

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Illinois-American Water Company :
: 09-0319
:
Proposed general increase in water and :
sewer rates. :

**REPLY BRIEF ON EXCEPTIONS OF THE STAFF
OF THE ILLINOIS COMMERCE COMMISSION**

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Pursuant to Section 200.830 of the Illinois Commerce Commission’s (“Commission”) Rules of Practice, 83 Ill. Adm. Code 200.830, Staff of the Illinois Commerce Commission (“Staff”), by and through its undersigned counsel, respectfully submits this Reply Brief on Exceptions to the Briefs on Exceptions (“BOE”) filed by Illinois-American Water Company (“Illinois-American,” “IAWC,” or the “Company”), Illinois Industrial Water Consumers (“IIWC”), the People of the State of Illinois (the “AG”), The Citizens Utility Board (“CUB”), the Village of Bolingbrook (“Bolingbrook”), the Village of Homer Glen and the Cities of Champaign and Urbana and the Villages of St. Joseph, Sidney, and Savoy (the “Municipalities”), and Staff, which were filed on March 8, 2010, in response to the Administrative Law Judge’s (“ALJ”) Proposed Order issued on February 22, 2010 (“Proposed Order” or “PO”). Staff addresses issues to which it replies in the order in which they appear in the Proposed Order.

I. CASH WORKING CAPITAL

The AG argues that Cash Working Capital (“CWC”) should be reduced because the Company: overstates revenue lags; improperly uses its 2005 lead lag study; and pays service company fees in advance. (AG BOE, pp. 22-26.) The Municipalities also argue that CWC should be reduced because the Company pays service company fees in advance. (Municipalities BOE, p. 10.) IIRC argues that CWC should be reduced for the same issues raised by the AG and for the uncollectibles included in the Company’s CWC calculation. (IIRC BOE, pp. 2-12.) In Staff’s opinion, these changes to the Proposed Order are unwarranted.

The arguments for overstated revenue lags are founded on the requirement in the Commission’s rules at 83 Ill. Adm. Code 280.90 that the bill due date be “at least” 21 or 14 days after the bill is postmarked. The Commission’s rules, however, set a minimum, rather than a maximum, number of days the due date must be after the billing postmark.

The arguments for paying service company fees in advance relate to the Company’s Service Company Agreement which calls for payment of estimated costs for the current month as soon as practicable after the last day of the preceding month. The Company’s CWC calculation, related to service company fees, is based on actual data in accordance with the Service Company Agreement. (IIRC Ex. 6.00SR, pp. 5-7.)

The argument that uncollectibles are included in the CWC calculation is unfounded as the Company’s CWC calculation reduces revenue lag for uncollectibles by reducing revenues used in the CWC calculation by the amount of uncollectible expense. (IIRC IB, p. 12.)

The argument that the Company improperly used its 2005 lead lag study is based on the lead lag study not reflecting the transition from bimonthly to monthly billing in the Champaign and Lincoln districts. The Company, however, calculated revenue lag for Champaign and Lincoln using a weighted-average of revenue lags for the other districts (*Id.*, p. 17); thus, the collection lags referenced by IWC (IWC IB, p. 29; IWC Ex. 3.0, p. 34; and IWC Ex. 3.2) were not used in the Company's calculation of revenue lag for the Champaign and Lincoln Districts.

II. PRIOR RATE CASE EXPENSE

The Company offered a technical correction to the calculation of prior rate case expense amortized in the current proceeding, claiming that the calculation in the Proposed Order's appendices was based on a two-year amortization period rather than the three-year amortization period adopted in the Proposed Order. (IAWC BOE, pp. 27-28.) Staff concurs with the correction and, for clarity's sake, points out that the difference of \$91,007 is an adjustment in addition to Staff's adjustment of \$62,000 already included in the Proposed Order.

Staff notes that no party took exception to the adjustment already included in the Proposed Order. Staff offers the following table to illustrate the calculation:

<u>Line</u>	<u>Description</u>	<u>Prior Rate Case Costs to Amortize</u> (a)	<u>Three-Year Amortization Per PO</u> (b)	<u>Sources</u>
1	Docket No. 07-0507 Amortization Remaining to be Taken	\$ 546,042		ICC Staff Exhibit 9.0, Schedule 9.1
2	Staff Adjustment Reflected in PO	<u>(187,047)</u>		Sum of PO Appendices B-F, pages 3, Line 12
3	Adjusted Amortization Remaining to be Taken	<u>\$ 358,995</u>		Line 1 + Line 2
4	Adjusted Amortization to be Taken Over Three Years		\$ 119,665	Line 3 divided by 3 years
5	Original Amortization per Company		<u>273,021</u>	Company Schedule C-10, First Revised
6	Final Order Total Adjustment		<u>\$ (153,000)</u>	Line 4 - Line 5 (rounded)

Note:

Original Staff Adjustment	\$ (62,349)
Additional Company Adjustment per BOE	<u>(91,007)</u>
Final Order Total Adjustment	<u>\$ (153,356)</u>

III. CURRENT RATE CASE EXPENSE

Staff continues to support the level of Current Rate Case Expense proposed in its Initial Brief ("IB"). Arguments that the rate case expenses in the current rate case are significantly greater than the rate case expenses from the prior docket are misleading because they compare estimated rate case expenses in the current rate case to the rate case expense approved by the Commission in the prior rate case. (AG BOE, pp. 51-57; Municipalities BOE, pp. 22-24.) Staff compared estimated rate case expenses in the current rate case to the actual rate case expenses from the prior docket. (Staff RB, pp. 7-8.) The estimated rate case expenses in the current rate case are less than the

actual rate case expenses from the prior docket. (See IAWC Schedule C-10.1.) There is no evidence showing that the amount of rate case expense the Company actually incurred in the last rate case was unreasonable. While it is clear that the Company significantly underestimated the rate case expense it would incur when it made its proposal in the last case, it is not clear why that, by itself, forms a basis for limiting what the Company can propose in this case.

IV. COST OF COMMON EQUITY

IAWC takes exception to the Proposed Order's conclusion that the Company has not demonstrated that the financial risk of IAWC is higher than that of the companies in the proxy samples and, accordingly, no financial risk adjustment should be made. Instead, the Company continues to argue that IAWC's degree of financial risk is greater than that of the sample companies forming the basis of Staff's cost of common equity estimate and alleges, therefore, that an upward adjustment to that estimate of 21 basis points (0.21%) is warranted. (IAWC BOE, p. 14.)

The Proposed Order's conclusion is correct. As noted in Staff's Reply Brief ("RB"), the Company's proposed financial risk adjustment is entirely reliant on the blind acceptance of numerous assumptions that are not only unsubstantiated, but are in many cases improbable. The Commission cannot accept an adjustment that is not supported with credible evidence. (Staff RB, pp. 12-13.)

The Company's Brief on Exceptions presents no new arguments to address the weaknesses in the Company's position; it merely resurrects the same arguments already presented in the Company's Initial and Reply Briefs, which the ALJ considered

before rejecting that position.¹ Therefore, for the reasons set forth in Staff's Initial and Reply Briefs, the Commission should confirm the Proposed Order's decision and accept Staff's cost of common equity proposal of 10.38% and reject the Company's proposed financial risk adjustment.

V. COST OF SERVICE

A. Reply to Illinois-American

Throughout this proceeding, Staff has consistently maintained that the Company's proposed demand factors render its cost of service study so deeply flawed as to be inappropriate for ratemaking purposes. (Staff IB, pp. 49-55; Staff RB, pp. 14-22.) The Proposed Order did not agree with Staff on this issue for various reasons that Staff addressed in its BOE. (Staff BOE, pp. 2-7.) The Proposed Order, however, does direct the Company to perform a direct demand study for its next rate case. (Proposed Order, p. 147.) The Company takes exception to this mandate (IAWC BOE, pp. 19-26) and thereby ignores the fact that, as the Proposed Order notes (Proposed Order, pp. 141-43), the Commission has consistently ordered the Company to present such updated demand factors since its Order in Docket No. 02-0690. (See Order, Docket No. 02-0690, p. 120 (August 12, 2003) ("IAWC is directed to provide updated demand factors for each rate area for which a rate increase is proposed."); Order, Docket No. 07-0507, p. 121 (July 30, 2008) ("Due to IAWC's decision not to provide demand factors for each district, as directed by this Commission in Docket No. 02-0690, the

¹ Although the Company now cites, in support of its proposed cost of common equity adjustment, two statements from the surrebuttal testimony of IAWC's capital structure witness James Kalinovich, that testimony provides nothing new. Mr. Kalinovich's surrebuttal testimony presents no analysis or explanation to justify his conclusions, but merely parrots the claims that had been previously presented in the direct testimony of IAWC's cost of equity witness Pauline Ahern, which the Company had cited in its earlier briefs.

Commission does not have an accurate estimate of the cost of serving each customer class in each district.”); Initiating Order, Docket No. 08-0463, p. 2 (July 30, 2008) (“Based upon the Company’s non-compliance with regard to provision of demand factors as directed by the Commission in Docket 02-0690 and the lack of a reasonably current cost of service study, an investigation should be initiated under Section 9-250 of the Act into all aspects of the rate design of IAWC[.]”).)

The Company’s objections to the Proposed Order’s requirement that it perform a direct demand study for its next rate case are baseless and should be summarily rejected by the Commission. The Company’s arguments on this issue proceed along two lines. The first line of argument seeks to defend the reasonableness of the indirect study IAWC prepared for this case. The second line discusses the problems that a direct demand study would create.

The Company uses a curious argument to defend its proposed analysis that focuses not on the reasonableness of the results produced, but rather on the qualifications of the study’s author. So, IAWC considers it noteworthy that the Proposed Order finds that “IAWC witness Mr. McKinley is qualified and able to conduct a study “consistent with the AWWA Manual...and his involvement gives assurance that the study was conducted as “such studies are normally undertaken in the water utility industry.” (IAWC BOE, p. 21.)

Whether or not Mr. McKinley has prepared accurate analyses consistent with the AWWA Manual over his long career is immaterial. Qualification to perform a cost study is a mere minimum requirement. Whatever Mr. McKinley has or has not done in the past does not guarantee the quality of his work in this case. That is a function of the

quality of the assumptions employed, the analyses performed and the conclusions reached. Each must be considered reasonable in order to find the study accurate. However, Staff's review uncovered a host of concerns about the study. Instead of responding to those concerns, IAWC would rather focus on Mr. McKinley's credentials and argue that his experience provides reason enough to accept the Company's analysis. This argument which seeks to divert attention from the record in this case can be safely ignored by the Commission. (See e.g., *Knox Motor Service v. Illinois Commerce Comm'n.*, 77 Ill. App.3d 590, 597 (4th Dist. 1979) ("We...find that the Commission may [take cognizance of facts adduced at prior hearings] only when such facts are introduced as evidence at a hearing where all parties have an opportunity to be heard.").)

What the Commission should focus on is the documented shortcomings of the Company's indirect analysis. Since Staff has demonstrated that the Company's approach falls far short, the only reasonable alternative to estimate ratepayer demands is through a direct measurement approach.

The Company's second argument, which dwells upon the obstacles to performing such a study, begins with a complaint that "[n]either Staff, nor any other party to this proceeding, has addressed a specific scope or methodology for a direct measurement study." (IAWC BOE, p. 22.) This argument seeks to shift the responsibility for performing such a study away from the Company onto others. (See 220 ILCS 5/9-201(c) ("[T]he burden of proof to establish the justness and reasonableness of the proposed rates or other charges...shall be on the utility.").) Even though performing this kind of analysis is generally considered a requirement for the

utility, IAWC nevertheless criticizes other parties for failing to do the work for it. In this way IAWC seeks to evade responsibility for a basic utility function.

IAWC goes on to complain that a lack of outside guidance for these activities will mean that “a direct study, its cost and its results will be subject to extensive challenge and litigation in the future proceeding in which it is presented.” (IAWC BOE, p. 22.) This argument is spurious as well. Rate proceedings, by nature, give parties free rein to question the costs and analyses used to determine the rates they pay. Since a determinant of those rates will be the direct demand study performed by IAWC, it would be unfair to any party to place any limits on the review of that analysis. Furthermore, the prospects of such a review will increase IAWC’s incentive to present a reasonable demand study that can withstand scrutiny and the regulatory process will benefit as a result.

IAWC goes on to complain about the cost of such a study, focusing on the cost of metering systems which it contends, cost approximately \$20,000 each to purchase and install. (*Id.*, pp. 22-23.) The Company then estimates that a cost of \$1.86 million would be needed to perform a direct demand study in Illinois. IAWC concedes that the Proposed Order considered this figure “unsubstantiated” but insists that Staff did not dispute this cost estimate.” (*Id.*)

This discussion raises a number of issues. For one, the fact that the Proposed Order correctly considers the \$1.86 million “unsubstantiated” indicates the Company did not convince the ALJ concerning the reasonableness of IAWC’s estimate. IAWC’s discussion of Staff’s view of this estimate also presents problems because it fails to reflect the serious questions Staff raised about IAWC’s cost estimate. In light of quite

different cost data provided by the Company for the most recent direct demand study performed by IAWC's affiliate in West Virginia, Mr. Lazare argued as followed in his rebuttal testimony:

The failure to provide an informed discussion of the West Virginia study calls into question whether IAWC has thoroughly and reasonably researched the direct measurement issue and drawn reasonable conclusions about the cost, time and reasonableness of such a study. It undermines the conclusions of IAWC witnesses McKinley and Kaiser that an indirect approach is a superior alternative.

A particular problem is that Mr. Herbert, the Company witness who actually prepared the West Virginia study, has nothing to say in his rebuttal testimony about the issue. It would have been useful to know, for example, whether Mr. Herbert who was involved in the most recent study conducted by American Water, actually agrees with the arguments of other Company witnesses concerning direct measurement studies and whether he considers the \$1.86 million estimate for a demand study reasonable in light of the far smaller cost of \$27,293 for the West Virginia study.

(Staff Ex. 13.0, pp. 16-17.)

The Company has since disavowed the \$27,293 figure (Proposed Order, p. 129) and has provided a revised partial cost estimate for the West Virginia study of \$54,000. (IAWC BOE, p. 23.) However, a considerable gap remains between that \$54,000 and the \$1.86 million estimated for a projected Illinois study. Discrepancies such as this provide good reason to question the Company's discussion of demand study costs.

IAWC goes on to claim that "a direct demand study would present significant operational concerns that any study methodology would have to address." (*Id.*, p. 24.) The Company states that "[a] direct demand study requires that the distribution systems being monitored be isolated from other mains, which creates operational and fire protection concerns." (*Id.*) The Company also raises reliability questions by suggesting that "the available technology for measurement of water demands...may, despite the

best effort of personnel performing the study, prove unreliable.” (*Id.*)

It is difficult to assess the Company’s argument because it comes at a late stage in the process. The discussion presents a particular problem because the Company in rebuttal declined a request, that Staff made in direct testimony, to discuss the West Virginia demand. In response to Staff’s request, IAWC witness McKinley said he found it “difficult to comment on the applicability of the West Virginia data” because he is “not familiar with the customers that compose the various customer classes nor the study related to determining the indicated demand factors.” (Staff Ex. 13.0, p. 15.) Since the West Virginia study was the most recent performed by an affiliate of the Company and presumably used the most up-to-date equipment and collection methods, a discussion of that analysis could have provided insights on operational and data collection challenges. However, this professed lack of familiarity by the IAWC witness leaves Staff and the Commission in the dark concerning possible shortcomings for such an analysis in Illinois. The most basic question which IAWC has still failed to answer is if a direct demand study can be performed at an apparently much lower cost in West Virginia, why should a proposed Illinois study be so much more costly while presenting operational and accuracy issues? The record lacks a satisfactory answer to that question.

The Company concludes its discussion by assuring in general terms the reasonableness of the indirect study presented for this case. After noting the Proposed Order’s expressions of “concerns” about its analysis, the Company summarily assures the Commission that “the concerns of Staff and IAWC with regard to the Capacity Factors Report’s data and methodology have either been shown to be unwarranted or

were addressed through adjustments.” (IAWC BOE, p. 25.) However, IAWC fails to explain in any detail how these arguments were refuted. In fact, the record indicates and the Proposed Order recognizes that the Company failed in this effort and has yet to provide a meaningful response to the serious questions Staff raised about its study.

Lastly, the time has come for IAWC to comply with the Commission’s repeated orders that it file an adequate cost study. The fact that the Commission was compelled to initiate a *sui generis* proceeding exclusively for the purpose of directing IAWC’s production of a cost of service study should have been quite sufficient indication to the Company that its prior efforts, or non-efforts, in this regard were a source of considerable dissatisfaction to the Commission. IAWC has not, it appears, taken this sufficiently to heart.

In sum, the Company has utterly failed to refute the arguments for requiring it to perform a direct demand study for its next rate case. The Proposed Order’s reasoning and conclusion on this matter should therefore be adopted by the Commission.

B. Reply to IWC

IWC’s arguments concerning the Proposed Order’s allocation of power costs should be rejected and the current approach should be adopted by the Commission.

IWC argues that power costs should be allocated in the same manner as pump investment rather than average daily water usage. (IWC BOE, p. 24.) It disagrees with the Proposed Order’s conclusion because “water demand and usage vary by season on the Company’s system.” (*Id.*) IWC goes on to conclude that “it is reasonable to anticipate greater total electric expense may occur in the summer when water demand and usage would be higher.” (*Id.*, pp. 25-26.)

There is a fundamental flaw with this argument. IIRC's contention that water usage varies by season is certainly true. However, that fact does not rule out the employment of a usage allocator for these costs. Since usage is greater in summer months, demands during those months will have a greater impact on the allocation of power costs than demands during winter months under a usage-based allocation. Thus, it is not clear how the usage allocator adopted by the Proposed Order would conflict with the argument presented by IIRC that water usage varies by season.

VI. MUNICIPAL RATE COMPARISONS AND OTHER INTERVENOR ISSUES

Both the AG and the Municipalities have taken exception to the Proposed Order because it does not summarize comments made at public forums and comments made online. (AG BOE, pp. 7-22; Municipalities BOE, pp. 1-2.)

As an initial matter, Staff commends the numerous involved responsible citizens affected by the IIRC proposed rates who participated in public forums and who filed comments through the Commission's website. Nonetheless, Staff is compelled to caution the Commission that summarizing specific public commentary which is not a part of the record for decision may be found to violate Section 10-103 of the Act and Section 10-35 of the Illinois Administrative Procedure Act ("APA"), both of which specifically require any Commission decision to be based exclusively upon the record for decision in the proceeding. (220 ILCS 5/10-103; 5 ILCS 100/10-35.) Section 10-35(a) of the APA enumerates those things that constitute the record for decision. (See 5 ILCS 100/10-35(a)(1)-(8).) Public comments, of the type that the AG and the Municipalities urge the Commission to quote and/or summarize are not included in those matters that constitute the record in this proceeding. While the Commission might

well take note of the fact that this proceeding has engendered an encouraging degree of public interest and comment, the specifics of that public comment is not a cognizable part of the record.

VII. NEW PROPOSED SECTION VIII.N, IAWC PENSION/OPEB PROPOSAL

The Company proposed inserting language assuming a Final Order in Docket No. 09-0400 which approves the Company's proposed change in accounting method for pension and OPEB costs. (IAWC BOE, p. 27.) Staff continues to oppose Company's request in Docket No. 09-0400 for the reasons discussed in Docket No. 09-0400. Staff agrees, however, that if the Commission grants the Company's request in Docket No. 09-0400, the test year pension and OPEB costs would need to be adjusted accordingly and the language proposed by the Company would need to be included in the Commission's Final Order in the instant proceeding.

VIII. REQUESTS FOR ORAL ARGUMENT

Both the Municipalities and the AG request that oral argument be heard by the Commission. (Municipalities BOE, p. 25; AG BOE, p. 2.) Staff believes that the Municipalities' request fails for procedural reasons and should be rejected. Additionally, Staff believes that the AG's request lacks specificity and should be, at the very least, limited by the Commission.

The Municipalities' request for oral argument is made pursuant to Section 200.850 of the Commission's Rules of Practice. (Municipalities BOE, p. 25.) Section 200.850 states, in relevant part:

- a) The Commission **may** hear oral argument upon seven days notice to the parties of the time and place upon:

- 1) Its own motion;
- 2) The motion of a party; or
- 3) A request for oral argument noted by a party on either its opening brief, reply brief or brief on exceptions, **accompanied by a statement in support of such request in the body of the brief.**

(Emphasis added.)

Despite the requirement in Section 200.850(a)(3) that a request for oral argument be accompanied by a statement in support of such request in the body of the brief, the Municipalities' BOE lacks the requisite statement. In fact, the sole sentence in the BOE merely states that the Municipalities "request oral argument pursuant to Ill. Admin. Code 200.850." (*Id.*) Staff believes that since the Municipalities' request for oral argument lacks the requisite statement in support thereof, the Commission should reject it.

While the AG's request for oral argument also references Section 200.850, the primary authority for its request is Section 9-201(c) of the Illinois Public Utilities Act (the "Act"). (AG BOE, p. 2.) Staff is aware that Section 9-201(c) of the Act provides that in this instance the AG must be given the opportunity to present oral argument. However, Staff is concerned about the open-ended and limitless nature of the AG's request. As the AG admits, it has raised numerous contested issues in the course of this proceeding. (*Id.*) Unfortunately, the AG's BOE (seventy-five pages long) does not even attempt to narrow the issues for oral argument. Moreover, the AG's suggestion that "all parties [should] address the Commission" (*Id.*) on all of the issues presented during the course of the instant proceeding is untenable, unwieldy and should be rejected.

Staff believes that the contested issues in the instant proceeding have been thoroughly examined through the processes and procedures surrounding testimony,

discovery, cross-examination and briefing. However, since the Commission must provide the opportunity for oral argument when requested pursuant to Section 9-201(c) of the Act, Staff recommends that the resulting oral argument be limited in scope. Accordingly, Staff suggests that it may be beneficial for the Commission to entertain oral argument on the methodology the Company used to develop the proposed demand factors it employed in its cost of service study, which demand factors Staff has consistently contended render the cost of service study so deeply flawed as to be inappropriate for ratemaking purposes. (Proposed Order, pp. 141-148.)

IX. CONCLUSION

For all the reasons set forth herein, Staff of the Illinois Commerce Commission respectfully requests that its recommendations be adopted in this proceeding.

Respectfully submitted,

A handwritten signature in black ink that reads "Linda M. Buell". The signature is written in a cursive, flowing style.

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