



## TABLE OF CONTENTS

	Page
I. Introduction.....	1
II. Rate Base .....	5
A. Resolved Issues.....	5
B. Contested Issues.....	5
1. Cash Working Capital.....	5
2. Business Systems Planning Study .....	14
C. Proposed Rate Base.....	16
III. Operating Revenues and Expenses .....	16
A. Resolved Issues.....	16
B. Contested Issues.....	16
1. Residential Sales Volumes and Revenues .....	16
2. Commercial Sales Volumes and Revenues.....	16
3. Industrial Sales Volumes and Revenues .....	16
4. General Inflation Adjustment for Non-labor O&M Expenses.....	18
5. Prior Rate Case Expense.....	19
6. Current Rate Case Expense.....	26
7. Purchased Power and Fuel Expense .....	32
8. Chemicals Expense .....	36
9. Insurance Other Than Group Expense .....	37
10. Management Fees .....	37
11. Gross Revenue Conversion Factor Adjustment.....	58
C. Proposed Operating Income & Revenue Requirement.....	59
IV. Cost of Capital & Rate of Return.....	60
A. Capital Structure .....	60
1. IAWC's Short-term Debt Ratio Is Appropriate .....	60
2. IAWC's Common Equity Ratio Is Appropriate.....	62
B. Cost of Debt .....	65
1. Short Term Debt .....	65
2. Long Term Debt.....	66
C. Cost of Common Equity .....	66
1. Adjustments to Proposals of IAWC and Staff are Necessary .....	67

## TABLE OF CONTENTS

(continued)

	<b>Page</b>
2. Adjustments for Financial and Business Risk .....	69
3. Financial Risk Adjustment.....	72
4. Response to AG and CUB Proposed Return on Common Equity .....	75
V. Cost of Service.....	77
A. Demand Study.....	77
1. The Capacity Factors Report Was Prepared in Accordance with the Commission-Approved Methodology for an Indirect Demand Study .....	77
2. The Use of Chicago Metro Data Is Appropriate and Beneficial.....	78
3. Non-residential Class Variation Factors Were Developed Appropriately .....	81
4. The Capacity Factor Report’s Maximum Hour Capacity Factors Are Appropriate .....	84
5. Staff’s Recommendation that the Commission Not Accept IAWC’s Capacity Factors Should Be Rejected.....	84
6. Staff’s Recommendation that IAWC Perform a Direct Measurement Demand Study Should Be Rejected .....	85
B. Cost-of-Service Study.....	89
VI. Rate Design & Tariff Terms And Conditions.....	93
A. Resolved Issues.....	93
1. Public Fire Charges by Meter Size – Chicago Metro .....	93
B. Contested Issues.....	94
1. Proposed Customer Charge.....	94
2. Single Block Residential Rate Structure.....	97
3. Multi-unit Residential Building Classification .....	98
4. Across-the-board Adjustment .....	98
5. Recovery of Uncollectible Accounts Expense.....	99
6. Chicago Metro Sewer Rate Increase.....	99
7. Public Fire Service Revenue Recovery – Zone 1 .....	100
8. Private Fire Charge .....	101
9. Rates for the Competitive Industrial, Large Sales for Resale and Large Other Public Authority Classes .....	101

**TABLE OF CONTENTS**  
(continued)

		<b>Page</b>
	10. Recovery of Overall Revenue Requirement .....	102
VII.	Other Issues.....	102
	1. The Suggestion by the Municipalities, AG and Bolingbrook that the Commission Compare IAWC's Rates to MOU Rates Should Be Rejected .....	102
	2. Pension / OPEB Accounting Proposal in Docket 09-0400.....	105
	3. The AG and Municipalities' Proposal For an Audit of IAWC's Sewage Treatment Operations Should Be Rejected .....	106
	4. The Municipalities' Recommendation Regarding the QIP Rider Should Be Rejected.....	109
	5. The Municipalities' Recommendation for an Investigation into IAWC's Promotional Practices Should be Rejected.....	110
VIII.	CONCLUSION.....	113

## I. INTRODUCTION

The Initial Briefs filed by Office of the Illinois Attorney General (“AG”), the Cities of Champaign and Urbana along with the Villages of Homer Glen, St. Joseph, Sidney and Savoy (the “Municipalities”), and the Village of Bolingbrook (“Bolingbrook”) assert that IAWC’s proposed water and sewer rates are higher than the rates charged by certain municipally-owned utility systems (“MOUs”). The AG, in particular, cites unsworn statements of certain attendees at public forums regarding rate levels.

As Ms. Teasley explained, Illinois-American Water Company (“IAWC” or “Company”) understands the concerns expressed with regard to the rates of MOUs, 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. 5.) 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 between 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 support the conclusion that comparisons of IAWC’s rates to those of MOUs are not practical for ratemaking purposes.” *Illinois-American Water Co.*, Docket 07-0507, Final Order, p. 44. (“Docket 07-0507 Order”). The Docket 07-0507 Order noted that the Commission establishes water and sewer rates based upon cost of service, not upon a comparison of adjacent or regional utility rates to those of the regulated utility. (*Id.*, p. 43.) In this proceeding, IAWC updated the analysis of the Municipal Rate Study and further demonstrated that comparisons of IAWC’s rates to those of MOUs do not support a conclusion that IAWC’s rates are unreasonable.

In addition, as discussed in IAWC's Initial Brief (pp. 1-2), IAWC cannot address concerns with regard to rate levels by proposing rates insufficient to cover the costs incurred by IAWC 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 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.) 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 discussed in IAWC's Initial Brief (pp. 2-4), IAWC has put in place extensive measures to assure that costs and rate levels are minimized.

Moreover, the Initial Briefs of AG, the Municipalities, Bolingbrook and the Illinois Industrial Water Consumers ("IWC") suggest unfamiliarity with the record in this proceeding and IAWC's proposed test year level of expenses. AG claims that IAWC's revenue deficiency in this case is \$60,519,567, when in fact, as the record makes clear, IAWC's requested revenue increase, as set forth in its surrebuttal evidence, reflects a number of adjustments made in the

course of this proceeding and is \$50,008,924. (IAWC Init. Br., App. A; IAWC Ex. 6.01SR.) Similarly, the Municipalities incorrectly state that IAWC's requested revenue increase is "\$61 million." (Muni. Init. Br., p. 4.) As a result, both the AG and the Municipalities overstate the amount of rate increases that IAWC's customers would experience if the increase proposed by IAWC is approved in full. Other errors in the Initial Briefs of AG, the Municipalities, IWC and Bolingbrook include:

- AG asserts that IAWC increased certain non-labor expenses by an inflation factor of 2.5%. (AG Init. Br., p. 29.) In fact, IAWC is proposing a non-labor inflation factor of 1.7%. (IAWC Init. Br., p. 33.)
- AG asserts that IAWC failed to remove the effect of uncollectible expense from the cash working capital calculation. (AG Init. Br., p. 15.) In fact, as IAWC explained in its Initial Brief (p. 12), AG/Joint Municipality ("AG/JM") witness 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.)
- In challenging IAWC's projection of fuel and power expense, IWC, as explained in Section III.B.7 below, does not refer to IAWC's current projection of test year purchased power expense, but to an outdated projection.
- The Municipalities state that, "IAWC's residential class for the (sic) Chicago Metro contains not only single-family homes and apartments but also large apartment and condominium complexes. If the declining block is eliminated, then those customers will see their bills increase even though their usage has not changed." (Muni. Init. Br., p. 20.) In fact, IAWC's Chicago Metro District already has a single block rate structure for the residential customer class, not a declining block structure. (IAWC Init. Br., p. 143.)
- Bolingbrook confuses the Self Provision Study and Customer Accounts Analysis. (Bol. Init. Br., pp. 7-8.) The Customer Accounts analysis is a component of the SCCS that looks specifically at customer service related costs, while the Self Provision Study is a separate study that compares the cost incurred by IAWC in obtaining certain services from the Service Company to the market cost that IAWC would incur if it were to itself retain the personnel needed to provide these services on a stand-alone basis. (IAWC Init. Br., pp. 59-60.)

AG also makes a number of proposals that are not supported by the testimony of any witness. For example, the AG (Init. Br., pp. 34-39.) recommends disallowing recovery of the entire unamortized balance of allowed prior rate case expense, despite the Commission's

decision in Docket 07-0507 to allow recovery of that balance over a period of years. No witness in this proceeding made such a recommendation. Similarly, AG proposes that IAWC's test year level of management fee expense be set at the level of management fees approved in the prior case, Docket 07-0507. No witness in this proceeding recommended that IAWC's test year level of management fee expense be set at the level approved in the prior case. In addition, the AG in some instances ignores the recommendation of its own witness, Mr. Smith. AG recommends (Init. Br., p. 42.) disallowance of the entire amount of the Service Company Cost Study ("SCCS"). This position disregards the testimony of Mr. Smith, who recommends instead that the allowed cost of the SCCS be limited to \$366,000. (AG/JM Exs. 1.0 (Smith), pp. 44-45; 5.0 (Smith Reb), p. 43.) Likewise, AG recommends use of the rate of return on equity of 7.44% proposed by Citizens Utility Board ("CUB") witness Mr. Thomas. (AG Init. Br., p. 49.) AG/JM witness Smith, however, recommends a 10.19% return on equity. (AG/JM Exs. 5.0, p. 16; 5.1, Schedule D.)

In their Initial Briefs, the AG, Bolingbrook and Municipalities also question the level of test year management fees proposed by IAWC. As discussed below, IAWC has presented extensive evidence regarding: the cost that IAWC would incur to provide all services through its own employees on a stand alone basis as compared to the cost that IAWC incurs to procure certain services from outside affiliate or non-affiliate providers; each service expected to be provided by the Service Company; the cost that IAWC expects to incur for the 2010 test year in procuring services from the Service Company as compared to the cost that IAWC would incur to procure the services from a non-affiliate provider at open market price levels that would be obtained through competitive bidding; the allocation of Service Company costs to regulated and non-regulated affiliates of American Water; and the drivers of increases in management fees

since the prior case. AG, Bolingbrook and the Municipalities' response to this information is to argue that the requested test year level of management fees is "too high," despite the fact that no witness in this proceeding contested the need for any given service, contended that the projected cost of any required service is inaccurate or asserted that the Service Company is not the least cost source of the service. The AG, Bolingbrook, and Municipalities' positions amount to nothing more than substitution of an arbitrary lower amount for prudent and necessary projected cost levels supported by detailed evidence. As 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, the proposals of AG, Bolingbrook, and the Municipalities should be rejected. *Peoples Gas Light & Coke Co. v. Slattery*, 373 Ill. 31, 25 N.E.2d 482, 497 (1940).

## **II. RATE BASE**

### **A. Resolved Issues**

Except with respect to the comprehensive planning study discussed at Section II.B.2 below, the resolved Rate Base issues remain as set forth in IAWC's Initial Brief.

### **B. Contested Issues**

#### **1. Cash Working Capital**

#### **Response to AG, IAWC and Municipalities**

In the present case, IAWC (Init. Br., pp. 24-33.) and AG (Init. Br., pp. 13-19.) recommend adjustments to cash working capital, based on assertions that: (i) 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) IAWC's prepayment of Service Company fees is unreasonable and should not be reflected in the cash working capital amount. The Municipalities also assert that IAWC should not be permitted to prepay the Service Company for services (Muni. Init. Br., p. 15.) Staff has withdrawn its previous support for these

recommendations. At hearing, Mr. Kahle stated: “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.) The contentions of AG, IWC and the Municipalities should be rejected for the reasons set forth below.

**(a) Use of 2005 Lead / Lag Study Is Appropriate**

AG and IWC express concern with IAWC’s use of 2005 data in connection with the lead lag study. (IWC Init. Br., p. 30; AG Init. Br., p. 14.) As IAWC explained in its Initial Brief (p. 16), however, the record shows that the lead-lag study in this proceeding was based on the lead-lag study that was used in the prior rate case, Docket 07-0507, and utilized the most recent fiscal year data available at the time that the prior rate case was being prepared. (*Id.*) 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 customer payments, including the late payment fee amount and late payment rules, have not changed between 2005 and the present. (*Id.*) Therefore, the Company’s decision to rely on the 2005 study was reasonable and should be approved.

AG suggests that the lead-lag study’s use of 2005 data is improper because there were “substantial billing problems” in Chicago Metro in 2005. (AG Init. Br., p. 14.) No witness in this proceeding, however, testified that billing problems in Chicago Metro in 2005 affected the lead/lag study. Moreover, neither the AG, nor any witness, suggests that there were “billing problems” outside of Chicago Metro in the rest of IAWC’s districts. As noted above, the Commission approved the lead/lag study for use in Docket 07-0507. Therefore, the AG’s concerns should be rejected.

**(b) IWC and AG Concerns that the Revenue Collection Lag Is Overstated Should Be Rejected**

AG and IWC 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 Init. Br., p. 30; AG Init. Br., pp. 13-14.) They assert that IAWC's revenue collection lag is somehow "inflated." (AG Init. Br., p. 14.) The position of these parties, however, is not based on a calculation of collection lags and ignores the purpose of CWC, which is to compensate the utility's investors for providing the funds required for those day-to-day business operations that 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), p. 2.) Rather, AG and IWC improperly seek 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 payment lags from classes other than the residential class and the effect of lags from large government or institutional customers, as discussed above. In addition, the 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, AG and IIRC's arbitrary substitution of a 21 day collection lag should be rejected.

Moreover, AG and IIRC's position is based on an incorrect premise that a collection lag of more than 21 days indicates that IAWC's customers are, on average, paying their bills late. In addition, the AG claims that, if a few large customers are responsible for a significant part of outstanding accounts, it is unfair that all customers "pay increased rates as a result of an inflated collection lag calculation." (AG Init. Br., p. 14.) The assertions of IIRC and AG suggest that they believe that the nature and extent of late payments by customers are somehow within IAWC's control. This is incorrect. IAWC's practices with respect to late payments are governed by comprehensive Commission rules, which AG and IIRC ignore.

As IAWC explained in its Initial Brief, there are 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 Init. Br., pp. 19-20; 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 1½% per month on any amount, including amounts previously past due, for utility service which is considered past due under this Section." Similarly, Section 280.90 (h) sets forth rules regarding payment rules for government agencies: "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. . ."

As IAWC also explained in its Initial Brief (p. 18), 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 day lag up. Thus, the large payment balances and 45 day payment period for these customers is, at least in part, responsible for the weighted average collection lag calculation of more than 21 days (which, under the applicable rules, could result even if all customers paid their bills on time, which they do not).

Moreover, as IAWC also explained in its Initial Brief, AG and IWC'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. (IAWC Init. Br., pp. 19-20; 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 related to uncollectible bills as an operating expense – uncollectible expense). (IAWC Init. Br., p. 20; IAWC Ex. 6.00SR (Kerckhove Sur), p. 11.) 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 another 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. (IAWC Ex. 6.00SR (Kerckhove Sur), p. 11.) These costs associated with late payment are costs incurred by IAWC in providing service and are properly recoverable in rates. (*Id.*, pp. 12-13.)

AG and IWC's proposal, by contrast, 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, AG and IWC's proposal should be rejected.

IWC raises two additional issues related to the collection lag. (IWC Init. Br., pp. 28-31.) First, IWC asserts that IAWC has not properly calculated the monthly lags for Champaign and Lincoln to reflect the switch to monthly billing for those districts. (*Id.*, pp. 28-30.) As IAWC witness Kerckhove explained, the lead-lag study already reflects the impact of moving Champaign and Lincoln from bi-monthly billing to monthly billing. Since the Company does not have actual history for the lags associated with monthly billing in the Champaign and Lincoln districts, the Company utilized the weighted average of lag days from all of the other IAWC districts. (IAWC Ex. 6.00R2 (Kerckhove Reb), p. 8.) The analysis of IWC witness Gorman, on the other hand, used revenue lags and service period lags for Champaign and Lincoln that do not reflect the conversion to monthly billing. (IAWC Ex. 6.00SR (Kerckhove Sur.), p. 17.) In addition, as Mr. Kerckhove explained, Mr. Gorman's proposed collection lags for Champaign and Lincoln erroneously use the collection days pertaining to bimonthly billing rather than service period days in his calculation, making his calculation of the Champaign and Lincoln collection days inconsistent with the calculation in the other districts. The formula originally used to calculate the collection days for Champaign and Lincoln included a factor to

account for bimonthly billing. Mr. Gorman's proposal, therefore, doubles the effect of the bimonthly billing factor and artificially cuts the collection period in half. (*Id.*, pp. 17-18.) As IAWC explained in its Initial Brief (pp. 12-13), AG/JM witness Mr. Smith also 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. (AG/JM Ex. 1.0, p. 28.) 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.)

IIRC also suggests that IAWC improperly made no allowance for uncollectible expense in its cash working capital calculation. (IIRC Init. Br., pp. 30-31.) As IAWC explained in its Initial Brief (p. 12), AG/JM witness Mr. Smith had 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.) With respect to IIRC's recommendation, as Mr. Kerckhove explained, no other allowance is necessary. (IAWC Ex. 6.00SR (Kerckhove Sur), p. 18.) Because uncollectibles expense is a separate operating expense line item, uncollectible expense is netted with revenues to reduce the revenue lag. To further adjust revenues for uncollectibles would double count the effect of uncollectibles in the calculation of cash working capital. (*Id.*)

**(c) The CWC Calculation Should Not be Adjusted To Reflect Prepayment of Service Company Fees**

AG, IIRC and the Municipalities assert that IAWC's CWC calculation should be adjusted to remove the effect of prepayment to the Service Company. (AG Init. Br., pp. 15-19;

Muni Init. Br., p. 15; IWC Init. Br., pp. 31-33.) These 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.)

As IAWC explained in its Initial Brief (p. 22), 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 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.*)<sup>1</sup> In the Service Company Agreement, the option to have the operating utilities, including IAWC, prepay for Service Company services was used. As IAWC explained in its Initial Brief, IAWC does in fact prepay Service Company charges, and this prepayment is reflected in IAWC’s lead-lag study and cash working capital calculation. (IAWC Ex. 6.00SR (Kerckhove Sur), pp. 6-7.)

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

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<sup>1</sup> IWC asserts that the Company “failed to provide any evidence that the Service Company charges did not already include Service Company overheads.” (IWC Init. Br., p. 32.) This misses the point. The Service Company does include overheads in its charges to IAWC, in accordance with the Service Company agreement. (IAWC Ex. 5.01; Tr. 465.) Had the prepayment option not been established, however, those overheads would increase by additional amounts to reflect the cost the Service Company would need to incur to obtain working capital.

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.) Thus, the prepayment terms are reasonable and should not be modified.

AG also argues that the Service Company Agreement does not in fact require prepayment (and the Municipalities cite a West Virginia Public Service Commission ("PSC") Order that they allege finds, with respect to an agreement between the Service Company and an affiliate of IAWC, that there is no provision for advance payments of the next monthly bill). (AG Init. Br., p. 16; Muni. Init. Br., p. 15.) These assertions, however, are contradicted by the express terms of the Service Company Agreement. Under the Service Company Agreement, IAWC is contractually required to prepay the Service Company for services. 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.*" (IAWC Ex. 5.01, p. 11 (Emphasis added)). The quoted language requires 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. Further, the Service Company Agreement continues, "[a]ll amounts so billed shall reflect the credit for payments made on the estimated portion of the prior bill..." (*id.*), confirming that the Service Company Agreement requires advance payment of an estimated amount. 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 CWC calculation to reflect its actual payment practices with respect to Service Company fees. (IAWC Ex. 6.00SR (Kerckhove Sur), pp. 6-7.) The prepayment terms impose cash working capital requirements on IAWC, which are reflected in the CWC calculation. If some other lead period for Service Company payments were imposed, IAWC would continue to be required to prepay the Service Company for services. 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.)

## **2. Business Systems Planning Study**

### **Response to AG**

AG recommends that the Commission disallow the \$625,240 cost of a Comprehensive Planning Study ("CPS"), which represents the Illinois portions of a study designed to identify the investment needed to replace aging business systems and to streamline and automate processes across American Water affiliates. (AG Init. Br., p. 17.) The AG asserts that the study's costs are "excessive" and the CPS "appears to duplicate" the services provided by the Service Company. No witness in this proceeding recommended that such a disallowance be made, nor has any witness testified that IAWC's investment in the CPS was imprudent. Moreover, no witness has testified that the cost of the CPS is excessive or that it duplicates Service Company services. In fact, as discussed below, the CPS is intended to study ways to enhance the services provided by the Service Company to IAWC's customers.

As IAWC explained in its Initial Brief (p. 14), AG/JM witness Smith initially suggested that the cost of the CPS was being double-counted. (AG/JM Ex. 1.0, pp. 24-25.) In response,

IAWC witness Kerckhove pointed out that the double-counting error was corrected in the Company's Errata filing on September 22, 2009. (IAWC Ex. 6.00R2 (Kerckhove Reb), p. 6.) As a result, Mr. Smith did not recommend exclusion of the CPS cost from rate base. (AG/JM Ex. 5.0, pp. 17-18.) Moreover, the record demonstrates that the CPS is necessary, and will review operational and system changes that will benefit customers.

Mr. Grubb explained that American Water began the CPS in the first quarter of 2009, and that its cost is being allocated to all the regulated entities of American Water based on customer count. (IAWC Ex. 5.00R2 (Rev.) (Grubb Reb), pp. 6-8.) IAWC's projected allocation for the test year is \$625,240. The purpose of the CPS is to satisfy IAWC customer and other stakeholder expectations, and review technology options to support the implementation of automated processes that provide improved service to customers. The impetus for the study was a general recognition that the systems and processes at American Water, which support many of IAWC's processes, were at the end of their useful life cycle, because: (1) they were designed to accommodate a much smaller customer base; (2) they are increasingly costly to maintain and support; and (3) customer expectations for service are different than they were when the existing systems were acquired. The lack of sufficient automation, for example, limits opportunities for a customer to conduct basic self-service tasks, or an employee's ability to quickly provide service to a customer that requires obtaining appropriate information consistently from across multiple non-integrated systems. American Water has undertaken a program to streamline and automate processes, and to remove inefficient manual tasks, controls and processes, in order to enhance IAWC's provision of service to its customers. As part of the CPS, American Water has conducted an internal evaluation of processes, along with the information systems associated

with those processes. The CPS therefore represents a prudent investment by IAWC in enhancing its business processes, and the cost should be allowed in rate base.

**C. Proposed Rate Base**

The Company's recommended Total Company rate base is \$613,076,601, as shown on Reply Brief Appendix A. The rate bases for each Rate Area are shown on the designated sheets of Reply Brief Appendix A.

**III. OPERATING REVENUES AND EXPENSES**

**A. Resolved Issues**

The resolved Operating Revenue and Expenses issues remain as set forth in IAWC's Initial Brief.

**B. Contested Issues**

**1. Residential Sales Volumes and Revenues**

IAWC addressed the issue of IAWC's projection of the number of residential customers in the test year and resulting test year revenue in its Initial Brief (pp. 27-28). No party, in their Initial Briefs, contested IAWC's test year projection of the number of residential customers or residential revenues at present rates.

**2. Commercial Sales Volumes and Revenues**

IAWC addressed the issue of IAWC's commercial test year revenue in its Initial Brief (pp. 28-31). No party, in their Initial Briefs, contested IAWC's test year projection of commercial revenues at present rates.

**3. Industrial Sales Volumes and Revenues**

**Response to IWC and AG**

IWC recommends that, based on the current operating conditions of IAWC's Large Industrial Customer, U.S. Steel, the test year level of Large Industrial sales should be 1,879,879

CCF. (IWC Init. Br., p. 35.) This 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 2005 through 2008. AG also recommends that this proposal regarding industrial sales of IWC witness Mr. Collins be adopted. (AG Init. Br., p. 47.)

As IAWC explained in its Initial Brief (pp. 31-33), the Company 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. (IAWC Ex. 5.00SR (Grubb Sur), p. 2.) This equates to an annualized usage of 1,630,896 CCF. Use of this current information is reasonable in light of the recent shift of U.S. Steel out of hot idle mode in July 2009. In addition, in IAWC's recent prior rate case, Docket 07-0507, the Commission found that the use of recent revenue data for sales for resale customers was a more appropriate basis for the projection of future water sales than use of 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.

The historical data on which IWC relies is not a reliable indicator of test year usage, as U.S. Steel (the sole customer in the class) is just now returning to higher levels of production, and therefore water usage capacity, from its hot idle period. (IWC Ex. 2.0, p. 6; IAWC Ex. 5.00R2 (Rev.) (Grubb Reb), pp. 9-10.) Because IWC's projection is based on historical data that 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.

IWC also proposes, as an alternative projection, utilizing the four months of August through November 2009 to calculate an annualized sales volume. (IWC Init. Br., p. 36.) No witness in this proceeding proposed use of this projection. Moreover, it should be rejected as an

arbitrary attempt to increase test year water sales levels to U.S. Steel. The crux of IWC witness Collin's concern with IAWC's original test year projection of sales to U.S. Steel was that the projection was based on a period when U.S. Steel's water usage was low because it was in "hot idle" mode. (IWC Ex. 2.0, pp. 5-6.) As IWC acknowledges, however, the hot idle mode ended in July 2009. (IWC Init. Br., pp. 35-36.) IWC claims that July 2009 was a "partial" hot idle month, but admits that U.S. Steel began making steel on July 7, 2009. (IWC Init. Br., p. 35-36; IWC Grubb Cross Ex. 6.) Thus, the U.S. Steel facility was back in production in July 2009. IWC's proposal to drop off July from its average because July's usage was lower than September or October amounts to a cherry picking of favorable data. If IWC's concern is that, until July 2009, U.S. Steel was in hot idle mode, IAWC's revised test year projection of sales to U.S. Steel, which includes the months in 2009 for which data is available after U.S. Steel left hot idle mode (July – November), is the most reasonable and appropriate projection.

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

AG argues (AG Init. Br., pp. 29-30.) that IAWC's use of a 2.5% non-labor inflation rate should be rejected. The AG's position overlooks the fact that, while 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, on rebuttal, the Company proposed to apply to certain non-labor expenses a 1.7% general inflation adjustor to forecast the respective test year expenses. (IAWC Exs. 6.00R2 (Kerckhove Reb), p. 11; 6.01R2.) The AG's argument is that inflation was negative for the 12 months ended October 2009. (AG Init. Br., p. 30.) As IAWC explained in its Initial Brief (pp. 33-35), however, the 1.7% inflation projection is reasonable, and is supported by the fact that actual inflation in year-to-date 2009 was positive and above 2%. According to the U. S. Government's Bureau of Labor Statistics, the CPI for the ten months ended October 31, 2009, is 2.3%. (IAWC Ex. 6.00SR (Kerckhove Sur), p. 26.) According to the U. S. Government's

Bureau of Labor Statistics, the PPI for the ten months ended October 31, 2009, is 2.6%. Thus, IAWC's proposed 1.7% general inflation adjustment is supported by 2009 inflation data.

## **5. Prior Rate Case Expense**

### **(a) Amount for Municipal Rate Study**

#### **Response to Staff and AG**

In their Initial Briefs, AG (AG init. Br., pp. 32-37.) and Staff (Staff Init. Br., pp. 13-15.) each oppose IAWC's request to recover actual expenses incurred in preparing the Commission-ordered Municipal Rate Study first utilized by IAWC in the prior rate case, Docket 07-0507. As IAWC explained in its Initial Brief (pp. 35-36), in Docket 07-0507, the Company initially projected a cost for the Municipal Rate Study of \$37,000, which was the cost level allowed by the Commission in Docket 07-0507. The Commission also determined in Docket 07-0507 that the cost of the Municipal Rate Study should be 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, \$187,047, amortized over the three year period remaining of the original five year amortization approved in Docket 07-0507 (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 will recover the cost of the Municipal Rate Study through the time of the Order in this proceeding ("Docket 09-0319 Order") based on the initial cost estimate. IAWC, believes, however, with respect to the Municipal Rate Study, the proposal to recover cost going forward (under the rates approved by the Docket 09-0319 Order) for the remainder of the amortization period based on the actual cost incurred is reasonable. (IAWC Ex. 7.00R2 (Rev.) (Bernsen Reb), pp. 2-3.) Due to the unique nature of the Municipal Rate Study, its cost was difficult to predict at the time the Company filed

Docket 07-0507. Moreover, as IAWC explained in its Initial Brief, and as Mr. Uffelman's testimony makes clear (IAWC Ex. 10.00R (Uffelman Reb), pp. 2-21), the issue of municipal rate comparisons, previously addressed by the Municipal Rate Study, has again been raised by certain parties in this proceeding. For that reason the Municipal Rate Study, prepared initially for Docket 07-0507, is used by Mr. Uffelman as a basis for the updated analysis of rate comparisons presented by IAWC in this proceeding. (IAWC Exs. 10.00R (Uffelman Reb); 10.00SR (Uffelman Sur.))

AG asserts that IAWC's request to include the amortization amount of \$62,349 in its present level of test year rate case expense is improper retroactive ratemaking, because, "IAWC is proposing that the Commission effectively add a surcharge to rates to compensate the Company for the difference between the rate case expense level included in current rates (based on expenses included in the test year that ended June 30, 2009), and the actual expense incurred by the Company in 2009." (AG Init. Br., p. 33.) AG, citing *Business & Prof. People for the Public Interest v. Illinois Commerce Comm'n*, 146 Ill. 2d 175 (1991) ("*BPI II*"), describes retroactive ratemaking as requiring that, "[o]nce the Commission establishes rates, the Act does not permit refunds if the established rates are too high, or surcharges if the rates are too low." (*Id.*) IAWC, however, is not proposing to establish a surcharge. Instead, IAWC is seeking to include in its test year level of amortized rate case expense for this proceeding a cost not previously recovered for a Study utilized by IAWC in both this and the prior rate proceeding.

Staff argues (Staff Init. Br., pp. 13-14.) that, "[t]he Company should not be allowed to amortize any component of rate case expense in excess of that approved by the Commission." As explained above and in IAWC's Initial Brief (pp. 35-36), IAWC considers recovery of the \$62,349 amortization amount related to the actual cost incurred for the Municipal Rate Study

appropriate under the circumstances. Moreover, as Staff points out (Staff Init. Br., p. 14), IAWC has identified a case where the Commission approved recovery of the unamortized balance of the (higher than approved) actual cost of a depreciation study prepared for the prior rate case. *See Illinois-American Water Co.*, Docket 95-0076. Likewise, Staff points to a case (IAWC's 2002 rate case, Docket 02-0690), where, "the Commission approved recovery of the unamortized balance of (lower than approved) actual prior rate case expense." (Staff Init. Br., p. 14.) The Commission has, therefore, approved recovery of the unamortized balance of the actual cost of a prior rate case expense where it was less than the forecasted (and approved) level of cost. IAWC submits that, where circumstances have produced an amount of rate case expense for a particular item that is above what was initially forecasted (and allowed), recovery of the actual cost over an amortization period may and, under the circumstances in this proceeding should, also be permitted.

**(b) Inclusion of Unamortized Amounts of Allowed Prior Rate Case Expense**

**Response to AG**

AG also asserts that "IAWC has assumed in its filing that it is entitled to add the unrecovered balance of the 2007 rate case expense to this year's rate case expense," but the "Commission did not authorize IAWC to defer the unamortized portion of the rate case expense for future recovery if it filed a rate case before the end of the amortization period." (AG Init. Br., p. 34.) The AG contends that recovery of the unamortized balance of allowed prior rate case expense is prohibited as either single issue ratemaking or retroactive ratemaking. (AG Init. Br., pp. 34-37.) This is a separate issue from the issue discussed above, relating to recovery of prior rate case expense above what was allowed in the prior case. Recovery of that cost should be allowed for the reasons discussed above. The reasons for allowance of rate case cost allowed in

a prior rate order to be recovered over an amortization period is addressed below. With respect to *allowed* prior rate case expense, recovery of unamortized balances is routinely permitted under longstanding Commission practice, and the AG's recommendations should be rejected.

As explained in IAWC's Initial Brief (pp. 44-45), because rate case expenses do not routinely occur every year, such expenses are routinely 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 421, 432 (4th Dist. 1993); *see, e.g.* Dockets 92-0116, 95-0076, 02-0690, 06-0070 (cons), 07-0507, 07-0585 (cons). Deferral and amortization of rate case expense results in a normalized test year level of rate case expense. (IAWC Ex. 7.00SR (Bernsen Reb), p. 6.) 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.

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.) Depending on the timing of the next rate case, some amounts may still be in the process of amortization, and as such would be included in the normalized level of test year rate case for the next rate case, consistent with test year rules.

As discussed in IAWC's Initial Brief (pp. 47-48), following *BPI II*, the Commission has made clear that there are certain types of expenses for which amortization and deferral are consistent with test year rules and can be allowed. This is confirmed by the fact that the Commission has routinely approved amortization as a proper way to "normalize" costs which would otherwise fluctuate greatly, including rate case expense. *See Illinois-American Water Co.*, Docket 07-0507 (tank painting, rate case expense); *Illinois American Water Co.*, Docket 02-0690 (tank painting, rate case expense); *Illinois-American Water Co.*, Docket 95-0076 (well and pump maintenance); *Illinois-American Water Co.*, Docket 92-0116 (current and prior rate case expense). As Staff points out in its Initial Brief (p. 13), the Company is entitled to recover in the current rate case the unamortized rate case expense from its prior rate case. And the Commission has routinely approved the recovery of unamortized balance of prior rate case expense in a subsequent case. *See Illinois-American Water Co.*, Docket 92-0116, 1993 Ill. PUC Lexis 46, \*29-36 (Feb. 9, 1993); *Illinois-American Water Co.*, Docket 02-0690; *Commonwealth Edison*, Docket 07-0566; *Central Illinois Light Co., et al.*, Dockets 07-0585 (cons.). In fact, AG acknowledges that the Commission allows recovery of the unamortized balance of prior rate case expense. (AG Init. Br., pp. 37-38.) Although IAWC did not obtain express authorization for recovery of the unamortized balance of prior rate case expense, no such approval is required by any order or rule, and no approval has been required in numerous orders which have allowed recovery of prior case allowed expenses.

No witness in this proceeding proposed that recovery of the unamortized balance of allowed prior rate case expense be denied. In fact, AG/JM witness Smith expressly addressed the amortization period for prior rate case expense (as discussed below) and made no

recommendation to deny recovery of the unamortized balance of prior rate case expense.

(AG/JM Ex. 1.0, pp. 34-35.)

AG's contention that recovery of the unamortized balance of prior rate case expense violates the rule against single issue ratemaking should be rejected. The rule against single issue ratemaking requires that the Commission examine all elements of the revenue requirement formula to determine the interaction and overall impact any change will have on the utility's revenue requirement. *BPI II*, 146 Ill. 2d at 244. All components of the revenue requirement, however, are under review in this rate case. As discussed above, moreover, such items as tank painting activity, rate case activity, well and pump maintenance or other items may be projected to be above or below "normal" levels. 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" and other methods of calculating such expenses may be used. *Illinois-American Water Co.*, Docket 02-0690, Final Order, p. 16. Where the fluctuation of a particular item is significant, a normalization rate-making approach is often deemed appropriate by the Commission. The normalized level of these expenses (including unamortized rate case expense from a prior case) are routinely considered and approved by the Commission, without a finding that they constitute single issue ratemaking.

Likewise, the AG's contention that recovery of an unamortized balance of prior rate case expense violates the rule against retroactive ratemaking should also be rejected. IAWC is not proposing refunds of rates approved in the past or any surcharge. As discussed above, the Commission has routinely approved the recovery of the unamortized rate case expense from a prior rate case, and approved such recovery without a finding that it is improper retroactive or single issue ratemaking.

AG also contends, with reference to AG/JM witness Smith's "normalization" approach, that "[c]onsistent with normalization of the rate case expense, the rate case expense determined to be reasonable and prudent for the 2010 test year should be the only regulatory or rate case expense included in rates in this docket. No recovery for unamortized 2007 rate case expenses should be allowed." (AG Init. Br., p. 39.) As IAWC discussed in its Initial Brief (pp. 46-48), Mr. Smith did not explain how his "normalization" approach would work. Mr. Smith also did not indicate that his "normalization" approach should apply to prior rate case expense; rather, his discussion was directed prospectively toward future rate cases. (AG/JM Ex. 1.0, p. 42.) AG does not explain why the concept of normalization precludes recovery of prior case rate case expense still in the process of amortization. Deferral and amortization of rate case expense, including prior case expense, however, is a form of normalization.

AG suggests, as a fallback (AG Init. Br., p. 39.) a modification of the amortization period for the components of unrecovered prior rate case expense. AG/JM witness Mr. Smith (AG/JM Ex. 5.0, p. 35.) recommended that Commission-approved unamortized amounts from the prior case having a remaining amortization period of 15 months as of April 30, 2010 be amortized over the same amortization period that the Commission approves in this case. The Company agreed that this amount should receive the same amortization period that is applied to the expense for the current case (the Company is proposing a 2 year amortization period for current rate case expense). (IAWC Ex. 7.00SR (Bernsen Sur., p. 3.) Mr. Smith (AG/JM Ex. 5.0, p. 35.) also recommended that Commission-approved unamortized amounts from the prior case having a remaining amortization period of 39 months as of April 30, 2010 continue to be amortized using the 39-month amortization period as previously approved. As Mr. Bernsen explained, however, for the components of unamortized prior rate case expense having a remaining

amortization of 39 months, IAWC is proposing a 36 month amortization period. This is not unreasonable given the small variation in months. The use of a 36 month amortization period would allow the amount to be amortized over exactly 3 years. (IAWC Ex. 7.00SR (Bernsen Sur., p. 3.)

## 6. Current Rate Case Expense

### Response to AG and Municipalities

AG and the Municipalities each contend that IAWC's test year level of current rate case expense is unreasonably high. (AG Init. Br., pp. 39-44; Muni. Init. Br., pp. 17-18.) Each party points to an increase in IAWC's requested level of rate case expense above what was allowed in the prior case, calling the increase unreasonable. AG and the Municipalities, however, ignore the fact that IAWC's proposed test year level of rate case expense is less than the amounts *actually* incurred by IAWC for its prior case. Moreover, in suggesting that IAWC has not taken action to limit its expenses in the rate case (*see* AG Init. Br., p. 41), AG and the Municipalities ignore the extensive cost control measures related to rate case expense that have been implemented by IAWC.

As IAWC explained in its Initial Brief (pp. 36-43), 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.) 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.) The projected costs of Legal Fees and Expenses, Revenue Requirement and CPA Review are decreased from actual amounts in the

prior case by 7%, 51% and 47%, respectively. (IAWC Schedule C-10.1.) This projected level of rate case expense reflects careful analysis of prior case costs and incorporates cost-control measures implemented to minimize expenses. (IAWC Ex. 7.00R2 (Rev.) (Bernsen Reb), p. 3.) In addition, the Commission Staff agrees that the Company's requested level of rate case expense is appropriate. (Staff Init. Br., p. 15.)

As also explained in its Initial Brief (pp. 36-40), the Company sought to keep 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 where appropriate. (IAWC Ex. 5.00SR (Grubb Sur), p. 12.) Therefore, the Company's requested rate case expense should be approved.

**(a) AG and the Municipalities' Arbitrary Reduction to Legal Rate Case Expense Should Be Rejected**

AG and the Municipalities recommend adoption of AG/JM witness Mr. Smith's proposal 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.) (The AG also suggests that, alternatively, the Commission could order "no increase" over the prior case allowed amount of \$650,000. (AG Init. Br., p. 41.) These recommendations, however, should be rejected because they are arbitrary, ignore the Company's detailed projection of rate case expense for this case and do not allow the Company an opportunity to recover its prudent expenses. Neither the AG nor the Municipalities contest the need for legal services in this case, nor do they contend that the projected level of rate case legal expense is inaccurate. Rather, their recommendations amount to nothing more than

substitution of an arbitrarily determined amount for prudent and necessary projected cost levels supported by detailed evidence.

As IAWC explained in its Initial Brief (p. 40), when setting utility rates, the Commission must determine that the rates accurately reflect the cost of service and 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). In developing his \$715,000 fee proposal, however, Mr. Smith simply adds 10% to the amount authorized in the prior rate case. (AG/JM Ex. 1.0, p. 44.) 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, 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 actual figure for rate case legal expense from the prior 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. (*Id.*) Furthermore, when one considers the projected approximate 5.7% increase in the market rates for legal services estimated for 2010 in the SCCS, the savings achieved by the Company amounts to nearly 14% over the previous rate case. (IAWC Ex. 11.01, Schedule 4.)

AG also asserts that “IAWC has offered no reason for the difference between this case and its last case,” and, “this case does not present new or unique legal issues...” (AG Init. Br., pp. 40-41.) These statements ignore the fact that, as discussed above, IAWC’s projected level of rate case legal expense is *less than* the actual rate case legal expense incurred by IAWC in the prior case. Although IAWC is requesting a lower level of rate case legal expense in this proceeding than it incurred in the last, IAWC’s current rate case expense projection includes the cost of a number of studies not performed in the prior case (such as the studies related to the Service Company’s fees and the cost of service study). (Schedule C-10.1.) IAWC was also required in this case to perform a new demand study, based on a different (Commission-approved) methodology from the demand study in the prior case, and examine a variety of rate design issues. (IAWC Init. Br., p. 37.) Despite the number of studies required in this case, IAWC nevertheless proposed rate case legal expense (and overall rate case expense) that was less than the actual amount incurred in the prior case.

The Municipalities also ask why IAWC could not have made more economical use of Service Company staff in prosecuting the rate case. (Muni. Init. Br., p. 17.) As IAWC explained in its Initial Brief (pp. 39-40, 42), contrary to the Municipalities’ assertions, 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 and attending public hearings). (IAWC Ex. 5.00SR (Grubb Sur.), p. 12.) As explained by Mr. Grubb, however, 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.) As Mr. Grubb explained, 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.) No witness in this proceeding challenged Mr. Grubb's conclusions in this regard.

In summary, AG and the Municipalities' proposed limitations on IAWC's rate case legal expense are arbitrary and deny IAWC recovery of its costs. In suggesting that IAWC be limited to an arbitrary 10% increase over the prior case, AG and the Municipalities provide no basis to dispute the reasonableness or prudence of the Company's legal fees. 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 lower than the actual legal expense incurred in the prior case.

**(b) AG and the Municipalities' Proposal to Disallow the Cost of the SCCS Should Be Rejected**

The AG and the Municipalities assert that the cost of the SCCS be disallowed because the Study did not comply with the Commission's requirements as set forth in Docket 07-0507. (AG Init. Br., p. 44; Muni. Init. Br., p. 18.) As discussed in Section III.B.10, below, the SCCS, in conjunction with extensive accompanying evidence, fully complies with the Docket 07-0507 Order. No witness in this proceeding challenged the methodology or results of the SCCS, or recommended that the Study's costs be entirely disallowed. Therefore, this recommendation should be rejected.

The AG also asserts that the cost of the SCCS is "outrageous" and should also be disallowed for that reason. (AG Init. Br., p. 42.) (Of note, this position disregards the testimony of the AG's own witness, Mr. Smith, who recommends that recovery for the Service Company Fee Study be limited to \$366,000. (AG/JM Exs. 1.0, pp. 44-45; 5.0, p. 43.)) As IAWC explained in its Initial Brief (pp. 43-44), the full cost of the SCCS is justified. Not only was the SCCS consultant selected as a result of a competitive bidding process, the SCCS is subject to

measured cost control efforts. (IAWC Ex. 7.00R2 (Bernsen Reb), pp. 6-7.) At IAWC's request, the consultant agreed to a "not-to-exceed" amount for the production of the SCCS 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 SCCS are consistent with the projection.

Moreover, as of September 30, 2009, the Company had already incurred \$357,371 for the Service Company Study. (IAWC Ex. 7.00R2 (Bernsen Reb), p. 7.) No witness to this proceeding contested this figure. Given that a significant portion of the cost of the SCCS had already been incurred as of September 2009, two months prior to hearings (and, as discussed above, no witness has recommended that the Study's cost be disallowed in its entirety), the AG's recommendation should be rejected.

AG also suggests that IAWC's \$422,900 projected level of expense of the SCCS is too high because Mr. Uffelman testified at hearing that, "[a]lthough he did not know the number of hours it took to complete the Study, he estimated it at 500 hours," and he would receive "\$175,000 to \$210,000 for the Study and for his services." (AG Init. Br. 43.) These suggestions mischaracterize Mr. Uffelman's testimony. At hearing, Mr. Uffelman was asked: "But can you give me an estimate of the number of hours *you* spent on the service company cost study?" (Tr. 405 (emphasis added).) Mr. Uffelman responded that he had spent approximately 500 hours on the Study. (*Id.*) Likewise, the \$175,000 to \$210,000 were Mr. Uffelman's estimate of the fees paid him for the SCCS. (Tr. 404-405.) As the AG acknowledges (AG Init. Br., p. 43), however, five or six people worked on the SCCS, including Mr. Mark Young. (Tr. 370.) Given that the referenced 500 hours and \$175,000 to \$210,000 in fees relate only to Mr. Uffelman's work on the Study (and not that of other personnel involved), these references do not suggest that IAWC's projected cost of \$422,900 for the entire SCCS is unreasonable.

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

In the Initial Briefs, the only party to oppose IAWC's proposed amortization periods for current rate case expense (a five-year amortization for the cost of service study, demand study, and SCCS and a two-year amortization for all other components of current rate case expense) were the Municipalities, who recommended a three-year amortization for amounts of rate case expense the Commission "does allow." (Muni. Init. Br., p. 18.) While IAWC would not object to amortization of the costs of the cost of service study, demand study, and SCCS over three, rather than five, years, IAWC continues to believe that a five year amortization of these components is reasonable. With respect to other components of rate case expense, IAWC's proposed two year amortization period is reasonable for the reasons given in IAWC's Initial Brief (pp. 44-46).

**7. Purchased Power and Fuel Expense**

In its Initial Brief, IIWC recommends that IAWC's Purchased Power and Fuel ("PPF") expense be set at \$0.144 per CCF of total test year sales volume. (IIWC Init. Br., p. 40.) IIWC asserts that (i) a comparison of IAWC's past actual PPF expenses to the proposed test year expense does not support IAWC's increased level of PPF expense; (ii) demands of new facilities do not account for the increase; and (iii) delivery charges are too small a factor to contribute to the overall increase in PPF expense from 2007 to the test year. (IIWC Init. Br., pp. 37-40.)

IIWC's Initial Brief relies on a series of conflicting and incorrect figures, however, as the basis of its recommendation. IIWC also ignores the final projected level of PPF expense recommended by IAWC (IAWC Ex. 6.01SR), which reflects, as discussed below, IAWC's increase in projected test year water sales to U.S. Steel (a revision advocated by IIWC). (IAWC

Exs. 6.01SR; 6.02SR) Moreover, IWC's own analysis of increases related to power distribution (delivery service) costs confirms the reasonableness of IAWC's test year PPF expense projection.

As the Company explained in its Initial Brief, due to the demands of new facilities, increasing delivery charges, and weather conditions which caused depressed demand in the years prior to the test year, PPF expense is projected to increase in the test year. (IAWC Init. Br., pp. 48-53.) IAWC's proposed level of test year PPF expense is \$ 9,039,309. (IAWC Ex. 6.01SR.) This reflects an increase in PPF expense related to IAWC's upward revision of its projected test year water sales to U.S. Steel. (IAWC Exs. 5.00SR, p. 2; 6.01SR; *see* Section III.B.3 above.) As IAWC also explained in its Initial Brief (pp. 51-52), 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. Comparing the Company's actual fuel and power expense data for the period 2007-2009 to the test year in this case 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). (IAWC Ex. 2.00SR (Norton Sur), p. 2.)

In its Initial Brief, IWC relies on the calculations of Mr. Collins from his direct testimony to develop its recommendation that IAWC's test year PPF expense level be set at \$0.144 per CCF of sales. (IWC Init. Br., p. 36.) The numbers used by Mr. Collins in his direct were never correct. First, IWC incorrectly states that the Company's test year expense for PPF is \$7,721,104. (IWC Init. Br., p. 36.) This figure was incorrect at the time of IWC's direct testimony (IAWC's proposed update level of PPF expense was \$8,839,320), and is incorrect now. IAWC's actual test year projection of PPF expense is \$ 9,039,309. (IAWC Ex. 6.01SR.) In addition, as result of IAWC's revised projection of test year water sales to U.S. Steel (*see* IAWC

Ex. 5.00SR, p. 2), the level of test year water sales to U.S. Steel would increase to an annualized usage of 1,630,896 CCF. As IAWC's original projection of water sales to U.S. Steel was 500,000 CCF, the new projection would add 1,130,896 CCF in sales to Mr. Collins test year level of water sales of 49,811,767 CCF, for a total of 50,942,663 CCF. This change also increases test year PPF expense by approximately \$200,000. IWC's Brief further misstates the Company's authorized PPF expense in the prior rate case as \$7,572,299. The actual figure is \$ 8,165,110<sup>2</sup>. (See Docket 07-0507 Order, Appendices A-F.)

Furthermore, Mr. Collins' PPF expense recommendations contained other flaws. First, his recommendation focuses on power use per CCF of customer sales. Sales, however, provide an incomplete picture of the Company's water production. The Company's water production also includes non-revenue water, which includes unaccounted-for water and water used for other known (non-sales) purposes, in addition to sales. (IAWC Ex. 2.00 (Norton Dir), p. 9.) IAWC's witness, Ms. Norton, by contrast, considers PPF expense on a total system delivery basis in concluding that IAWC's test year level of PPF expense is reasonable. (IAWC Ex. 2.00SR (Norton Sur), p. 2.)

In addition, as explained by Mr. Kerckhove, Mr. Collins calculates fuel and purchased power 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), pp. 16-17.) Instead of calculating test year amounts for fuel and purchased power for the Chicago Metro, Pekin, and Lincoln rate areas, Mr. Collins groups them into the result of Total Company less Zone 1 by default. This understates the fuel

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<sup>2</sup> Using Mr. Collins' total sales volume of 52,588,940 CCF from the prior case, this equates to a corrected PPF expense of \$0.155 per CCF in the prior case (not \$0.144). Although, as discussed herein, IAWC does not accept IWC's proposed use of the prior case per CCF PPF amount as a basis for determining IAWC's test year PPF expense in this case, multiplying \$0.155 by IAWC's revised projected total water sales for 2010 of 50,942,663 CCF produces a level of PPF expense of approximately \$7,896,000.

and purchased power cost per CCF from the prior rate case and overstates the fuel and purchased power adjustment for the total company by \$80,221. Instead, Mr. Collins should have extended the calculation for each rate area, with the Total Company amount the sum of the individual rate areas. The effect is to erroneously reduce fuel and purchased power costs for the Company by artificially applying a “fallout” rate to all non-Zone 1 rate areas. (*Id.*)

IIRC’s Initial Brief Appendix A (“IIRC Appendix A”) presents an analysis of IAWC’s PPF expense that IIRC claims supports the conclusion that IAWC’s projected level of test year PPF expense is unreasonable. IIRC Appendix A, however, was not prepared by any witness in this proceeding and no witness’ testimony supports its reliability or accuracy. No witness testified that the numbers or calculations contained in IIRC Appendix A were accurate or that the methodology employed to develop Appendix A is appropriate (for example, IIRC Appendix A does not contain any data for 2009, although, as IAWC’s evidence shows, PPF expense per 1000 gallons system delivery is projected to decline from 2009 to the test year (IAWC Ex. 2.01SR)). Further no witness testified that the conclusions IIRC makes in its Initial Brief based on IIRC Appendix A are valid.

Moreover, the conclusion in IIRC’s Initial Brief regarding increases in distribution costs, based on the calculations in Appendix A, serve to confirm the reasonableness of IAWC’s test year projection of PPF expense. IIRC does not appear to dispute IAWC’s projected increase in distribution charges in 2009 and the test year, as compared to prior years. (IIRC Init. Br., p. 40; *see* IAWC Init. Br., p. 50.) In fact, IIRC, relying on IIRC Appendix A, calculates that there has been an estimate 8.26% increase in per unit distribution costs from 2007 to 2010. (IIRC Init. Br., p. 40.) As a result, IIRC concludes that, for 2010 as compared to 2007, “[a]n 8.26% increase on 20% of Illinois-American’s total electric power costs represents a weighted average increase of

only 1.65% ( $8.26\% \times 20\% = 1.65\%$ ) in total electric power costs.” (*Id.*) Applying a 1.65% increase to IAWC’s total power costs for 2007 of \$8,648,490, as shown on IWC Appendix A, however, produces a total power cost of \$8,791,190. Applying IWC’s logic, and adding the \$200,000 for added fuel and power expense related to the projection of increased sales to U.S. Steel, as discussed above, results in a total power cost projection of \$8,991,190 for 2010, which is consistent with IAWC’s actual projection of test year \$9,039,309.

IWC also suggests that the “addition of the new facilities on the Illinois-American system should contribute to a decrease in the purchase power and fuel expense on a per CCF basis.” (IWC Init. Br., p. 39.) IAWC demonstrated, however, that new facilities would in the aggregate increase power demands and PPF expense. (IAWC Init. Br., pp. 50-51.) For example, as indicated in the Company’s Initial Brief, the Champaign district saw electric power costs per million gallons increase by approximately 15% with the introduction of the new facility in that district- \$191.88/MG prior to the new facility being brought online and \$224.82/MG afterwards. (IAWC Init. Br., p. 50.) Because IWC’s recommendations regarding PPF expense are based on incorrect data or flawed analyses, and IAWC has demonstrated, as explained in its Initial Brief (pp. 48-53), that its projection of test year power cost is reasonable, IWC’s proposed adjustment to calculate PPF at \$0.144 per CCF should be rejected.

## **8. Chemicals Expense**

IAWC set forth the basis for its projection of test year chemical expense in its Initial Brief (pp. 53-55). No party, in Initial Briefs, contested IAWC’s proposed level of test year chemical expense.

## 9. Insurance Other Than Group Expense

### **Response to AG**

AG recommends disallowance of the portion of Insurance Other Than Group (“IOTG”) expense that is identified as a “Retrospective Accrual” on the grounds that the expense was not included in IAWC’s initial filing. (AG Init. Br., p. 30.) As IAWC explained in its Initial Brief (p. 56), however, 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. (IAWC Ex. 7.00R1 (Rev.) (Bernsen Reb), p. 3.) Moreover, as IAWC further explained in its Initial Brief, 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. (*Id.*) This review results in an adjustment to annual IOTG expense that represents insurance costs for current claims in excess of premium costs, and is therefore an appropriate test year cost. (*Id.*)

Although Staff initially objected to the inclusion of the Retrospective Accrual as a test year expense, Staff witness Wilcox withdrew his adjustment related to the Retrospective Accrual. (Staff Ex. 9.0, p. 5.)

## 10. Management Fees

### **Response to AG, Bolingbrook and the Municipalities**

#### **(a) IAWC’s Evidence in this Proceeding Fully Meets the Requirements of the Commission’s Order in Docket 07-0507**

In their Initial Briefs, the AG, Bolingbrook and the Municipalities (AG Init. Br., pp. 44-46; Bol. Init. Br., pp. 4-7; Muni. Init. Br., p. 12) challenge the methodology used by IAWC in the

SCCS to determine projected market prices expected to result from competitive bidding for services projected to be required in 2010. These parties suggest that, to project market prices, IAWC was required at the time that the SCCS was prepared to obtain actual bids for expected 2010 services. Bolingbrook, for example, claims that, “[b]ased on the Commission’s express directive in its Order in Docket No. 07-0507, IAWC was to prepare a SCCS based on ‘competitive bidding in the open market.’ IAWC has failed to prepare such a study in this proceeding. Rather, IAWC has prepared a ‘comparative study of Service Company cost and market prices for certain services.’” (Bol. Init. Br., p. 5.) As discussed below, however, the Docket 07-0507 Order does not require use of a particular methodology to project market prices, and does not require that IAWC conduct a bid process. Furthermore, the methodology used in the SCCS to project 2010 market prices was not criticized in the testimony of any witness in this proceeding.

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. Docket 07-0507 Order, pp. 30-31 (emphasis added).

As explained in the SCCS and in IAWC’s Initial Brief (pp. 58-67), to make the showing required by the Docket 07-0507 Order, IAWC submitted evidence (including three separate studies) through five witnesses: Ms. Teasley, who discusses IAWC’s service procurement practices and sponsors a study (“Self Provision Study”) that compares the cost that IAWC would incur to provide all services through its own employees on a stand alone basis to the cost that IAWC incurs to procure certain services from outside affiliate or non-affiliate providers; Mr.

John Young, who describes in detail each service expected to be provided by the Service Company and supports certain information set out in the SCCS; Mr. Bernard L. Uffelman of Uffelman Advisory Services (“UAS”) and Mr. Mark Young of Deloitte & Touche LLP (“Deloitte”), who sponsor the SCCS , which, for those services that could be obtained by IAWC from affiliate or non-affiliate providers, compares the cost that IAWC expects to incur for the 2010 test year in procuring services from the Service Company to the cost that IAWC would incur to procure the services from a non-affiliate provider at open market price levels that would be obtained through competitive bidding; and Mr. Grubb, who discusses the allocation of Service Company costs to regulated and non-regulated affiliates of American Water, and the development and conclusions of the “Belleville Lab Study,” which supplements the SCCS analysis performed by Deloitte and UAS. This evidence, collectively, is referred to as the “SC Cost Evidence.” Each argument raised by these parties in their Initial Briefs that relates to the SC Cost Evidence will be addressed below.

As explained in IAWC’s Initial Brief (pp. 59-62), for services that IAWC could obtain from either affiliate or non-affiliate providers, the comparison required by the Docket 07-0507 Order was provided by the SCCS prepared by IAWC’s consultant, Deloitte. The SCCS concluded that, for services that: (i) IAWC obtains from the Service Company; and (ii) can be obtained from an affiliate or non-affiliate source, the projected amount that IAWC would pay to the Service Company for 2010 services (based on the Services Company’s cost incurred (“SC Cost”) with no profit margin) is well below the projected open market prices that IAWC would pay to non-affiliate service providers for required services. (IAWC Ex. 10.00 (Uffelman Dir), p. 6.) For such services, the projected level of savings that results from use of the Service Company to provide required services is at least approximately \$7.274 million. (IAWC Ex.

10.00SUPP (Uffelman Supp., p. 2.) No witness in this proceeding disputed the methodology used to project market prices that would result from competitive bidding or Mr. Uffelman's calculation of the level of savings. As the record shows, IAWC's policy, as discussed by Ms. Teasley (IAWC Ex. 1.00 (Teasley Dir), p. 17), 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. 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 (affiliate or non-affiliate), including the Service Company. (*Id.*)

As Ms. Teasley indicated, in most cases, the Service Company (which provides required services at cost under an approved affiliated interest agreement) is found to be the most cost-effective and qualified source for required services. (IAWC Ex. 1.00 (Teasley Dir), p. 17.) In certain circumstances, however, the Service Company is unable to provide the specialized services needed to address specific situations. As the record shows, 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.*, pp. 17-18.) In procuring services that are cost effective and reliable, IAWC utilizes such procedures as are required to secure cost-effective service providers, including where appropriate requests for proposals ("RFP") and bid processes. (*See, e.g.*, IAWC Exs. 1.00SUPP (Teasley Supp), p. 2; 7.00R2 (Rev. (Bernsen Reb.) p. 6; ICC Staff Ex. 2.0, Att. A, p. 3.) In their briefs, AG, Bolingbrook and the Municipalities do not contend otherwise.

Without the benefit of evidence, however, AG, Bolingbrook<sup>3</sup> and the Municipalities maintain that IAWC should, at the time of the SCCS, have conducted a procedure to obtain competitive bids as a basis to project market prices for services expected to be required during 2010. As explained in the SCCS, to project 2010 market prices, IAWC's consultant, Deloitte, utilized data from two types of sources. First, Deloitte used widely utilized surveys of market prices for each area of service that IAWC expects to require during 2010 (Accounting, Engineering, Information Technology (IT), Legal and Management Consulting). (IAWC Ex. 11.01, pp. 10-13.) As the SCCS describes, the market surveys contain 2007 or 2008 information (the most recent annual information available at the time the SCCS was prepared) relating to the compensation, fee and billing practices for the five categories of professional services firms. For services such as accounting, engineering and legal services, market survey data focused on the Midwest region was used. (*Id.*) Based on the research conducted, Deloitte concluded that the surveys selected each provide a reliable indication of market prices for services covered by the survey.

Second, Deloitte utilized "Supplemental Data," which consists of market price information provided by non-affiliate suppliers (or prospective suppliers) to American Water of services in all five service areas during the two year period prior to the SCCS. (IAWC Ex. 11.01, pp. 10-13.) This market price information included information obtained through RFPs or bidding. (IAWC Exs. 12.00 (J. Young Dir), pp. 27-28; 11.01, pp. 8, 14-18.) As the SCCS explains (IAWC Ex. 11.01, pp. 8, 14-18), to supplement the market survey information used in

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<sup>3</sup> Bolingbrook also criticizes IAWC because IAWC's witness Ms. Teasley was not familiar with the statutory requirements for competitive bidding by municipalities. (Bol. Init. Br., pp. 6-7.) Bolingbrook does not explain, however, how or why certain requirements that apply to municipalities, but not private investor owned water utilities, have an application to IAWC or relevance to this proceeding. Bolingbrook also does not explain why Ms. Teasley's purported lack of familiarity with municipal competitive bidding rules that do not apply to IAWC has any bearing on IAWC's service procurement process (which, as noted herein, no witness has challenged).

the analyses and verify that the market survey rates are an appropriate measure for comparison to the Service Company's hourly rate, Deloitte requested information from American Water regarding rates quoted or charged by third-party vendors to American Water for services provided. American Water provided the Supplemental Data regarding rates charged for services provided to it or subsidiaries by third-party vendors in relevant markets. The Supplemental Data was obtained from invoices, and also from responses obtained by American Water in connection with service RFP requests. (*Id.*, pp. 14-18; Schedules 1.2, 2.2, 3.3, 4.4 and 5.2.) For example, Supplemental Data regarding hourly billing rates for engineering firms that provide service to American Water was prepared from information provided by the Service Company for contracted services with eight non-affiliate engineering firms. (IAWC Ex. 11.01, pp. 15-16.). Supplemental Data regarding hourly billing rates for law firms that provide service to American Water was prepared from information provided by the Service Company for contracted services with eleven non-affiliate law firms. (*Id.*, p. 17.) This Supplemental Data supports the reasonableness of the market rates for engineering services as a comparative measure for use in the Market Analysis section of the SCCS.

In light of SCCS's use of the Supplemental Data, the claims by AG, Bolingbrook and the Municipalities in their Initial Briefs that, to project 2010 market pricing, the SCCS "did not contain cost information obtained through competitive bidding," (AG Init. Br., p. 45.) or, "[t]he methodology of the SCCS does not include **even one** competitively bid service" (Bol. Init. Br., p. 7. (emphasis in original)), are simply wrong. Moreover, as noted above, no witness criticized any aspect to the procedure used by IAWC to forecast 2010 market costs.

As the SCCS also explains, Deloitte applied appropriate escalators to the pricing information provided by the surveys and Supplemental Data to develop projected service pricing

for 2010. Because the market surveys contained 2007 or, in the case of information technology services, 2008 price information, the market rates for each service category were escalated using the consumer price index (“CPI”) to determine 2010 expected cost levels. (IAWC Ex. 11.01, p. 8.) Thus, the market survey and Supplemental Data arrive at expected 2010 hourly prices as would be obtained through competitive bidding. As with all other aspects of the SCCS, no witness challenged use in the SCCS of this approach, or suggested that, at the time of the SCCS, some other approach was feasible.

Also, without the benefit of evidence, AG, Bolingbrook and the Municipalities maintain in their Initial Briefs that, to project 2010 market prices, IAWC should also have sought bids for expected 2010 services. The SCCS, however, was prepared over a period of several months prior to the filing of this proceeding on May 29, 2009 (Tr. 363), and the Docket 07-0507 Order did not require the issuance of RFPs in that time frame to project market prices. IAWC interpreted the Order as requiring a comparison of projected Service Company costs to the expected cost of services “had they been obtained through competitive bidding on the open market”, and IAWC presented this comparison through the SCCS for services that can be obtained from affiliate or non-affiliate (and, as explained in IAWC’s Initial brief (pp. 63-64), the Self Provision Study for other services).

In suggesting the Docket 07-0507 Order contemplated a bid requirement, the AG, Bolingbrook and the Municipalities simply disregard the Docket 07-0507 Order’s actual language. Further, these parties assume in their Initial Briefs, without the benefit of evidentiary support, that to project 2010 service pricing, the issuance of RFPs to prospective suppliers during the SCCS timeframe would have been feasible. No witness testifying for the AG, Bolingbrook or the Municipalities (or any other party) suggested that such a procedure could feasibly be

employed, or that such an approach would produce projected 2010 pricing information more accurate than that produced by the projection method that Deloitte employed. Indeed, no witness criticized the SCCS's methodology or its results in any way. In addition, no witness suggested that information received in that time frame would provide a better indicator of actual 2010 pricing than did the extensive survey information and Supplemental Data utilized in the SCCS.

The statements of AG, Bolingbrook and the Municipalities on this point amount to no more than speculation of counsel that some procedure or methodology for the SCCS other than that utilized by Deloitte would have been preferable. The Commission, however, must base its decision on the evidentiary record. 220 ILCS 5/10-103 (“any finding, decision or order made by the Commission shall be based exclusively on the record for decision in the case”); *Business & Prof. People for the Public Interest v. Illinois Commerce Comm’n*, 136 Ill. 2d 192, 227 (1989) (“*BPI I*”). That record includes extensive evidence submitted by IAWC in support of the approach used in the SCCS, and includes no testimony criticizing the SCCS' approach. Nor is there any evidence supporting the speculation of counsel for AG, Bolingbrook and the Municipalities that some better method to project 2010 pricing may have been available. For these reasons, the Commission should conclude that the estimation of 2010 pricing for services expected to be utilized by IAWC as set out in the SCCS is reasonable and consistent with the requirements of the Docket 07-0507 Order.

In their Initial Briefs, AG and the Municipalities also criticize various aspects of the Company's test year projections of Service Company hours and costs. These criticisms are also unfounded. The Municipalities, for example (Muni. Init. Br., pp. 13-14.) note uncertainty regarding whether the hourly rates set out in the SCCS are the same of those that American Water would “bill” to IAWC. As the SCCS makes clear, they are not. As discussed in IAWC's

Initial Brief (pp. 62), the SCCS sets out extensive information with regard to projected 2010 Service Company hourly costs. As the SCCS explains (IAWC Ex. 11.01, pp. 13-18), to provide the comparison required by the Docket 07-0507 Order, it was necessary to adjust the hourly costs for Service Company personnel to provide an “apples-to apples” comparison with non-affiliate supplier hourly charges. For example, outside service providers, such as law firms, normally do not assess a separate hourly rate for clerical personnel, such as secretaries, who support professional personnel retained by a particular client. (*Id.*, p. 7.) Under the Services Agreement, however, the Service Company does apply an hourly charge for such personnel. Accordingly, to develop an apples-to-apples comparison, Deloitte adjusted the Service Company hourly charges to incorporate the cost for “support” personnel into the hourly charges of the personnel supported. (*Id.*, pp. 7-8.) Without this adjustment (and the other adjustments described in the SCCS) the comparison sought by the Docket 07-0507 Order could not have been provided. No witness in this case criticized the approach used in the SCCS for the purpose of projecting Service Company hourly costs or for adjustment of Service Company hourly costs for purposes of providing the required comparisons.

The AG and Municipalities also assert that the projection of 2010 hourly costs was not adequately explained. Each aspect of the 2010 hourly cost projection is explained in the SCCS (IAWC Ex. 11.01) at pages 5 to 18. The 2010 cost projection is provided in Schedules in the SCCS that are supported by the testimony of Mr. John Young. (*Id.*, Schedules 1.1, 2.1, 2.2, 3.1, 3.3, 4.1, 4.4, 5.1, 5.2.) For the SCCS, the 2010 projection was categorized by area of service and professional classification (job type or category). (*Id.*, Schedules 1.1, 2.1, 3.1, 4.1, 5.1.) For each job classification within each area of service, the detail shows the number of hours forecasted to be required, and the cost for each hour of service. For each job category, the SCCS

compares the Service Company cost for each category to the level of cost that could be expected in the event that IAWC were to secure the service involved through competitive bidding. The Study's process used to determine both projected 2010 Service Company costs (supported by witnesses Mr. John Young, Mr. Grubb, Ms. Uffelman and Mr. Mark Young) and expected 2010 market prices is explained in the SCCS and the related testimony. (*See* IAWC Init. Br., pp. 60-62.) As indicated above, no witness in this case criticized the SCCS' methodologies used to project either Service Company 2010 hourly cost or 2010 market prices. Therefore, there is no basis to conclude that IAWC's 2010 projections were not adequately explained.

In its Initial Brief, AG speculates that a non-affiliate supplier could offer to perform a given service for fewer billed hours than is forecasted in the 2010 projection for performance of the service by the Service Company. (AG Init. Br., p. 46.) Yet, no witness in this proceeding identified even one service area (Accounting, Engineering, IT, Legal or Management Consulting) or job classification for which, in the opinion of the witness, the number of hours forecasted in the projection was unreasonably high. Thus, there is no evidentiary basis for the speculation of AG with respect to the SCCS approach. Given that the Service Company performs work at cost (with no profit component), it is just as easy to speculate that non-affiliate providers would have an incentive to utilize more hours than would the Service Company in performing a particular service. In any event, neither the SCCS's projection of 2010 Service Company hourly costs nor its estimate of 2010 market prices that would be expected if services were obtained through competitive bidding were criticized by a witness in this case. The unsupported speculation of counsel in the Briefs of AG, Bolingbrook and the Municipalities should be disregarded. In addition, for the reasons discussed herein, the requests by Bolingbrook and the Municipalities to

strike the SCCS, the Self Provision Study and related testimony, and Bolingbrook's related request that the proceeding be dismissed, should be denied.

**(b) IAWC's Projected 2010 Service Company Costs Are Reasonable and Supported by Extensive Record Evidence**

The AG, Municipalities and Bolingbrook assert that IAWC's Management fees are "excessive" (AG Init. Br., p. 22.) and that "IAWC has failed to control its costs" owed to the Service Company. (Bol. Init. Br., p. 3.) As IAWC explained in its Initial Brief (pp. 57-58), 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. IAWC witness Mr. John Young provides a detailed description of the services that the Service Company provides, and addresses the benefit that those services provide to IAWC. As Mr. Grubb explained, the projected 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.) In addition, Schedules 1, 2, 3, 4, and 5 to the SCCS provide detailed information regarding the projected hours and hourly rates for services to be provided by the Service Company to IAWC in the test year, each professional classification of the Service Company, and comparisons for each classification to projected market prices. (IAWC Ex. 11.01.) No witness challenged the detailed forecast data presented in these schedules for any classification.

AG also asserts in its Initial Brief that IAWC has "failed to exercise fiscal discipline," with respect to management fee levels. (AG Init. Br., p. 22.) As explained above, however, no witness in this proceeding criticized in any respect IAWC's service procurement policies, practices or procedures. As discussed above and in the evidence provided by Ms. Teasley, IAWC's policy is to procure services from affiliate or non-affiliate providers based on

considerations of service quality, cost effectiveness, timeliness and adequacy of alternative providers. (IAWC Ex. 1.00 (Teasley Dir.) p. 17.) Furthermore, as explained by Ms. Teasley and in IAWC's Initial Brief (pp. 68-69), the evidence shows that IAWC takes affirmative steps to both monitor and control the costs incurred by IAWC from the Service Company. (IAWC Ex. 1.00 (Teasley Dir), p. 22; IAWC Init. Br., pp. 68-69.) IAWC also reviews and approves each Service Company budget affecting IAWC before it takes effect, and conducts detailed reviews of Service Company bills and cost allocations. (IAWC Ex. 1.00 (Teasley Dir), p. 22.)

In its Initial Brief, AG refers to four e-mails in which IAWC challenged or objected to a Service Company charge or service. According to AG, these documents demonstrate that the Service Company adds unwarranted costs and that its "service is poor." (AG Init. Br., pp. 26-28.) No witness in this proceeding, however, has testified that any service provided by the Service Company is inadequate, and no witness has challenged the projected cost of any specific service that IAWC expects to obtain from the Service Company during the test year. Further, given the broad scope of services performed for IAWC by the Service Company (as described by IAWC witness John Young), the four e-mails selected by AG for reference do not demonstrate, as AG asserts, that all or a significant portion of the services provided by the Service Company to IAWC are inadequate. These documents do, however, provide support for Ms. Teasley's testimony discussed above regarding IAWC's efforts to monitor and review Service Company billing and performance. As AG points out, "[a]s shown in AG Cross Exhibit 9, Mr. Kaiser appropriately objected to paying for travel for six Service Company people to spend four days in Illinois, and the number of Service Company representatives was cut." (*Id.*, p. 27.) Similarly, in another example cited by the AG, IAWC witness Ms. Norton objected to charges for a project that should have been assigned enterprise-wide, not just to Illinois. These examples undercut

AG's premise that IAWC does not exercise "fiscal" discipline with respect to Service Company charges.

AG also asserts that, because the Company's test year level of management fees represents a larger increase from 2009 than planned and budgeted increases from 2007 to 2008 and 2008 to 2009, IAWC has not been able to demonstrate economies of scale from the use of the Service Company. (AG Init. Br., p. 23.) This point also is unsupported by the testimony of any witness. Further, as the record shows, IAWC presented detailed and uncontroverted evidence regarding economies of scale provided by the Service Company. As Ms. Teasley explained, IAWC's participation in the American Water system provides efficiencies that have allowed IAWC to minimize costs. These efficiencies include customer support through a national call center, support from the American Water Laboratory in Belleville, Illinois, and efficiencies in such areas as human resources, legal, corporate finance, environmental safety, engineering, communications and information technology systems. (IAWC Ex. 1.00 (Teasley Dir), p. 24.) As the SCCS shows, with respect to services that can be outsourced to an affiliate or non-affiliate provider, 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 \$7.24 million. (IAWC Ex. 10.00SUPP (Uffelman Supp), p. 2.)

As Mr. John Young explains, as part of the Company's strategic sourcing program, IAWC utilizes an 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. 12.00 (J. Young Dir), p. 23.) The goals of the energy supply procurement process are to achieve lower pricing than would be possible without

an agreement, in addition to reducing price volatility and increasing price predictability. Mr. John Young's testimony identifies numerous other economies of scale, such as the Labor Relations function, (pp. 11-12), which oversees recruiting using a variety of national and regional job boards. This approach reduces the cost of access to these services by leveraging the combined size of the American Water Companies to obtain better pricing. As a result, IAWC incurs a lower cost for recruiting than it would if this process were handled on a stand-alone basis.

IAWC also provided detailed evidence as to why the level of test year management fees has increased over the amount allowed in the prior case and over prior years. As IAWC explained in its Initial Brief (p. 71), Mr. Grubb provided information addressing 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. (IAWC Ex. 5.00SR (Grubb Sur), pp. 10-11.) As Mr. Grubb explained, the level of management fees approved by the Commission in the last rate case, based on IAWC's projection for the test year ended June 30, 2009, was \$17,250,322<sup>4</sup>. (*Id.*, p. 10.) The actual management fees incurred by IAWC for the twelve months ended June 2009 was \$18,528,898, which is above the amount allowed in rates in Docket 07-0507 by \$1,278,578 or 7.41%. The drivers of this difference in projected versus actual expenses were pension and OPEB costs in the amount of \$604,365 and depreciation expense of \$520,826. (*Id.*) All other costs for the twelve months ended June 2009 were on a combined basis only 1.00% above the projected level. (*Id.*, p.

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<sup>4</sup> In Docket 07-0507, the Commission disallowed IAWC's recovery of incentive compensation expense. IAWC is not requesting recovery of incentive compensation expense in this case. Therefore, the referenced figures exclude incentive compensation expense to allow an "apples-to-apples" comparison. (IAWC Ex. 5.00SR (Grubb Sur), p. 10.)

11.) As the record shows, the increase in pension and OPEB was caused by the recent decline in the stock market which impacted the level of pension/OPEB plan assets. (*Id.*) Depreciation expense increased due to investment the Service Company has made in depreciable assets such as building renovations, upgrade of computer systems and servers and the purchase of system software. (*Id.*)

The increase in management fees from the actual twelve months ended June 2009 to the end of December 2010 is projected to be \$2,607,156. (IAWC Ex. 5.00SR (Grubb Sur), p. 11.) The drivers for this increase are an expected labor and group insurance expense increase in the amount of \$1,505,427, a pension cost increase in the amount of \$287,211, a maintenance expense increase of \$521,974 and a depreciation expense increase of \$683,487. (*Id.*) All other costs for the twelve months ended December 2010 are projected to decrease by 6.7%. (*Id.*) As Mr. Grubb explains, the increase in labor and group insurance costs relates to merit increases, a decrease in the amount of labor costs capitalized and a small increase in the work force due to filling vacancies. The increase in pension costs was discussed previously. The increase in maintenance costs is related to the increase in Information Technology systems that require maintenance or service agreements. And finally, depreciation expense has increased due to the Service Company's purchase of depreciable assets. (*Id.*)

In addition, the Self-Provision Study confirms the economies of scale obtained by IAWC through outsourcing the provision of certain services, whether to the Service Company or a non-affiliate provider, by demonstrating the additional cost that IAWC would incur if it retained its own employees to provide, on a standalone basis, those services that: (i) IAWC obtains from the Service Company; and (ii) can be obtained from an affiliate or non-affiliate source. (IAWC Exs. 1.00 (Teasley Dir), p. 18; 1.04.) 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 would amount to approximately \$6.25 million. (IAWC Ex. 1.00SUPP (Rev.) (Teasley Supp), p. 3.) As in the case of the SCCS, the Self-Provision Study was not challenged by any witness in this proceeding.

Bolingbrook contends that, “the Self Provision Study somehow concludes that IAWC would need more employees than the Service Company to complete the tasks.” (Bol. Init. Br., p. 8.) This contention demonstrates a fundamental misunderstanding of the Self-Provision Study. As discussed above, the Self-Provision Study determined how many additional employees IAWC would have to hire to perform itself the services expected to be provided by the Service Company in the test year, on a stand-alone basis (i.e., if IAWC did not outsource services to affiliate or non-affiliate providers). As the Self-Provision Study shows, the increased cost to IAWC of performing the services on a stand-alone basis would be approximately \$6.25 million. This amount is attributable to the economies of scale offered by outside providers.

**(c) AG’s Recommendation that the Commission Deny Any Increase in Management Fees Should Be Rejected**

Disregarding the testimony of its own witness, Mr. Smith, who recommends that IAWC’s level of management fees be increased by 5% (which recommendation itself should be rejected as discussed below), AG suggests that the Commission should deny IAWC any increase in the test year Service Company expense. (AG Init. Br., p. 24.) This recommendation was not made by any witness in this proceeding and is unsupported by the record. Contrary to the AG’s assertion, IAWC has, as discussed above and in detail in its Initial Brief (pp. 57-71), explained the basis for its test year level of management fees. 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 the AG proposes.

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 cost of each service to be acquired from the Service Company during the test year. (IAWC Exs. 5.00 (Rev.) (Grubb Dir), pp. 2-12; 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.) AG does not contest the need for any given service. The AG 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, AG's proposal amounts to nothing more than an arbitrary limitation on prudent and necessary projected cost levels supported by detailed evidence.

As a fallback alternative, AG recommends Mr. Smith's proposed 5% increase over the affiliate management fee charges from Docket 07-0507. (AG/JM Ex. 5.0, p. 50.) As IAWC discussed in its Initial Brief (pp. 69-71), Mr. Smith's 5% recommendation, however, is also an arbitrary limit that is not based on any specific analysis of IAWC's management fees, and ignores increases in Service Company costs that are demonstrated by the evidence. Despite the evidence, the AG 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%. For the reasons discussed above and in IAWC's Initial Brief (pp. 57-71), AG's proposal should be rejected.

**(d) The AG and Municipalities' Recommendation that the Commission Order an Independent Audit of the Service Company Should Be Rejected**

The Municipalities and AG recommend that the Commission order the Company to participate in an independent third party study conducted under the guidance of the Illinois Attorney General into the operations, billing practices, and other functions conducted by the Service Company. (Muni. Init. Br., p. 13; AG Init. Br., p. 26.) These recommendations are unwarranted. No witness in this proceeding recommended such a study, or suggested that one is in any way necessary. In this proceeding, IAWC has already provided, as discussed above: extensive information on the nature and benefit of services provided by the Service Company to IAWC; the professional or functional classification of all Service Company personnel expected to provide 2010 services, the number of projected hours of services required in the test year, and the related hourly cost; a detailed budget for the Service Company's services in the test year; a detailed description of the process for allocating Service Company costs to IAWC and its regulated affiliates; and the testimony of five witnesses regarding Service Company operations and costs. IAWC's evidence in this case has addressed the Service Company's operations, billing practices, costs and functions. No witness in this proceeding challenged the results of the SCCS, the Self-Provision Study or the Belleville Lab Study. No witness testified that any service provided to IAWC by the Service Company was unnecessary. No witness testified that the Service Company budget was inaccurate. Given the extensive opportunity in this case for parties to review and examine information regarding the services IAWC receives from the Service Company, it is difficult to imagine what benefit there would be in ordering yet another study to develop the very same types of information presented in this case.

Moreover, the Municipalities' suggestion that the cost of this unnecessary study be borne by the utility is not consistent with the requirements of the Public Utilities Act. The Commission may order independent audits or investigations, but only when "it has reasonable grounds to believe that the audit or investigation is necessary to assure that the utility is providing adequate, efficient, reliable, safe, and least-cost service and charging only just and reasonable rates therefor, or that the audit or investigation is likely to be cost-beneficial in enhancing the quality of service or the reasonableness of rates therefor." 220 ILCS 5/8-102. As discussed above and in IAWC's Initial Brief, the AG and Municipalities have failed to establish that such grounds reasonably exist. The cost of independent audits or investigations, moreover, "shall be recovered as an expense through normal ratemaking procedures." (*Id.*)

**(e) IAWC's Hiring of Additional Employees Does Not Support a Finding that Management Fees Are Unreasonable**

The AG (AG Init. Br., pp. 20-22) and Municipalities (Muni. Init. Br., pp. 9-11) argue that, because IAWC is hiring more direct employees, the level of services required by IAWC from the Service Company, and thus the level of management fees, should be reduced. The AG and Municipalities point to the shift of employees to the Service Company in the prior case (AG Init. Br., p. 20), and assert that while that shift justified increasing management fees, IAWC's proposed increase in both employee count and management fees is unreasonable. As discussed above, however, IAWC's proposed increase in management fees is supported by substantial evidence of record.

IAWC explained in detail the reason for the addition of employees at the utility. As Ms. Norton testified, to improve overall customer service and business performance, IAWC initiated a process to increase the state-level focus of its management structure. (IAWC Ex. 2.00 (Norton Dir), p. 5.) Through this process, IAWC's ability to provide customer service and to follow cost-

effective and operationally sound business practices will be enhanced. As part of this process, certain positions at the Service Company have been re-designated as state-specific positions at IAWC. (*Id.*) This change allows the employees in these positions to focus solely on IAWC and the provision of service in Illinois (in many cases, the employees already spent the majority of their time serving IAWC). For example, as part of the process to enhance the state-level focus of IAWC's management structure, the engineering functions for the Company, including the planning and execution of the capital budget, were transferred from the engineering department at the Service Company's Central Regional office in St. Louis, Missouri to a "state-focused" IAWC engineering department in Belleville, Illinois. (IAWC Ex. 3.00 (Kaiser Dir), p. 4.) This transfer to an Illinois-based engineering department has enhanced the planning, tracking and execution of the capital program for the Company. (*Id.*) The creation of a state focused staff has also increased coordination with the IAWC operations and production staff in the planning and design of major projects. (*Id.*) As IAWC has explained, its test year level of management fees is justified and its projected increase in personnel reasonable and appropriate as it will enhance IAWC's ability to provide customer service and follow cost-effective and operationally sound business practices. Thus, the concerns of AG and the Municipalities are unfounded.

**(f) The AG's Attempt To Reference Proceedings in other Jurisdictions Should Be Disregarded**

The AG, referencing an order of the California Public Utilities Commission ("CPUC") (Decision 09-07-021, July 9, 2009) ("California Order") in a rate proceeding involving California-American Water Company ("Cal-Am") (*see* IAWC-AG Admin. Notice Documents 1-3), and an order by the Tennessee Regulatory Authority ("Tennessee Order") involving Tennessee-American Water Company ("Tenn-Am"), suggests that other regulatory commissions are "troubled" by the level of Service Company charges in their jurisdictions. (AG Init. Br., pp.

24-26.) The AG asserts that these orders show that, when concerned with the level of Service Company fees, the regulatory commissions in California and Tennessee ordered independent audits, and this Commission should do the same. The AG's assertions should be disregarded.

No witness in this proceeding has provided any testimony which would support a finding that the conclusions of California Order or the Tennessee Order have applicability to this case. There has been no showing of comparability between Cal-Am, Tenn-Am and IAWC, and, as discussed above, there is no basis for concern regarding management fees in this proceeding. There is no testimony regarding the similarity of conditions of operations, service area characteristics, types of service provided, number of customers, the nature and extent of Service Company services provided or other elements of comparability between IAWC and either Tenn-Am or Cal-Am. Absent a showing of comparability between IAWC and either Cal-Am or Tenn-Am, there is no basis for relying on either the California or Tennessee Order to support any specific claim regarding IAWC's proposed rate increase. *Central Ill. Light Co., et al.*, Docket Nos. 06-0070 (Cons.) Final Order on Rehearing, p. 27 (May 16, 2007) (study comparing companies' administrative and general costs could not be used to show that utility costs are reasonable, where there was no showing that the companies were truly comparable to the utility); Docket 07-0507 Order, pp. 43-44 (proposal to reduce O&M expense based on comparison of public utility to MOUs rejected because of fundamental differences between public utility and MOUs); *Antioch Milling Co. v. Public Service Co. of Northern Illinois*, 4 Ill. 2d 200, 210 (Ill. 1954) (excluding evidence of differing rates where party failed to demonstrate that the utilities being compared were sufficiently similar to warrant comparison). Mere reference to the orders in these other states does not provide a basis for concern.

Moreover, the California Proceeding is still pending, and the CPUC authorized California-American to “file a petition for modification of [the California Order] that fully discloses all non-regulated operations which use any assets or employees included in revenue requirement.” California Order (IAWC-AG Admin. Notice Doc. 1), p. 134. Pursuant to that authorization, Cal-Am filed a petition for modification (IAWC-AG Admin. Notice Doc. 2) regarding the allocation of general office costs from the Service Company, seeking reversal of approximately \$825,000 of the adjustments to Service Company expense in the California Order. Importantly, the California Division of Ratepayer Advocates (“DRA”), filed a response in which the DRA stated that it “acknowledged [California-American’s] efforts to comprehensively document and account for its non-regulated operations” and that it did not oppose the petition to modify. (IAWC-AG Admin. Notice Doc. 3.) Because the California Proceeding is still pending before the CPUC, the decision is not final. Moreover, given the absence of any record evidence in this proceeding of the comparability of IAWC and Cal-Am or Tenn-Am, there is no basis to consider the conclusions of either the California Order or Tennessee Order as an appropriate basis to question the level of Service Company charges in Illinois. Nor do they support the AG’s “suggestion” of an independent audit. Such an audit is unwarranted, as discussed above.

#### **11. Gross Revenue Conversion Factor Adjustment**

AG recommend that IAWC’s Gross Revenue Conversion Factor (“GRCF”) be calculated on a district by district basis. (AG Init. Br., pp. 46-47.) In support of this approach, AG claims that calculating a state-wide GRCF would “distort” the assignment of costs to the districts. (*Id.*, p. 47.) As IAWC explained in its Initial Brief (pp. 71-72), however, the Company maintains uncollectibles on its books at the state corporate level. (IAWC Ex. 6.00R2 (Kerckhove 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.) 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.

AG/JM witness Mr. Smith developed 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 (Kerckhove 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.) Therefore, the AG's recommendation should be rejected.

### **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 Reply Brief Appendix A. The operating income statement for each Rate Area is shown on the respective designated sheet of Reply Brief Appendix A.

#### **IV. COST OF CAPITAL & RATE OF RETURN**

##### **A. Capital Structure**

##### **1. IAWC's Short-term Debt Ratio Is Appropriate**

##### **Response to AG and Municipalities**

AG and the Municipalities recommend that IAWC switch 3.26% of its capitalization from common equity to short-term debt, asserting that short-term debt financing is more cost-effective. (AG Init. Br., pp. 47-49; Muni. Init. Br., pp. 15-16; AG/JM Ex. 5.0, pp. 6-17.)

However, AG's recommendation is improper because, as discussed below, it views the short-term debt component of the capital structure in isolation and ignores the fact that IAWC must maintain a balanced capital structure overall in order to obtain capital on reasonable terms. As IAWC explained in its Initial Brief (pp. 74-76), 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. This requires that IAWC maintain a balanced capital structure and a favorable rating for debt, as discussed below. (IAWC Ex. 20.00SR (Kalinovich Sur), pp. 2-3.)

Moreover, 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.

AG and the Municipalities focus incorrectly on the cost of common equity in isolation, rather than on the combined cost of capital (debt and equity) that results from a given capital

structure. As IAWC explained in its Initial Brief (p. 79), AG and the Municipalities ignore the high risk associated with financing long-term investments with short-term debt, which can result in a rapid and unnecessary rise in costs to ratepayers. As IAWC explains in its Initial Brief (p. 78), 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. 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.)

As IAWC further explained in its Initial Brief (p. 78), 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 until long-term debt or equity can be issued. 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. (IAWC Ex. 20.00SR (Kalinovich Sur), pp. 13-14.) 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.)

## 2. IAWC's Common Equity Ratio Is Appropriate

### Response to IWC

IWC asserts that IAWC's proposed capital structure is not reasonable, because its common equity ratio is above historical levels. (IWC Init. Br., p. 21.) As IAWC explained in its Initial Brief (p. 74), 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. 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. (*Id.*, pp. 7-8.)

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 in effect assigns its own "rating," developed in a manner similar to that used by the rating agencies for public debt. IAWC must therefore maintain a certain rating in order to issue capital on reasonable terms as it is required to maintain adequate and reliable service. (*Id.*) This requires that IAWC maintain a balanced capital structure. (*Id.*, p. 3.) As a result, as IAWC explained in its Initial Brief (pp. 75-76), 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.)

As IAWC's Initial Brief also explained (pp. 76-77), IAWC's common equity ratio is consistent with that of other comparable utilities. 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. 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 twenty six 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.*) Staff witness Sheena Kight-Garlisch also 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.) Based on these comparisons, IAWC's forecasted average capital structure for the twelve-month period ending December 31, 2010 is reasonable.

Significantly, IWC witness Mr. Gorman's own proxy groups' data supports 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). (IWC 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. Moreover, 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 IWC's concern regarding IAWC's common equity ratio is unwarranted.

Nor is there any substance to IWC's concern that there is a conflict of interest by virtue of American Water's equity infusions to IAWC. (IWC Init. Br., p. 24.) As IAWC explained in its Initial Brief (p. 81), American Water, like any other independent investor, will evaluate the risk and reward profile of common equity contributions to IAWC and make a common equity investment if it expects to earn a reasonable return on its investment. Although American Water is not required to invest in the common equity capital of IAWC or any other specific entity, American Water 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.)

IWC also contends that IAWC should have a capital structure similar to that of American Water because IAWC's bond rating is tied to the financial risk represented by

American Water. (IWC Init. Br., p. 23.) As IAWC explained in its Initial Brief (p. 82), however, IAWC's operating risk profile is significantly different than the risk profile of American Water. American Water 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' operations, it is reasonable to expect that the capital structure of IAWC and American Water would differ.

IAWC must maintain a financial position to attract capital in all possible economic circumstances, irrespective of the capital structure of American Water. Furthermore, if IAWC obtained a credit rating, it would be significantly lower than American Water's/AWCC's BBB+ rating. 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), p. 7.) In addition, the historical returns earned by American Water 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 American Water 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.

## **B. Cost of Debt**

### **1. Short Term Debt**

IAWC proposes, and Staff supports for the purposes of this case, a forecasted short-term debt cost rate of 1.97%. (IAWC Init. Br., p. 84.) The AG and CUB have not challenged IAWC and Staff's proposal in their Initial Briefs. IWC proposes a short term debt cost of 1.0%. (IWC

Init. Br., p. 21.) As indicated by Mr. Rungren, because the Company is relying on a forecasted 2010 test year, a forecasted 2010 cost of short-term debt – IAWC’s proposed 1.97% – should be applied. (IAWC Ex. 4.00R2 (Rungren Reb), p. 11.)

## **2. Long Term Debt**

As indicated in its Initial Brief, the Company accepts Staff’s projected overall embedded cost of long-term debt of 6.24%. (IAWC Init. Br., pp. 84-85.) In its Initial Brief, IIRC accepted IAWC’s previously projected cost of long-term debt of 6.28%. (IIRC Init. Br., p. 20.) This projection has been superseded in light of IAWC’s acceptance of Staff’s cost of long term debt.

### **C. Cost of Common Equity**

In their respective Initial Briefs, Staff, IIRC, AG, and CUB state that the Company is proposing a 12.25% return on equity (“ROE”) and address their arguments accordingly. (Staff Init. Br., p. 36; IIRC Init. Br., p. 4; AG Init. Br., p. 49; CUB Init. Br., p. 4.) As indicated by the surrebuttal testimony of Ms. Ahern and as explained by IAWC in its Initial Brief (pp. 86-87), based on adjustments to correct errors in the analyses of Staff witness McNally and IIRC witness Gorman, a reasonable range of ROE would be 10.70%-11.10%. IAWC has proposed the midpoint of this range, 10.90%, as a reasonable ROE. (IAWC Init. Br., p. 85.) To the extent that the Initial Briefs in this proceeding address themselves to the 12.25% figure, those arguments should be disregarded as irrelevant. Furthermore, although Staff opposes IAWC’s adjustments to Mr. McNally’s analysis in its Initial Brief (Staff Init. Br., pp. 28-31), none of the other parties has expressly contested the adjustments to their return on equity calculations in Ms. Ahern’s rebuttal and surrebuttal testimony. As explained below, the Commission should accept the Company’s adjustments and adopt a cost of common equity of 10.90%.

## **1. Adjustments to Proposals of IWC and Staff are Necessary**

As demonstrated by Ms. Ahern in her testimony, correction for the errors in the analyses offered by Staff and IWC produce results within her proposed reasonable range of ROE: 10.70%-11.10%. (IAWC Init. Br., pp. 86-111.)

### **(a) Adjustments to IWC**

The Company's Initial Brief demonstrated that the DCF and CAPM analyses offered by Mr. Gorman, and relied upon by IWC, contains several flaws. IWC's DCF analysis is faulty because (i) Mr. Gorman improperly excluded data produced by his constant-growth model, (ii) Mr. Gorman's use of a sustainable growth model was both illogical and previously rejected by the Commission, and (iii) Mr. Gorman's multi-stage DCF model incorrectly excluded relevant data. (IAWC Init. Br., pp. 92-93.) Gorman's CAPM analysis was similarly flawed because his (i) derivation of the historical market equity risk premium is incorrect, (ii) "forward-looking" equity risk premium is not truly a prospective equity risk premium, and (iii) 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. (*Id.*, p. 95.) In testimony and in IAWC's Initial Brief, the Company proposed adjustments to correct these errors. (*Id.*, pp. 92-96.) In its Initial Brief, IWC has offered no refutation of Ms. Ahern's adjustments to Mr. Gorman's work. Consequently the Commission should accept them.

### **(b) Adjustments to Staff Analysis**

As explained in IAWC's Initial Brief (pp. 91, 93-94), in her analysis Ms. Ahern proposed to adjust Mr. McNally's DCF and CAPM analyses to correct for (i) inappropriate use of recent spot yields of treasury bonds, as opposed to available forecasts, and (ii) miscalculation of implied 20-year forward U.S. Treasury yield. After full adjustment, including financial and business risk

factors (discussed below), a risk adjusted cost of common equity of 10.81% and 11.09% results from Mr. McNally's analysis. (IAWC Init. Br., p. 96.) As demonstrated below, Staff's responses in its Initial Brief fail to refute the Company's proposed adjustments.

Staff's response to Ms. Ahern's use of forecasts to replace Mr. McNally's use of spot yields mischaracterizes the nature of such forecasts and should consequently be disregarded. Staff incorrectly characterizes forecast data as only proxies for investor expectations. However, as explained by Ms. Ahern in her surrebuttal testimony, this is not so. (IAWC Ex. 8.00SR (Rev.) (Ahern Sur), pp. 2-3.) The forecast data relied upon by Ms. Ahern in her analysis represents a consensus of approximately 50 of the country's leading economists from Blue Chip Financial Forecasts. As soon as those forecasts are publicly available, under the Efficient Market Hypothesis, they are immediately assimilated by investors. Consequently, rather than being mere proxies of expectations, they represent factors that directly impact investors' expectations and therefore the market prices they are willing to pay for common stocks.

Staff also asserts that there is "no valid justification" not to use the spot yield figures. (Staff Init. Br., p. 28.) This is untrue. As noted above, the forecasts represent information readily available to investors that impacts their behavior. Further, use of such data is in fact more appropriately in keeping with the prospective nature of ratemaking. (IAWC Ex. 8.00SR (Ahern Sur), p. 3.) Last, contrary to Mr. McNally's view, such forecasts are no less appropriate than are the Zacks' long-term forecasts of earnings per share growth utilized by Mr. McNally in his DCF analyses. Hence, like Zacks' long-term forecasts of EPS growth, Blue Chip Financial Forecasts should be used for cost of capital and ratemaking purposes. (*Id.*)

Finally, Staff's critique of Ms. Ahern's recalculation of McNally's implied 20-year forward U.S. Treasury yield must be rejected. (Staff Init. Br., pp. 31-32.) Staff fails to cite a

single exhibit in support of its analysis. Consequently, this argument, having no basis in the record, should be disregarded by the Commission.

## **2. Adjustments for Financial and Business Risk**

Criticisms of the Company's rate of return recommendation focus primarily on two issues, (1) a proposed business risk adjustment, (2) a proposed financial risk adjustment. Because the Company demonstrated the necessity of such adjustments through testimony and in its Initial Brief, the Commission should accept these figures and the Company's proposal to include them in its adjustments. (IAWC Init. Br., pp. 87-90.)

### **(a) Business Risk Adjustment**

The Company's Initial Brief explained the basis for a business risk adjustment of 15 basis points (0.15%). (IAWC Init. Br., pp. 87-89.) No party has adequately rebutted the evidence supporting such an adjustment. Consequently, the Commission should accept Ms. Ahern's analysis.

### **Response to CUB**

CUB presents no arguments in its Initial Brief not fully addressed in the Company's Initial Brief. (IAWC Init. Br., pp. 102-103.) In short, CUB mischaracterizes Ms. Ahern's proposal by claiming it is a previous rejected market-to-book ratio adjustment. This is not so. Ms. Ahern's business risk adjustment in no way advocates a market-to-book ratio adjustment, and is instead meant to account 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 concentration of sales-for-resale customers. (IAWC Init. Br., p. 103.) Because CUB witness Mr. Thomas exhibits a misunderstanding of this analysis, his critique should be disregarded.

## **Response to IWC**

IWC's criticism of IAWC's business risk adjustment fails on each point. First, IWC mischaracterizes the proposed adjustment as a previously rejected size-based adjustment. Contrary to IWC's assertion, Ms. Ahern's proposed business risk adjustment is not a size-based adder. This assessment ignores the other factors relied upon by Ms. Ahern in calculating the adjustment. (IAWC Init. Br., pp. 87-89.) Second, IWC incorrectly assumes that because the companies in the proxy groups used to develop the ROE analyses have similar bond ratings, IAWC must have equal bond ratings. This assumption is incorrect and is unsupported by analysis of the factors unique to IAWC, discussed by Ms. Ahern in her analysis of business risk. (IAWC Init. Br., p. 87-89.) Finally, IWC's assertion that the Company's status as a wholly-owned subsidiary should eliminate the need for a business risk adjustment is unsupported. As noted in the Company's Initial Brief, the Company must be evaluated as a stand-alone company. (IAWC Init. Br., p. 102.) Furthermore, the factors cited by IWC as mitigating business risk due to the Company's subsidiary status (availability of services from the Service Company and superior management expertise) are unrelated to the factors that Ms. Ahern relied on in making her business risk adjustment, namely: 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 Init. Br., p. 101.) IWC's arguments are thus unpersuasive and should be disregarded.

## **Response to Staff**

The Company first takes issue with Mr. McNally's characterization of Ms. Ahern's estimation of market capitalization as purely hypothetical. As a preliminary matter, any estimate is hypothetical to some extent in that it reflects the need project a value which cannot be observed by relying on analogous observable data. As explained by Ms. Ahern in her surrebuttal,

she has done just that, by estimating IAWC's market capitalization based upon the market-to-book ratios of the proxy group companies. (IAWC Ex. 8.00SR (Rev.) (Ahern Sur), pp. 7-8.) This move is no more hypothetical than using the market data of that very same proxy group to arrive at a cost rate of common equity applicable to IAWC because IAWC's is not directly observable. In other words, if the market data of a proxy group or groups is appropriate for cost of capital purposes for IAWC, that market data is also appropriate to use to estimate a market capitalization for IAWC. (IAWC Ex. 8.00SR (Rev.) (Ahern Sur), pp. 7-8.)

Second, the Company points out that Staff makes the same error as IWC in mischaracterizing the proposed business risk adjustment as a size-based adjustment. As explained above, Ms. Ahern relied on a number of factors in calculating her proposed adjustment, which happened to include, but were not limited to, the relative size of IAWC. Ms. Ahern also considered regulatory risks specific to Illinois, the availability and quality of IAWC's water supply, the unique, capital-intensive nature of water utilities, the lower depreciation experienced by IAWC relative to other kinds of utilities, and IAWC's concentration of sales-for-resale customers. These factors are explained in detail in the Company's Initial Brief. (IAWC Init. Br., pp. 87-89.)

Third, the Company would correct the assertion of Staff that Ms. Ahern based her business risk adjustment solely on size and the Ibbotson study. This contention is directly contradicted by the testimony offered by Ms. Ahern in her surrebuttal, where she identified a number of factors that went into her analysis of IAWC's relative business risk. (IAWC Ex. 8.00R2 (Rev.) (Ahern Reb), pp. 16-17.)

### **3. Financial Risk Adjustment**

The Company's Initial Brief explained the basis and necessity for a financial risk adjustment (IAWC Init. Br., pp. 89-90), and further established the necessity of including such a factor in Ms. Ahern's adjustments to Staff and IWC analyses. (*Id.*, pp. 96-98.)

#### **Response to IWC**

IWC makes two contentions in its Initial Brief, both of which should be rejected. First IWC suggests that assuming the proxies used in credit rating analysis are valid proxies, and "assuming they have similar bond ratings," no adjustment is necessary. (IWC Init. Br., p. 20.) IWC repeats the same analytical error here that it committed in arguing its position on business risk. Namely, rather than address the issue, IWC has chosen to assume it away by supposing that proxies similar to IAWC in some respects, must therefore be similar in all respects, including bond rating. Not so. As indicated in the Company's Initial Brief, it is precisely because the proxies *do not* have the same financial risk as IAWC that an adjustment is necessary. (IAWC Init. Br., pp. 103-104.) Second, IWC suggests that the IAWC should have a credit and a bond rating higher than its parent company. This assertion is unsupported in an analysis of IAWC and should be disregarded. As indicated by the Company in its Initial Brief, Ms. Ahern conducted an analysis of IAWC and determined that the Company's debt would be rated in the bottom of the BBB/Baa or top of the BB/Ba bond rating categories. (IAWC Init. Br., p. 90.) Because IWC's has offered no evidence to refute Ms. Ahern's analysis, its unfounded criticisms should be disregarded.

#### **Response to CUB**

CUB levels two criticisms against IAWC's proposed financial risk adjustment. It asserts (i) that there is no evidence of what IAWC's debt would be rated at were it to be rated by Moody's and S&P, and (ii) that credit ratings are artificially inflated. (CUB Init. Br., p. 18.) The

first proposition is incorrect because it ignores the analysis offered by Ms. Ahern to estimate such ratings, as outlined in IAWC's Initial Brief. (IAWC Init. Br., p. 90.) The second argument is addressed largely in IAWC's Initial Brief (IAWC Init. Br., p. 104), but as presented in CUB's Initial Brief the argument is troubling because it mischaracterizes the testimony of Ms. Ahern. In her testimony, Ms. Ahern does not agree that credit rating agency projections are inflated. Rather, she acknowledges the existence of past artificially inflated credit ratings for residential mortgage-backed securities and collateralized debt obligations linked to subprime mortgage loans, and not utility long-term debt. (IAWC Ex. 8.00R2 (Rev.) (Ahern Reb), pp. 20-21.) Further, she only assumes *arguendo* that such ratings are inflated to make the point that *if* such ratings are inflated, then they are generally inflated and on a relative basis, and IAWC is still financially riskier than the proxy group and would require an appropriate adjustment. (*Id.*) This is a far cry from "agree[ing] that the credit rating agency projections are inflated." As CUB has offered no meaningful argument to refute IAWC's proposed financial risk adjustment, its criticisms should be rejected.

### **Response to Staff**

Staff opposes Ms. Ahern's 21 basis point financial risk adjustment to Mr. McNally's analysis and raises two arguments against Ms. Ahern's proposed financial risk adjustment: (i) that Ms. Ahern overstated the credit rating of the companies in Mr. McNally's utility group, (ii) that Ms. Ahern understated the credit rating for IAWC.

First, contrary to Staff's assertion, Ms. Ahern has not overstated the credit rating of the companies in Mr. McNally's utility group. Staff has misconstrued Ms. Ahern's testimony. In her testimony (IAWC Ex. 8.00SR (Rev), p. 5), Ms. Ahern clearly states "the Utility Group's credit rating is BBB", the same credit rating identified by Staff in the sentence immediately

following the accusation that Ms. Ahern has overstated the Utility Group's credit rating. What Ms. Ahern did do, however, is base her financial risk estimate on the utility group's bond rating. (IAWC Init. Br., p. 96.) As she explained, and despite Staff assertions to the contrary, because bond yields are based upon bond ratings and not credit ratings, it is imperative that any financial risk adjustment based upon those yields be based upon bond rating differences between IAWC's likely bond rating and the bond rating of the Utility Group. (IAWC Ex. 8.00SR (Rev.) (Ahern Sur), p. 5.) Staff has not refuted this point in its Initial Brief.

Second, Staff argues that Ms. Ahern has underestimated the credit rating for IAWC by "assume[ing]" a "Strong" business risk profile for IAWC. This assertion ignores the testimony offered by Ms. Ahern. Contrary to Staff's assertion, Ms. Ahern did support her conclusions. As she explained, Ms. Ahern's analysis was based on her review of financial metrics for IAWC updated for 2008 on Schedule 8.05R2 and S&P's expanded business risk and financial risk matrix. (IAWC Ex. 8.00SR (Rev.) (Ahern Sur), p. 5.) Ms. Ahern further buttressed her conclusion based on her analysis of the credit and bond ratings of IAWC's parent company. (*Id.*)

Finally, Staff criticizes Ms. Ahern's estimate of the Company's credit rating as "conjectural" and merely the "opinion" of Ms. Ahern. (IIWC Init. Br., pp. 34-35.) All Staff has really done is point out the inherent nature of estimating an unknown variable based on measurable analogues. Staff's own suggestion that IAWC should be rated differently is no less based on the "opinion" of Mr. McNally than IAWC's estimates were based on the "opinion" of Ms. Ahern. As demonstrated above, Ms. Ahern supported her conclusions with analysis of available data and showed that they were reasonable. Because Staff's contention here presents no real argument, it offers no aid to the Commission and should be rejected.

#### **4. Response to AG and CUB Proposed Return on Common Equity**

##### **(a) Mr. Thomas' Analysis Should be Disregarded**

CUB's analysis, provided by Mr. Thomas, offers little in the way of arguments not already disposed of by the Company's Initial Brief, such as his objection to (i) the use of analyst's forecasts, (ii) Ms. Ahern's beta coefficient in her CAPM analysis, and (iii) Ms. Ahern's EMRP analysis. (IAWC Init. Br., pp. 98-101.) Generally, as explained in the Company's Initial Brief, 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, render Mr. Thomas' proposed return on common equity inaccurate, and should thus be excluded from further consideration. One point does, however, merit discussion.

The general tenor of CUB's Initial Brief is a recommendation that the Commission take the "long-term view of the capital markets." (CUB Init. Br., p. 11.) CUB's suggestion is correct, in part. As indicated by Ms. Ahern, the cost of capital, including common equity cost rate, is a long-term concept. Further, Mr. Thomas is also correct when he states that short-term uncertainty can impact costs. Most critically, Mr. Thomas also states in CUB Exhibit 2.0 that "the Commission's task is to determine that the allowed rate of return on common equity for regulated companies like IAWC is sufficient for the period that rates will be in effect." Rates set in IAWC's current proceeding are likely to be in effect for two years. While the cost of capital is a long-term concept, it must be recognized that IAWC must attract long-term capital in the short term; during the current, uncertain economic recovery, as Mr. Thomas states, the short-term uncertainty might increase costs. The Commission needs to be mindful of such uncertainty related to increasing capital costs, as well as the current uncertain economic environment where IAWC's capital costs are indeed rising. Taking a long-term view of capital markets, while recognizing short-term uncertainty and the resulting increase in capital costs, will ensure a return

on common equity consistent with the principles established in the *Hope* and *Bluefield* cases regarding the maintenance of financial integrity and the ability to attract capital.

For all the reasons above, the Commission should reject the proposals of Mr. Thomas as offered by CUB and AG.

**(b) AG's Position Is Contradicted by the AG's Own Witness**

AG has made no arguments of its own in its Initial Brief regarding the cost of common equity. Instead, it incorporates the proposal of Mr. Thomas by reference. (AG Init. Br., p. 11.) In so doing, AG has puzzlingly ignores the testimony of its own witness, Mr. Smith, who recommended the cost of common equity should be an average of the estimates of Mr. McNally and Mr. Gorman. (AG/JM Ex. 5.0, p. 16.) Based on those original calculations, the result is 10.19%. However, the above-noted adjustments to those analyses is also applicable to Mr. Smith's recommended average. AG has not directly opposed Mr. Ahern's adjustments to those analyses. Mr. Smith's recommendation, as adjusted for the errors in Mr. Gorman and Mr. McNally's calculations, therefore, supports the Company's recommended cost of common equity.

Finally, because AG's citation to Mr. Thomas' analysis contains no supporting arguments (AG Init. Br., p. 49.) and is fully subsumed by the Company's discussion of CUB's brief, it is not addressed separately. For the reasons discussed above, the Commission should accept Mr. Ahern's adjustments to Mr. McNally's and Mr. Gorman's analyses of the cost of common equity and approve IAWC's proposed 10.90%.

## V. COST OF SERVICE

### A. Demand Study

#### Response to Staff

##### 1. The Capacity Factors Report Was Prepared in Accordance with the Commission-Approved Methodology for an Indirect Demand Study

Staff asserts that the methodology used to prepare the Company's Capacity Factors Report is flawed. Staff contends that, although IAWC used a methodology similar to that approved by the Commission in Docket 08-0463, the methodology is not "detailed" and therefore it has no measure of prior Commission approval. As the Company explained in its Initial Brief, the proposed methodology used to prepare the *Report on Capacity Factors by Customer Class for the Illinois-American Water Company* ("Capacity Factors Report") did receive prior Commission approval in Docket 08-0463. (IAWC Init. Br., pp. 105-06.) The proposed methodology set forth a step by step approach to perform an indirect demand study, and indicated the categories of data that would be utilized (such as system demand data, customer billing data, and actual data "to the extent possible"). (IAWC Ex. 13.02.) The parties to Docket 08-0463, including Staff and the Company, then filed a Joint Motion seeking approval of the proposed methodology. The Commission granted the Joint Motion and expressly approved the proposed methodology. (IAWC Ex. 13.00 (McKinley Dir), p. 6.) The Company used this approved methodology to prepare the Capacity Factors Report for the present case. Staff asserts, however, that "[t]he general nature of the content shows that the motion clearly left to a later date the development of a specific plan for deriving [] demand factors." (Staff Init. Br., pp. 42-46.)

IAWC does not maintain that, in Docket 08-0463, the Commission approved all aspects of the Capacity Factors Report, or that the approved methodology identified all the data to be

used in the Capacity Factors Report and the details of the application of that data. For example, IAWC does not maintain that the specific approach used in the Capacity Factors Report to develop the residential daily variation factors (“RDV”) was approved by the Commission. Rather, as IAWC explained in its Initial Brief (pp. 105-110), the Capacity Factors Report was developed in accordance with, and consistent with, the approved methodology, which set forth the steps to be taken in performing the study. Staff’s assertion that the Commission’s approval of the methodology left to a later date the development of a specific plan sets is misguided: IAWC does not disagree that the detailed implementation of the Commission-approved methodology was performed later, as explained in the Capacity Factors Report. As explained below and in IAWC’s Initial Brief (pp. 105-121), however, the Capacity Factors Report was prepared in accordance with the approved methodology and the data used was consistent with the approved methodology. Staff’s conclusion, that “there is no basis to conclude that the Commission has given prior approval in any form IAWC’s proposals in this case,” (Staff Init. Br., p. 46.) is simply incorrect. The Commission approved the indirect study methodology as IAWC proposed (*see* IAWC Ex. 13.02), and IAWC’s Capacity Factors Report is consistent with that methodology.

## **2. The Use of Chicago Metro Data Is Appropriate and Beneficial**

Staff, in its Brief (pp. 46-47), objected to the use of pumpage data from four Chicago Metro service areas. Staff asserted that the Chicago Metro data was used to “develop residential maximum day ratios for all Illinois districts.” (*Id.*, p. 46.) This is incorrect. As the Capacity Factors Report explains (IAWC Ex. 13.01R1, pp. 13-17), and as discussed at length in the Company’s Initial Brief (IAWC Init. Br., pp. 107-112), the RDV factor is one component in the calculation of maximum day and maximum hour capacity factors. Actual data for the four Chicago Metro service areas was used to confirm the preliminary estimates of the RDV factor.

Where Residential MD/ADMM data is not available, judgment considerations determine the RDV factor, supported by the reasonableness of the resulting system diversity factors. (IAWC Ex. 13.00R1 (McKinley Reb), p. 7.) Maximum day and average day pumpage for these four areas, however, was available and 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”). (*Id.*, pp. 6-8.) 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. (*Id.*, pp. 7-8.) 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 American Water Manual. (*Id.*, p. 8.)

As IAWC also explained in its Initial Brief (p. 108), this type of residential data is not generally available for other districts operated by the Company. 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. 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, because Residential MD/ADMM data is considered indicative of the ratio of residential maximum day to average day water usage in the Midwest, and because the preliminary RDV factors were in the range considered acceptable by the AWWA Manual, the Company determined that it was appropriate to base the proposed RDV factors on Residential MD/ADMM. (IAWC Ex. 13.00R1 (McKinley Reb), pp. 7-8.) Though Staff argues that the Chicago Metro data is a “proxy” for actual data from districts across the state, the Chicago Metro data was used only to corroborate RDV factors from other districts (developed from that district’s data) and demonstrate their reasonableness. The Company did not rely on the Chicago Metro data to derive RDV factors—it did, however, use it to check the RDV factors as was required in the Methodology approved by the Commission in Docket 08-0468, which ordered that “[t]o the extent possible, actual demand data” be used to derive demand factors. (IAWC Ex. 13.02, pp. 2-3.) The Company’s confirmation of RDV factors derived from each district’s own data against actual demand data from wholly residential districts in Chicago Metro is exactly the kind of use of actual data contemplated by the methodology as approved by the Commission.

Staff’s contention that Chicago Metro data is unreliable due to the district’s alleged weather sensitivity (Staff Init. Br., p. 50) is unsupported by the record and runs counter to actual data supplied by the Company. As IAWC explained in its Initial Brief (pp. 109-110, 112), IAWC compared its Chicago Metro data to residential demand data received in the direct measurement demand study of Interurban in Docket 07-0507. This comparison demonstrated that residential class variation between the two districts differed very little. (IAWC Ex. 13.00SR (McKinley Sur), p. 3.) Staff’s argument regarding weather sensitivity is meanwhile based on its unsupported assertion that the water uses referenced in Mr. McKinley’s rebuttal testimony

“could be considered weather sensitive usage.” (Staff Init. Br., p. 50.) Therefore, no data in the record disproves the comparison of actual residential demand data from two different districts in the state with similar residential class variation. (IAWC Init. Br., pp. 110-111.)

### **3. Non-residential Class Variation Factors Were Developed Appropriately**

In its Initial Brief, Staff also claims that the non-residential class variation factors the Company derived are problematic because they rely on old data from previous dockets and they do not vary between districts. (Staff Init. Br., p. 49.) Staff’s complaint that the Company used historical data in deriving its class variation factors is incorrect for two reasons—first, because Staff relied on the same data in deriving its class variation factors (which have since been withdrawn) (Staff Ex. 6.0, pp. 32-33), and second, because the Company’s class variation factors are consistent with the AWWA Manual. (IAWC Ex. 13.00R1 (McKinley Reb), p. 8.)

As IAWC explained in its Initial Brief (pp. 114-115), the class variation factors are supported by the Company’s data and were developed in accordance with the methodology approved by the Commission in Docket 08-0463. The Company’s Chicago Metro district data presented in this case provides actual measurement of residential class variation, and its reasonableness is supported by the data derived from the demand study in Docket 07-0507. (IAWC Ex. 13.00SR (McKinley Sur), p. 3.) This data also shows that residential class variation factors do not vary much across the state. (*Id.*) Based on this actual residential class variation data, the Company developed non-residential class variation factors that are lower than the residential class variation, as is “typically found in water utilities.” (*Id.*, p. 11.) Moreover, the Commission-approved methodology makes no requirement that class variation factors vary between districts, or that district-specific class variation factors be derived. (IAWC Ex. 13.02.)

As IAWC's Initial Brief also explained (pp. 114-115), 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 were accepted by the Illinois Commerce Commission in previous rate case dockets. (IAWC Ex. 13.00R1 (McKinley Reb), p. 15.) Furthermore, Mr. McKinley explained that the variation in daily demands within the maximum month are expected to be lower for commercial and industrial customers than for residential customers because commercial/industrial water usage is less influenced by weather conditions than is residential usage. (*Id.*) Because actual data supports the Company's assumption, it is reasonable and should be accepted.

The reasonableness and reliability of IAWC's non-residential class variation factors is further demonstrated by Staff's discussion of the Other Water Utilities class for the Interurban district. Staff claims that the higher variability of the Other Water Utilities class for Interurban during the peak month undermines the Company's position that the residential class has a higher variability than non-residential classes. (Staff Init. Br., pp. 51-52.) However, as is discussed in the Company's Initial Brief, the Other Water Utilities class is for wholesale water service, and is therefore typically a mixture of large residential customers in suburban areas with some commercial and possibly light industrial customers served as one composite group (master metered). (IAWC Init. Br., p. 115.) As a result this class' demands are similar to those of the residential class, and would be expected to have class variations consistent with the residential variation. 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.*)

Staff's claim that the Company erred in comparing the Chicago Metro residential demand data to the data derived from the Interurban direct measurement demand study in Docket 07-0507 also ignores the approved methodology, and ignores Mr. McKinley's testimony explaining the comparison. In its Initial Brief, Staff claims that Mr. McKinley "seeks to tie [the Chicago Metro] data to the results of the Company's 2007 Interurban Capacity Factors Report." (Staff Init. Br., p. 48.) This claim ignores Mr. McKinley's testimony that he "did not seek to "tie" [the Chicago Metro data] to the 2007 Interurban Capacity Factors Report." (IAWC Ex. 13.00SR (McKinley Sur), p. 3.) As discussed above, the Company used the Interurban data only to confirm the reasonableness of the Chicago Metro data. This comparison is warranted by the Commission-approved Methodology, which requires the Company to compare the respective data sets to test their compatibility. (IAWC Ex. 13.02, p. 3.)

Staff's objections to the Company's use of the AWWA Manual to check the reasonableness of its results are similarly misplaced. In both his direct and rebuttal testimony, Mr. Lazare relied on a hypothetical example from the AWWA Manual to refute the Company's assertion that residential variation factors are greater than commercial and industrial class variation factors. (Staff Exs. 6.0, p. 29; 13.0, pp. 10-11.) In its Initial Brief, Staff resuscitates this example, and contends that there is no evidence to support the Company's assertion that the example cited by Mr. Lazare is indeed hypothetical. (Staff Init. Br., pp. 53-54.) In so doing, Staff completely ignores Mr. McKinley's testimony that "[a]s a member of the AWWA Rates and Charges Committee, [he] assisted in the preparation of the current edition of the AWWA M-1 Manual and [has] first-hand knowledge about its development." (IAWC Ex. 13.00SR (McKinley Sur), p. 6.) Mr. McKinley went on to explain that the example cited by Mr. Lazare "was for illustrative purposes only, and therefore did not rely on any actual utility data." (*Id.*)

Meanwhile, the data in the AWWA Manual relied upon by the Company in demonstrating the reasonableness of its conclusions in the Capacity Factors Report is based on actual data. (IAWC Ex. 13.00R1 (McKinley Reb), p. 8.)

Staff also asserts that the Company's class variation factors for its districts in Illinois are undermined by a study conducted in the state of West Virginia. (Staff Init. Br., p. 55-56.) As an initial matter, Staff offered no basis on which to conclude that a comparison between water usage in Illinois and West Virginia is warranted. Nonetheless, Staff claims that the data collected in West Virginia showed that it may not always be reasonable to assume that the residential class has a higher ratio of peak day demands to average day demands than other classes. (*Id.*, p. 55.) However, the Company's assumption is supported by its use of actual data collected in Illinois, and further supported by the AWWA Manual. (IAWC Ex. 13.00SR (McKinley Sur), pp. 3-6.)

#### **4. The Capacity Factor Report's Maximum Hour Capacity Factors Are Appropriate**

Staff asserts that IAWC's maximum hour capacity factors are flawed solely because they are based on its maximum day demand factors. (Staff Init. Br., p. 59.) As discussed above, because the Company's Capacity Factors Report methodology is sound, and its maximum day demand factors are well-grounded and reasonable, there is no basis on which to object to its maximum hour capacity factors.

#### **5. Staff's Recommendation that the Commission Not Accept IAWC's Capacity Factors Should Be Rejected**

Staff's recommendation that the Commission not accept the Company's demand factors is groundless. In its testimonial evidence and its Initial Brief, the Company has demonstrated the reasonableness of its Capacity Factors Report and its results, all developed in accordance with the Commission-approved methodology of Docket 08-0463. (IAWC Init. Br., pp. 105-115.) There is therefore no basis on which to object to the Company's Capacity Factors Report or its

derived demand factors. Because the Company fully complied with the Commission's prior orders in Dockets 07-0507 and 08-0463, and produced a demand study in accordance with a Commission-approved methodology which provided reasonable demand factors for each district backed by actual data and expert opinions, those demand factors should be approved for use in this case.

**6. Staff's Recommendation that IAWC Perform a Direct Measurement Demand Study Should Be Rejected**

Staff proposes that the Commission order IAWC to perform a direct measurement demand study in its next case. (Staff Init. Br., p. 62.) This proposal ignores the substantial cost, operational concerns and potential for inaccuracy that would occur if such a study were performed. By Staff's own admission, such a direct measurement study would put "further upward pressure on rates which have been rising for a number of years." (Staff Ex. 6.0, p. 39.) Staff expressly states that indirect demand studies are both more cost-efficient and time-efficient than direct demand studies. (Staff Init. Br., p. 62.) The sole basis on which Staff proposes a direct measurement demand study is that such a study would purportedly be more accurate, but the Company's evidence shows, as discussed below, that accuracy concerns (for example, if the study is performed in a wet year) also exist with a direct measurement study. In fact, Staff levels significant criticisms of the results of the direct measurement demand study IAWC performed in Docket 07-0507, questioning the "usefulness" of that study's data. (Staff Init. Br., p. 53.) This raises the question of why Staff recommends that IAWC perform a direct measurement study again in its next case.

As IAWC witness Mr. McKinley explains, there is potential that direct study data will be characterized as unreliable, as occurred in Docket 07-0507. 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.)

As IAWC explained in its Initial Brief, other concerns with a direct measurement study include: (1) the estimated cost of a direct measurement demand study is \$1.86 million; (2) equipment failures may occur, such as the meter failures in the direct measurement demand study in Docket 07-0507; and (3) the negative impact on operations, such as fire protection. (IAWC Init. Br., pp. 117-118; IAWC Exs. 13.00R1 (McKinley Reb), p. 4; 3.00R1 (Kaiser Reb), pp. 1-3.) Staff’s Initial Brief stated, without further support, that these arguments, including much higher cost, inaccurate results and decreased fire protection for ratepayers “are not persuasive.” (Staff Init. Br., p. 64.)

In particular, Staff overlooks the fact that direct measurement studies suffer from 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.) Staff appears to disregard these serious concerns.

Staff points to a direct measurement demand study conducted by IAWC’s parent company, American Water, in the state of West Virginia and suggests that, as the cost of the study undertaken in West Virginia was \$54,000, IAWC’s concerns about the cost of a direct measurement study are unwarranted. (Staff Init. Br., p. 65.) This suggestion ignores the surrebuttal testimony of Mr. Kaiser, who testified that the cost of the outside consultant alone in the West Virginia study was over \$54,000. (IAWC Ex. 3.00SR (Kaiser Sur), p. 18.) Moreover, as IAWC explained in its Initial Brief (p. 118), the study conducted in West Virginia is the same kind of study the Commission rejected in Docket 07-0507. (IAWC Init. Br., p. 118; Staff Init. Br., p. 54.) The West Virginia study consisted of a small number of metering points, the data from which was then applied to other districts in that state. (IAWC Init. Br., p. 118.) Staff’s comparisons of the cost of the West Virginia study and its estimate for a study in Illinois are therefore further undermined, as far more metering points would have to be used to perform a statewide study in Illinois. Furthermore, while Staff contends that the Company did not address any operational concerns in the West Virginia study (Staff Init. Br., p. 65), the Company experienced operational difficulties with its similar direct measurement study in Illinois in 2007, and Staff has repeatedly questioned the reliability of that study’s results. (Staff Init. Br., pp. 48, 52, 54.)

Staff offers no specifics on how a direct study should be conducted in Illinois, and Mr. Lazare 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 Staff's proposal to order a direct study in the present case.

### **Response to IWC**

IWC also objected to the Capacity Factors Report results. IWC claimed that the Capacity Factor Study did not measure capacity factors for Zone 1 with Champaign, and therefore the capacity factors used for it do not reflect its actual usage. (IWC Init. Br., pp. 41-42.) As a result, IWC 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.*, p. 42.)

IWC's Initial Brief explained (pp. 119-121), however, that IWC's concern is unsupported. As discussed above, because the Capacity Factors Report incorporates "actual historical data and billing data from all of IWC's service areas to develop capacity factors for each district," IWC's complaint is baseless. (IWC Ex. 13.00R2 (McKinley Reb), p. 3.) IWC has provided in the Capacity Factors Report 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) 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 IWC's proposed Rate Areas (such as Zone 1 with Champaign), which have yet to be approved). (IWC Ex. 13.00R2 (McKinley Reb), p. 2.) 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 in IAWC's Initial Brief (pp. 107-110), IIRC's concerns were 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. (IAWC Ex. 13.00R2 (McKinley Reb), pp. 2-3.) 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. (*Id.*, p. 4, Table 1. ) As the record shows, and as IAWC explained in its Initial Brief (pp. 120-121), the cost allocation factors do not significantly change between the various rate area configurations. 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. (IAWC Ex. 13.00R2 (McKinley Reb), 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, 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**

### **Response to Staff**

Staff's position on the COSS is not entirely clear. Staff appears to believe the COSS is reasonable, stating in its Initial Brief (pp. 66-67), "Staff has found that the structure of the Company's proposed cost of service study and the allocators chosen for that study to be reasonable for this proceeding" and "the key argument that makes the base-extra approach

acceptable for ratemaking in this case is its consistent use in previous water rate cases in Illinois. (Staff Ex. 6.0, p. 6.) ... For this reason, Staff finds it acceptable for use in this case. (*Id.*) The specific allocation factors chosen by the Company for its cost study also appear to be reasonable.” Staff witness Mr. Lazare testified 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.) Staff’s only concerns with the COSS appear to be related to its concerns with demand factors, addressed above. (Staff Init. Br., p. 66.)

Though Staff supported the use of the base-extra capacity method (which utilizes non-coincident peak demands to measure the cost of service) in this and prior rate case proceedings (Staff Ex. 6.0, p. 2; Docket 07-0507 Order, p. 108; IAWC Ex. 9.00R1 (Herbert Reb), pp. 1-2), Staff proposes that the Commission order the Company to prepare a cost of service study based on coincident capacity factors in its next rate case. (Staff Init. Br., p. 69.) This proposal is entirely without precedent, as there is no evidence in the record of any water or wastewater utility in Illinois, or any other jurisdiction, performing a cost of service study based on coincident capacity factors. (IAWC Init. Br., p. 125.) Furthermore, as discussed in the Company’s Initial Brief, the base-extra capacity method and its use of non-coincident peak demand allows the Company to equitably allocate the cost of service. (*Id.*, pp. 123-125.)

Staff fails to address the subjectivity inherent in deriving respective classes’ usage from coincident peak demand. (Staff Init. Br., p. 71.) As discussed in the Company’s Initial Brief, allocation of costs using coincident peak demand would require the Company to “estimate what each class’ usage was on a specific day.” (IAWC Init. Br., p. 125.) Staff did not counter this point in its testimonial evidence. (Staff Ex. 13.0, pp. 23, 25-26.) Staff likewise failed to counter this point in its Initial Brief. (Staff Init. Br., pp. 69-71.) Though Staff does state that coincident

peak demands are utilized to measure cost of service by Illinois electric and gas utilities (*Id.*, p. 71), it offers no evidence of operational similarities between water and gas and electric utilities on which to base a meaningful comparison.

Staff recognizes that use of the base-extra capacity method allows all system ratepayers to benefit from the non-coincident peak demands resulting from system diversity. (Staff Ex. 6.0, p. 5.) Because the base-extra capacity method provides an economic benefit to ratepayers, costs should therefore be shared proportionately based on the respective classes' non-coincident demands. (IAWC Ex. 9.00R1 (Herbert Reb), p. 4.)

As a result, the Commission should reject Staff'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.

### **Response to IWC**

IWC claims in its Initial Brief that the Commission should not use the COSS in this case because it did not provide demand factors specifically designed for Rate Zone 1 and Rate Zone 1 with Champaign. (IWC Init. Br., pp. 41-42.) This argument is without merit. As discussed above and in the Company's Initial Brief (IAWC Init. Br., pp. 105-110, 121), the demand study

utilized data from every rate district in which the Company sought a rate increase in Docket 07-0507 as required by the Commission in Docket 08-0463. Moreover, the Company did provide demand factors for Rate Zone 1 and Rate Zone 1 with Champaign. (IAWC Ex. 13.00R2 (McKinley Reb), pp. 2-3.) Because IIRC's concerns were fully addressed in the Company's testimonial evidence and its Initial Brief, the Commission should disregard them.

IIRC also asserts that the Company's allocations for purchased power cost do not reflect seasonal power price differentials, and that the AWWA Manual supports Mr. Gorman's proposal to allocate power costs to extra capacity, using the COSS's Factor 6. (IIRC Init. Br. pp. 42-43.) Mr. Gorman's proposed allocation of purchased power costs would lead to cost misallocations, however, and must be rejected. IIRC's 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.*) As IAWC explained in its Initial Brief, however, the Company's allocation of purchased power costs using Factor 1 correctly reflects actual power costs. The Company has obtained contract pricing for 80% of its test year electric supply, which gives the Company fixed pricing throughout the contract term, rather than seasonal rates as were charged with the previous contracts. (IAWC Init. Br., pp. 126-28.) Thus, there are no seasonal price differentials for power supply costs.

In addition, IIRC's proposed use of Factor 6 would allocate far too much power cost to the extra capacity function. (IAWC Ex. 9.00R2 (Herbert Reb), p. 15.) As explained in IAWC's Initial Brief (pp. 127-28), 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 IIRC'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 IWC incorrectly assumes, 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, IWC's reference to the AWWA Manual is misplaced. 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.*)

## **VI. RATE DESIGN & TARIFF TERMS AND CONDITIONS**

### **A. Resolved Issues**

#### **1. Public Fire Charges by Meter Size – Chicago Metro**

In its Initial Brief (p. 52), AG recommends that IAWC's public fire charges in Chicago Metro should increase with the size of a customer's meter, consistent with the direct testimony of AG witness Rubin, who 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. (AG Ex. 2.0, p. 23.) As IAWC indicated in its Initial Brief (p. 131), IAWC 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.)

**B. Contested Issues**

**1. Proposed Customer Charge**

**Response to Staff**

Staff and the Company agree that the Company should move toward collecting more fixed costs through the customer charge. (IAWC Init. Br., p. 137; Staff Init. Br., p. 85; Staff Ex. 7.0, p. 14.) In furtherance of this goal, the Company proposed a basic customer charge which includes all fixed customer-related costs properly recovered in the customer charge. (IAWC Init. Br., p. 137.) As discussed in the Company's Initial Brief, failure to recover these fixed costs through the customer charge results in higher usage rates, disproportionately impacting high-volume consumers. (*Id.*)

The Company calculated an aggregate state-wide 5/8-inch meter customer cost of \$18.14 per month. (IAWC Init. Br., p. 138.) In order to move toward the goal of recovering all fixed costs through the customer charge, the Company proposes the following customer charges: \$16.00 per month for Zone 1, including Sterling and Pekin, \$14.00 per month for Champaign, \$13.50 per month for Chicago Metro – Water, \$10.50 per month for Lincoln and \$10.40 per month for South Beloit. (*Id.*)

Staff's proposed customer charges do not go as far as the Company's toward achieving the goal of a uniform customer charge. Staff proposes capping the customer charge at 80% of actual customer cost, \$14.50 per month. (Staff Init. Br., p. 87.) This charge structure would lead to less recovery of fixed costs through the customer charge, as well as a greater negative impact on Champaign for the present case. Because the results of Staff's proposal run counter to the

Commission's goal, and because Staff recognizes the importance of achieving a uniform customer charge (p. 85), the Commission should reject it in favor of the Company's proposal.

Staff opposes the Company's proposal to implement a "minimum system" charge ("MSC"). Staff's concern is that it is impossible to determine the costs associated with distribution mains that provide minimum service. (Staff Init. Br., p. 72.) The derivation of the Company's proposed MSC charge is explained in detail in the Company's Initial Brief. (IAWC Init. Br., pp. 139-140.) Company witness Mr. Herbert performed an analysis of the Company's system to determine the costs associated with providing a basic unit of water service to each of the Company's customers. (*Id.*) As Mr. Herbert explained, the monthly minimum system cost per customer is \$4.67. (*Id.*, p. 140.) Because charging this amount to each customer in addition to the basic customer charge discussed above would represent a substantial monthly increase, however, the Company is proposing to phase in the MSC, starting with a monthly MSC of \$1.75 per customer. (*Id.*) As the Commission directed the Company to consider recovery of more fixed costs in its customer charge in Docket 07-0507, and because the Commission recently approved recovery of 80% of this type of "fixed delivery service" costs through customer charges in two recent cases: *Nicor* (Docket 08-0863) and the *Ameren Illinois Utilities* (Docket 07-0585 (cons.)), the Company believes its proposal is appropriate and should be approved. (IAWC Init. Br., p. 139.)

As also explained in IAWC's Initial Brief (pp. 142-43), the Company's total proposed customer charge recovery is consistent with Staff's recommendation that the customer charge recover at 80% of total fixed customer costs. As the Company discussed in its Initial Brief, the Commission has issued recent decisions approving customer charges which recover 80% of fixed delivery costs. (*Id.*, p. 141.) A calculation of 80% of the Company's total fixed customer costs,

consisting of the items included in the basic customer charge and the MSC, would equal \$18.25, which is close to the Company's proposed total recovery of \$17.75. (*Id.*, pp. 142-143.)

Therefore, IAWC's proposal is reasonable and should be approved.

### **Response to AG and the Municipalities**

Both the AG and the Municipalities assert that IAWC's proposed customer charge contains overhead costs such as executive salaries that are not properly included in the customer charge. (Muni. Init. Br., p. 18; AG Init. Br., p. 50.) As explained in the Company's Initial Brief (IAWC Init. Br., pp. 140-141.) in the Docket 07-0507 Order, the Commission directed IAWC to consider, in designing rates, the recovery of more fixed costs through the customer charge. All items included in the Company's customer charge are properly considered customer-related costs, and therefore, consistent with the Commission's directive, can be recovered through the customer charge. (IAWC Ex 9.00R2 (Herbert Reb), pp. 2-5.) While AG does not consider these items to be "cost based" (AG Init. Br., pp. 49-50), it has offered no basis on which to conclude that items such as general supplies and administrative salaries are not customer-related (given that, for example, such costs do not vary by the amount of water used).

In their Initial Briefs, neither the AG nor the Municipalities opposed IAWC's proposed inclusion of the MSC in the customer charge. The Municipalities also suggests that the Company's inclusion of costs in the fixed customer charge, in accordance with the Commission's directive in Docket 07-0507, is unduly burdensome to low-income ratepayers. (Muni. Init. Br., p. 19.) No witness in this proceeding, however, identified even one low-income customer who would be unduly burdened by IAWC's proposed customer charge. Moreover, the Municipalities ignore the Commission's directive to consider movement towards inclusion of

more costs in the customer charge, as well as the Company's many efforts to otherwise minimize costs. (*See, e.g.,* IAWC Init. Br., p. 138.)

## **2. Single Block Residential Rate Structure**

### **Response to AG**

AG opposes the Company's proposal to implement a single block rate residential structure in place of the current declining block rate structure for all districts other than Chicago Metro (which already has a uniform block rate structure). AG's main concern in arguing for retention of the declining block rate structure is to prevent purported rate increases for residents living in multi-unit buildings. (AG Init. Br., p. 51-52.) As IAWC explained in its Initial Brief (pp. 143-46), multi-unit buildings in Chicago are currently on a single block rate structure, and multi-unit buildings outside Chicago are generally not classified as residential and would therefore stay on a declining block rate structure. (*Id.*, p. 145.) AG's concern is therefore inapplicable. Furthermore, Staff supports the Company's proposal to implement a single block residential rate structure. (*Id.*, p. 144; Staff Ex. 5.0, p. 7.)

As the Company's Initial Brief explained, AG fails to accept that the declining block rate structure allows large usage residential customers to pay more favorable rates for discretionary purposes, such as lawn watering. (IAWC Init. Br., p. 143.) This class of customers has a poor load factor and uses water at times of high peak demands when supplies may be near capacity, and AG has offered no reason why such usage should be charged a lower rate than small volume residential usage. (*Id.*)

### **Response to The Municipalities**

In its Initial Brief and in reliance on AG witness testimony, the Municipalities argue that the Commission should accept AG's proposal to retain the declining block rate structure for residential customers throughout the state (as discussed above, the Municipalities overlook the

fact that Chicago Metro is already on a single block structure). (Muni. Init. Br., pp. 20-21.) As the Municipalities' concerns are identical to AG's, these issues have been fully addressed above.

### **3. Multi-unit Residential Building Classification**

In its Initial Brief (pp. 146-47), IAWC proposes to conduct a review of multi-family residential buildings regarding their customer classification. No party, in their Initial Briefs, opposes this proposal.

### **4. Across-the-board Adjustment**

#### **Response to Staff**

Staff recommends that IAWC's COSS be rejected (due to concerns with the demand factors) and that rates be set across the board. (Staff Init. Br., pp. 93-94.) As IAWC explained in its Initial Brief (pp. 105-128), however, the Company's demand factors and COSS are reasonable, in accord with the Commission's prior order in Docket 07-0507 as well as Illinois law and ratemaking practice, and provide an appropriate basis on which to set rates in this proceeding. As a result, the Commission should accept the Company's proposed COSS-based rate design. Moreover, as discussed above, Staff's witnesses repeatedly testified to the soundness of IAWC's COSS methodology. Staff's primary concern appears to be with the demand factors. As also discussed above, IAWC has addressed these concerns. Therefore the Commission should conclude the COSS is appropriate for setting rates. (*Id.*)

In addition, Staff's rate design proposals themselves do not fully utilize an across-the-board approach. (IAWC Ex. 9.00SR (Rev.) (Herbert Sur), p. 6.) As Staff acknowledges in its Initial Brief, "Mr. Rukosuev incorporated an across-the-board reduction of rates *as much as possible* without conflicting with his own rate design objectives." (Staff Init. Br., p. 94 (emphasis added)). Moreover, Staff's across the board proposal would not further the Commission's goal of setting rates as close as possible to the cost of service in each district.

*South Beloit Water, Gas & Electric Co.*, Docket 03-0676 (cons), Final Order, p. 45 (October 6, 2004); *see* IAWC Init. Br., p. 147.

Should the Commission approve a different revenue requirement than that proposed by the Company, it should scale back the Company's proposed revenue requirement while retaining its reasonable rate design. (IAWC Ex. 9.00SR (Herbert Sur), pp. 1-2.)

### **Response to IWC**

As discussed in the Company's reply to Staff, the COSS presents reasonable results which comply with the Commission-ordered methodology of Docket 08-0468. IWC proposes an across-the-board rate increase instead of using the COSS results. (IWC Init. Br., p. 45.) IWC's concerns about the COSS are the result of a misreading of the capacity factors for Rate Zone 1 and Rate Zone 1 with Champaign, as discussed in Section V. (IAWC Init. Br., pp. 105-110, 126.) Furthermore, IWC offers no support for its position on an across-the-board rate increase. (IWC Init. Br., p. 45.) Because IWC's concerns on this issue have been fully addressed, there is no merit to this proposal and the Commission must disregard it.

### **5. Recovery of Uncollectible Accounts Expense**

As IAWC explained in its Initial Brief (p. 148), 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.) In their Initial Briefs, no party opposed IAWC's position in this regard.

### **6. Chicago Metro Sewer Rate Increase**

#### **Response to Staff**

The Company is currently collecting only 39.00% of its cost of service for Collection and Treatment customers in the Chicago Metro Sewer rate district. (IAWC Init. Br., p. 150.) Staff recognizes this under-recovery (Staff Init. Br., p. 91.) and agrees that, in order to begin to align

revenues with costs, some “significant increases” are “necessary.” (*Id.*) Staff, however, proposed one modification to Chicago Metro Sewer rates: Staff “altered the 2nd block non-residential usage rates (manually) from \$3.3361 to \$2.6689, and a portion of the revenues that was lost was shifted to the residential class single block usage rates.” (Staff Init. Br., pp. 91-92.) As IAWC explained in its Initial Brief (pp. 149-51), the Company’s proposal for rate increases to the Chicago Metro Sewer Rate Area are intended to further cost-of-service goals. 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. (*Id.*) Because Staff’s adjustment to the 2<sup>nd</sup> block non-residential moves away from this goal, it is not cost-based and should be rejected. (*Id.*)

### **Response to AG**

As discussed above, the Company’s proposed rate increases for the Chicago Metro Sewer district are aimed at achieving the Commission’s cost-of-service goals for rates. Currently, the Company is recovering only 39.00% of its cost of service for Collection and Treatment customers in the Chicago Metro Sewer rate district. (IAWC Init. Br., p. 150.) AG argues, however, that the Company’s rate increase for this customer class and district be limited to 50%. (AG Init. Br., p. 54.) As IAWC explained in its Initial Brief (pp. 150-51), because this limitation is arbitrary and would not allow the Company to move towards achieving the Commission’s goals of matching revenues with costs in each district, this position should be rejected.

### **7. Public Fire Service Revenue Recovery – Zone 1**

As IAWC explained in its Initial Brief (p. 151.) IAWC agreed that the Company should 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.) In their Initial Briefs, no party opposed IAWC's position in this regard.

## **8. Private Fire Charge**

### **Response to Municipalities**

The Municipalities propose for the first time in their Initial Brief (Muni. Init. Br., pp. 22-23.) that the Company's recovery of the private fire charge in Chicago Metro be reduced to only cover the cost of service. As Staff witness Mr. Rukosuev testified, the Municipalities' argument is the result of a misconception that the private fire protection charge should be based only on the cost of service. (Staff Init. Br., p. 85.) Mr. Rukosuev also testified that any reduction of the private fire charge in Chicago Metro would in turn necessitate allocation of that portion of the revenue requirement to other charges or customer classes, possibly creating adverse bill impacts for other customers. (*Id.*) Staff therefore agrees with the Company that no reduction to the private fire charge is warranted. (*Id.*; IAWC Init. Br., p. 152.)

## **9. Rates for the Competitive Industrial, Large Sales for Resale and Large Other Public Authority Classes**

### **Response to IWC**

IWC indicated that it would support the Company's proposed rate increases for the Competitive Industrial and Large Sales for Resale classes, which are below what could be supported by the COSS, if the Company could provide a justification for the relatively small rate increases. As explained in its Initial Brief (IAWC Init. Br., p. 153), the Company offered testimony that showed that the customers receiving the rate increase at issue have alternative water supplies, but that their rates contribute in excess of fixed costs and therefore keeping these

customers on the system with relatively low rates benefits all other ratepayers. IWC does not address this explanation in its Initial Brief. (IWC Init. Br., p. 44.)

## **10. Recovery of Overall Revenue Requirement**

### **Response to Staff**

Staff argues for use of its rate design even if the Commission approves a different revenue requirement. This approach, however, would move the Company's revenue collection farther from cost-of-service goals. (Staff Init. Br., p. 94-95.) The Company's proposed rate design matches revenues and rates as closely as possible, given the Company's concerns with bill impact mitigation. (IAWC Init. Br., p. 154.) Because Staff's rate design does not further the Commission's goals, the Commission should order usage of the Company's rate design and adjust it to match the ordered revenue requirement.

## **VII. OTHER ISSUES**

### **1. The Suggestion by the Municipalities, AG and Bolingbrook that the Commission Compare IAWC's Rates to MOU Rates Should Be Rejected**

As discussed in Section I above, the Initial Briefs of the AG, Bolingbrook and the Municipalities assert that IAWC's rates are unreasonably high when compared to neighboring MOUs. 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.) As the Commission found in Docket 07-0507, 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 (p. 43.) 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.*, p. 43.)

In this proceeding, IAWC again addressed the issue of the propriety of comparing IAWC's rates to those of MOUs in detail (IAWC Init. Br., pp. 154-69.) In this proceeding, IAWC considered the extensive analysis presented in the Municipal Rate Study and also considered information from certain municipalities (Des Plaines and Mt. Prospect) that was not available in the prior proceeding. Based on the updated review, IAWC confirmed that a comparison of IAWC's rates to those of MOUs does not support a conclusion that IAWC's rates are unreasonable. Therefore, as IAWC's Initial Brief explains in detail, IAWC has reconfirmed the findings of the Docket 07-0507 Order with regard to this issue, and submits that comparisons of IAWC's rates to those of MOUs are not meaningful in ratemaking proceedings.

As IAWC discussed in its Initial Brief (p. 155), in its review of the Municipal Rate Study, the Commission in Docket 07-0507 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 to MOUs of service standards imposed by the Commission on IOUs 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 recommendation of certain parties to Docket 07-0507 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 AG, Bolingbrook and the Municipalities propose to revisit the Commission's conclusions in the prior case. None of these three parties, however, point to any factor related to the MOUs referenced in this proceeding that would in any way alter the Commission's analysis or conclusions in Docket 07-0507. Further, as discussed in IAWC's Initial Brief (pp. 154-69), IAWC has performed an updated and expanded analysis, drawing on the findings of the Municipal Rate Study and also on data from the Des Plaines and Mt. Prospect MOUs that was not available in the prior case. This analysis concludes that the "Municipal Witnesses" (as defined in the Initial Brief), established no basis to revisit the Commission's conclusions in Docket 07-0507, as the existence of 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.

As IAWC's Initial Brief explains, IAWC witness Mr. Uffelman's updated analysis of the comparability of MOUs and IOUs 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, Municipalities' witness Fundich admitted 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 fees from developers...[which] allows [MOUs] to not place system expansion costs on the backs of existing users.” (HG Ex. 4.0R, p. 8.) These fundamental differences between MOUs and IOUs, such as IAWC, render rate comparisons of the type offered by AG, Bolingbrook and the Municipalities unable to support a conclusion that IAWC’s rates are unreasonable. 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).

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

In IAWC’s Initial Brief (pp. 169-71), IAWC explained that it is seeking approval in Docket 09-0400 of a change in its accounting procedures for pension and OPEB expense. Under the proposed change, 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”) would 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. If IAWC’s proposal in Docket 09-0400 is approved, the Company would reflect, beginning in May 2010, 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. (IAWC Ex. 5.00SUPP (Grubb Supp), p. 4.) 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.)

As IAWC also explained in its Initial Brief (p. 171), 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 costs as shown on IAWC Exhibit 5.02SUPP. This level of cost recovery is consistent with the deferral and amortization proposal discussed above and by IAWC witness Grubb. No party, in their Initial Briefs in this proceeding, has opposed IAWC's proposed level of recovery of pension and OPEB expense in this case using the accounting methodology at issue in Docket 09-0400, should that methodology be approved in Docket 09-0400.

### **3. The AG and Municipalities' Proposal For an Audit of IAWC's Sewage Treatment Operations Should Be Rejected**

#### **Response to AG and Municipalities**

Both the AG (Init. Br., pp. 53-54) and the Municipalities (Init. Br., pp. 23-26) assert that IAWC's sewer treatment costs are unreasonably high and that the Commission should order an independent audit of IAWC's wastewater treatment operations. The AG suggested that such an audit include an "assessment of whether there are public or other wastewater treatment operators that provide the service to IAWC water customers at a more reasonable and comparable cost." (AG Init. Br., p. 54.) These recommendations should be rejected.

As IAWC explained in its Initial Brief (pp. 176-79), 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. 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.

Moreover, IAWC already thoroughly reviews its wastewater treatment options. As IAWC's Initial Brief explains (pp. 177-78), IAWC performs Comprehensive Planning Studies ("CPS") of each service district on a routine basis. The CPS evaluates potential growth in demand on a 15-year planning window, the capability of existing infrastructure to meet present and projected demand in light of regulatory requirements, and project necessary improvements to satisfy customer and regulatory demand. Additionally, prior to any major project (including wastewater treatment plant expansion), a separate engineering study to consider alternatives and determine the appropriate scope of the proposed project is completed to verify the results of the broader CPS. (IAWC Ex. 3.00Rs (Rev.) (Kaiser Reb), p. 3.)

IAWC also coordinates with state regulatory authorities by submitting these engineering reports for review and approval to the Chicago Metropolitan Agency on Planning ("CMAP") and the Illinois Environmental Protection Agency ("IEPA"), prior to any major projects being undertaken. 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.) The state regulatory agencies who must approve any IAWC sewage treatment plans conduct their own reviews of treatment options. 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. (*Id.*, pp. 2-3.)

The AG's suggestion of an investigation into the possibility of public or other operators operating IAWC's wastewater system should be rejected. No witness in this proceeding identifies municipalities that are willing to, or are able to, take over IAWC's wastewater treatment plants. Moreover, IAWC already engages in comprehensive reviews of alternative sewage treatment options. As discussed above, IAWC and regulators review a variety of sewage treatment options during its planning process. (IAWC Ex. 3.00R2 (Rev.) (Kaiser Reb), p. 3.)

Moreover, the "assessment" recommended by the AG is beyond the scope of the Commission's authority. With respect to the acquisition of sewer utility systems by municipalities, the legislature has established a variety of statutory options by which such municipalities may acquire, construct or operate sewer utility systems, each with its own specific set of provisions and requirements. *See, e.g.*, 65 ILCS 5/11-117-1 (municipality may acquire, construct, own and operate a public utility); 65 ILCS 5/11-137-1 (municipality may purchase or lease waterworks or sewerage system); 65 ILCS 5/11-137-2 (municipality may acquire, or construct, and maintain and operate a combined waterworks and sewerage system). In fact, the legislature has provided an express statutory avenue for municipalities to review and consider the feasibility of acquiring a utility sewer system. The Illinois Municipal Code provides that:

a municipality may pass a resolution of intent to study the feasibility of purchasing or exercising its power of eminent domain to acquire any water system or water works, *sewer system or sewer works*, or combined water and sewer system or works, or part thereof. Upon the passage of such a resolution, the municipality shall have the right to

review and inspect all financial and other records, and both corporeal and incorporeal assets of such utility related to the condition and the operation of the system or works, or part thereof, as part of the study and determination of feasibility of the proposed acquisition by purchase or exercise of the power of eminent domain, and the utility shall make knowledgeable persons who have access to all relevant facts and information regarding the subject system or works available to answer inquiries related to the study and determination. 65 ILCS 5/11-124-5 (emphasis added.)

If a municipality seeks to acquire a sewer utility system, it would have to do so in accordance with one of these (or other applicable) statutory provisions. The Commission only has those powers granted to it by statute. *Business and People for the Public Interest v. Illinois Commerce Comm'n*, 136 Ill. 2d 192, 201 (1989). Given the presence of an express statutory scheme for acquisition of sewer systems (or portions thereof) by municipalities, it is outside the scope of the Commission's jurisdiction to require a study to establish a mechanism for this purpose other than that prescribed by statute.

#### **4. The Municipalities' Recommendation Regarding the QIP Rider Should Be Rejected**

##### **Response to Municipalities**

The Municipalities claim in their Initial Brief (p. 23.) that IAWC's proposed Qualifying Infrastructure Surcharge ("QIP") Rider for the Chicago Metro and Champaign Districts (the subject of Docket 09-0251) will use the same 2010 test year as the current rate case. Therefore, the Municipalities contend, IAWC will be collecting revenues that were not anticipated when the instant proceeding was filed. The Municipalities go on to assert, "IAWC has not in this case identified which projects in the 2010 test year are also being used for the new QIP rider. Thus, the Final Order in this docket must ensure that the excess revenues that IAWC will collect under the new QIP Rider for the Chicago Metro and Champaign districts are deducted from the revenue requirements in this docket." The Municipalities' recommendation was not made in the testimony of any witness in this proceeding. Moreover, it appears to ignore the rules relating to

QIP riders: QIP projects, by definition, may only include “replacements [that] were not included in the calculation of the rate base in the utility’s last rate case.” 83 Ill. Adm. Code § 656.40(a)(5). Thus, projects that are included in the final test year rate base in this proceeding would not, by definition, be QIP projects. Moreover, the Municipalities’ concern regarding “excess revenues” is unwarranted. The Municipalities appear to be suggesting that IAWC’s projection of QIP revenues for 2010 should reflect the possibility of more QIP revenues. As Mr. Kerckhove explained, however, revenues at present rates for the test year do not reflect QIP revenues. (IAWC Ex. 6.00 (Kerckhove Dir), p. 8.) The revenues from these surcharges were eliminated from the forecast to reflect at present rates only base rates revenues. (*Id.*) As a result, there is no basis for the Municipalities’ concern.

**5. The Municipalities’ Recommendation for an Investigation into IAWC’s Promotional Practices Should be Rejected**

**Response to Municipalities**

The Municipalities recommend that the Commission, “open an investigation into the advertising and communications policies of IAWC.” (Muni. Init. Br., p. 26.) In support of this proposal, the Municipalities contend that one of IAWC’s customer communications is “deceptive and misleading,” and the Commission should order an investigation into them pursuant to the Illinois Uniform Deceptive Trade Practices Act (“UDTPA”), 810 ILCS 510/2. (*Id.*, pp. 25-26.) The heading of the communication states, “High quality water and wastewater service for around a penny a gallon,” and the communication then explains, “High-quality, reliable water and wastewater service for around a penny a gallon. From Bolingbrook to Mount Prospect and from Oswego to Orland Hills, that’s what customers in 39 communities served by Illinois-American Water pay for a gallon of water delivered to your home, or a gallon of wastewater taken away from you home. Around a penny a gallon.” (AG Cross Ex. 3, p. 2.) According to the

Municipalities, on two sample water and sewer bills, the total bill amount (water and sewer) represents 1.66 cents per gallon and 2.68 cents per gallon respectively. (Muni. Init. Br., p. 26; AG Cross Exs. 3, 5.) Thus, the Municipalities allege that the customer communication “creates a likelihood of confusion or misunderstanding.”

The Municipalities’ concerns in this regard are unsupported and should be disregarded. As will be discussed, the Commission is not charged with responsibility for the enforcement of UFTDA. Moreover, the Municipalities provide no basis to conclude that the referenced communication is deceptive. The communication states that service is provided for “around a penny a gallon.” (AG Cross Ex. 3, p. 2.) The language of the communication states that “around a penny a gallon” is what customers pay, respectively, “...for a gallon of water delivered to your home, *or* a gallon of wastewater taken away from you home.” (AG Cross Ex. 3, p. 2 (emphasis added).) Thus, the referenced service said to be available for “around a penny a gallon” is either the “delivery” of water or the “taking away” of wastewater”. In its calculation above, however, counsel for the Municipalities does not set out a separate water or sewer service charge. Instead, counsel’s calculation combines all charges for water “and” sewer services to produce a higher per gallon figure. Moreover, counsel does not calculate a separate cost for “delivery” or “taking away”. Instead, counsel adds to the cost the charges for purchased water, which, as Ms. Teasley explained, is a major component of the bill. (Tr. 182-83.) Thus, the Municipalities offer no information at all which suggests that the cost of the “delivery” of water or “taking away” of wastewater is not “around a penny per gallon” as the communication indicates. As a result, the request for an investigation is baseless.

Moreover, the Municipalities are asking that the Commission assume an enforcement role under UDTPA, despite the fact that UDTPA contains its own enforcement mechanism and

requirements. The purpose of the UDPTA is to address situations where one competitor is harmed or may be harmed by the unfair trade practices of another. *Disc Jockey Referral Network, Ltd. v. Ameritech Pub. of Ill.*, 230 Ill. App. 3d 908, 914-15 (1st Dist. 1992). It is not generally intended as a consumer protection statute. *Id.* UDTPA provides: “A person likely to be damaged by a deceptive trade practice of another may be granted injunctive relief upon terms that the court considers reasonable.” 815 ILCS 510/3. Thus, relief under UDTPA is only available to a “person likely to be damaged” by conduct in the future. *Id.*; *Glazewski v. Coronet Ins. Co.*, 108 Ill.2d 243, 253 (1985). Furthermore, enforcement of UDTPA is, by its terms, through a private right of action, not Commission investigation. Moreover, the question of what constitutes an unfair trade practice under UDTPA goes beyond the context of utility service and so is beyond the proper scope of the Commission’s jurisdiction. *Commonwealth Edison Co.*, 181 Ill. App. 3d 1002, 1008 (2d Dist. 1989) (in considering a land sale by utility, Commission exceeded its statutory authority when it inquired into the environmental impact of the residential development). Moreover, as discussed above, the Municipalities do not demonstrate that there is anything deceptive about the communication, nor has any witness in this proceeding alleged that any customer of IAWC is likely to be damaged in the future by the referenced customer communication. *See Brooks v. Midas-International Corp.*, 47 Ill. App. 3d 266, 274-76 (1st Dist. 1977) (denying injunctive relief for customer who failed to allege facts which would indicate that the he was ‘likely to be damaged’). Nor have the Municipalities or any witness alleged that any customer has in fact been damaged. The Municipalities claim only that the customer communication “creates a likelihood of confusion or misunderstanding” and “potentially provid[ed] misinformation for the purpose of discouraging customers to attend [public] forums.” No witness in this proceeding has testified, however, that there is a “likelihood” of customer

confusion as a result of the customer communication. In fact, no witness even testified as to a potential for confusion. No party has identified any IAWC customer who was actually confused or deceived by the “around a penny a gallon” language. Nor has any witness testified that the customer communication somehow “discouraged” customers from attending public forums (which, as the AG notes, were well-attended (AG Init. Br., pp. 2-5)). As a result, there is no basis on the record of this case to support the contention that an investigation is warranted.

### **VIII. CONCLUSION**

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

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Respectfully submitted,

ILLINOIS-AMERICAN WATER  
COMPANY

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