data, was misplaced is unsupported and incorrect. Mr.

McKinley testified that weather sensitivity cannot be demonstrated by simply comparing data from Chicago Metro to data from other rate areas, as Mr. Lazare did. (IAWC Ex. 13.00R1 (McKinley Reb.), p. 10.) While the Company recognizes that weather is a factor in determining customers' usage, consumption is the product of water use factors, of which weather is itself only one contributing factor. (IAWC Ex. 13.00SR (McKinley Sur.), p. 7.) Among the factors other than weather that determine usage are "general economic conditions in the service area, relative efficiency on fixtures and toilets, availability of automatic irrigation systems, yard size, type of grass, relative mixture of single family versus multifamily units, or customer preferences and priorities for yard maintenance." (IAWC Ex. 13.00R1 (McKinley Reb.), p. 10.) Thus, there is no basis to conclude that Chicago Metro is more weather sensitive than other districts. (*Id.*, p. 11.)

Mr. Lazare also suggested that the use of Chicago Metro data is inconsistent with the Commission-approved methodology for the demand study. Despite the Commission's approval of the methodology in the Joint Motion, Mr. Lazare argued that the same methodology applied in this case had not "already received some level of approval by the Commission." (Staff Ex. 13.0, p. 6.) Furthermore, Mr. Lazare asserted that the Commission-approved Methodology did not constitute a "detailed plan" because it did not disclose the specific data to be used. (*Id.*, p. 7.)

As discussed above, the methodology of the Capacity Factors Report was expressly approved by the Commission. (IAWC Ex. 13.00 (McKinley), p. 6.) The methodology was detailed, and the Company's use of actual residential demand data from the four Chicago Metro districts satisfies the Commission-approved methodology, stated that actual data should be used "to the extent possible." (IAWC Exs. 13.00R1 (McKinley Reb.), p. 3; 13.02.)

Mr. Lazare's comparison of the use of Chicago Metro data to the use of Interurban data in Docket 07-0507 is also inapposite, and should be disregarded. Mr. Lazare's complaint is based largely on Mr. McKinley's comparison of actual Chicago Metro data with residential MD/ADMM values derived from the Company's limited direct demand study of the Interurban district for Docket 07-0507. (IAWC Ex. 13.00R1 (McKinley Reb.), pp. 9-10; Staff Ex. 13.00, p. 8) As Mr. Lazare correctly noted, the data supplied by the Interurban study covered medium- and low-density residential areas, but did not cover high-density residential areas. (Staff Ex. 13.00, p. 9.) However, Mr. Lazare seems to have interpreted Mr. McKinley's reference to the Interurban study as an attempt to "tie" it to the Chicago Metro data; however, Mr. McKinley explained that he cited the Interurban study only to show the reasonableness of the Chicago Metro data. (IAWC Ex. 13.00SR (McKinley Sur.), pp. 3-4.) As discussed above, use of actual data "to the extent possible" is consistent with the Commission-approved methodology for the capacity factors report.

(b) Pekin Data

According to Mr. Lazare, applying Chicago Metro's residential ratios to produce maximum day demand factors for the entire state leads to anomalous results, particularly in the Pekin District. (Staff Ex. 6.0, pp. 23-26.) However, these results were largely based on incorrect monthly billing data, which it has since corrected.

Mr. Lazare asserted that when the Chicago Metro ratios were used to determine residential usage variation in the Pekin district, the results indicated that, given the average daily pumpage for the maximum month, non-residential customers would have to consume less than 70% of their average maximum month usage on the maximum day to balance the residential maximum day usage calculated by IAWC. (Staff Ex. 6.0, pp. 24-25.) Mr. Lazare also asserted

that the Company's initial data on the Pekin district showed variation in residential usage that appeared inconsistent with the peak month's small variation in system usage. (*Id.*, p. 26.)

The anomalous results found by Staff witness Lazare regarding residential usage variations over the maximum month for Pekin have been fully resolved. Following Mr. Lazare's observations, the Company determined that the average day in the maximum month usage value for the Pekin system was overstated. (IAWC Ex. 13.00R1 (McKinley Reb.), p. 11.) This value was derived from monthly system billing information, which was initially assumed to be based on calendar months, but which was recently determined to actually represent more than 30 or 31 calendar days for the indicated maximum month. (*Id.*) Therefore, adjustments were made to revise the maximum month system data for each district, except those in the Chicago Metro rate area, the Interurban District and the Pontiac District, for which different data sources (not affected by billing periods length of more than 30 days) were used. (*Id.*) This resulted in changes to certain of the RDV values in the Capacity Factors Report and minor changes to the customer class capacity factors for the following districts: Alton, Cairo, Peoria, Streator, South Beloit, Champaign, Lincoln, Pekin, and Sterling. The changes were reflected in a revised Capacity Factors Report. (IAWC Exhibit 13.01R1.) These capacity factor changes are not considered material and, as discussed by Mr. Herbert, do not require revisions to the Company's cost of service study. (IAWC Ex. 13.00 (McKinley Reb.), p. 12.)

Mr. Lazare thereafter agreed that "[t]he Company's revisions to key operating statistics for its non-Chicago districts in its rebuttal testimony eliminates the argument for my alternative methodology for developing maximum day and maximum hour demand factors." (Staff Ex. 13.0, p. 1.)

(c) Maximum Day Variation Factors for Non-Residential Classes

Mr. Lazare also objected to the Company's proposed maximum day variations for the Company's customer classes other than the residential class. In the Capacity Factor Report, the maximum day variations for the commercial, industrial and other non-residential classes were established as a certain percentage of the RDV. Relying on data from the Sterling District in which the ratio of average day use for the maximum month to average daily usage for the year is higher for the commercial class than the residential class, Mr. Lazare testifies that the Company should not "[assume] the opposite, which is that residential customers vary more." (Staff Ex. 6.0, pp. 28-29.) He supports this statement with a selected quote from the AWWA Manual, which states that "[f]or residential customers, there is also likely to be some daily variation in usage throughout the maximum-month, although it is typically likely to be less than the commercial and industrial class variations." (Staff Ex. 13.0, p. 11.) Mr. Lazare also asserted that the Company's maximum day capacity factor for the Other Water Utilities class lower than for the residential class, while simultaneously calculating a higher ratio of the maximum day to the average day for the year for the residential class than for the Other Water Utilities class. (*Id.*, p. 13.)

Staff witness Lazare is incorrect in his assumptions about class variation factors, as the Company's conclusion that residential class variation is higher than other classes is supported by actual data as well as the AWWA Manual. The Company's conclusion on residential class variation "is supported by the overall resulting capacity factors by class, the resulting diversity ratios, which are in the range of reasonableness, and the class capacity factors previously utilized by IAWC in its rate filings which have been accepted by the Illinois Commerce Commission in previous rate case dockets." (IAWC Ex. 13.00R1 (McKinley Reb.), p. 15.) Furthermore, Mr. McKinley explained that despite the data from Sterling, the variation in daily demands within the

maximum month are expected to be lower for commercial and industrial customers than for residential customers because their water usage is less influenced by weather conditions than residential customers. (*Id.*) Because actual data supports the Company's assumption, it is reasonable and should be accepted.

Mr. Lazare's comparison of the Other Water Utilities class to the residential class is also inapposite. The Other Water Utilities class in Interurban to which Mr. Lazare refers is for wholesale water service and is therefore typically a mixture of largely residential customers in suburban areas with some commercial and possibly light industrial customers that are served as one composite group (master metered). (IAWC Ex. 13.00SR (McKinley Sur.), p. 8.) Therefore, his comparison is unrelated to, and does not contradict, the assertion that water usage for commercial and industrial customers is less influenced by weather than for residential customers. Furthermore, data shows that the industrial and commercial classes in Interurban both have lower minimum maximum day demands than that district's residential class. (*Id.*)

3. Staff's Recommendation for a Direct Measurement Demand Study Should Be Rejected

The Commission-approved methodology for the Capacity Factors Report is considered an indirect demand study method, which derives demand factors based on analysis of accumulated system-wide data over several years. Because of his criticisms of the demand study, all of which are addressed above, however, Mr. Lazare recommended that the Commission order a direct measurement demand study, which would "entail[] placing time-sensitive meters on a sample of customers to measure their demands on a real time basis." (Staff Ex. 6.0, p. 12.) As discussed below, such a study is not appropriate. Such a study would be expensive, create possible operational concerns, and potentially produce unreliable data. In fact, as Mr. Lazare acknowledges, a direct study involves a "potential impact on system costs" and "[i]n the current

economic environment it would be difficult to justify the additional cost of embarking on a course of directly measuring ratepayer demands to derive demand factors [as it] would entail adding further upward pressure on rates that have been rising for a number of years.” (*Id.*, p. 39.)

As Mr. Lazare’s own testimony shows, there are concerns with utilizing a direct measurement study per Mr. Lazare’s proposal. Mr. Lazare recognizes that the indirect approach costs much less than the direct approach. He testified that the indirect approach “would avoid the expense of installing time sensitive meters, gathering data from those meters and developing demand factors from the data which would all be required to directly measure ratepayer demands.” (Staff Ex. 6.0, p. 14; *see* Staff Ex. 13.0, p. 22.) As discussed above, Mr. Lazare recognized that a direct demand study’s cost would cause “upward pressure on rates.” (Staff Ex. 6.0, p. 39.) In fact, the Company estimates that the cost of a direct study in Illinois, if ordered in this case, would be \$1.86 million. (IAWC Ex. 3.00R1 (Kaiser Reb.), p. 3.) Mr. Lazare does not dispute this figure. (Staff Ex. 6.0, p. 38.) Mr. Kaiser explained that purchase and installation of water meters to measure individual customers “are not typically configured in a manner to easily permit such measurements,” and that their installation and maintenance cost approximately \$20,000 per meter. (IAWC Ex. 3.00R1 (Kaiser Reb.), p. 2.)

As indicated above, Mr. Lazare acknowledged that an indirect study “could derive demand factors more quickly and thereby would conform more closely to the expedited timeframe envisioned by the Commission for this case.” (Staff Ex. 6.0, p. 13.) Meanwhile, a direct measurement study would require a longer period of time, both to install recording meters, and to gather and analyze the readings therefrom. (*Id.*, pp. 13-14.) He added that the “time issue alone would argue for using an indirect method to develop demand factors for the Company.” (*Id.*, p. 13.) The Company agrees with Mr. Lazare’s assessment that indirect demand studies are

more time-efficient than direct studies. (*See* IAWC Ex. 9.00SR (Rev.) (Herbert Sur.), p. 4.) The Company estimates that a direct study would require approximately 18 to 24 months to complete. (IAWC Ex. 3.00R1 (Kaiser Reb.), p. 3.) Mr. Lazare does not dispute this estimate. (*Id.*)

Although Mr. Lazare suggests that direct studies are more accurate than indirect studies, as IAWC witness Mr. McKinley explains, there is potential that direct study data will be unreliable. If the Commission were to order a direct study in the present case, short-term weather conditions could affect the results. Mr. McKinley noted that if a demand study were to occur over a “wet year,” the system peak might not occur, leading to inaccurate results. (IAWC Ex. 13.00R1 (McKinley Reb.), p. 4.) Mr. Kaiser concurred, testifying that in periods of wet weather and economic downturn, both of which Illinois is currently experiencing, data collected under a direct study may not indicate actual peak usage conditions. (IAWC Exs. 3.00R1 (Kaiser Reb.), pp. 1-2; 3.00SR (Kaiser Sur.), p. 20.) Accuracy of data collected through individual meters is also undermined by the reliability of the equipment, which is “prone to failure due to the underground environment in which they are typically installed.” (IAWC Ex. 3.00R1 (Kaiser Reb.), p. 2.) Additionally, the volume of data that the meters record regarding maximum day and maximum hour usage can prove difficult to effectively manage, further undermining the usefulness of the readings. (*Id.*)

In addition to the added cost and time to complete a direct measurement study, as well as the potential for inaccurate results, direct demand studies suffer from the significant operational concerns related to diminished firefighting capabilities. Direct studies may require isolation of parts of the distribution system, which “would reduce the ability to deliver water to the customers in the event of a large demand like the need to fight a fire.” (IAWC Ex. 3.00R1 (Kaiser Reb.), p. 3; see IAWC Ex. 13.00R1 (McKinley Reb.), p. 4.) Additionally, in order to

ensure that firefighting capacity would not be diminished in the event a demand study were ordered, “[t]he alternative would be to double or triple the cost of a demand study by installing two or three times the number of meters.” (IAWC Ex. 3.00R1 (Kaiser Reb.), p. 3.)

Mr. Lazare points to a direct measurement study undertaken by the Company’s affiliate West Virginia American Water. (Staff Exs. 6.0, pp. 29-30; 13.0, pp. 14, 16-17.) The direct demand study conducted by the Company’s parent in West Virginia, however, is inapplicable to a discussion of a direct demand study in Illinois and should be disregarded. As Mr. Kaiser explained, the West Virginia study was smaller in scope than what Staff has proposed for IAWC. Furthermore, the study consisted of only fifty metering points covering two districts, the results of which were then applied to other districts in the state. (*Id.*, pp. 18-19.) The Commission criticized a similar approach by the Company in its demand study in Docket 07-0507. (*Id.*, p. 19.)

The cost of the outside consultant to the West Virginia study alone was \$54,000. (IAWC Ex. 3.00SR (Rev.) (Kaiser Sur.), p. 18.) For a similar study to be conducted in Illinois, the Company would have to take many more meter readings, resulting in a five-fold increase to the cost of that aspect of the study alone. (*Id.*, p. 19.) Furthermore, the West Virginia study’s cost was lessened by placing meters on pump stations serving primarily residential customers, few of which exist in Illinois. (*Id.*) Though Mr. Lazare introduced the topic of the West Virginia study, he failed to address or dispute any of the points Mr. Kaiser made in conclusively demonstrating the study’s inapplicability to Illinois.

Mr. Lazare offered no specifics on how a direct study should be conducted in Illinois, and he also admits that he is “not aware of [the] Commission (or any regulatory Commission) requiring a water or wastewater utility to perform a direct measurement study.” (IAWC Ex. 3.00R1 (Kaiser Reb.), p. 3.) Because a direct study would offer no added benefit to Illinois

ratepayers, and would add upward pressure to rates, the Commission should reject Mr. Lazare's proposal to order a direct study in the present case.

4. IWC's Objections to the Demand Study Should Be Rejected

IWC witness Gorman objected to the Demand Study. Mr. Gorman claimed that the Capacity Factor Study did not measure capacity factors for the "pricing area" of Zone 1 with Champaign, and therefore the capacity factors used for it do not reflect its actual usage. (IWC Ex. 1.0, pp. 72-73.) Therefore, Mr. Gorman argues that the Company's proposed rate design and cost allocation for Rate Zone 1 with Champaign should be set aside in favor of a uniform percent change to all of Rate Zone 1 with Champaign's rate elements. (*Id.*, pp. 76-77.)

IWC witness Mr. McKinley explained, however, that Mr. Gorman's concern is not warranted. As discussed above, because the Demand Study incorporates "actual historical data and billing data from all of IWC's service areas to develop capacity factors for each district," Mr. Gorman's complaint is baseless. (IWC Ex. 13.00R2 (McKinley Reb.), p. 3.) IWC has provided the Capacity Factor Report that includes capacity factors for each district for which a rate increase is sought (in accordance with a methodology that was approved by the Commission in Docket 08-0463). (*Id.*, p. 2.) The Docket 07-0507 order (page 121) that Mr. Gorman refers to stated: "As an initial matter, in Docket 02-0690, the Commission directed IWC to provide updated demand [capacity] factors for each district for which a rate increase is proposed in its next rate case." Thus, it is clear that the customer class capacity factors that the Commission sought were those for districts in which a rate increase was sought, not "pricing areas" as Mr. Gorman alleges. (*Id.*) The fact that IWC proposes to consolidate certain districts into rate Zone 1 for rate design purposes (namely, moving towards the goal of single tariff pricing), does not change the fact that the appropriate approach was to develop capacity factors for each district. (*Id.*)

Moreover, as discussed below, Mr. Gorman's concerns, although unwarranted, are easily addressed. Actual demand data for SPSPSB, Sterling, and Champaign (the components of Zone 1 and Zone 1 with Champaign) was utilized in the Capacity Factor Report. (*Id.*, pp. 2-3.) The Capacity Factor Report contains sufficient information in Tables 2, 2a and 2b to determine revised cost allocation factors for SPSPSB, Zone 1 and Zone 1 with Champaign rate areas. This data can be combined and appropriately weighted in order to produce both cost allocation factors and capacity factors by customer class for the new Zone 1 and the proposed Zone 1 with Champaign.

To further address Mr. Gorman's concern, however, actual demand data for SPSPSB, Sterling, and Champaign (the components of Zone 1 and Zone 1 with Champaign) was combined and appropriately weighted in order to produce both cost allocation factors and capacity factors by customer class for the new Zone 1 and the proposed Zone 1 with Champaign. (IAWC Ex. 13.00R2 (McKinley Reb.), p. 4, Table 1.) As the record shows, the cost allocation factors do not significantly change between the various rate area configurations. (*Id.*) The impact of adding Sterling to SPSPSB has a negligible impact on both the SPSPSB maximum day and maximum hour ratios. (*Id.*, p. 7.) Adding Champaign to this relationship produces a maximum day ratio 1.6% greater than the former Zone 1 maximum day ratio and only 0.9% greater than the former Zone 1 maximum hour ratio. (*Id.*) The relative changes between the various rate area configurations are minor and are generally what would be expected when considering the relative average daily usage and customer class capacity factors developed separately for SPSPSB, Sterling, and Champaign in the Capacity Factor Report. (*Id.*, pp 7-9.) These new system diversity factors all fall within the 1.10 to 1.40 range deemed acceptable by the AWWA Manual. (*Id.*, p. 9.) Most importantly to Mr. Gorman's stated concerns, the customer class

capacity factors “do not materially affect the results of the cost of service study.” (*Id.*, pp. 9-10; IAWC Ex. 9.00SR (Rev.) (Herbert Sur.), p. 8.)

B. Cost-of-Service Study

1. IAWC’s Cost of Service Study Is Reasonable

The Company has submitted an updated cost of service study (“COSS”) in the present case, in accordance with the requirements of Docket 07-0507 that the Company provide a COSS in this case. The COSS is an updated version of the cost allocation studies performed in Docket 08-0463, which was based on the revenue requirements previously approved by the Commission in Docket 07-0507. (IAWC Ex. 9.00 (Herbert Dir.), pp. 3-4.) For this case, the Company’s COSS was updated to utilize the revenue requirements proposed in this case. The Company performed cost allocation studies for the Champaign, Chicago Metro Water, Lincoln, Pekin, Zone 1 (the former SPSPSB and Sterling), Zone 1 with Champaign, and Chicago Metro Wastewater rate areas. (*Id.*, p. 4.) Staff’s general acceptance of the COSS methodology is demonstrated by Mr. Lazare’s testimony that the COSS conforms to the approach presented in the AWWA Manual and “therefore provides a reasonable basis for allocating costs in this proceeding.” (Staff Ex. 6.0, p. 2.)

In performing the COSS, the Company used the base-extra capacity method. This method allocates the cost of water service in proportion to the various classifications’ use of water, facilities and services. (IAWC Ex. 9.00 (Herbert Dir.), p. 5.) The base-extra capacity method was approved for use in IAWC’s COSS by the Commission in Docket 08-0463. (*Id.*) This method is long-recognized in Illinois, and the Company used it in previous cases. (*Id.*; Staff Ex. 6.0, pp. 6, 10.) It is also recognized in the AWWA Manual, and is widely accepted as a sound method of allocating the costs of water service. (IAWC Ex. 9.00 (Herbert Dir.), p. 5.)

Costs in the base-extra capacity method are allocated based on various specific factors, depending on the nature of the cost. Costs that vary with the amount of water consumed are considered base costs, and are allocated in direct proportion to daily average consumption. (IAWC Ex. 9.00 (Herbert Dir.), p. 6.) Costs associated with meeting usage in excess of the average, most often maximum day requirements, are allocated to partially as base costs in proportion to average daily consumption, and partially as customer classifications as maximum day extra capacity costs in proportion to maximum extra capacity, and, for certain pumping stations and transmission mains, partially as fire protection costs. (*Id.*, pp. 6-7.) Storage facility costs and the capital costs of distribution mains, which are designed to meet maximum hour and fire demand requirements, are allocated on the basis of average consumption, maximum hour and fire demand requirements. (*Id.*) Similarly, fire demand costs are allocated in proportion to the relative potential demands on the system of the system's hydrants. (*Id.*) Costs for pumping facilities and the operation and maintenance of mains are allocated on the combined bases of maximum day and maximum hour extra capacity. (*Id.*, pp. 7-8.) Meter costs are allocated to customer classifications in proportion to the meter equivalents of the sizes and quantities serving each class. (*Id.*, p. 8.) Customer accounting, billing and collecting costs are allocated based on the number of customers in each classification, and costs for meter reading on the basis of metered customers. (*Id.*) Administrative and general costs are allocated on the basis of allocated direct costs, as was the cost of cash working capital, though different factors were used for these categories. Finally, depreciation accruals are allocated on the basis of the function of the facilities being depreciated for each depreciable plant account. (*Id.*, p. 9.)

The base-extra capacity method uses non-coincident peak demand to allocate costs, which is more exact and more cost-efficient than using coincident peak demands. Allocating

costs based on coincident peak demand involves a great deal of subjectivity and guess-work, as it is not possible to determine the respective classifications' demands on the system based on the coincident peak demand. (IAWC Ex. 9.00R1 (Herbert Reb.), p. 4.) Furthermore, designing a system based on noncoincident peak demands, which relies on system diversity, allows for construction of a smaller and more cost-efficient system. (Staff Ex. 6.0, p. 5; IAWC Ex. 9.00R1 (Herbert Reb.), p. 3.) Because all classes benefit from the cost-efficiency created by utilization of system diversity, cost are therefore shared proportionately based on each class' respective non-coincident demand.

Because of the inherent flaws in use of coincident peak demand, that method is not used in Illinois or any other jurisdiction. The base-extra capacity method and its component use of non-coincident peak has long been used in Illinois, and is considered an acceptable means of allocating costs. (Staff Ex. 6.0, p. 10; IAWC Ex. 9.00R1 (Herbert Reb.), p. 2.) However, because of the weaknesses of using coincident peak demands, including its relatively high cost and its inexactitude, neither the Company nor Staff can point to any water or wastewater utility commission ordering a cost of service study based on its use. (IAWC Ex. 9.00R1 (Herbert Reb.), p. 5.)

2. Staff's Proposal For a Future Study Using Coincident Peaks Should Be Rejected

With respect to the future use of the base-extra capacity method, Mr. Lazare complained that, although the Company allocates costs to ratepayers based on non-coincident peak demands, it uses coincident peak demands in allocating its own costs. Mr. Lazare refers in particular to water treatment plant in the Champaign service area. (Staff Ex. 6.0, pp. 5-6.) He requests that the Commission order the Company to prepare a COSS using coincident capacity factors in its next rate case. (*Id.*, p. 7.)

Mr. Lazare's objections to the COSS, base-extra capacity method and use of non-coincident peak are inconsistent with his history of supporting such cost of service studies. In Docket 07-0507, for example, Mr. Lazare supported the Company's use of the base-extra capacity method, which was based on non-coincident peak demands. (IWAC Ex. 9.00R1 (Herbert Reb.), pp. 1-2; Illinois-American Water Co., Docket 07-0507 (Order, p. 108.) He also stated in his direct testimony that the COSS, which, again, uses the base-extra capacity method, conforms to the AWWA Manual and "therefore provides a reasonable basis for allocating costs in this proceeding." (Staff Ex. 6.0, p. 2.) He further stated that he finds the base-extra capacity method "acceptable for ratemaking in this case." (*Id.*, p. 5.)

As Mr. Herbert explained, the benefit of using non-coincident peak demand is that it "recognize[es] the diversities of demands of various classes," allowing for construction of a "smaller, more efficient system." (IAWC Ex. 9.00R1 (Herbert Reb.), p. 3.) Like Mr. Lazare in Docket 07-0507, Mr. Herbert cites the AWWA Manual's statement that in using base-extra capacity and non-coincident peak, "all classes share proportionately in the economies of scale and cost savings of this smaller, integrated, and diverse system" to support the Company's COSS methodology. (*Id.*)

While Mr. Lazare correctly states that the Champaign water treatment plant was built to meet collective system demand, he is incorrect in suggesting that costs should therefore be allocated based on coincident peak demand. (Staff Ex. 6.0, pp. 5-6; IAWC Ex. 9.00R1 (Herbert Reb.), p. 4.) While the plant has enough capacity to meet diverse class peak demands whenever they may occur, every class served by it benefits from system diversities. As discussed above, costs should therefore be shared proportionately based on each class' non-coincident demands. (IAWC Ex. 9.00R1 (Herbert Reb.), p. 4.) Though Mr. Lazare argues that a cost of service study

should focus on allocation of costs rather than sharing of benefits, what he fails to appreciate is that the smaller, more diverse system allowed by the use of non-coincident peak demand allocation leads to the shared benefit of lower costs. (Staff Ex. 13.0, pp. 24-25.)

Moreover, as Mr. Herbert explained, estimating individual class peak demands on the coincident peak day would be much more subjective than estimating non-coincident demands. (IAWC Ex. 9.00R1 (Herbert Reb.), p. 4.) For non-coincident demands, one can study the pattern of usage for each class based on actual billing records and system delivery over the course of several months of data.) In using coincident peak demand, “one would have to estimate what each class’ usage was on a specific day” in order to allocate costs. (*Id.*, p. 4.) This task would be “especially difficult” should the peak day occur on a weekend. (*Id.*) Mr. Lazare failed to counter this fact in his rebuttal testimony, other than to offer his proposal that the Commission order a direct demand study, as discussed above. (Staff Ex. 13.0, pp. 23, 25-26.)

The Commission should reject Mr. Lazare’s recommendation that the Commission order the Company’s next cost of service study based on coincident peak demand, which is unsupported by precedent or evidence. As discussed above, Mr. Lazare acknowledges that he is not aware of any water or wastewater utility in Illinois, or in any other jurisdiction, performing a cost of service study based on coincident capacity factors. (IAWC Ex. 9.00R1 (Herbert Reb.), p. 5.) Further, Mr. Lazare acknowledges that he is not aware of any Commission in any jurisdiction ordering a water utility to perform a cost of service study using coincident capacity factors. (*Id.*) Nor does any other witness make similar proposal. Because Mr. Lazare’s proposal has no basis and is counter to long-established ratemaking practice in Illinois, the Commission must reject it.

3. IWC's Concerns About Rate Area Specific Demand Factors Are Unwarranted

Mr. Gorman also claims that the COSS for Zone 1 and Zone 1 with Champaign are not based on rate-area specific demand factors, and that the COSS therefore suffers from problems attendant to the Company's demand study in its last rate case. (IWC Ex. 1.0, pp. 72-74.) Mr. Gorman's suggestion that the COSS is not based on rate area-specific demand factors is unfounded, as discussed above in Section V.A. 4. Actual demand data from each district was used to create their respective capacity factors. Thus, the cost allocation factors in the COSS, including those which apply to Zone 1 and Zone 1 with Champaign, do use rate area-specific information. (IAWC Ex. 13.00R2 (McKinley Reb.), pp. 2-3.) Therefore, Mr. Gorman's contention that the COSS defectively lacks rate area-specific information, as was an issue in the Company's last rate case, is also unwarranted and baseless. (*Id.*, p. 3.) Additionally, changes to the demand study's capacity factors to account for the addition of Champaign into Zone 1 resulted in no material impact to the COSS. (*Id.*, p. 7.)

4. IWC's Allocation of Purchased Power Costs Is Incorrect

Mr. Gorman also asserts that the Company's allocations for purchased power cost do not reflect seasonal power price differentials, and that the AWWA Manual supports his proposal to allocate power costs to extra capacity, using the COSS's Factor 6. (IWC Ex. 1.0, pp. 74-75.) Mr. Gorman's proposed allocation of purchased power costs would lead to cost misallocations, however, and must be rejected. His proposal is based on his contention that the Company's purchased power costs vary greatly by season, and rise in periods of peak water demand. (*Id.*) He therefore suggests that Factor 6, which is tied to peak demands, produces a better allocation. (*Id.*, p. 75.)

The Company's allocation of purchased power costs using Factor 1 correctly reflects actual power costs. As Ms. Norton discusses, the Company has obtained contract pricing for 80% of its test year electric supply. (IAWC Ex. 2.00R (Rev.) (Norton Reb.), p. 2.) The new power contracts give the Company fixed pricing throughout the contract term, rather than seasonal rates as were charged with the previous contracts. (*Id.* pp. 3-4.) Thus, there are no seasonal price differentials for power supply costs.

In addition, using Factor 6 would allocate far too much power cost to the extra capacity function. (IAWC Ex. 9.00R2 (Herbert Reb.), p. 15.) IAWC reviewed a sample of power bills for the Company and analyzed the portion of the demand charge compared to the total bill for each month and then annualized the lowest demand charge for the year. (*Id.*) The difference between the annualized demand charge for the minimum month compared to the actual demand charges for the year was only 3.0% of the total annual power bill. Allocating this small portion of the power costs on an extra capacity basis would result in very minor changes to the cost allocation. Therefore Mr. Gorman's recommendation should be rejected. The appropriate factor to allocate power costs is Factor 1, based on average daily usage. (*Id.*; IAWC Exs. 9.00SR (Herbert Sur.), p. 9; 9.01SR) Because the Company's purchased power costs do not vary seasonally as Mr. Gorman incorrectly assumes, his use of Factor 6 would lead to a gross over-allocation of 32% of power costs to extra capacity. (IAWC Ex. 9.00SR (Rev.) (Herbert Sur.), p. 9.)

Moreover, Mr. Gorman misreads the AWWA Manual. The AWWA Manual directly addresses purchased power costs and states that "power costs are allocated principally to the base cost component and suggests that demand charges can be allocated to extra capacity to the degree that they vary with pumping requirements." (IAWC Ex. 9.00SR (Rev.) (Herbert Sur.), p.

9.) The important phrase, however, is “to the degree it varies with demand pumping requirements.” (IAWC Ex. 9.00R2 (Herbert Reb.), p. 15.) Because there is an electric demand charge every month, regardless of the level of use, it is not the total demand charge that should be considered extra capacity, but only the degree that the demand charge varies with pumping requirements. (*Id.*) Because Mr. Gorman provides no basis for his suggestion, the Commission should reject it.

VI. RATE DESIGN & TARIFF TERMS AND CONDITIONS

A. Introduction

The Company’s rate design proposal in the present case updates the rate design proposals in Docket 08-0463 (which has now been dismissed). In its Docket 08-0463 Initiating Order (“Initiating Order”), the Commission required the Company to (i) provide updated demand factors for all rate areas in which a rate increase was proposed in Docket 07-0507 along with a cost of service study, and (ii) investigate all aspects of rate design for all service areas. (IAWC Ex. 5.00 (Rev.) (Grubb Dir.), pp. 12-13.)

In its direct evidence in Docket 08-0463, the Company, in consultation with its rate design consultant, Mr. Herbert, proposed rates based on the revenue requirements authorized by the Commission in the Docket 07-0507 Order. The Company also addressed certain rate design issues raised by the Commission in the Docket 07-0507 Order and made related rate design proposals (“Docket 08-0463 Proposals”). IAWC Ex. 5.00 (Rev.) (Grubb Dir.), p. 14.) In this case, IAWC has updated the COSS used in Docket 08-0463 (which was based on the revenue requirements approved in Docket 07-0507) to reflect the revenue requirements proposed in this case. As discussed below, IAWC is maintaining the Docket 08-0463 Proposals in this case, but has updated them to reflect the updated COSS (as a result of this update, IAWC is proposing to move the Champaign District to Zone 1, and is also proposing certain rate impact mitigation

measures). (*Id.*, pp. 14-15.) The Company developed four alternative rate design proposals in this case, all of which have been presented to the Commission, and recommends its Alternative 3A as shown on IAWC Ex. 9.09 for approval. (IAWC Ex. 9.00 (Herbert Dir.), p. 12.)

In the Docket 07-0507 Order, the Commission indicated its support for movement toward single tariff pricing (“STP”), as well as other specific issues discussed below. (IAWC Ex. 5.00 (Rev.) (Grubb Dir.), p. 16.) The Commission therefore ordered the Company to study aspects of STP, including (i) review and analysis of customer class usage patterns in each downstate district, and it required the Company to propose a uniform block structure if appropriate, (ii) analysis of common usage rates for the SPSPSB District, and (iii) analysis of whether the Sterling District should be included in an STP group with the SPSPSB Districts. (*Id.*, p. 17.) The Commission also approved the application of certain uniform fees and charges, and ordered the Company to revise its tariffs to make them more uniform and consistent. (*Id.*)

The Company agrees that movement toward STP should be made where appropriate. (IAWC Ex. 5.00 (Rev.) (Grubb Dir.), p. 17.) In this proceeding, IAWC has examined both the consolidation of rate areas and the movement towards uniform customer charges, block structures and usage charges. This examination is primarily directed to the so-called “downstate” districts: Southern, Peoria, Streator, and Pontiac, which together form one of IAWC’s STP areas. In Docket 07-0507, these districts were combined in a rate area with South Beloit and referred to as the SPSPSB District and are now part of “Zone 1.” (The Company is also proposing to include Sterling and Champaign in Zone 1, as discussed below.) IAWC, however, also reviewed whether the approaches to STP discussed above could be applied to other rate areas outside Zone 1. (*Id.*, p. 18.)

IAWC has addressed the following specific rate design matters discussed in the Docket

07-0507 Order:

- Movement of the SPSPSB District and other rate areas towards STP.
- Study of customer charges to assess the recovery of a greater portion of fixed costs for each rate area through the customer charge.
- Design of alternative inclining-block rate structures for each rate area.
- Analysis of potential rate structures for non-residential customers that would include the use of demand charges in addition to customer charges and volumetric charges.
- Study of the cost to provide public fire service for each municipality or fire district based on the cost of service allocation studies within each rate area.
- For the Chicago Metro District – Sewer - determination of the appropriate unit rate for collection and treatment customers and collection-only customers using less than 1,000 gallons per month

(IAWC Ex. 5.00 (Rev.) (Grubb Dir.), pp. 18-19.)

As discussed in detail by Mr. Herbert, IAWC is proposing several steps towards STP, including moving Sterling and Champaign into Zone 1 and implementing uniform customer charges, block structures and usage charges in Zone 1 (with the exception of the 5/8 inch meter customer charge). The Company is also proposing to include additional fixed costs in its customer charge for all rate areas through a phase in process. For all rate areas, IAWC is proposing a one-block structure for the residential class, which would replace the present declining block structure for that class. IAWC is also proposing to set cost-based public fire charges for all rate areas except Chicago Metro – Water, and is proposing new sewer rates. IAWC is not proposing the expanded use of non-residential demand charges at this time, and intends to collect demand billing data that would allow implementation of non-residential demand charges, if appropriate, in the future.

B. Resolved Issues

1. Public Fire Charges by Meter Size – Chicago Metro

The Company initially proposed to continue with a uniform public fire protection rate assessed on all customers in Chicago Metro. In his direct testimony and in AG Ex. 2.05, AG witness Rubin proposed that IAWC establish public fire rates on a graduating scale fixed to the size of each customer's meter, beginning at 5/8-inch, with a maximum charge assessed 1.5-inch meters and larger. Mr. Rubin argued the public fire charge rate structure should reflect the differences in cost of providing fire protection services for various sized customers. (AG Ex. 2.0, p. 23.) Mr. Grubb accepted Mr. Rubin's proposal as reasonable, with the caveat that the final rates to be used would have to be based on the final revenue requirement authorized by the Commission. (IAWC Ex. 5.00R2 (Rev.) (Grubb Reb.), pp. 22-23.)

2. Public Fire Charges – Lincoln and Pekin

An analysis of the public fire costs per customer by municipality for the Chicago Metro area and per hydrant by municipality in all other rate areas was prepared and is presented in IAWC Exhibit 9.10. Present levels of public fire protection charges in Lincoln and Pekin are insufficient to meet the cost of service. The Company is therefore proposing public fire charges in those districts be increased 32.2% and 35.5%, respectively, to move the rates toward cost of service levels. (IAWC Ex. 9.00 (Herbert Dir.), p. 22.) Staff supports this proposal. (Staff Ex. 5.0, p. 39.)

3. Champaign & Sterling Consolidation with Zone 1

IAWC has proposed consolidating its Champaign and Sterling Districts with Zone 1. (IAWC Ex. 9.00 (Herbert Dir.), p. 12.) In his testimony, Staff witness Boggs recommended that Champaign and Sterling be included in the Zone 1 Single Tariff Pricing Group as proposed in Alternative 3A of Mr. Herbert's cost of service study. (Staff Ex. 7.0, pp. 5-7.) Mr. Boggs

suggested the move would be a step toward STP, which the Commission has supported in past rate cases. (*Id.*, p. 7.) In his rebuttal testimony for the Company, Mr. Grubb agreed with Mr. Boggs' recommendation to include Champaign and Sterling in the Zone 1 Single Tariff Pricing Group. No other witness opposed consolidation of Sterling or Champaign with Zone 1. The appropriate level of customer charges for the combined area is addressed separately below. (IAWC Ex. 5.00R1 (Grubb Reb.), p. 2.)

4. Tinley Park Wholesale/Westbury

The Company originally proposed to include on its Tenth Revised Sheet No. 37, sewer rates for Tinley Park Wholesale and Tinley Park Westbury, (IAWC Ex. 9.00 (Herbert Dir.), p. 23.) and its associated areas. Mr. Rukosuev recommended that language and references thereto be removed because the arrangement with those service areas is not regulated by the Commission, and should not therefore be included in tariff sheets regulated and approved by the Commission. (Staff Ex. 5.0, p. 47.) Mr. Grubb stated in his rebuttal testimony that the Company does not oppose Staff's recommendation to remove this tariff language. (IAWC Ex. 5.00R1 (Grubb Reb.) p. 3.)

5. Champaign/Lincoln Monthly Billing

IAWC is proposing to move customers in Champaign and Lincoln off of their current bi-monthly billing structure, and switch to monthly billing as part of its continuing effort to move toward STP, and to provide consistency and uniformity among the Company's tariffs. (IAWC Ex. 6.00 (Rev.) (Kerckhove Dir.), p. 19.) Staff witness Mr. Boggs agreed with this assessment in his direct testimony and stated that the proposed move would be reasonable. (Staff Ex. 7.0, pp. 29-30.) Mr. Boggs further recommended revisions to the Company's tariff Sheet No. 11, Section 15, Terms and Conditions of Billing and Payment, letter C to reflect the change, and that the Company be required to file the related changes to the billing interval in its compliance filing for

the Rules and Regulations section of Tariff sheet No. 23. (*Id.*, p. 30.) In his rebuttal testimony, Mr. Kerckhove indicated that the Company agrees with Mr. Boggs' recommended revisions. (IAWC Ex. 6.00R1 (Kerckhove Reb.), p. 8.)

6. Non-residential Declining Block Structures

The Company is proposing to maintain a declining block structure for its non-residential customers. (IAWC Ex. 9.00 (Herbert Dir.), p. 16.) As Mr. Herbert explained, the declining block rate structure offers a mechanism to recover cost differences based on class water use and demand characteristics in a fair and equitable manner. (*Id.*) Staff does not oppose this IAWC's proposal to maintain the declining block structure. (Staff Ex. 5.0, p. 6.) As indicated by Mr. Rukosuev, "non-residential users, who are large water users, usually have favorable cost of service characteristics that justify a declining block structure," and "the average cost to serve such customers falls as their usage is more evenly distributed throughout the year." (*Id.*)

7. Pekin Industrial Class

In his rebuttal testimony, Mr. Rukosuev proposed to lower the Company's proposed non-residential 4th block rates to reduce the rate increase for the 100% customer class billing frequency for the Pekin industrial class. (Staff Ex. 12.0, p. 9.) Mr. Rukosuev was concerned that the magnitude of increase to the 4th block in percentage (approximately a 50% increase) and dollar amount. (*Id.*)

The Company does not agree with Mr. Rukosuev's characterization of these increases for the Pekin industrial class as "rate shock," or that mitigation is warranted for this class. However, in the interests of resolving issues in the present rate case, the Company accepts Mr. Rukosuev's redesign of Pekin industrial class rates as set forth on pages 8-9 of his testimony. (IAWC Ex. 5.00SR (Grubb Sur.), p. 17.)

8. Pekin 5/8" Customer Charge

In his rebuttal testimony, Mr. Rubin indicated that based upon his calculations, the 5/8" customer charge for the Pekin district would be nearly identical to the customer charged in Zone 1 (\$13.37 and \$13.47, respectively). (AG Ex. 6.0, p. 9.) Based on this similarity, Mr. Rubin recommended setting Pekin's 5/8 customer charge to be equal to the proposed customer charge for Zone 1. (*Id.*) The Company agrees with this recommendation. (IAWC Ex. 9.00SR (Rev.) (Herbert Sur.), p. 16.)

9. Lincoln 3"+ Meter Charges

Staff witness Boggs agreed with IAWC's proposed rates for 3" meters in the Lincoln district. (Staff Ex. 14.0, p. 5.) However, Mr. Boggs also recommended that in its next rate case, the Company should set customer charges for Lincoln's meter sizes 3" and greater be set equal to those in Zone 1 and Pekin, so that a more uniform rate design and movement toward STP could be achieved. (*Id.*)

While not agreeing outright that Lincoln's rates should be set as Mr. Boggs recommends, the Company agrees to review and analyze this issue in the next rate case and, if appropriate, make a recommendation to set Lincoln's customer charges for meter sizes greater than 3" equal to those in Zone 1 and Pekin. (IAWC Ex. 5.00SR (Grubb Sur.), p. 18.)

10. University of Illinois Current Rate Structure

The Company initially opposed maintenance of the current block rate structure of the University of Illinois ("University"). Mr. Gorman argued that the current structure be left intact, and the Commission approve a uniform percent change for all University rate elements to coincide for an increase in revenues. (IIWC Ex. 1.0, pp. 77-78.) The Company agreed to maintain the current rate block structure, and recommends that the determination of the final

usage charge be based on the final revenue requirement and rate design as ordered by the Commission. (IAWC Ex. 5.00R2 (Rev.) (Grubb Reb.), pp. 21-22.)

11. Customer Count

Initial differences between the Company's residential customer count and the IWC's initial customer count led to divergent projections of residential test year revenue. Upon explanation by Mr. Grubb regarding the causes of the different counts (discussed under Residential Revenues (Section III.C.1 above)), Mr. Collins accepts use of IAWC's actual September 2009 residential customer count. (IWC Ex. 4.0, p. 7.) As discussed in Section III.C.1, however, the Company continues to support its residential test year revenue projection due to concerns that Mr. Collins' projection was based on incorrect customer allocations. (IAWC Ex. 5.00SR (Grubb Sur.), pp. 4-5.)

12. Non-residential demand charges

Given the Commission's interest in use of non-residential demand charges, the Company reviewed the possibility of their further use. At the present time, the Company is not proposing to implement non-residential demand charges, but is proposing to implement demand metering for certain customers considered appropriate candidates for demand charges, such as wholesale and some large industrial customers. (IAWC Ex. 5.00 (Rev.) (Grubb Dir.), pp. 23-24.) Based on the results of this study, the Company will propose demand charges for those customers where appropriate in its next rate case. (*Id.*, p. 24.) No witness opposed this proposal.

13. Reconnection Charges

The Company is proposing a uniform after-hours reconnection rate for all rate areas of \$138. (IAWC Ex. 5.00 (Rev.) (Grubb Dir.), p. 28.) This amount reflects the average cost of after-hours reconnections, in light of the Commission's emphasis on uniform charges in Docket 07-0507. (*Id.*) Because of the Commission's emphasis on uniformity and its benefits to

customers, Staff agrees that after-hours reconnection charges should be uniformly set at \$138. (Staff Ex. 5.0, p. 43.)

14. Home Inspection Fee

Upon reviewing its \$25 home inspection fee applicable to all rate areas, the Company determined that because no home inspections were requested by customers or conducted by the Company over the past three years, the fee should be eliminated. (IAWC Ex. 5.00 (Rev.) (Grubb Dir.), p. 28.) Staff finds this proposal reasonable and concurs that the fee should be eliminated. (Staff Ex. 5.0, p. 44.)

15. Tariff Language Changes

The Company has proposed various changes to language of its water tariffs. (IAWC Ex. 6.00 (Rev.) (Kerckhove Dir.), p. 23; Staff Ex. 5.0, pp. 44-46.) Because the proposed changes add clarity and consistency across the tariff sheets, they are unopposed.

C. Contested Issues

1. Proposed Customer Charge

As noted above, the Company developed a number of alternative rate designs in the present case. Mr. Herbert discussed the Company's position, that the Commission adopt IAWC's proposed Alternative 3A, shown on IAWC Exhibit 9.08. (IAWC Ex. 9.00 (Herbert Dir.), p. 21.) Alternative 3A includes, among other things, moving additional fixed costs into the customer charge for all rate areas through a gradual phase-in, and movement toward a more uniform customer charge throughout the Company's service areas.

In the prior rate case, the Commission's order stated that IAWC should "consider proposing rates whereby a greater portion of its fixed costs will be recovered through the customer charge for each rate class." Docket 07-0507 Order, p. 122. Pursuant to that directive, the Company is proposing to include more fixed costs in the customer charge as discussed below.

In determining the amount of additional fixed costs to include in customer charges, Mr. Herbert conducted a minimum system analysis and included the results as a component of the customer charge. (IAWC Ex. 9.00 (Herbert Dir.), p. 18.) His analysis involved determining what portion of the distribution system results from connecting additional customers to the system regardless of the level of usage. In other words, his analysis determined what would be the cost of the distribution system if all that was needed was to connect every customer so that they could receive a basic unit of service (one cubic foot of water). (IAWC Ex. 9.00R2 (Herbert Reb.), p. 8.)

(a) Basic Customer Charge

IAWC's basic customer charge was developed in Alternative 1 of Mr. Herbert's rate design, which incorporates the result of the revised cost allocations using the demand factors discussed above as well as revised customer charges to reflect the customer charge analysis set forth in each cost allocation study. (IAWC Exs. 9.00 (Herbert Dir.), pp. 13-14; 9.05.) The basic customer charge includes all fixed customer-related costs properly recovered in the customer charge (as discussed below, the Company is also proposing to recover further fixed costs through a minimum system charge). (IAWC Ex. 9.00R2 (Herbert Reb.), p. 5.) As Mr. Herbert explains, failure to allocate the full fixed costs requires that those costs be recovered through consumption charges, with disproportionate impacts on high-volume customers. (*Id.*) Staff shares the Company's concern that such disproportionate recovery would be inequitable, and supports the inclusion of more fixed costs in the customer charge. (Staff Ex. 7.0, p. 14.)

To this end, Mr. Herbert indicated that various items such as depreciation, return and taxes associated with meters and services as well as an allocable portion of administrative and general expenses, payroll taxes and general plant were included for recovery in the customer charge. (IAWC Ex. 9.00R2 (Herbert Reb.), p. 2.) These factors represent actual costs expended in providing customer service and are therefore properly included in fixed cost recovery through

the customer charge. Their inclusion is also in keeping with the directives of the AWWA Manual. (IAWC Exs. 9.00R2 (Herbert Reb.), pp. 3-4; IAWC Ex. 9.01R2.)

As the record shows, the range of customer costs among districts from \$14.11 per month for a 5/8-inch meter to \$21.61 per month. (IAWC Ex. 9.02.) The aggregated state-wide customer costs would result in an \$18.14 per month customer charge for a 5/8-inch meter. (IAWC Exs. 9.00 (Herbert Dir.), p. 13.) Based on this analysis, IAWC proposes movement towards a uniform customer charge as follows: a \$16.00 per month charge for Zone 1, including Sterling, and Pekin, a \$14.00 per month charge for Champaign, a \$13.50 per month charge for Chicago Metro - Water, a \$10.50 per month charge for Lincoln and a \$10.40 per month charge for South Beloit.

Movement toward a more uniform customer charge in Zone 1 is equitable because, generally, the costs the Company incurs in providing service are similar regardless of where the customers are located. Purchasing, installing, and reading meters, billing customers, and other customer-related costs generally do not vary significantly within Zone 1. Staff agrees with this assessment. (Staff Ex. 7.0, pp. 8-9.). Where the proposed customer charge is less than \$16.00, the proposed charge reflects consideration of the potential size of the increase to customer charges, especially for small volume users, that would have been required to move the customer charge all the way to the \$16.00 Zone 1 rate at this time. (IAWC Exs. 9.00 (Herbert Dir.), p. 13.)

(b) Minimum System Charge

The customer charges, as determined in the Alternative 1 rate design and IAWC Exhibit 9.02, recover the operation and maintenance expenses and capital costs associated with meters and service lines and the operating costs to read a customer's meter and render and collect a bill. (IAWC Ex. 9.00 (Herbert Dir.), pp. 17-18.) These are the costs that are typically recovered in customer charges for water utilities. In accordance with the Commission's directive in Docket

07-0507 to consider recovery of more fixed costs in the customer charge, however, IAWC undertook an additional analysis to identify additional fixed costs that might properly be included in the customer charge. (*Id.*, pp. 17-19.) This analysis, the “minimum system analysis,” resulted in a proposed “minimum system” charge (“MSC”) which IAWC proposes to add to the customer charge as discussed below. In essence, the minimum system analysis is the basis for a rate design proposal (not a cost allocation) in response to the Commission’s directive that IAWC study inclusion in the metered service customer charge of a greater portion of the fixed cost of service for each rate area. The Commission has approved recovery of 80% of a utility’s “fixed delivery service” costs through the customer charge in two recent cases: *Nicor* (Docket 08-0863) and the *Ameren Illinois Utilities* (Docket 07-0585 (cons.)). This suggests that the Commission has a strong interest in rate design that recovers fixed costs through the customer charge. The MSC proposal represents a rate design proposal that accomplishes the result the Commission requested in IAWC’s prior case

In the energy utility industry, a common practice is to determine what portion of the distribution system results from connecting additional customers to the system regardless of the level of usage. (IAWC Ex. 9.00 (Herbert Dir.), p. 18.) This is commonly referred to as a minimum system analysis. The minimum system analysis looks at the effect of including in the metered service customer charges a fixed cost component related to the minimum system, or the system required to connect customers so that they can receive a basic unit of service. A basic unit of service can be considered to be one cubic foot of water per day (which could be delivered on an average day). (IAWC Ex. 9.00R2 (Herbert Reb.), pp. 7-8.)

For IAWC, the smallest size main with a significant length of pipe is a 2-inch main. (IAWC Ex. 9.00 (Herbert Dir.), p. 18.) In his analysis, Mr. Herbert applied the current cost of

installing each size main to the footage of mains by size to determine the current cost of the actual distribution system. (*Id.*) He then applied the unit cost of the 2-inch main to the entire system and divided this result by the actual current cost. This ratio was 38.3%, representing the portion of the distribution system assigned as the minimum system and allocated to the number of customers. The 38.3% factor was then applied to the revenue requirement associated with mains – operation and maintenance expenses, depreciation and return and taxes. The revenue requirement associated with the customer portion of the distribution system was divided by the number of customers and twelve months to produce a monthly minimum system cost of \$4.67 per customer. (*Id.*; IAWC Exhibit 9.03). Since the \$4.67 amount of minimum system cost represents an additional 29.2% increase to the proposed \$16.00 customer charge, IAWC proposes recovering the minimum system cost in phased-in steps. In this case, the first step increase to the customer charge would be \$1.75 per month. (IAWC Ex. 9.00 (Herbert Dir.), pp. 18-19.)

(c) AG Witness Mr. Rubin Inappropriately Excludes Necessary Items from the Customer Charge

Mr. Rubin recommends excluding a list of items identified as “overheads” or indirect costs, and excludes these items from recovery in the customer charge. (AG Ex. 2.0, p. 6-7.) These overheads include executive salaries, advertising, outside services, property tax, and capital stock tax. (*Id.*) As explained by Mr. Herbert, the items Mr. Rubin seeks to exclude are all cost-causative factors related to providing customer service and billing, and are no less critical to the Company’s ability to provide customer-related services to IAWC’s customers than the direct costs Mr. Rubin is willing to include. (IAWC Ex. 9.00R2 (Herbert Reb.), p. 4.) Mr. Rubin’s analysis excludes most of the allocable indirect costs that are appropriately allocated as customer costs and also appropriately recovered in customer charges. (IAWC Ex. 9.00 (Herbert

Sur.), p. 11.) Mr. Rubin compounds this error by excluding millions of dollars of allocable administrative and general expenses and taxes, such as administrative salaries, other administrative and general supplies and expenses, as well as uncollectible accounts and property taxes. (*Id.*, p. 12.) Further, Mr. Rubin’s proposal to exclude these items is directly contrary to the Commission order from the previous rate case for IAWC to consider including more fixed costs in the customer charge.” *See* Docket 07-0507 Order, p. 122.

(d) AG Witness Mr. Rubin Mischaracterizes the MSC Charge

Mr. Rubin rejects the MSC addition to the customer charge because in part, he incorrectly views it as a cost allocation method rather than simply a rate design approach. The MSC addition was in response to a Commission directive that required the Company to explore methods to recover additional fixed costs in the customer charge. The Commission has approved recovery of 80% of fixed costs through the customer charge in two recent cases: Nicor (Docket 08-0863) and the Ameren Illinois Utilities (Docket 07- 0585 (cons.)). This suggests that the Commission has a strong interest in rate design that recovers fixed costs through the customer charge. As discussed above, the Company’s MSC is an appropriate and reasonable rate design approach to address the Commission’s directive as stated in the prior case. Mr. Rubin’s criticisms should be disregarded. (IAWC Ex. 9.00R2 (Herbert Reb.), pp. 6-7.)

(e) Staff Witness Mr. Boggs’ Calculation of the Customer Charge Excludes Appropriate Customer Costs

Staff witness Boggs agreed in part with the general approach of the Company in determining the proposed customer charge. Mr. Boggs agreed that movement toward a uniform customer charge would be reasonable and in keeping with the preferences of the Commission. (Staff Ex. 7.0, p. 13.) Mr. Boggs also supports approval of the Company’s proposed customer charges for meters sizes larger than 5/8-inch. (Staff Ex. 14.0, pp. 3-5.) Staff and IAWC diverge

however in their respective treatments of two key issues, namely the calculation of the level of customer charge and the appropriate mitigation on the customer charge increase in Champaign.

Citing recent Commission decisions, Mr. Boggs suggests in his testimony that the Company be limited to recovery of 80% of its fixed customer costs in the customer charge. He uses the 80% factor to make various recommendations for customer charges and suggests that the maximum customer charge in any area should be \$14.50. (Staff Ex. 7.0, pp. 14-16.) However, Mr. Boggs's recommendation has the effect of excluding costs properly included in the customer charge and ignores the allocation for the minimum system component provided by Mr. Herbert, which makes his calculations incomplete.

As explained by Mr. Herbert, it is the Company's position that the orders referenced by Mr. Boggs (Dockets 08-0863 and 07-0585 (cons.)) permitted the utilities in those cases to recover 80% of their "fixed delivery service" costs through the customer charge, and that the fixed delivery services costs include investment in mains that connect all customers as well as other costs that do not vary with volume of service delivered. (IAWC Ex. 9.00R1 (Herbert Reb.), p. 6.) Consequently, the approved recovery in those cases covered more than just the fixed customer costs that Mr. Boggs uses to calculate the his figures for IAWC. In order to be consistent with these orders, the 80% factor should be applied to all IAWC's fixed customer costs, including the MSC as discussed by Mr. Herbert. Applying the MSC to Mr. Boggs' calculations, if the minimum system cost of \$4.67 per customer per month (see Exhibit 9.03) were added to the customer costs of \$18.14, there would be a total of \$22.81 of fixed costs per month applicable to the monthly customer charge, 80% of which would equal \$18.25. (IAWC Ex. 9.00R1 (Herbert Reb.), pp. 6-7.) The resulting number is close to the Company's proposed

customer charge of \$17.75. For these reasons, the Commission should reject the customer charge recommendations of Mr. Boggs

(f) Customer Charge Increases in the Champaign District

Mr. Boggs recommended that Champaign's customer charges be set at the same rate as the customer charge in Zone 1 and Sterling, rather than the lower rate proposed by IAWC. (Staff Ex. 7.0, pp. 13-14.) Mr. Boggs suggested that although Champaign's 5/8-inch meter customers would experience a higher percentage increase in customer charges than other Zone 1 5/8-inch meter customers under his proposal, those customers would benefit from having the costs of capital improvements spread amongst a much larger customer base, and greater uniformity in the customer charges for all Zone 1 rate areas could be achieved. (*Id.*)

IAWC is concerned that the proposed \$17.75 customer charge per month for Zone 1 would represent a 58% increase over Champaign's existing customer charge. For this reason, the Company initially proposed a customer charge for Champaign that is \$2.00 less than Zone 1. If the Commission's order in this case produces a customer charge for Zone 1 that is less than that proposed by the Company, the Company would consider utilizing the same charge in Champaign as is utilized for Zone 1. (IAWC Ex. 9.00R1 (Herbert Reb.), p. 8.)

2. Single Block Residential Rate Structure

IAWC has proposed in this case to eliminate the declining block structure for residential customers outside of Chicago Metro (which already has a single block residential rate structure) and replace it with a single block structure. (IAWC Ex. 9.00R2 (Herbert Reb.), pp. 9-10.) As Mr. Herbert explained, large usage residential customers are likely using water for discretionary purposes such as watering lawns or other outdoor use. This class of customers has a poor load factor and uses water at times of high peak demands when supplies may be near capacity. Such usage should not be priced at a lower block rate than small users that use water for basic needs.

With a single block structure, all residential usage is priced at the same rate. (IAWC Ex. 9.00 (Herbert Dir.), p. 16.) Although the proposal is supported by Staff, the AG opposes Company's proposal to eliminate the declining block rate for the residential customer class outside of Chicago Metro and recommends switching the Chicago Metro residential class from a single block to a declining block. (AG Ex. 2.0, p. 14, 16.) The AG's proposal should be rejected.

As discussed above, in the Company's prior rate case (Docket 07-0507), the Commission discussed at length general considerations regarding movement towards single tariff pricing. A single block billing structure is in keeping with those considerations. (IAWC Ex. 5.00 (Rev.) (Grubb Dir.), pp. 16-17.) Further, single block rate setting is an increasingly common method of setting rates in the industry, and is acknowledged as such by the AG's principal witness on the issue, Mr. Rubin. (IAWC Ex. 9.00R2 (Herbert Reb.), pp. 9-10.) A single block structure is also supported by Staff witness Mr. Rukosuev, who stated in his testimony:

[A] single block rate structure would better reflect the residential class COSS since that class has a poor load factor. In addition, a single block structure would provide simplicity, that is, a less complex rate structure that can be easily understood by customers and provide an incentive to conserve water through a usage-based price signal. For the Company, a single block structure would provide a sense of predictability and more stability in revenues.

(Staff Ex. 5.0, p. 7.) Such a structure is particularly appropriate to IAWC's service area in this case, as the record indicates that nearly all (99.3%) of IAWC's residential customers currently fall within the first billing block and so the residential class is essentially functioning as a uniform block structure. Additionally, as Mr. Herbert explains, a one-block rate can be lower than what the first block rate of a declining structure would have to be, and would benefit most users. (IAWC Ex. 9.00R2 (Herbert Reb.), pp. 9-10.) This uniformity of consumption habits and benefits to consumers confirm that a declining block structure is unnecessary, and, as indicated

by Mr. Rukosuev and Mr. Herbert, that a single block structure would be preferable. (Staff Ex. 5.0, p. 7.); IAWC Ex. 9.00R2 (Herbert Reb.), p. 10.)

Mr. Rubin's main concern regarding the adoption of a single block structure (and its retention in Chicago Metro) appears to be that such a structure is unfair to non-residential customers and master-metered residential apartment complexes. (AG Ex. 2.0, pp. 16-18.) As Mr. Herbert explains, however, in Chicago Metro apartment and condominiums are classified as residential and are already on a one block structure. Any increases experienced by these customers will be no more than that of any single-family residence. (IAWC Ex. 9.00R2 (Herbert Reb.), pp. 10-11.) Moreover, master-metered customers in service areas outside Chicago will be unaffected because multi-family dwellings outside of Chicago Metro are typically not classified as residential and will continue on a declining block structure. (*Id.*, pp. 11-12.) AG witness Mr. Rubin has conceded that a single block structure would be appropriate in circumstances where the residential class does not include large apartments and condominium complexes, as IAWC is proposing in the service areas outside Chicago Metro. (*Id.*, p. 10.) For these reasons, the Commission should approve IAWC's proposal to adopt a single block structure for its residential customers outside of Chicago Metro.

With respect to Mr. Rubin's suggestion that the Commission require IAWC eliminate the single block structure presently in place in Chicago Metro, this suggestion should be rejected. The use of a single block rate "means that residential users pay the same usage rate per 1000 gallons or ccf of water regardless of their total usage, their per capita usage, or the type of residence they have." (IAWC Ex. 9.00SR (Rev.) (Herbert Sur.), p. 16.) A single block residential rate structure in Chicago Metro is reasonable, for the reasons discussed above, and is consistent with the shift towards single tariff pricing.

Moreover, Mr. Rubin bases his concerns on a single anecdotal customer complaint, by a master meter complex customer, requesting the establishment of a declining block rate structure for Chicago Metro residential customers and that IAWC establish a separate class for multi-family residences. (AG Ex. 6.0, p. 14.; IAWC Ex. 9.00R2 (Herbert Reb.), pp. 12-13.) Mr. Rubin indicates that one “concerned citizen” contacted the Attorney General about a situation with large master metered apartment buildings and combination accounts. Mr. Rubin acknowledged, however, he does not have knowledge of any other specific situation like the one he refers to in his testimony. (IAWC Ex. 9.00R2 (Herbert Reb.), p. 12.) Therefore, it appears that Mr. Rubin’s proposal to maintain a declining block structure for all customers in all IAWC’s service areas and reject IAWC’s proposal to adopt a uniform residential usage charge statewide is being driven by the complaints related to one large building complex in Chicago. This is not an appropriate basis for rejecting IAWC’s proposed block structures. (*Id.*, p. 13.)

3. Multi-unit Residential Building Classification

Mr. Rubin also recommends that the Company should be required to file with its next case sufficient data to establish apartment and condominium customers as a separate customer class. (AG Ex. 2.0, p. 21.) Mr. Rubin points to the size of meters and rates of consumption at certain structures to suggest that “dozens of customers” outside Chicago Metro are likely master-metered multifamily residences. As indicated by Mr. Grubb, these indicia (meter size and volume of consumption) do not lead to the conclusion that Rubin’s identified structures are indeed master metered multi-family residences. (IAWC Ex. 5.00SR (Grubb Sur.), p. 15.) IAWC has reviewed its records and confirmed that only two multi-family customers outside of Chicago Metro are classified as residential. To address Mr. Rubin’s concern, however, IAWC has agreed to engage in a review of its multi-family residential customers to determine their customer classification and propose, if appropriate, a uniform classification of these customers based on

the review's findings. Such revisions, if any, would be included in the Company's next rate case. (*Id.*, pp. 15-16.)

4. Across-the-board Adjustment

While, as discussed above, the COSS is reasonable and fully in accordance with Illinois practice and prior Commission orders, Staff witness Mr. Lazare objects to aspects of the COSS, that relate to his concerns with the Capacity Factors Report (demand study) (which IAWC addresses above). Mr. Lazare recommends, in his rebuttal testimony, that the Commission reject the Company's proposed revenue requirement allocations based on the COSS in favor of an across the board rate increase. (Staff Ex. 13.0, p. 18.) His proposal, however, is not justified.

Mr. Lazare's suggestion that the Commission reject setting rates based on cost of service in favor of an across the board rate increase is inconsistent with the Commission's preference for cost-based rates, and is undermined by his own testimony supporting the COSS methodology and the fact that Staff witnesses Mr. Boggs and Mr. Rukosuev, in their rate designs, do not adopt an across the board increase. The Commission has a preference that rates be set as close as possible to the cost of service for each class. *South Beloit Water, Gas & Electric Co.*, Docket 03-0676 (cons.), Final Order, p. 45 (October 6, 2004). As noted above, Mr. Lazare supported the use of the Company's base-extra capacity method in its last rate case. (IWAC Ex. 9.00R1 (Herbert Reb.), pp. 1-2.) He stated that the COSS's methodology conforms to the AWWA Manual, and that the COSS "provides a reasonable basis for allocating costs in this proceeding." (Staff Ex. 6.0, p. 2.) Mr. Lazare stated that the base-extra capacity method is "acceptable for ratemaking in this case." (*Id.*, p. 5.) Furthermore, neither staff witness Boggs nor staff witness Rukosuev's rate design utilize an across the board rate increase. (IAWC Ex. 9.00SR (Rev.) (Herbert Sur.), p. 6.) Because there is no evidentiary support for Mr. Lazare's proposal, the Commission must reject it.

IIRC witness Gorman also proposes an across the board increase, based on perceived concerns with the Company's Capacity Factors Report and COSS. (IIRC Ex. 1.0, p. 77.) Mr. Gorman's proposal that the Commission order a uniform percentage increase to all classes in Rate Zone 1, however, is unsupported. As discussed above, both the Company's Capacity Factors Report and COSS are reasonable and provide an appropriate basis on which to set rates. Furthermore, Mr. Gorman's assertion that a uniform change would be more equitable for large users while being generally consistent with the Company's proposals for other classes is entirely unsupported by any evidence. (IAWC Ex. 9.00R2 (Herbert Reb.), p. 17.) Because the Company has demonstrated that its proposed rate increases are reasonable, and no evidence has been offered to support any alternative increases, the Commission should reject Mr. Gorman's and Mr. Lazare's unsupported proposals for uniform percentage rate changes in favor of the Company's reasonable and well-supported proposals.

5. Recovery of Uncollectible Accounts Expense

For rate design purposes, IAWC is proposing to recover losses from uncollectible accounts on an equal, per customer basis through the customer charge. (IAWC Ex. 9.00R2 (Herbert Reb.), p. 4.) AG witness Mr. Rubin opposes this proposal on the grounds that it would be inequitable for IAWC customers to share the burden of recovering uncollectible accounts equally on a per customer basis. Recovering uncollectible accounts via customer charge however, allows consumers to share the burden equally and fairly, and is consistent with the allocation of uncollectible expense in the COSS.

Uncollectible accounts are allocated in the COSS on a per-customer basis. With the cost so allocated in the COSS, it is only logical that it be recovered in the same manner through an equal customer charge, rather than based on consumption. (IAWC Ex. 9.00SR (Rev.) (Herbert Sur.), pp. 14-15.)

Customer charge recovery of uncollectible expense is consistent with cost causation. As Mr. Herbert explains, 91% of uncollectible accounts are allocated to the residential class because the residential class is primarily responsible for the accounts that are written off as uncollectible. (*Id.*, p. 15.) Mr. Herbert prepared an analysis of write-offs for the Interurban district in 2008. As the analysis shows, the residential class share of the total write-offs is 91.80%, which is very similar to COSS Factor 13 for residential at 90.98% based on the number of customers. (*Id.*; IAWC 9.03SR.) Thus, although Mr. Rubin is correct to point out that recovery of uncollectible expense through the customer charge results in the residential class paying about 90% of uncollectible expense, residential customers are responsible for about 90% of all uncollectible accounts. As demonstrated by this data, distributing the expense equally in this manner closely tracks causative factors. Contrary to Mr. Rubin's suggestions, the allocation of this expense to customer charge has nothing to do with a customer's amount of consumption or revenue generated by a customer class. (IAWC Ex. 9.00SR (Rev.) (Herbert Sur.), p. 15.) Allocating recovery based on consumption would force larger users (principally non-residential customers) to pick up an amount disproportionate to the total amount of uncollectible accounts they are responsible for as a class. (*Id.*)

6. Chicago Metro Sewer Rate Increase

The rate design for Chicago Metro - Wastewater relied upon the results of the cost of service allocation presented in Exhibit 9.01. The cost allocation shows the cost of service attributable to Collection Only customers, Collection and Treatment customers, and Treatment Only customers. (IAWC Ex. 9.00 (Herbert Dir.), p. 22.) The cost allocation results show that under the allowed rates in the last case, the Collection Only customers are contributing revenues in excess of their costs and the Collection and Treatment and Treatment Only customers are contributing revenues far less than their costs. (*Id.*)

The proposed rate design begins to realign the revenues with the cost of service and is presented in IAWC Exhibit 9.05 – CMWW. For Collection Only customers, the proposed rates were left unchanged from existing rates (consisting of a fixed charge and a single block consumption charge.) (IAWC Ex. 9.00 (Herbert Dir.), p. 23.) The residential fixed charge for Collection Only customers includes an allowance of 1.33 ccf or 1,000 gallons. For Collection and Treatment customers, the proposed rates begin to move toward the cost for providing such service and also include a fixed charge, a single-block consumption charge for residential and a two-block consumption charge for non-residential. (*Id.*) The residential fixed charge also includes an allowance of 1.33 ccf or 1,000 gallons.

Staff witness Mr. Rukosuev argued in his rebuttal testimony that the Company's proposed rates for certain sewer customers would result in rate shock. (Staff Ex. 12.0R, p. 18.) Mr. Rukosuev admits that the Company is currently collecting only 39.0% of its cost of service for Collection and Treatment in the Chicago Metro Sewer rate district. (Staff Ex. 12.0, p. 11.) Mr. Rukosuev however, specifically amended the 2nd block non-residential usage rates for this rate area. (*Id.* p. 12.) Mr. Rukosuev is incorrect in suggesting that the Company's rates would result in rate shock, and there is no reason to adjust the Company's proposed rate increases as Mr. Rukosuev proposes.

The Company's proposal for rate increases to the Chicago Metro Sewer Rate Area are intended to further cost-of-service goals, and should be accepted by the Commission. The Company's rate design for this area is "specifically designed to link the residential consumption rate with the first block rate for the commercial class and the customer charges for commercial and residential customers." (IAWC Ex. 9.00SR (Rev.) (Herbert Sur.), p. 2.) This proposed structure would result in the same bill for residential and commercial customers consuming less

than 20,000 gallons per month. (IAWC Ex. 9.00SR (Rev.) (Herbert Sur.), p. 2.) Because Mr. Rukosuev's adjustment moves away from this goal, it is not cost-based. (IAWC Ex. 9.00SR (Rev.) (Herbert Sur.), p. 2.) (IAWC Ex. 9.00 SR (Fev.) (Herbert Sur.), p. 2.)

AG witness Mr. Rubin recommends that wastewater treatment rates increase by no more than 50%. (AG Ex. 2.0, p. 25.) Limiting the increase to 50% would not allow IAWC to recover its costs (or would simply require shifting the costs elsewhere). (IAWC Ex. 9.00R2 (Herbert Reb.), p. 14.) Mr. Herbert also noted that Mr. Rubin overestimates the magnitude of rates likely to be incurred by the average IAWC wastewater treatment customer. Rather than the \$70.00 per month for 7 CCF of service suggested by Rubin, the actual figure, as indicated by Mr. Herbert, is \$63.50 under the proposed rates. (*Id.*)

7. Public Fire Service Revenue Recovery – Zone 1

Staff initially proposed that the Company be allowed to increase public fire service charges by 19.88% in Zone 1 with Champaign to allow it to recover 100% of its cost of service. (Staff Ex. 7.0, pp. 20-21.) The Company agreed with this proposal. (IAWC Ex. 9.00R1 (Herbert Reb.), p. 10.) Despite having initially proposed the 19.88% increase, Mr. Boggs then changed his position on rebuttal and proposed that the public fire service recovery be limited to 89% of cost, so as to meet the Staff's proposed revenue requirement. (Staff Ex. 14.0, p. 9.)

The Commission should accept Mr. Boggs' initial proposal to allow the Company to collect 100% of its public fire service costs in Zone 1 with Champaign. Allowing the Company to do so is consistent with Staff's initial proposal, and is consistent with Mr. Rukosuev's acceptance of the Company's proposed public fire rates in other districts. (IAWC Ex. 9.00SR (Rev.) (Herbert Sur.), p. 4.) For the sake of consistency and allowing the Company to collect all its reasonable expenses, the Commission should accept the 19.88% increase in public fire service charges in Zone 1 with Champaign.

8. Private Fire Charge

Concerns have been raised by Homer Glen witness Mr. Schofield about IAWC's fees for maintaining systems necessary for fire protection sprinkler services. While he has not made a specific recommendation to the Commission in this matter, he questions why there should be a monthly charge for private fire protection. (HG Ex. 3.0, p. 2.) As indicated by Mr. Grubb, the fees associated with these private fire systems represent an allocation of the costs associated with providing fire protection service. This includes capital costs for the assets necessary to make the service available, depreciation, taxes, maintenance and administrative costs. (IAWC Ex. 5.00R2 (Rev.) (Grubb Reb.), p. 23.) The COSS, provided by Mr. Herbert, provides the details as to which costs were allocated (and how) to develop the private fire service rates. (IAWC Ex. 9.00 (Herbert Dir.), pp. 7-9.) IAWC's COSS evidence, therefore demonstrates that the private fire charge is appropriate. As HG has not identified any specific concern with the level or allocation of private fire charges, the Commission should reject Mr. Schofield's concerns in this matter.

9. Rates for the Competitive Industrial, Large Sales for Resale and Large Other Public Authority classes

IIWC witness Mr. Gorman argues that the Company's proposed rate increases in Zone 1 for the Competitive Industrial and Large Sales for Resale classes are too low, and that the proposed increase for the Large Other Public Authority class is too high. (IIWC Ex. 1.0, pp. 76-77.) First, Mr. Gorman asserts that the proposed rate increase for the Large Other Public Authority class is too high. (*Id.*, p. 76.) The proposed revenue for the Large Other Public Authority classification in Zone 1, however, is approximately \$255,000 less than the amount supported by the COSS. (IAWC Ex. 9.00R2 (Herbert Reb.), p. 17.)

Mr. Gorman's other class-specific complaints alleged that the rate increases for the Competitive Industrial and Large Sales for Resale classes were lower than could be supported by

the COSS. (IWC Ex. 1.0, pp. 76-77.) Mr. Herbert responded by explaining that because these two classes have alternative sources of supply to which they could switch if the Company's rates rose too high, competitive pressures require the Company to keep the rates at a certain level. (IAWC Ex. 9.00R2 (Herbert Reb.), p. 16.) Moreover, even with rates lower than could be supported by the COSS, keeping these customer classes on the Company's system directly benefits other ratepayers through those classes' contributions to fixed costs, which remaining classes would otherwise bear. (*Id.*, pp. 16-17.)

As Mr. Herbert explained further, the contract rates have been approved by the Commission. In order to achieve approval, the contract customers and the Company had to demonstrate that a viable alternative supply was available. (IAWC Ex. 9.00SR (Rev.) (Herbert Sur.), p. 10.) The contract customers, MEMJAWA in the large sales for resale class and Saugnet in the competitive industrial class, both have alternative supplies. The cost allocation study shows that the variable cost to produce water (power, chemicals, waste disposal) is approximately \$0.43 per ccf. Each of the contract customers' rates is far in excess of the variable costs, which means these customers are providing a contribution to fixed costs. (*Id.*, pp. 10-11.) Because the competitive rates recover IAWC's incremental cost of service and provide a contribution to fixed costs, if the competitive customers left IAWC's systems, IAWC's other ratepayers would be deprived of the benefit of this contribution to fixed costs. Mr. Gorman's criticism should therefore be rejected. (*Id.*) Thus the Company has shown that the rates for the Competitive Industrial and Large Sales for Resale classes are reasonable.

10. Recovery of Overall Revenue Requirement

Staff's rebuttal testimony rate design originally did not produce Staff's own proposed revenue requirements. (Staff Exs. 8.0, Schedule 8.1R-Total; 12.0; 14.1R; IAWC Ex. 5.00SR

(Grubb Sur.), p. 18.) The Staff’s revised rebuttal filings, however, did establish rate designs that receive the Staff’s revenue requirement. (Staff Exs. 12.OR; 14.ORC.)

Mr. Rukosuev also recommends that should any revenue requirement other than Staff’s proposal be accepted, the Commission should adjust all rate blocks by a uniform percentage to recover the difference. (Staff Ex. 12.0, p. 19.) Staff’s proposal moves the Company’s rate structure farther from cost of service goals, and it should therefore be rejected. The Company proposes that should the Commission choose not to use its revenue requirement, the Commission should nonetheless use the Company’s original rate design and scale it back to match the final accepted revenue requirement. (IAWC Ex. 9.00SR (Rev.) (Herbert Sur.), pp. 1-2.) This proposal will ensure that revenues move towards cost of service goals. (*Id.*, p. 2.) Because the Commission intends to generally move towards cost of service for rate design, the Company’s proposal aligns with the Commission’s intent and should be accepted.

VII. OTHER ISSUES

1. Municipal Rate Comparisons

(a) Background

In testimony filed in this proceeding, witnesses testifying on behalf of Des Plaines, Homer Glen, and Mount Prospect, as well as the AG (together, the “Municipal Witnesses”), expressed concern related to the level of IAWC’s water and sewer rates when compared to the rates charged by certain municipally-owned water and sewer utilities (“MOUs”), in particular those of Des Plaines, Mt. Prospect, New Lenox and Mokena. The thrust of their argument is that IAWC’s rates are unreasonably high because the water or sewer bills of the referenced MOUs reflect rates lower than those of IAWC.

In Docket 07-0507, IAWC presented and the Commission considered the *Analysis Of Water Rates, Fees And Charges For Selected Cities In The Vicinity Of The Chicago Metro*

District Of Illinois-American Water Company (the “Municipal Rate Study”), which examined data from representative MOUs in Downers Grove, Lemont, Woodridge and Wheaton (together, the “Docket 07-0507 Municipalities”). In its review of the Municipal Rate Study, the Commission considered the “fundamental differences” between MOUs and an investor owned utility (“IOU”) like IAWC, including MOUs’ significant tax subsidies and unique sources of revenue and funding for capital projects, the inapplicability of service standard imposed by the Commission on MOUs and the freedom of MOUs from local, state and federal taxes to which IAWC is subject. Docket 07-0507 Order, pp. 31-44. Based on this and other evidence, the Commission found:

...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. (Docket 07-0507 Order, p. 44.)

The Commission rejected the AG’s and Docket 07-0507 Municipalities’ recommendation to reduce the Company’s O&M expense for Chicago Metro because the expense was purportedly higher than the O&M expense of certain MOUs’, and concluded: “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.” (*Id.*, pp. 43-44.)

In this case the Municipal Witnesses have attempted to revisit the Commission’s conclusions in the prior case, suggesting in testimony that comparisons to the rates of certain MOUs in areas adjoining IAWC’s service territories is appropriate. In short, the Municipal

Witnesses have raised the same issues regarding MOU rates that were litigated in the prior case, referring to different representative MOUs as examples. None of the Municipal Witnesses, however, point to any factor related to the MOUs referenced in this proceeding which would in any way alter the Commission's analysis or conclusions in Docket 07-0507. Further, as discussed below, IAWC has performed an updated and expanded analysis, drawing on the findings of the Municipal Rate Study and also reviewing the data from the Des Plaines and Mt. Prospect MOUs that was not available in the prior case. This analysis concludes that the Municipal Witnesses have established no basis to revisit the Commission's conclusions in Docket 07-0507, as the existence of the significant differences between IAWC's cost and rate structure and those of MOUs is again confirmed. As in Docket 07-0507, comparisons of IAWC's rates to those of MOUs are not meaningful for ratemaking purposes

IAWC witness Mr. Uffelman, who was one of the authors of the Municipal Rate Study, performed an extensive review, applying the analysis and conclusions of the Municipal Rate Study in the prior case to the contentions raised by the Municipal Witnesses in this case, information provided by the Municipal Witnesses and the municipalities of Des Plaines and Mt. Prospect in this case. Mr. Uffelman's updated analysis of the comparability of MOUs and IOUs, utilizing the data provided in this case, confirms that there are fundamental differences in the cost and rate structures of MOUs and IOUs, and that the Commission's findings in Docket 07-0507 are correct and should not be revisited. (IAWC Exs. 10.00R (Uffelman Reb.); 10.00SR (Rev.) (Uffelman Sur.)) In fact, Homer Glen witness Mr. Fundich admits that the cost structures of MOUs and IOUs are different, and that MOUs "have the advantage of collecting development impact (tap-on) and capacity expansion fess from developers...[which] allows [MOUs] to not place system expansion costs on the backs of existing users." (HG Ex. 4.0R, p. 8.) As discussed

below, various fundamental differences between MOUs and IOUs, such as IAWC, render rate comparisons unable to support a conclusion that IAWC's rates are unreasonable. Therefore, there is no basis to reexamine the fundamental differences recognized in the Final Order of Docket 07-0507 between MOU and IAWC rates.

The Municipal Witnesses offer no meaningful analysis to support the position that IAWC's rates or costs can be compared to those of MOUs. The Municipal Witnesses assertions of "comparability" are essentially limited to stating the obvious: that IAWC and the referenced MOUs both provide water or sewer utility service. Consistent with longstanding Illinois law and regulatory policy, the Commission should not "afford any appreciable weight or reliance on" a comparison of utility rates or costs to those of entities not shown to be "comparable." *See Central Ill. Light Co., et al.*, Docket Nos. 06-0070, 06-0071, 06-0072 (Cons.) Final Order, p. 27 (May 16, 2007); *see also Antioch Milling Co. v. Public Serv. Co. of N. Ill.*, 4 Ill.2d 200, 210 (1954) (holding that evidence on the rates charged by other utilities should be disregarded where the party proffering the evidence failed to show "that the [utilities'] conditions of service were comparable"); *Citizens Util. Co. of Ill.*, Docket 94-0481, 1995 WL 612576, *7 (Sept. 13, 1995) (declining to rely on a depreciation study where evidence demonstrated how non-comparable the utility at issue was to other water and sewer utilities). As explained below, IAWC's evidence shows (confirming the Commission's findings on Docket 07-0507) that there are significant differences between the rate and cost structures of MOUs and those of IAWC which render comparisons meaningless. Accordingly, there is no basis to revisit the findings made on this issue in Docket 07-0507. (IAWC Ex. 10.00SR (Rev.) (Uffelman Sur.), p. 2.)

(b) Concerns Regarding Municipal Rate Comparisons Were Rejected by the Commission in Docket 07-0507

The concerns expressed by the Municipalities and AG have been raised in recent prior proceedings before the Commission. In the Order in Docket 05-0681 (06-0094, and 06-0095 Cons.), the Commission expressed concern that the rates of IAWC may not be just and reasonable based on a comparison of those rates to the rates of certain surrounding municipalities. To address this concern, the Commission directed the issue be considered in IAWC's next rate case. Accordingly, the Commission considered the issue in Docket 07-0507, in which the Company submitted the Municipal Rate Study. (Docket 07-0507 Order, pp. 31-44; IAWC Ex. 10.00R (Uffelman Reb.), p. 2.)

The Municipal Rate Study concluded, among other things, that the cost structures on which the rates of IOUs are based differ from those of MOUs. Docket 07-0507 Order, p. 44. It further concluded that a comparison of relative rates between the two could not support the conclusion that IAWC's rates were unreasonable. (*Id.*; IAWC Ex. 10.00R (Uffelman Reb.), p. 4.) On the basis of the record in that case, the Commission determined 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." Docket 07-0507 Order, p. 44. Lastly, as Staff in that case pointed out, the Commission sets rates based on the cost of service, not by a comparison of rates. (Docket 07-0507 Order, p. 43; IAWC Ex. 10.00R (Uffelman Reb.), p. 5.)

As discussed below, Mr. Uffelman explains that, based on a review of information from MOUs like Des Plaines and Mt. Prospect, the differences in conditions identified in the Municipal Rate Study are further confirmed. Thus, as in Docket 07-0507, a comparison of

IAWC's costs and/or rates to those of MOUs cannot support a conclusion that IAWC's costs or rates are unreasonable.

(c) There Are Numerous Cost Structure and Rate Setting Differences between MOUs and IOUs

(i) Rate Setting and Regulation

As the testimony provided by Mr. Uffelman explains, authority over regulation of rates and rate design of water and sewer utilities differs depending on whether the utility is an IOU or an MOU. (IAWC Ex. 10.00R (Uffelman Reb.), pp. 5-6.) Generally, the rates of IOUs are regulated by the state public utility commissions ("PUC"), while the rates for most MOUs are established by their owners (i.e., self-regulated by municipal boards, councils, commissions, water districts, etc.). State PUCs have long relied on the cost of service ("COS") standard, also referred to as the revenue requirements method, for establishing just and reasonable utility rates. Not only does the approach to setting rates vary by type of utility ownership, but the degree or extent of regulation including cost recovery, varies greatly depending on whether the utility is an IOU or an MOU. The absolute flexibility in establishing rates enjoyed by MOUs allowed them to execute rate increases at their discretion, while IAWC must engage in lengthy regulatory processes. (*Id.*) For example, as the testimony of Mr. Uffelman noted, the Management's Discussion and Analysis section of the Des Plaines 2008 comprehensive Annual Financial Municipal Rate Study ("CAFR") states the following: "Increase/Decrease in City-Approved Rates – while certain tax rates are set by statute, the City Council has significant authority to impose and periodically increase/decrease rates (property taxes, water, sewer, impact fees, building fees, home rule sales tax, prepared food tax, etc.)." (*Id.*)

(ii) Shared Resource Subsidization

MOUs operate their water and sewer systems on a cash needs basis, but because MOU costs are accounted for in an Enterprise Fund, the MOUs allocate certain costs, including operation and maintenance (“O&M”) and administration costs, through inter-departmental charges to the General Fund. (IAWC Ex 10.00R (Uffelman Reb.), pp. 7-8.) Unless municipalities prepare and regularly update indirect cost allocation studies or plans for allocating shared costs for personnel, equipment (e.g., vehicles, computer hardware and software systems) and facilities (e.g., municipal office buildings and parking lots and or garages) incurred by the General Fund to the Enterprise Fund, costs incurred by the water and sewer systems may be understated. As stated in the Municipal Rate Study (Docket 07-0507, Final Order pp. 41, 44), understatement of shared resource utilization and costs by as much as 20% may result in lower MOU rates that do not reflect the true, or fully allocated, cost of providing the municipal utility services, thus providing a cross subsidy to the municipal utility customers. (*Id.*, p. 9.)

(iii) Disparate Taxation

MOUs also enjoy tax advantages, not available to IOUs. As discussed by Mr. Uffelman (and in the Municipal Rate Study, Docket 07-0507 Order, p. 44), IOUs are responsible for paying taxes to local, state, and federal authorities. These taxes may include property and franchise taxes paid to local authorities; gross receipts, income, capital stock, and franchise taxes paid to state authorities; and income taxes and payroll taxes paid to the federal government. MOUs are not normally subject to taxation by local, state, or federal governments. (IAWC Ex. 10.00R (Uffelman Reb.), p. 9.)

Additionally, as Mr. Uffelman stated in his testimony, since IOUs pay taxes that MOUs do not, there are administrative costs that IOUs incur that MOUs do not. (*Id.*, pp. 8-9.) For example, IOUs pay property taxes based on the assessed value of utility property. Therefore, for

IOUs, detailed property records establishing the book value of utility plant investment must be maintained for multiple municipalities, since each taxing body has its own individual tax rates. MOUs have no such requirements and therefore do not incur the same level of administrative costs that must be recovered through IOU rates.

(iv) Surcharges for Non-Residents

MOUs often include a surcharge for water sold to customers outside the geographic limits of the municipality. Imposition of non-resident surcharges is a common practice of MOUs. (IAWC Ex. 10.00R (Uffelman Reb.), p. 10.) For example, information posted on the City of Des Plaines' website under "Utility Billing" states: "The water rate currently is \$3.228 per hundred cubic feet and a minimum charge of \$16.14 for 500 cubic feet or less for usage inside city limits. For outside city limits the new rate is \$6.456 per hundred cubic feet and a minimum charge of \$32.28 for 500 cubic feet or less." IAWC, unlike Des Plaines which charges customers outside the city 100% more for the same service, serves all of its customers, including Chicago-Metro District customers, without the imposition of surcharges based on residency status.

(v) Plant Funding Mechanisms

As discussed by Mr. Uffelman (and in the Municipal Rate Study, Docket 07-0507 Order, p. 37-42, 44), utilities are very capital-intensive and require huge investments in plant and other infrastructure to provide utility services. (IAWC Ex. 10.00R (Uffelman Reb.), p. 11.) Utility assets typically have long service lives and require capital funding over long periods of time. Once plant is placed in service, the fixed costs associated with funding and recovery of such investment are embedded in rates for many years and the utility has little control over a major portion of its revenue requirements and resulting service rates. (*Id.*)

In some cases developers are required to share in the cost of providing infrastructure or to make up-front payments for plant investment. State PUCs have adopted rules concerning advances for construction or contributions in aid of construction (“CIAC”) for the extension of services and other infrastructure by regulated IOUs. Up-front payments may be recorded as either CIAC or advances for construction, depending on the PUC’s policies, practices and accounting instructions. (*Id.*, pp. 11-12.) The tax implications, if any, of developer contributions must be addressed by IOUs. The authority to review these issues rests with the PUC having regulatory jurisdiction over the IOU. (*Id.*)

Most MOUs are self-regulated and typically require the developer to construct all facilities to specification and contribute those facilities to the MOU. (IAWC Ex. 10.00R (Uffelman Reb.), p. 12.) MOUs typically have a larger portion of their plant investment contributed by developers than do IOUs. In addition to developer contributions, MOUs also benefit from charging connection fees, sharing facilities and resources with other municipal departments, and from receiving grants. MOUs, therefore, have to raise less capital to fund plant investment than do regulated IOUs, which results in lower debt service requirements and lower revenue requirements.

IOUs, however, have to finance a larger portion of their plant investment, resulting in additional revenue requirements due to higher levels of depreciation expense and the additional return requirement, both debt and equity, resulting from a larger capital structure required to finance non-contributed plant. (*Id.*) The additional common equity return would also result in a higher income tax expense component required to be included in the IOU’s rates.

Ultimately, MOUs lower debt service requirements are achievable by shifting the costs to the homeowner in other areas. For example, a developer may include the contributions to the

MOU in the price of a lot or a home and the purchaser of the lot or home ends up financing the plant contributed by the developer to the MOU as part of their mortgage. (IAWC Ex. 10.00R (Uffelman Reb.), pp. 12-13.) The Mount Prospect Water and Sewer Rate Calculation for 2010 Budget Year, shows no amounts for debt servicing. (IAWC Ex. 10.00SR (Rev.) (Uffelman Sur.), p. 21.) This can easily be interpreted as a practical example of the above factors (developer contributed property, cost shifting to homebuyers, grants, cash needs accounting, and shared infrastructure/subsidy from other governmental bodies) working to hide the actual cost of service, keeping rates low. (*Id.*)

MOUs utilize plant contribution mechanisms for funding plants, and typically establish water connection and tap fees to generate additional revenues for capital improvement projects, or use grants and/or state low interest loan programs to expand their systems and facilities. (IAWC Ex. 10.00R (Uffelman Reb.), p. 14.) For example, the Statement Of Revenues, Expenses, And Changes In Net Assets for the Water/Sewer Enterprise Funds in the City of Des Plaines 2008 CAFR reflects an intergovernmental amount of \$153,853 related to Operating Grants and Contributions. (*Id.*) These funds are classified as water/sewer operating revenues and presented as offsetting (subsidizing) operating expenses including capital outlays. In certain cases, connection fee revenues are also used by the MOUs to cover ongoing operating costs, thus creating a need for future customers to fund capital projects. (*Id.*)

Under applicable regulations IAWC also funds a portion of its plant investment with contributions. However, the per customer level of plant cost reflected in rates for the MOUs is substantially below the level of plant cost which IAWC is required to support in rates. The ability to collect revenue through fees and other capital funding measures unavailable to IAWC therefore helps MOUs keep rates lower than IAWC. (*Id.*)

(vi) Other Tax Subsidies for MOUs

MOUs also enjoy direct tax subsidies. For example, the DuPage Water Commission (“DWC”) is directly subsidized by a district-wide sales tax of 0.25% imposed throughout DuPage County. (IAWC Ex. 10.00R (Uffelman Reb.), p. 15.) As Mr. Uffelman explains, MOU customers of Des Plaines and Mount Prospect benefit from subsidies related to the purchase of Lake Michigan water. (*Id.*, p. 16.) Mount Prospect’s Water and Sewer Fund also received “special service area taxes” in the amount of \$1.5 million, and 228,633 in “other revenue,” consisting of tap-on fees, late fees and interest income during 2008. Without this tax subsidy, the Mt. Prospect would have to increase water and sewer rates by approximately 20%. (IAWC Ex. 10.00SR (Rev.) (Uffelman Sur.), p. 20.) MOU customers of Mount Prospect also benefit from the subsidies (direct payments by the Village) related to the purchase of water through the Northwest Suburban Municipal Joint Action Water Agency (“JAWA”). (*Id.*, p. 19.)

In Des Plaines, the proceeds from a Motor Fuel Tax are used to fund utility-related street repairs. (Tr. 619-22.) As Des Plaines witness Mr. Duddles explained, when Des Plaines performs work on a water main in its utility system, as part of the project the City has to dig up the street. (Tr. 622.) Work to repair or improve the water main itself is funded by the City’s Water Enterprise Fund. (*Id.*) As part of the project, however, street repair or rehabilitation is required once the water main work is done. This street repair or rehabilitation part of the project is funded by the Motor Fuel Tax (Tr. 622; IAWC Cross Ex. 2), and, as Mr. Duddles admits, such street repairs would be the responsibility of IAWC for work that it does on its utility system in Des Plaines. (Tr. 619.) The use of Motor Fuel Tax revenues to fund street repairs associated with MOU water and sewer services represents a funding source not available to an IOU, such as IAWC. (IAWC Ex. 10.00SR (Rev.) (Uffelman Sur.), p. 13.) This represents a difference between Des Plaines’ MOU cost structure and that of IAWC. Moreover, these subsidies

supporting the DWC, Mount Prospect and Des Plaines MOUs are cost components that are not reflected in the water bills of the residents subjected to that tax. (IAWC Ex. 10.00R (Uffelman Reb.), p. 15.)

(vii) MOUs Are Increasing Rates As Well

MOUs are presently increasing rates as well. For example, the City of Joliet, in its Department of Public Utilities 2009 Business Plan for its 2009 Water and Sewer operations, states that: operations costs are increasing; capital investments are required for EPA mandates and aging infrastructure; current rates are lowest in the area but the gaming revenue subsidy and tap-on fee revenues have dropped; proposed rate changes comparable to the region need to cover operations and capital requirements, and fee schedules need to reflect cost of service. According to the 2009 Business Plan, the Joliet City Manager recommendation is to: eliminate daily rebates and sewer separation rebates effective October 1, 2009; increase water and sewer rates by 35% also on October 1, 2009; increase fees and penalties to cover costs; and implement 5% annual water and sewer rate increases on October 1, 2010 and October 1, 2011. (IAWC Ex. 10.00R (Uffelman Reb.), pp. 17-18.) Therefore, the comparison rates referenced by the Municipal Witnesses may soon increase as well, further undermining the rate comparison offered in this case.

Disclosures from Mount Prospect in its 2005 Water & Sewer Rate Study indicate that Mount Prospect's rates were not covering its cost of providing water and sewer services, and even though capital project completion dates and budgets were being adjusted, Mt. Prospect still needed to implement double digit rate increases and institute a new monthly customer services fee. Further, the 2007 and 2008 studies show planned annual increases through 2015. (IAWC Ex. 10.00SR (Rev.) (Uffelman Sur.), p. 19.)

It is interesting to note that at the same time as Mount Prospect is recommending that the Commission reject IAWC's proposed rate increase, as it would impose an economic burden upon a large segment of its residents and businesses, the Village has no problem raising its own utility and tax rates on the same residents and businesses.

(d) Homer Glen Witness Mr. Fundich's "Alternative" Approach To Municipal Rate Comparisons Is Unavailing

Homer Glen witness Mr. Fundich offered various concerns about the present rate case, calling for a reconsideration of MOU and IOU rate comparisons. (HG Ex. 4.0R, pp. 8-12.) Apart from the fact that Mr. Fundich has offered no testimony to establish the appropriateness of such comparisons, as discussed below, it is important to note several problems with the foundation of his testimony. Mr. Fundich admits he is unfamiliar with the evidence presented in Docket 07-0507, which thoroughly addressed the issue he raises, and in which the Commission reached conclusions contrary to his current position, as noted above. ((HG Ex. 4.0R, p. 8; IAWC Ex. 10.00SR (Rev.) (Uffelman Sur.), p. 2.) Additionally, Mr. Fundich has no expertise, licenses or certifications in accounting or finance, sufficient to give him a grounding in the cost structures of IAWC or MOUs. (IAWC-HG Joint Ex., pp. 20-21, Responses to IAWC-HG 4.04, 4.05.) These gaps in his foundational knowledge of the relevant issues cast serious doubt on the value of his testimony in the present case.

In his testimony Mr. Fundich asserts that "revisiting a comparison to municipal rates is appropriate." (HG Ex. 4.0R, p. 8.) This assertion is unfounded given the material differences of the respective cost structures of MOUs and IAWC. Mr. Fundich points to no changed factor related to the MOUs referenced in this proceeding which would affect the Commission's analysis or conclusions reached in Docket 07-0507. In fact, Mr. Fundich admits "that the cost structure of MOU rates is different from private water company rates." (*Id.*) As Mr. Uffelman

noted in his testimony, the Commission found that the record in Docket 07-0507 (Order, p. 45), that such comparisons were “not practical for rate making purposes.” There has been no change of circumstances that would remove or change any of the differences addressed in the Municipal Rate Study, or support a change in the Commission’s conclusion that comparisons of the rates and cost structures of an IOU and MOUs do not support a conclusion that the rates of the IOU, such as IAWC, are unreasonable. (IAWC Ex. 10.00SR (Rev.) (Uffelman Sur.), p. 4.)

Mr. Fundich claims that comparisons of the levels of rate increases of New Lenox, Mokena and those of IAWC should be considered. (HG Ex. 4.0R, p. 10.) His assertion that it is appropriate to compare the level of increase of IAWC’s rates to the level of increase in MOU’s rates should be disregarded because, just as there is no basis for comparison of rates of the referenced MOUs to those of IAWC, there is no basis to compare levels of rate increases. (IAWC Ex. 10.00SR (Rev.) (Uffelman Sur), p. 7-8.)

Moreover, Mr. Fundich’s own numbers indicate that the MOU water and sewer rates increased at a faster rate than IAWC’s during the period 2005 through 2009. The increase of \$19.39 in IAWC’s water and sewer rates from 2005 to 2009 as provided by Mr. Fundich represents an increase of 16.56% compared to the MOU average rate increase of 32.45% for the same time period as is utilized by Mr. Fundich. (IAWC Ex. 10.00SR (Rev.) (Uffelman Sur.), p. 8.) As Mr. Fundich has not established any basis for his theory that differing levels of rate increases over time provide a basis for comparison between IAWC’s rates and those of MOUs, his testimony should be disregarded.

Mr. Fundich’s testimony is based solely on his comparison of the water and sewer rates of the Villages of Mokena and New Lenox to the water and sewer rates of IAWC applicable to providing service to customers in Homer Glen. Mr. Fundich’s testimony and discovery

responses, however, indicates that he has established no basis for comparison of the rates or cost structures of IAWC and the MOUs. Specifically, Mr. Fundich admits that he does not possess knowledge of whether or not the MOUs utilize property or other tax collections to offset water and sewer services, and that he performed no analysis of the comparability of the systems, facilities, and operating practices of the MOUs and that no documents were relied upon in providing testimony related to comparing IAWC rates with Mokena and New Lenox rates. (IAWC-HG Joint Ex., p. 24, Response to IAWC-HG 4.27.) Further, Mr. Fundich admits that he did not study the service area, operations, accounting, or financing of the MOUs or IAWC, nor does he contend that these factors are nearly identical for the MOUs and IAWC. (IAWC-HG Joint Ex., p. 27, Response to IAWC-HG 4.36; IAWC Ex. 10.00SR (Rev.) (Uffelman Sur.), pp. 3-4.) Other than his testimony, Mr. Fundich did not conduct any studies relating to water and sewer costs or services, operational and supply costs, and any other aspects of the water and wastewater services in Mokena, New Lenox, and Homer Glen. Mr. Fundich also provided no cost of service studies or any other information related to the comparability of the Mokena and New Lenox systems to IAWC (other than the rate comparisons presented in his testimony) (IAWC-HG Joint Ex., p. 22, Response to IAWC-HG 4.24).

Mr. Fundich does not, therefore, demonstrate comparability of the respective systems, thus rendering his comparisons meaningless. *See Central Ill. Light Co., et al.*, Docket Nos. 06-0070, 06-0071, 06-0072 (Cons.) Final Order, p. 27 (May 16, 2007) (evidence comparing rates of one utility system to another must be supported by showing of comparability of systems). *See also Antioch Milling Co. v. Public Serv. Co. of N. Ill.*, 4 Ill.2d at 210. Accordingly, Mr. Fundich establishes no basis to revisit the findings made in Docket 07-0507. (IAWC Ex. 10.00SR (Rev.) (Uffelman Sur.), p. 2.) Moreover, Mr. Fundich provided no analysis evaluating the

reasonableness of any specific cost incurred by IAWC in providing water and or sewer service in Homer Glen or elsewhere. Therefore, Mr. Fundich has no basis to conclude that any such cost is excessive or unreasonable.

None of the Municipal Witnesses purported to offer expert testimony on the subject of the reasonableness of the IAWC's rates, nor the appropriateness of a comparison between MOU and IOU rates. They identified themselves only as "policy witnesses". (DP Ex. 01, p. 1; DP Ex. 02, p. 1; MP Ex. 1.0, p. 1; HG Ex. 2.0, p. 1.) None of the witnesses provided any substantive analysis in their testimony as to the comparability of the MOU systems, facilities, service areas or operating practices to those of IAWC. Nor did they provide any substantive analysis in their testimony as to the comparability of the applicable regulatory and service standards. (IAWC Ex. 10.00R (Uffelman Reb.), pp. 19-20.) Further, none of the witnesses purported to challenge the findings of the Commission or the Municipal Rate Study in the prior rate case, Docket 07-0507. The Municipal Witnesses have failed to account for cost and rate structure differences between IAWC and MOUs in their analyses, rendering their comparisons meaningless.

As Ms. Teasley testifies, IAWC is aware of the comparative rate differences with rates of certain MOU's, but cannot address the concerns by proposing rates to match those of entities which have an entirely different cost and accounting structure as compared to IAWC. IAWC does, however, recognize customer concerns, and has responded with extensive measures to control its costs and rates. (IAWC Ex. 1.00R (Teasley Reb.), p. 5.) These measures are discussed in detail in Sections I and III, above.

2. Pension / OPEB Accounting Proposal in Docket 09-0400

As Mr. Grubb explained (IAWC Ex. 5.00 (Rev.) (Grubb Dir.), p. 29), in accord with the ratemaking treatment of pension and other-post retirement benefit ("OPEBs") costs approved by the Commission in past proceedings, IAWC has proposed recovery in rates as operating

expenses of the accrued levels of these costs under the applicable accounting rules. These rules are Financial Accounting Board Statement No. 87 (“FAS 87”) in the case of pension expense and Financial Accounting Board Statement No. 106 (“FAS 106”) in the case of OPEB. The proposed rate recovery for these costs is based on actuarial studies that determine each respective cost. No witness in this proceeding had opposed IAWC’s recovery of the accrued levels of pension and OPEB costs as initially proposed by IAWC.

Due to market conditions, however, the level of pension/OPEB cost increased significantly, commencing in 2009, from the level for the prior year. Based on the changed level and significant fluctuation of these costs, IAWC filed with the Commission a Petition in Docket 09-0400 seeking approval for accounting purposes to amortize a portion of the amount of pension and OPEB costs commencing in 2009, with deferral of the unamortized balance. In this regard, IAWC believes that the fluctuating pattern of these expenses is expected to be similar to that of other costs, such as tank painting, that are amortized for rate making purposes. (IAWC Exs. 5.00 (Rev.) (Grubb Dir.), p. 29; 5.00SUPP (Grubb Supp.), pp. 2-6.)

As shown in IAWC Exhibit 5.01SUPP, the Company has reviewed the actual level of pension and OPEB expense determined in accordance with FAS 87 and FAS 106, respectively, from 2000-2008 and the projected level from 2009-2014. (IAWC Ex. 5.00SUPP (Grubb Supp.), p. 4.) This review shows that pension and OPEB expense exhibits a pattern of fluctuation comparable to the pattern for such costs as tank painting. In particular, there is a significant increase in the expense in 2009, but the expense then trends downward through 2014. The Company therefore proposes that, commencing January 1, 2009, the annual amount of pension and OPEB costs above the amount currently reflected in rates (as approved by the Commission in Docket 07-0507) (the “Pension/OPEB Amount”) be amortized over a five year period. (*Id.*)

The Company would begin amortizing the Pension/OPEB Amount over the five year period at the time rates go into effect following this proceeding (expected to be May 2010), with the unamortized balance included in rate base. Thus, beginning in May 2010, the Company would reflect one-fifth of the Pension/OPEB Amounts for 2009 and 2010 as an operating expense and include the unamortized four-fifths balance of these Pension/OPEB Amounts in rate base. (*Id.*) In each succeeding year, the Company would begin amortizing the Pension/OPEB Amount, starting in January of that year, over a five year period, with the unamortized balance included in rate base. If the Commission approves the Company's proposal, IAWC's ratepayers would benefit as a result of a reduction in the revenue requirement in the amount of \$1,061,543 for pension and \$313,241 for OPEB. (*Id.*, p. 5.)

If IAWC's proposal in Docket 09-0400 is approved, IAWC would seek to recover in rates in this proceeding the levels of pension and OPEB cost as shown on IAWC Exhibit 5.02SUPP. This level of cost recovery is consistent with the deferral and amortization proposal discussed in this proceeding by IAWC witness Grubb. If the Commission does not approve the proposal in Docket 09-0400, IAWC will seek recovery of the projected levels of these costs as reflected in the schedules sponsored by IAWC witness Bernsen in the present case. (Schedule C-2; *see also* IAWC Ex. 5.02SUPP.)

3. Service Concerns in Homer Glen

As explained by Ms. Teasley, and as discussed above, IAWC is required to provide adequate efficient and reliable service. As indicated by the testimony of Ms. Norton and Ms. Teasley, in furtherance of the effort to maintain efficient, high quality service IAWC has recently undertaken a number of new programs targeted at improving service and operational efficiencies. (IAWC Ex. 2.00 (Rev.) (Norton Dir.), pp. 3-4.) As discussed by Ms. Teasley, a reliability centered maintenance program that includes reactive, preventative and predictive/condition-

based maintenance is being implemented by IAWC throughout the state. This program will help to ensure that customers receive reliable, efficient service. (IAWC Ex. 1.00 (Teasley Dir.), p. 23.) In addition, in the Chicago Metro District, IAWC is in the process of designing and implementing a Capacity Management Operations Maintenance (“CMOM”) program for IAWC’s wastewater systems. The goal of the program is to improve collection systems performance, reduce sanitary sewer overflows, reduce equipment and operational failures, extend the life of systems and equipment, and provide measures to correct problem areas. (IAWC Ex. 2.00 (Rev.) (Norton Dir.), p. 4.)

Witnesses on behalf of Homer Glen, however, expressed concerns over the quality of services provided by IAWC. As indicated by Ms. Norton, their concerns touch on five points: (1) that leak repairs were not attended to in a timely manner, (2) that water meters were not installed in a timely fashion, (3) that IAWC did not restore rights of way in a timely manner, (4) that IAWC does not comply with local ordinances, and (5) that IAWC does not adequately maintain fire hydrants in Homer Glen. (IAWC Ex. 2.00SR (Norton Sur.), p. 6.) These assertions were made in the direct testimonies of Homer Glen witnesses Mr. Daley and Mr. Schofield, without the benefit of examples or other supporting evidence. (*Id.*, pp. 6-12.)

As Ms. Norton explains, the broad allegations of the Homer Glen witnesses do not support the conclusion that IAWC provides anything less than high quality service. Although the Homer Glen witnesses subsequently provided examples of their alleged concerns in discovery (*see generally*, IAWC/HG Joint Ex. 1), the Company has demonstrated that even in light of these examples, Homer Glen’s concerns are baseless. As will be discussed below, IAWC witness Norton’s testimony showed that Homer Glen’s so-called service quality allegations should be disregarded.

(a) IAWC Repairs Leaks in a Timely Fashion

IAWC seeks to identify and repair leaks in an efficient and timely manner. In some instances, however, a leak cannot be repaired until it is brought to IAWC's attention. As indicated by Ms. Norton, IAWC representatives have been working closely with Homer Glen employees, as well as the Homer Glen Sewer and Water Task Force representatives, to ensure that all issues related to leaks and service concerns are addressed in a timely manner. IAWC has also eliminated several suspected leaks through testing, which indicated the presence of groundwater, not treated drinking water. Further, IAWC takes steps to educate and involve Homer Glen employees and Task Force representatives in leak repair matters. (IAWC Ex. 2.00R (Rev.) (Norton Reb.), pp. 7-8.)

(b) IAWC Appropriately Installs Water Meters in New Construction

Mr. Daley expressed concern over unmetered usage during construction projects, and the possibility that structures within Homer Glen were not being properly metered. IAWC was aware of this concern prior to the current rate case and appropriately responded by revising existing construction water tariffs in late 2008. IAWC also executed a review in 2009 of all known developments built in Homer Glen since 2001, to ensure that all structures were being appropriately metered. A small number of unmetered structures were identified, and occupants of those structures were contacted to apply for service. At structures for which no application for service was received, service was terminated. IAWC continues to work with the Sewer and Water Task Force in an attempt to better control the unauthorized use of unmetered water through occupancy permits. This process will ensure water meters are properly installed. (IWAC Ex. 2.00R (Rev.) (Norton Reb.), pp. 8-9.)

When issued discovery requesting examples of inadequate meter installation, Homer Glen witnesses produced a list of six addresses. In every instance, the addresses were locations where new construction had started prior to implementation of the new tariffs allowing metering of construction water. Further, these locations were identified during the 2009 audit and prior to notification by the Village. In all cases, meters were either installed or water service was terminated until an account was established. (IAWC Ex. 2.00SR (Norton Sur.), p. 8.)

(c) IAWC Will Comply with Homer Glen Ordinances in Connection with Repairs/Maintenance

Homer Glen passed Ordinance 07-0670 in November 2007, under which a permit and fee would be required for all operation and maintenance work within Village limits. As discussed by Ms. Norton, IAWC legal staff reviewed the ordinance, and determined that the operation and maintenance of facilities existing prior to the ordinance were exempt from the permit requirement. (IAWC Ex. 2.00R (Rev.) (Norton Reb.), pp. 9-10.) IAWC has not performed any work that has required this permit. Further, IAWC has indicated its willingness to comply with Ordinance 07-0670, should IAWC perform any work subject to its provisions. (IAWC Ex. 2.00SR (Norton Sur.), p. 9)

(d) IAWC Repairs Rights of Way in a Timely Fashion

Homer Glen's right-of-way ordinance requires right of way restoration to be completed within 10 days of construction. As discussed by Ms. Norton, IAWC acknowledges that there has been one instance where IAWC has failed to meet the 10 day deadline, due to an internal misfiling error. In this instance, restoration was completed as soon as IAWC was notified of the error. As for additional examples offered by Homer Glen, these instances involved residents who were dissatisfied with the type of restoration conducted (seeding). (IAWC Ex. 2.00SR (Norton Sur.), p. 10.) Further, as Ms. Norton indicated, once IAWC became aware of the

residents' dissatisfaction, it dispatched landscapers to re-sod the areas in question. (*Id.*) The examples cited by Homer Glen in fact show that IAWC works diligently to redress customer concerns once it is made aware of any problems.

(e) IAWC Complies with all Requirements Regarding Hydrant Inspection/Maintenance

Homer Glen witness Mr. Schofield made certain unspecified allegations that IAWC's maintenance of hydrants is "not as stated by IAWC," and that the fire department has found unspecified "issues" with hydrants. In discovery, Homer Glen produced a list of certain hydrants, but provided no explanation as to why hydrant maintenance was considered inadequate. (IAWC Ex. 2.00SR (Norton Sur.), p. 13.) IAWC's records indicate that routine annual inspections were conducted and appropriate maintenance was performed at each hydrant indicated by Homer Glen. IAWC is not aware of, and Homer Glen has not provided any, information regarding maintenance concerns at the specified hydrants. (IAWC Ex. 2.00SR (Norton Sur.), pp. 13-14. Consequently, the Commission should disregard Homer Glen's offered testimony on this subject.

(f) Homer Glen Municipal Requirements Increase the Cost of Restoration for IAWC

In his testimony for Homer Glen, Mr. Fundich expressed concerns over the assertion of IAWC witness Ms. Norton that restoration and pavement costs have increased within the Village since the passage of Ordinance 07-0670 (imposing a 10-day deadline to restore rights of way). Mr. Fundich disputed that the date that work is completed could change bottom line cost, asserting that "the amount of asphalt, concrete or grass restoration required to be performed at a particular site, whether such work is performed 10 days, 30 days or 100 days" later has no effect. He further claimed the costs for labor, materials and equipment could not vary based on when such repairs occurred. (HG Ex. 4.0R, pp. 2-3.)

Contrary to the assertions of Mr. Fundich, the timing of repairs and restorations directly affects the ultimate cost of such remedial efforts. As discussed by Ms. Norton, several factors combine to raise costs when short-term deadlines are imposed on restoration efforts. Specifically, Ms. Norton provided figures in her testimony indicating that premium charges assessed on IAWC by landscaping contractors for expedited restorations could lead to cost increases on the order of 100%. (IAWC Ex. 2.00SR (Norton Sur.), p. 11.) In addition, IAWC is able to achieve economies of scale when it can group multiple projects into a single large project. The unit cost of most restoration projects declines substantially as the number of units increase. (*Id.*), p. 12.)

4. Sewage Treatment Planning

AG witness Mr. Rubin expressed concern that IWAC's rates for wastewater treatment services were generally high and recommended: (1) that the Commission should audit IAWC's "wastewater treatment operations, with a particular emphasis on the size and efficiency of the treatment plant," (2) that the Commission "retain an independent consultant at IAWC's expense to conduct a study of the costs, benefits and feasibility of selling its wastewater treatment operation to a municipal wastewater treatment supplier or, alternatively, of retiring the plant and interconnecting with the nearest municipal treatment system." (AG Ex. 2.0, p. 4.) As discussed below, this recommendation should be rejected.

Additionally, Des Plaines witness Mr. Duddles, on behalf of the city of Des Plaines, complained in his testimony that IAWC had not adequately improved sewage services in Des Plaines. (DP Ex. 02, p. 2.) The record demonstrates that Mr. Duddle's concerns are unfounded.

(a) IAWC Conducts Extensive Planning for Wastewater Treatment Operations

Wastewater treatment is very capital-intensive. Depreciation, return on investment, and income taxes account for \$6.8 million of the \$8.8 million in wastewater treatment cost of service.

As noted by Mr. Kaiser, such costs are not uncommon, as “wastewater plants typically have a level of capital investment per gallon of treatment capacity that is considerably higher than potable water.” (IAWC Ex. 3.00R2 (Rev.) (Kaiser Reb.), pp. 1-2.) Contributing to these expenses are regulatory requirements, which increasingly require additional levels of treatment, such as the Nitrogen and Phosphorus removal required at the Oak Valley and Chickasaw WWTPs. (*Id.*, p. 2.) Given the capital intensive nature of wastewater operations, wastewater plant investment is subject to an extensive and comprehensive planning process.

As Mr. Kaiser explained IAWC performs Comprehensive Planning Studies (“CPS”) of each service district on a routine basis. (*Id.*, p. 3.) The focus of a CPS is to determine the patterns of growth or decline in system demands. It provides evaluation of potential growth in demand on a 15-year planning window, evaluation of the capability of existing infrastructure to meet present and projected demand in light of regulatory requirements, and finally it projects necessary improvements to satisfy customer and regulatory demand. Additionally, prior to any major project (including wastewater treatment plant expansion), a separate engineering study focused on that facility is completed to verify the results of the broader CPS. Importantly, this engineering study considers alternatives and determines the appropriate scope of the proposed project. (*Id.*)

IAWC also coordinates with state regulatory authorities by submitting these engineering reports for review and approval by the Chicago Metropolitan Agency on Planning (“CMAP”) and the Illinois Environmental Protection Agency (“IEPA”), prior to any major projects. For example, this process was followed in selecting the size, location and service area of the Oak Valley Wastewater Treatment Plant. (IAWC Ex. 3.00R2 (Rev.) (Kaiser Reb.), p. 3.) Because of the detailed process involved in the selection, design and scope of IAWC’s wastewater treatment

operations, which includes participation and approval by independent state regulators, there is simply no need to impose additional costs on IAWC by conducting a redundant audit, as suggested by Mr. Rubin. (*Id.*, pp. 2-3.)

Mr. Rubin's suggestion of an investigation into possible municipal acquisition of IAWC's wastewater treatment facilities or interconnection with another system is also baseless. Mr. Rubin identifies no municipalities that are willing to, or are able to, take over IAWC's wastewater treatment plant. Moreover, IAWC already engages in comprehensive reviews of alternative sewage treatment options. As discussed by Mr. Kaiser, IAWC reviews a variety of sewage treatment options during its planning process. (*Id.*, p. 3.) Further, the state regulatory agencies who must approve any IAWC sewage treatment plans conduct their own reviews of treatment options. For example, prior to proposing Chickasaw WWTP improvements, IAWC and relevant regulatory agencies examined the facility planning area, population growth projections, alternative treatment processes, and an option to off-load the treatment to another service provider. CMAP approved the project and agreed with IAWC that "treatment at the nearest publicly owned treatment plant was . . . not feasible." (*Id.*, p. 3-5.) In another example, IAWC is currently evaluating improvements to the Valley Marina WRF, including the possibility of off-loading treatment to the Fox River Water Reclamation District, rather than expanding that facility. Thus, because the Company's planning process and the regulatory approval review already address Mr. Rubin's concerns, his recommendation is unnecessary. (*Id.*, p. 5.)

(b) The Concerns of Des Plaines Witness Duddles are Unwarranted

Mr. Duddles, on behalf of the city of Des Plaines, testified that no significant capital improvements have been made in Des Plaines in the last several years and that the current filing does not include any anticipated improvements to the city's sewage system to alleviate annual

overflows. (DP Ex. 02, p. 2.) As Mr. Kaiser testified, however IAWC is actively engaged in sewer improvement projects in Des Plaines. Specifically, IAWC has recently bid out a sewer improvement project covering the Des Plaines service area, at an anticipated investment of approximately \$900,000. (IAWC Ex. 3.00R2 (Rev.) (Kaiser Reb.), p. 7.) IAWC is also in the process of developing construction plans for an additional project, estimated to cost up to \$2 million to improve the same system. These improvement projects include manhole and sewer waterproofing and rehabilitation, sewer lining, and replacement of sanitary sewer mains to reduce storm water infiltration and inflow, alleviate sewer surcharging, and reduce the potential for sewer overflows. Consequently, Mr. Duddle's concerns are unwarranted. (*Id.*)

VIII. CONCLUSION

For the reasons set forth above, the Company requests the Commission approve the rate increases for each of the Rate Areas as set forth in Appendix A.

Dated: January 7, 2010

Respectfully submitted,

ILLINOIS-AMERICAN WATER
COMPANY

By: /s/ Albert D. Sturtevant

One of its attorneys

Christopher W. Flynn

Albert D. Sturtevant

Niloy Ray

JONES DAY

77 West Wacker Drive

Chicago, IL 60601-1692

Telephone: (312) 782-3939

Facsimile: (312) 782-8585

cwflynn@jonesday.com

adsturtevant@jonesday.com

nray@jonesday.com

John J. Reichart

Joni K. Ott

Illinois-American Water Company

727 Craig Road

St. Louis, MO 63141

314-996-2287

John.Reichart@amwater.com

Joni.Ott@amwater.com

Boyd J. Springer

PO Box 3007

Glenview, IL 60025

bjspringer@sbcglobal.net

CHI-1736341