STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

ILLINOIS-AMERICAN WATER COMPANY	:	
	:	No. 09-0319
	:	
Proposed general increase in water rates	:	

ILLINOIS INDUSTRIAL WATER CONSUMERS
BRIEF ON EXCEPTIONS

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INDEX

ILLINOIS INDUSTRIAL WATER CONSUMERS BRIEF ON EXCEPTIONS

INTRODUCTION

Come now the Illinois Industrial Water Consumers ("IIWC"), by their attorneys, Lueders, Robertson & Konzen, LLC, and pursuant to 83 Ill. Adm. Code Part 200-830, and Section 10-111 of the Public Utilities Act ("Act" or "PUA") (220 ILCS 5/10-111), offer the following Brief on Exceptions to the Administrative Law Judge's ("ALJ") Proposed Order ("PO" or "Proposed Order") dated February 22, 2010.

IIWC agrees with and supports portions of the Proposed Order. However, IIWC respectfully takes exception to the Proposed Order's: (i) decision to approve Illinois-American Water Company's ("IAWC" or "Company") requested level of Cash Working Capital; (ii) the conclusion that the Company's requested level of purchased power and fuel expense should be approved; (iii) acceptance of the demand factor reflecting the Company's cost of service studies; (iv) approval of the Company's allocation of purchased power costs; and (v) rejection of proposals for across-the-board increases.

To the extent IIWC has not discussed a specific issue in its Brief on Exceptions, it should not be considered to have abandoned or waived that issue. It relies on the arguments made in its Initial Brief of January 7, 2010 and its Reply Brief of January 21, 2010, unless specifically stated otherwise herein.

Exception 1

IV. RATE BASE

A. Cash Working Capital

With the exception of the acknowledgment that the Company inappropriately included uncollectibles in the lead/lag study used to calculate its Cash Working Capital ("CWC") adjustment, the Proposed Order declines to make any adjustment to CWC in this case. (*See*, PO at 16-18). The PO specifically declines to adjust the 34.71-24.09 revenue lag days used by the Company. (IAWC Br. at 18; PO at 16-17). It also rejects any adjustment to the CWC to remove the effect of IAWC's pre-payment for services rendered by its Service Company. (PO at 17). The Proposed Order's failure reduce the revenue lag days to 21 days, and to remove the effect of pre-payments to the Service Company, results in an overstated CWC. IIWC respectfully takes exception to the Proposed Order's conclusions on these issues. IIWC addressed these issues in its Initial and Reply Briefs and incorporates those arguments by reference here. (IIWC Br. at 24-32; IIWC R. Br. at 3-9).

(i) Revenue Lag

The Proposed Order states:

> The Commission does not believe that IIWC's assumption regarding customer behavior is consistent with the information in the record regarding actual customer behavior. The Commission believes that IAWC has explained why its revenue lag exceeds 21 days. While the Commission understands the AG's fairness concern, the proposal to use 21 revenue lag days ignores what is actually experienced by IAWC. While the Commission might consider a proposal for different allocation of the CWC responsibility among the customer classes in future rate proceedings, it cannot simply ignore a legitimate

> cost of providing service. The Commission concludes that the Company's proposal is more reasonable than setting the revenue lag at 21 days, and the 21 day proposal will not be adopted. (PO at 16-17).

In concluding that IIWC's assumptions regarding customer behavior are inconsistent with information in the record regarding actual customer behavior, and that IAWC has explained why its revenue lag exceeds 21 days, the Proposed Order overlooks relevant portions of the record.

<u>Actual Customer Behavior</u> - The only information in the record that describes actual customer behavior was provided by IAWC witness Kerckhove in his rebuttal testimony on Schedule IAWC Ex. 6.03R2. This schedule was a workpaper taken from Mr. Kerckhove's cash working capital study. The workpaper develops the collection lag days used in the various IAWC districts, and incorporated into the Company's cash working capital study. Specifically, the workpaper shows the development of cash working capital collection days for the Champaign and Lincoln Districts based on bi-monthly billing. However, in this case, the Company is proposing monthly billing for the Champaign and Lincoln Districts. (*See*, IAWC Br. at 132). Thus, the Company has failed to show, and the record fails to contain, accurate information regarding "actual customer payment habits" during the test year (2010), or for 2005, that reflects the Company's proposal for the monthly billing for the Champaign and Lincoln Districts.

In contrast, IAWC's revenue lag data, in its lead/lag study, reflects Mr. Kerckhove's adjustments to actual company billing data from the 2005 lead/lag study to reflect the Company's proposal for monthly billing in the Champaign and Lincoln Districts. Thus, in this context, the revenue lag data used by the Company, does not reflect "actual customer behavior." Instead, it reflects data which is over four years old and which has been adjusted to reflect a change in the Company's billing policy. Therefore, the Company's proposal does not reflect current or actual customer behavior.

The closest the record comes to providing "actual" customer data on collection periods is provided in the form of a spreadsheet IAWC witness Mr. Kerckhove relied on to measure the revenue lag in this proceeding. (IAWC Ex. 6.03R2). However, the spreadsheet overstates the revenue lag for several reasons. First, Mr. Kerckhove did not properly adjust for uncollectible accounts in his measurement of revenue lag. (IIWC Ex. 3.0 at 35). The analysis considers average daily revenue and average accounts receivable. The flaw in measuring the revenue lag with this data is that a portion of the accounts receivable and daily revenue reflects revenue associated with uncollectible bills. Removing uncollectibles from revenue and from accounts receivable would reduce the number of revenue lag days measured from this analysis. (*Id.*).

Second, the analysis was based on calendar year 2005, and not the test year in this proceeding. There was no demonstration that 2005 was a normal year, or in any way reflecting the rate characteristics that underlie the Company's operations today. Indeed, it is not clear whether or not Mr. Kerckhove selected 2005 simply because it would inflate the revenue lag measurement, and thus inflate his cash working capital study. (*Id.*).

Finally, as described above, the Company does not have actual customer revenue and accounts receivable for the Champaign and Lincoln Districts based on its proposal to bill those districts on a monthly billing basis, rather than a bi-monthly basis. As noted by IIWC witness Gorman, using the actual customer data provided by the Company indicates that the revenue lag for these districts on a monthly billing cycle would support revenue collection periods of less than 21 days. (IIWC Ex. 3.0 at 34).

Company Explanation - The PO accepts the Company's argument that while the revenue lag exceeds 21 days, the maximum payment term for residential customers, the relatively small number of customers that pay late can cause the revenue lag to be greater than the ICC-mandated residential payment lag. However, the PO's assessment of this issue is based on the Company's arguments, which are without merit and flawed.

The error in the logic is clearly demonstrated by the fact that there is already a mechanism that allows IAWC to recover late payment costs from the specific customers who pay bills late. Indeed, IAWC is permitted to charge a late fee of 1.5% to customers who pay their bills late. As such, this cost associated with customers who pay late should not be included in cost of service and billed to customers who pay their bills on time. (IIWC 1.0 at 69-70).

The effect of this late payment customer phenomenon on IAWC's measurement of revenue lag is clearly illustrated by Mr. Kerckhove's surrebuttal testimony. (IAWC Ex. 6.00SR 15-16). There, Mr. Kerckhove provided examples of the collection of revenue lag data based on a five-customer sample. In that example, Mr. Kerckhove showed four customers who paid their bills on time, and one customer who paid late. Based on that example, if one customer (20% of total) pays late, it will cause the revenue lag to increase above the Commission's prescribed 21-day payment term. This is clear proof that using a revenue lag of greater than 21 days increases rates to customers that pay on time to compensate the Company for the cost of customers who do not pay on time. This is unjust and unwarranted because, as noted above, IAWC has a separate mechanism to recover its cost associated with customers who pay late. It need not increase prices to customers who do pay on time to recover this late payment cost.

The Company's explanation of the reasons for a revenue lag in excess of 21 days is flawed. The Company argued that revenue lag in excess of 21 days would be appropriate because it has a small number of governmental customers to which standard rates do not apply. (PO at 16). Mr. Kerckhove stated that certain governmental customers have up to 45 days to pay their bills. (IAWC Ex. 6.00SR at 10). IIWC does not dispute this fact, but does note that this does not support the use of a revenue lag of longer than 21 days. While IAWC may have a relatively "small number" of governmental accounts that pay their bills in 45 days or less, it also has a significant number of "non-residential customers" that are required to pay in 14 days or less. (Kerckhove, Dec. 9 Tr . at 415). As shown on IAWC Ex. 16.0, Schedule C-3 (page 1), out of total revenue in 2008 of $126 million, approximately $34 million was for non-residential customers ($34 million/$126 million, or 27%), and only $7.1 million was for other public authorities ($7.1 million/$126 million, or 5.6%). If the PO recognizes that IAWC has a relatively small number of customers (5.6%) that can pay their bills in 45 days, then it should also consider that IAWC has a relatively larger number of non-residential customers (27%) that must pay their bills in 14 days or less. Consideration of all customers shows that a 21-day revenue lag is reasonable. The weighted average revenue collection day as developed below in Table 1 would be 19.5 days.

TABLE 1

Weighted Average Revenue Collection Day

Description	2008 Revenues (1)	Percent of Total (2)	Maximum Collection Lag (3)	Weighted Average Collection Lag* (4)
Residential	101.1	60.4%	21	12.7
Commercial & Industrial	35.0	20.9%	14	2.9
Other Public Authorities	7.1	4.2%	45	1.9
Other	24.1	14.4%	14	2.0
Total	167.3	100.0%		19.5

Source: Section 285.302, Schedule C-3, page 1 of 6.
* Column 3 * Column 2.

A weighted average of total customers would clearly show that use of a revenue lag of 19.5 days is highly conservative, and reasonable in terms of estimating IAWC's cost of service for all of its customers who comply with the ICC payment terms, rules, and conditions.

The PO also reasons that the Commission may consider a proposal for a different allocation of the CWC cost allocation responsibility among customer classes in future rate proceedings to capture late payment costs. (PO at 17). The PO asserts that it cannot simply ignore late payment costs because they are a legitimate cost of providing service. IIWC does not dispute the PO's conclusion that IAWC is fully entitled to recover its costs associated with late payments. However, there is no need for a cost of service adjustment as anticipated by the PO nor is there a need to increase the working capital requirement in order to accomplish this objective.

Current regulatory mechanisms exist that allow IAWC to recover its costs associated with customers who comply with the ICC payment terms and conditions and those who pay late. Tariff rates should not include additional charges related to the Company's costs incurred because certain customers pay their bills late. Rather, IAWC is entitled to recover late payment costs from customers who actually pay their bills late via a late payment charge. There is no dispute on this mechanism for full cost recovery available to IAWC. The only dispute is whether or not customers who comply with the ICC rules and payment terms should pay a portion of the costs associated with other customers who pay their bills late. The PO will allow IAWC to recover late payment cost from customers who pay their bills on time. IIWC asserts this is not reasonable.

(ii) Prepayment of Service Company Fees

The PO rejected IIWC's proposal to modify the cash working capital study to include commercially reasonable payment terms from IAWC to the American Water Works Service Company. (PO at 17). The PO notes that IAWC argues that it would be inappropriate to make this recognition, because the payment terms of the affiliate interest transaction have been approved by the Commission. (*Id.*). The PO also concludes that if IAWC did not make prepayment to the Service Company, the Service Company would incur its own cash working capital requirement which would have to be passed on to IAWC anyway. Therefore, the PO concludes that if the Commission were to make an adjustment to the cash working capital requirement, it would deny the opportunity to recover the reasonable cost of providing utility service. (*Id.*).

The PO's conclusion that Service Company fees would increase if IAWC is not allowed to include Service Company payments as a prepayment is based on Company arguments that are without merit and completely unsupported in the record. The only evidence the Company provided on its Service Company cost was included in the direct testimony of IAWC witnesses Ms. Karla O. Teasley, Mr. Bernard Uffelman and Mr. Mark Young. (*See*, IAWC 1.0 at 16). IAWC offered Mr. Uffelman to support a study conducted in response to the Illinois Commerce Commission's Order of July 30, 2008 to conduct a study comparing the cost of the services obtained from the Service Company to the cost of such services, had they been obtained through a competitive bidding process on the open market. (IAWC Ex. 10.00 at 4). In comparing IAWC's cost for services from the Service Company to competitive suppliers for the same services, Mr. Uffelman did not adjust the Service Company cost to include additional working capital for IAWC. Rather, Mr. Uffelman simply relied on the Service Company billing rate as the cost of service to IAWC in comparison to competitive suppliers. Further, Mr. Uffelman did not provide any evidence that a third-party supplier of Service Company fees would require prepayment for these fees in the way that the Service Company requires. There is no evidence of record or legitimate basis to support the assertion that the Service Company working capital cost is not already provided for in its fees.

IAWC offered two witnesses to compare Service Company fees with third-supply suppliers. IAWC witness Uffelman and IAWC witness Young performed an analysis which compared the Service Company fees for IAWC to third-party suppliers. (IAWC Ex.10.0; IAWC Ex. 11.0). That analysis simply considered a comparison of IAWC's Service Company fees, with an estimate of what a third-party supplier would charge for comparable services. This analysis did not include additional working capital for IAWC for prepaying for Service Company fees. As a result, either working capital associated with Service Company fees is already included in its billing service cost, or the Company has not reflected all of IAWC's cost associated with its Service Company operations. Therefore, the PO erred when it stated:

> If IAWC did not prepay for Service Company services, the cost would be shifted to the Service Company. Because the Service Company Agreement allows the Service Company to pass its costs directly on to IAWC, Illinois-American could not actually avoid the cost and ratepayers would ultimately be responsible for the costs. (PO at 17).

For the reasons stated above, and for the reasons stated in IIWC's Initial and Reply Briefs, the Proposed Order should be modified as indicated below. (IIWC Br. at 24-32; IIWC R. Br. at 3-9).

Proposed Language

The Proposed Order's Section IV.A.5. - Commission Conclusions - on the Cash Working Capital Issues (PO at 16-18) should be revised as shown below.

IV. RATE BASE

A. Cash Working Capital

5. Commission Conclusion

*** * * ***

Having reviewed the positions of the parties, the Commission is ~~not~~ convinced that it is appropriate and ~~or~~ reasonable to ~~simply assume~~ conclude that 21 lag days should be used as the revenue lag ~~days~~ for IIWC's CWC study. ~~because it is the number appearing in the Commission's rules. Also, Section 285.2070 of Part 285 specifically contemplates the use of a lead/lag study. The Commission does not believe that IIWC's assumption regarding customer behavior is consistent with information in the record regarding actual customer behavior. The Commission believes that IAWC has explained why its revenue lag exceeds 21 days. While the Commission understands the AG's fairness concern, the proposal to use 21 revenue lag days ignores what is actually experienced by IAWC. While the Commission might consider a proposal for a different allocation of the CWC responsibility among customer classes in future rate proceedings, it cannot simply ignore a legitimate cost of providing service. The Commission concludes that the Company's proposal is more reasonable than setting the revenue lag days at 21 days, and the 21-day proposal will not be adopted.~~

* * * *

The Commission is sensitive to concerns that affiliated interest transactions have the potential to have adverse consequences for ratepayers. It does not appear that in this instance any party is arguing that IAWC's actions are prohibited by the Services Company Agreement. ~~Instead, the argument is that IAWC's CWC requirement could be lowered if it did not prepay for Service Company services. While that argument may be correct as far as it goes, there are other consequences to consider. If IAWC did not prepay for Service Company services, the cost would be shifted to the Service Company. Because the Service Company Agreement allows the Service Company to pass its costs directly on to IAWC, Illinois-American could not actually avoid the cost and ratepayers would ultimately be responsible for the costs. As a result, the Commission sees no benefit to ratepayers from modifying the CWC requirement to address this concern and the proposal to do so is hereby rejected.~~ The Commission believes the CWC requirement for Service Company fees should reflect commercially reasonable payment terms. The Commission finds that Service Company's payment terms for development in the CWC requirement should be based on 15 days lag in payment for Service Company services.

As explained above, the AG expresses concern about relying on the 2005 lead/lag study, arguing in part, that there were problems associated with the billing data for the Chicago Metro area in 2005. The Commission notes that the 2005 lead/lag study formed the basis for rates in Docket No. 07-0507. While there may be benefits to having an updated lead/lag study, the record does not contain such a study. In the Commission's view, ~~there is no viable alternative to the~~ the preferred alternative to using IAWC's erroneous lead lag study ~~as the starting point for estimating the CWC requirement.~~ is to correct for a reasonable revenue lag and Service Company prepayment. The Commission ~~does not~~ believes the record supports rejecting IAWC's lead/lag study.

IIWC and the AG also complain that the lead/lag study does not correctly reflect the transition from bimonthly to monthly billing in the Champaign and Lincoln districts. IAWC provided testimony explaining how its lead/lag study was modified to reflect the transition from bimonthly to monthly billing in those two districts. Based upon its review of the record, the Commission concludes that IAWC has ~~reasonably~~ not reflected the transition to monthly billing in the Champaign and Lincoln Districts. It appears to the Commission that a further adjustment to the lead/lag study is ~~un~~necessary and the proposals to do so are ~~not~~ adopted.

The final area of concern regarding IAWC's lead/lag study relates to the treatment of uncollectibles. IIWC and the AG believe that the lead/lag study should exclude the impact of uncollectibles. ~~As the Commission understands it, IAWC agrees and has modified its lead/lag study to remove the impact of uncollectibles.~~ The Commission agrees that a lead/lag study should not include the impact of uncollectibles.

Exception 2

II. OPERATING EXPENSES AND REVENUES

C. Purchased Power and Fuel Expense

The Proposed Order concludes:

> The Commission finds IAWC's explanation of its PPF expenses to be more clear and straightforward. It appears that the decrease in electric power supply cost has been offset to some extent by increases in electric delivery service cost and increased electricity usage. In the Commission's view, IAWC Ex. 2.01 SR, which shows actual PPF expense by district, for 2007 through 2009 along with the current projections for the 2010 test year, largely supports IAWC's position. As stated earlier, PPF depends upon electric power supply costs, electric delivery costs, and the amount of electricity used. The Commission also believes this exhibit does not support IIWC's assertion that there is anything unusual about the cost of electricity on a per gallon or CCF basis. To the extent IIWC recommends a reduction in IAWC's proposed PPF expense, the Commission concludes that the record does not support such an adjustment and it will not be adopted. (PO at 52).

IIWC respectfully takes exception to the Proposed Oder’s conclusion on this issue. IIWC addressed purchased power expense in its Initial and Reply Briefs, and incorporates those arguments here by reference. (IIWC Br. at 24-32; IIWC R. Br. at 24-26).

The PO errs in its finding that the record does not support an adjustment to the IAWC’s purchased power and fuel expense. The PO is correct that the cost of purchased power and fuel is a function of electric power supply costs, electric delivery costs, and the amount of electricity used. However, to determine whether the total costs associated with electric power supply and electric delivery are reasonable, it is helpful to look at the per unit costs of both electric power supply and electric delivery costs included in the test year by the Company. The Company claims that its electric power supply costs for the test year have decreased, because the per unit cost of supply for 80% of its load has decreased under its new power supply contract. (IAWC Ex. 2.0R at 1-2).

However, upon closer inspection of the actual per unit cost of electric power supply that the Company has included in the test year purchased power and fuel expense, IIWC shows that the Company's ***per unit cost of electric power supply for the test year is higher*** than the per unit costs of electric power supply for both 2007 and 2008. This is the case despite the fact that the Company had a more expensive contract for electric power supply on a per unit basis in 2007 and 2008. For example, the Company's power supply expense for 2007 was $0.0664 per kWh and its delivery service expense was $0.0167 per kWh. (*See*, App. A to IIWC's Init. Br). For the test year, the Company's power supply expense is $0.0719 per kWh (an 8.3% increase vs. 2007) and delivery service expense is $0.0181 per kWh (an 8.2% increase vs. 2007).

It appears that the Company ***has applied the same percentage increase*** to both electric power supply costs and electric delivery services costs despite its claim that the price of its power supply has actually declined for 80% of its electrical load. The fact that the Company's per unit cost of electric power supply included in its test year expense has increased, as compared to 2007 simply defies logic, when the record is clear that the Company's electric power supply cost under contract has decreased on a per unit basis.

The Commission states in its view that IAWC Ex. 2.01 SR, which shows actual purchased power and fuel expense by district, for 2007 through 2009 along with the current projections for the 2010 test year, largely supports IAWC's position. (PO at 52). As stated earlier, purchased power and fuel expense depends upon electric power supply costs, electric delivery costs, and the amount of electricity used. However, the Commission would error in relying on this exhibit to justify the reasonableness of the total level of purchased power costs. The Company has focused attention on the total costs of purchased power expense in this exhibit. However, the per unit cost of supply ($/kWh) for each district is not shown on this exhibit. As stated above, the per unit costs of power supply included in the test year expense should be examined to determine whether the Company's proposed test year expense is reasonable. A closer examination of the Company's electric power supply costs included in the test year on a per unit cost basis shows an increase versus historic 2007 and 2008 per unit electric power supply costs, when there has actually been a decrease in the price of 80% of the Company's power supply. This increase in the Company's per unit costs of supply appears unreasonable, which in turn makes the total costs included in the test year unreasonable.

As a result, IIWC continues to recommend that the Company's test year purchased power expense remain at the level approved in the last rate case.

For the reasons stated above and for the reasons stated in IIWC's Initial and Reply Briefs, the Proposed Oder should be modified as indicated below.

Proposed Language

The Proposed Order's Section V.C.3. - Commission Conclusions - Purchased Power and Fuel Expense issues (PO at 52) should be revised as shown below.

V. OPERATING EXPENSES AND REVENUE

C. Purchased Power and Fuel Expense

3. Commission Conclusion

IAWC's proposed level of test year purchased power and fuel expense, contained its surrebuttal testimony, is $9,039,309. IAWC says this value reflects an increase in PPF expense related to IAWC's upward revision of its projected test year water sales to U.S. Steel. IIWC believes that IAWC has overstated the cost of PPF and recommends that the Commission ~~limit the cost of PPF, on a per CCF basis, to $0.144 per CCF, which is the value that was reflected in Docket No. 07-0507.~~ approve a level of PPF expense equal to the level approved on a per unit of cost basis ($0.144/CCF) in the last case.

~~The Commission understands IIWC's concern in that PPF expense for water and sewer utilities can be significant. The cost of PPF is a function of electric power supply costs, electric delivery costs, and the amount of electricity used. As an initial matter, because IAWC has operating districts throughout Illinois, the cost of electric delivery services will not be identical in each district. Additionally, it does not appear that IIWC has properly considered the amount of electricity used in each district. In fact, it is not entirely clear how the Commission is expected to implement the IIWC proposal for each district based on a cap of $0.144 per CCF. Finally, it also appears that IIWC's proposal to limit IAWC's PPF expense may be at least somewhat inconsistent with its position that IAWC has understated sales to U.S. Steel in the Interurban district of Zone 1. In summary, the Commission is not convinced of the merit in IIWC's proposed method for capping or calculating PPF expense.~~

~~The Commission finds IAWC's explanation of its PPF expenses to be more clear and straightforward. It appears that the decrease in electric power supply cost has been offset to some extent by increases in electric delivery service cost and increased electricity usage. In the Commission's view, IAWC Ex. 2.01 SR, which shows actual PPF expense by district, for 2007 through 2009 along with the current projections for the 2010 test year, largely supports IAWC's position. As stated earlier, PPF depends upon electric power supply costs, electric delivery costs, and the amount of electricity used. The Commission also believes this exhibit does not support IIWC's assertion that there is anything unusual about the cost of electricity on a per gallon or CCF basis. To the extent IIWC recommends a reduction in IAWC's proposed PPF expense, the Commission concludes that the record does not support such an adjustment and it will not be adopted.~~

The Commission agrees with IIWC's concern with respect to the per unit cost of electric power supply included in the PPF test year expense by the Company. The total cost in dollars of PPF is a function of electric power supply costs, electric delivery costs, and the amount of electricity used. However, to determine whether the total costs associated with electric power supply and electric delivery are reasonable, it is helpful to look at the per unit costs of both electric power supply and electric delivery costs included in the test year by the Company.

Upon inspection of the actual per unit cost of electric power supply that the Company has included in the test year PPF as shown in App. A to IIWC's Initial Brief, the Company's per unit cost of electric power supply for the test year is higher than the per unit costs of electric power supply for both 2007 and 2008. This is the case despite the fact that the Company had a more expensive contract for electric power supply on a per unit basis in 2007 and 2008. This is a cause for concern for the Commission since the record is clear that the Company's electric power supply cost for the 80% of its supply under contract has decreased on a per unit basis.

The Commission agrees with the IIWC's concern that the per unit costs of electric power supply included in the test year by the Company is unreasonable, which in turn makes the total costs included in the test year unreasonable. As a result, the Commission agrees with IIWC's recommendation that the Company's test year purchased power expense remain at the level approved in the last rate case.

Exception 3

VI. COST OF CAPITAL AND RATE OF RETURN

C. Cost of Common Equity

The Proposed Order states:

> In conclusion, the Commission finds that IAWC's cost of common equity is in the range of 10.04% to 10.72%, and that a mid-point cost rate of 10.38% would be appropriate for purposes of calculating IAWC's cost of capital and setting rates in this proceeding. (PO at 110).

IIWC respectfully takes exception to the PO's conclusion on this issue. IIWC addresses the return on equity issue in its Initial and Reply Briefs and incorporates by reference those arguments here. (IIWC Br. at 4-13; IIWC R. Br. at 9-11).

The range adopted by the PO is equal to the Staff-proposed range of 10.04% (risk premium) to 10.72% (DCF). (PO at 109). IIWC believes that Staff's risk premium estimate is unreasonably high and inflates the low-end return on equity range. As shown on Staff Exhibit 4.0, Schedule 4.7, Staff's utility group risk premium of 10.04% was based on a market return of 12.70% and risk-free rate of 4.13%, which produced a market risk premium of 8.57% (12.70% - 4.13%). The utility group risk premium is unreasonable, because it reflects an inflated market risk premium. As IIWC witness Gorman demonstrated, historical data indicates a market risk premium of around 5.7% to 6.5%. He also showed that a proper DCF-based market risk premium would be around 7.45%. (IIWC Ex. 1.0 at 46 and 60). This information should be used to correct Staff's risk premium estimate. Using a market risk premium of 7.45% in Staff witness McNally's utility group risk premium study would produce a cost of equity of 9.27%.[1] Using this corrected risk premium, Staff's estimated range would change to 9.27%-10.72% and a midpoint of 10.0%.

IIWC recommends the Commission modify the PO range as estimated by Staff to 9.24%-10.72% and approve a return on equity of 10.0%.

IIWC also notes that the record is clear that Staff's recommended midpoint of 10.38% overstates a fair return for IAWC in this proceeding. As discussed at pages 6-10 of IIWC Ex. 1.0, a return on equity for IAWC in this proceeding should be no higher than 10.2%. The average authorized return on equity for affiliates of IAWC over the last several years has been 10.2%. This return on equity has supported investment grade bond ratings and access to capital for IAWC's

[1] $4.13\% + 0.69 * (7.45\%) = 9.27\%$.

parent company and Treasury affiliate, which are the primary sources of capital for IAWC and its other utility affiliates. (IIWC Ex. 1.0 at 6-10).

IIWC also showed that capital market costs are considerably lower than in IAWC's last rate case, where the Commission approved a return on equity of 10.35%. (IIWC Ex. 1.0 at 9). Since its last rate case, a 30 to 60 basis points drop in utility bond yields has occurred. (IIWC Ex. 1.0 at 9-10). This drop in utility bond yields is clear proof that IAWC's return on equity in this case should be lower than in its last rate case.

For all the reasons stated above, and in IIWC's Initial and Reply Briefs, the PO's determination that a 10.38% return on equity is reasonable should be modified. (IIWC Br. at 4-13; IIWC R. Br. at 9-11). The Commission should approve a return on equity of 10.0% as recommended by IIWC witness Gorman, and which is also a return on equity that would be supported using Staff's DCF and risk premium analyses, when the risk premium analysis used by Staff is adjusted to reflect a more reasonable market risk premium estimate. IIWC recommends the PO be modified as indicated below.

Proposed Language

The Proposed Order's Section VI.C.7. - Commission Conclusions - VI.D. - Approved Cost of Capital and Rate of Return on Rate Base on Cost of Common Equity and IV[sic] - Findings and Ordering Paragraphs - issues (PO at 108-110, 199) should be revised as shown below.

VI. COST OF CAPITAL AND RATE OF RETURN

C. Cost of Common Equity

7. Commission Conclusion

* * * *

Having reviewed the positions of the parties, and putting aside the question of adjustments for business and financial risk, discussed below, the Commission observes that the Staff and IIWC recommendations are somewhat similar and both appear to be generally sound. ~~Of the two, the Staff proposal seems better suited for use in this proceeding, in part due to the Staff witness' explanation of his reasons for not accepting the IAWC "corrections" to the Staff DCF and CAPM analyses.~~

~~One such example is Staff's reasons for using then-current 30-year Treasury-bond yields rather than the average analysts' Blue Chip forecasts of Treasury-bond yields. The Staff witness testified that the most-recent spot rate at the time of his analysis is not inconsistent with the prospective nature of the cost of capital, since a U.S. Treasury yield is the cost of capital for that U.S. Treasury security. While experts may disagree over which data is most appropriate for use in these complicated analyses, as they have here, the Commission does not believe the record in this case requires~~ major ~~that corrections be made to the Staff's DCF and CAPM determinations.~~ Staff's methods produce identical results to the IIWC when corrections are made to Staff's risk premium studies as proposed by the IIWC.

However, the Commission does agree with IIWC that the Staff risk premium estimate of the cost of equity is slightly overstated. This is because it is based on a market risk premium of 8.75% that is too high. As IIWC explained, historic data indicates a market risk premium of 5.7% to 6.5% and a proper DCF market based premium would be 7.45%. Correcting Staff's analysis to use a market risk premium of 7.45% would produce 9.27% risk premium estimate.

Based on the evidence, the Commission believes that IIWC's and Staff's analyses are supported in the record, bring reasonable results and should be utilized. ~~as corrected above, are supported in the record, produce reasonable results and should be utilized.~~

* * * *

In conclusion, the Commission finds that IAWC's cost of common equity is in the range of ~~10.04 to 9.27%~~ 9.27% to 10.72%, and that a mid-point cost rate of ~~10.38%~~ 10.0% would be appropriate for purposes of calculating IAWC's cost of capital and setting rates in this proceeding.

D. Approved Cost of Capital and Rate of Return on Rate Base

Taking into consideration the Commission's conclusions regarding capital structure, cost of short-term debt, cost of long-term debt, and cost of common equity the Commission finds that IAWC should be authorized to earn a rate of return of ~~8.05~~ % 7.87% on its rate base. The table below shows the development of that authorized rate of return:

Component	Percentage	Cost	Weighted Cost
Short-term debt	2.83%	1.00%	0.03%
Long-term debt	49.84%	6.24%	3.11%
Common equity	47.33%	~~10.38~~% **10.0%**	~~4.91~~% 4.73%
Total	100%		**~~8.05~~%** 7.87**%**

IV. FINDINGS AND ORDERING PARAGRAPHS

(7) a just and reasonable rate of return which IAWC should be allowed an opportunity to earn on its net original cost rate base is 7.87% ~~8.05%~~; this rate of return incorporates a rate of return on common equity of 10.0% ~~10.38 %~~;

Exception 4

VII. COST OF SERVICE

A. Demand Factors

The Proposed Order concludes that IIWC is correct in its argument that the cost of service studies presented for Rate Zone 1 and Rate Zone 1 with Champaign do not include the correct demand factors. (PO at 145). The PO also apparently agrees with IIWC that the impact of using the “correct” demand factors cannot be determined, because the cost of service studies at issue were not re-run. (PO at 145-146). However, despite the fact that the wrong demand factors were used in the subject cost studies, and the impact of the use of the right demand factors is unknown, the PO concludes that IIWC’s concerns about the Company demand factors are “misplaced.” The PO correctly notes that the issue the Commission “. . . must decide, in establishing rates, is whether such rates are cost-based.” (PO at 146). The PO purports to reject an assumption it believes is implicit in IIWC’s arguments – that the demand factors from Illinois-American Water Company Docket 02-0690 and developed in Docket 97-0102, are superior to the Company demand factors shown in IAWC Ex. 13.0R2 at page 4. (*Id*.).

In sum, without knowing the impact of using the admittedly incorrect demand factors and on the unsupported assumption that the admittedly incorrect demand factors are superior to the demand factors developed in another case, the Proposed Order rejects IIWC’s criticism of the demand factors. IIWC respectfully takes exception to the PO’s conclusions on this issue. IIWC argued this issue in its Initial and Reply Briefs, and incorporates those arguments by reference. (IIWC Br. at 41-42; IIWC R. Br. at 26-28).

IIWC’s concerns about the demand factors used in the Company’s cost of service studies for Rate Zone 1 and Rate Zone 1 with Champaign are not misplaced. First, the suggestion that IIWC’s concerns are misplaced is based on the mistaken belief that because the correct demand factors vary “immaterially” from the incorrect demand factors there would not be much difference in the results produced by use of the correct demand factors instead of the incorrect demand factors. (*See*, PO at 145). However, because the cost studies were not re-run, one cannot know that this is in fact the case. Indeed, the record contains not a scintilla of evidence that it is, in fact, correct. Furthermore, the record suggests that it very well may not be the case.

IIWC Exhibit 3.0, page 28 shows a comparison of the allocation of base and peak day/peak hour (demand) factors. (IIWC Ex. 3.0 at 28, Table 1). As shown in that table under column 4, IAWC witness Mr. Herbert allocated approximately 58.48% of base-related cost based on his demand factor study. In contrast, IAWC witness McKinley's rebuttal testimony indicated that only 57.08% of total revenue cost should be allocated on base. (*Id.*). The remainder should be allocated on the demand factors (max day/max hour) and customer factors.

While the percent change is relatively small (1.4%), the allocator is used to spread significant difference in cost between classes. When over 50% of the total revenue requirement in Illinois is spread on a base volume allocator, it is critically important to accurately measure the base volume allocation factor. By overstating the base allocation of total cost, the Company is over-allocating cost to high volume users, and conversely under-allocating cost to low volume users. As such, the PO's conclusion that this small differential in allocation factors does not produce meaningful results, is erroneous.

Second, the statement that the issue the ". . . Commission must decide, in establishing rates, is whether such rates are cost based." actually supports IIWC's position, not the rejection of that position. It supports IIWC's position because the subject studies admittedly used the wrong demand factors and the studies were not re-run. Therefore, one cannot determine if rates based on those studies are, in fact, cost based. As shown above, the use of the correct versus the incorrect factors, no matter how small the actual difference between the two may be, could have significant impact on the costs allocated to the various customer classes in the affected operating districts. (Rate Zone 1 and Rate Zone 1 with Champaign). Thus, one cannot fairly determine the cost responsibility of those classes, which in turn means one cannot determine if the resulting rates are "cost-based." Therefore, the Commission cannot meet its obligation to determine whether the rates approved are in fact "cost-based," as the PO agrees it should.

Third, the suggestion that IIWC implicitly assumes the demand factors from prior Illinois cases are superior to the incorrect demand factors, does not support the PO's conclusion that IIWC's arguments are misplaced. IIWC has merely pointed out, and the Proposed Order apparently agrees, that the Company did not use the correct demand factors. Indeed, implicit within the Proposed Order's rationale is that use of the incorrect demand factors is superior to the use of the correct demand factors. Use of these factors will not allow the Commission to correctly determine cost responsibility. The Commission needs an accurate idea of the cost of serving each class to set rates as close as possible to cost. (Central Illinois Light Company, d/b/a AmerenCILCO, ICC Dkt. 07-0585, et al., (Cons.), Order, Sept. 24, 2008 at 79). In the absence of such a study which allows the Commission to get an accurate idea of the cost of serving each class for Rate Zone 1 with Champaign, the Commission should instead direct that rates should be increased on an equal percentage across-the-board basis. Concluding that the incorrect demand factors have been used, and that the correct demand factors should have been used, does not require the Commission to implicitly or explicitly determine that demand factors from another case are superior under any circumstance.

Indeed, the Commission need only determine whether or not the correct demand factors were used in this case. The Proposed Order correctly observes that they were not. The use of the incorrect demand factors could unfairly shift costs among the customer classes. Under the circumstances, the Commission should not use the cost of service studies, which incorporate the incorrect demand factors to set rates in this case. Instead, the rates for Rate Zone 1 and Rate Zone 1 with Champaign, should be set on an across-the-board basis.

For the reasons stated above, and for the reasons stated in IIWC's Initial Brief and Reply Briefs (IIWC Br. at 41-42; IIWC R. Br. at 26-28), the Proposed Order should be modified as indicated below.

B. Cost of Service Analysis

The PO concludes that IIWC's proposal to allocate power costs on the basis of Factor 6 which is used to allocate the cost of pump investment, should be rejected. (PO at 147-148). The PO notes that IIWC argues that the use of Factor 6 gives recognition to the fact that there is a "seasonal pricing difference" in purchased power costs, and the increased purchased power costs associated with peak periods that usually coincide with peak water demands. (PO at 148).

The PO notes that the Company says that its new contract for power is a fixed price contract with no seasonal variations and affects 80% of the Company's power supply. Therefore, according to the Company, an allocation factor that varies with demand pumping would not be appropriate given the fixed price contract. (*Id.*).

The PO concludes that the use of allocation Factor 1 for purchased power is more reasonable for the allocation of costs that are largely fixed. The PO concludes there is no good reason to undertake an investigation of the Company's power purchasing practices as recommended by IIWC. (*Id*.).

The PO states:

> The Commission believes the record is clear that IAWC has entered into a purchased power contract for 80% of its test year electric supply and that the new power contracts give IAWC fixed pricing throughout the contract term, rather than seasonal rates as were charged with the previous contracts. In the Commission's view, IIWC's suggestion to allocate purchased power costs, which are largely fixed for IAWC, using an allocation factor that varies with demand pumping would not be appropriate. The Commission finds that IAWC's proposed allocation factor for purchased power costs more reasonably allocates costs that are largely fixed. The Commission also finds that there are insufficient reasons to undertake an investigation of IAWC's power procurement activities at this time. The Commission does not believe doing so at this time would be an efficient use of the Commission's or IAWC's resources. (PO at 148).

IIWC respectfully takes exception to the PO's conclusion on this issue. IIWC addressed this issue in its Initial and Reply Briefs and incorporates those arguments by reference here. (IIWC Br. at 42-43; IIWC R. Br. at 31-33).

The Proposed Order focuses on the fact that the Company has signed a fixed price contract for 80% of its total power supply. (PO at 148). The Proposed Order's focus is misplaced because a fixed price contract does not mean that power costs do not vary by season, rather the price was simply averaged over the seasonal usage. The contract does not change the fact that water demand and usage vary by season on the Company's system. Electricity usage and demand vary accordingly. Thus, it is reasonable to anticipate greater total electric expense may occur in the summer when water demand and usage would be higher. Indeed, the use of a fixed price contract suggests that IAWC may not be minimizing its cost of purchased power. (IIWC Ex. 3.0 at 29-30). IAWC did not refute IIWC's evidence that power cost changes by season and it can minimize its power cost by changing its on-peak/off-peak usage. If power cost is not allocated based on demands and usage, customers will not be allocated a portion of IAWC's power cost in line with how their demands cause IAWC to incur power costs.

For the reasons stated above, and for the reasons stated in IIWC's Initial and Reply Brief, (IIWC Br. at 42-43; IIWC R. Br. at 31-33), the Proposed Order should be modified as indicated below.

Proposed Language

The Proposed Order's Section VII.C. - Commission Conclusion - on Demand Factor Cost of Service Analysis - issues (PO at 141-148) should be revised as shown below.

VII. COST OF SERVICE

C. Commission Conclusion

* * * *

> IIWC is correct that the cost of service studies do not technically include the "correct" demand factors. As IAWC Exhibit 13.00R2 shows, however, the technically "correct" demand factors vary only immaterially from the demand factors that were used. While IIWC argues that it is impossible to know the impact of including the "correct" demand factors because the cost of service studies were not re-run, the Commission believes IIWC's concerns are valid. ~~misplaced.~~ As previously discussed, an issue the Commission must decide, in establishing rates, is whether such rates are cost-based. The Commission agrees with IIWC that failure to use the appropriate demand factors for Rate Zone 1 with Champaign will not allow the Commission to determine whether rates are cost based in that District. ~~The Commission rejects IIWC's implicit assumption that demand factors from Docket No. 02-0690, which were actually~~

~~developed in Docket No. 97-0102, are superior to the demand factors shown on IAWC Exhibit 13.0R2 at page 4.~~

Having determined that the demand factors ~~proposed~~ used by IAWC for Rate Zone 1 with Champaign are not correct, ~~reasonable for purposes of this proceeding,~~ the Commission will not rely on IAWC's cost of service study for Rate Zone 1 with Champaign, and directs rates to be increased on an equal percent across-the-board basis. ~~address the remaining cost of service issues. It appears IAWC and IIWC generally agree that the base-extra capacity method is appropriate for use in this proceeding. Staff witness Mr. Lazare suggests that IAWC should be required to substitute coincident peak demand for non-coincident peak demand in future cost of service studies. Staff witness Mr. Rukosuev implicitly relies upon IAWC's cost of service study in developing his recommended consumption rates. All things considered, the Commission believes that for purposes of this proceeding, the record supports a finding that IAWC's proposed cost of service studies are reasonable.~~

* * * *

While the Commission has already found that IAWC's demand factors, derived from an indirect measurement method, should be used for purposes of setting rates in this proceeding, with the exception of Rate Zone 1 with Champaign, it has done so because the only alternative would produce a worse result. The Commission finds IAWC cost estimate for a direct demand study, $1.86 million, to be unsubstantiated. The Commission, nevertheless, realizes that if it orders IAWC to perform a direct demand study, it could cost a significant amount of money.

* * * *

The Commission believes the record is clear that IAWC has entered into a purchased power contract for 80% of its test year electric supply and that the new power contracts give IAWC fixed pricing throughout the contract term, rather than seasonal rates as were charged with the previous contracts. In the Commission's view, IIWC's suggestion to allocate purchased power costs, which are largely fixed for IAWC, using an allocation factor that varies with demand pumping would ~~not~~ be appropriate. The Commission finds that IAWC's proposed allocation factor for purchased power does not ~~costs more~~ reasonably allocate~~s~~ costs that vary with peak demand. ~~are largely fixed.~~ The Commission also finds that there are ~~in~~sufficient reasons to review ~~to undertake~~

> ~~an investigation of~~ IAWC's power procurement activities.~~ at this time.~~ The Commission directs IAWC to present information demonstrating that it is purchasing power in a least- cost fashion in its next case. ~~The Commission does not believe doing so at this time would be an efficient use of the Commission's or IAWC's resources.~~

Exception 5

VIII. RATE DESIGN

E. Across the Board Increase Proposal for Consumption Charges

The Proposed Order concludes that it will not adopt the recommendation of IIWC for an across-the-board increase in Rate Zone 1 with Champaign, or the Staff's recommendation for an across-the-board increase on a company-wide basis for all of the Company's operating districts. (PO at 174-175).[2]

With regard to IIWC's proposal, the Proposed Order states:

> For the most part, this issue has already been resolved above in the Order in the discussion of demand factors and cost of service studies. Mr. Lazare's recommendation on this point has not been adopted. Also, IIWC's concerns, while not entirely without merit, are not significant enough to justify increasing rates on an across-the-board basis rather than relying on IAWC's cost of service study for Zone 1.

IIWC respectfully takes exception to the PO's conclusion on this issue. IIWC addressed the need for an across-the-board increase in its Initial and Reply Briefs and incorporates those arguments by reference here. (IIWC Br. at 41-44; IIWC R. Br. at 31-33).

In Exception 4 above, IIWC explains why the failure to use the correct demand factors

[2] IIWC will not argue Staff's position in this Brief on Exceptions, but supports Staff's proposal for an across-the-board increase for all of the Company's operating districts.

adversely impacts the Company's cost of service study for Rate Zone 1, and its impact on the allocation of costs among customer classes.

Because the Commission cannot be sure that the rates associated with a cost study based on incorrect demand factors are in fact cost based, and because the use of the incorrect demand factors has significant impact on the allocation of costs to the customer classes, the classes which would receive the largest increases under the Company's studies cannot be sure that those increases are in fact cost based.

Furthermore, the Proposed Order has approved a rate mitigation approach for customers in the Pekin District based on rate increases of 50%. (PO at 151). In the Rate Zone 1 with Champaign District, the University of Illinois was scheduled to receive an increase of over 50%, which is due in large part to the results of the cost of service study that used the improper demand factors. (*See*, IAWC Ex. 9.08 Sch. CHA at 9, Ln. 25, comparing Col. F to Col. H). Increases of this magnitude should not be imposed on customers unless the Commission is sure that it has a fairly accurate estimate of the cost of serving the various rate classes. As IIWC has explained, it does not believe the Company has a fairly accurate measurement of the cost of serving the rate classes in Rate Zone 1 with Champaign. Therefore, an across-the-board increase would be appropriate.

For the reasons stated above, and for the reasons stated in IIWC's Initial and Reply Briefs, the PO should be modified as shown below. (IIWC Br. at 41-43; IIWC R. Br. at 31-33).

Proposed Language

The Proposed Order's Section VIII.E.4. Commission Conclusion - on Across-the-Board Increase Proposal for Consumption Charges issues - (PO at 174) should be revised as shown below.

VIII. Rate Design

E. Across-the-Board Rate Increase Proposal for Consumption Charges

4. Commission Conclusion

*** * * ***

> For the most part, this issue has already been resolved above in this order in the discussion of demand factors and cost of service studies. Mr. Lazare's recommendations on this point have not been adopted. ~~Also,~~ However, IIWC's concerns, ~~while not entirely without~~ have merit, and are ~~not~~ significant enough to justify increasing rates on an equal percent across the board basis rather than relying on IAWC's cost of service study for Zone 1 with Champaign.

CONCLUSION

For the reasons stated above, IIwC's exceptions to and clarifications of the Proposed Order should be adopted.

Dated this 8th day of March, 2010.

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