STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Charmar Water Company Proposed General Increase in Water Rates	)	11-0561
Cherry Hill Water Company Proposed General Increase in Water Rates	)	11-0562
Clarendon Water Company Proposed General Increase in Water Rates	)	11-0563
Killarney Water Company Proposed General Increase in Water Rates	)	11-0564
Ferson Creek Utilities Company Proposed General Increase in Water And Sewer Rates	)	11-0565
Harbor Ridge Utilities, Inc. Proposed General Increase in Water And Sewer Rates	)	11-0566 (Cons.)

*****PUBLIC*****

**INITIAL BRIEF OF THE STAFF
OF THE ILLINOIS COMMERCE COMMISSION**

JESSICA L. CARDONI
MICHAEL J. LANNON
Office of General Counsel
Illinois Commerce Commission
160 N. LaSalle, Ste. C-800
Chicago, IL 60601
Phone: (312) 793-3305
(312) 814-4368
Fax: (312) 793-1556
E-mail: jcardoni@icc.illinois.gov
mlannon@icc.illinois.gov

Counsel for the Staff of the
Illinois Commerce Commission

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INITIAL BRIEF OF THE STAFF
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Staff of the Illinois Commerce Commission ("Staff"), by and through its undersigned counsel, pursuant to Section 200.800 of the Illinois Commerce Commission's ("Commission" or "ICC") Rules of Practice (83 Ill. Adm. Code 200.800), respectfully submits its Initial Brief in the instant proceeding.

I. BACKGROUND

On June 29, 2011, Charmar Water Company ("Charmar"), Cherry Hill Water Company ("Cherry Hill"), Clarendon Water Company ("Clarendon"), Killarney Water

Company ("Killarney"), Ferson Creek Utilities Company ("Ferson Creek"), and Harbor Ridge Utilities Company ("Harbor Ridge") (collectively, "UI", "Utilities, Inc." or "the Companies") filed tariffs seeking a general increase in water and sewer rates.[1] On August 2, 2011, the Commission entered Suspension Orders commencing the investigation concerning the propriety of the Companies' request for rate increases and on November 2, 2011 entered a Resuspension Order extending the suspension through May 27, 2012. At a status hearing on September 1, 2011, the Administrative Law Judge ("ALJ") assigned to this proceeding granted Staff's request to consolidate the six dockets. The ALJ established a schedule for the submission of pre-filed testimony, hearings, and briefs (*Tr.*, Sep. 1, 2011, p. 6-7).

The People of the State of Illinois ("AG") intervened on September 8, 2011 and filed Direct and Rebuttal Testimony. On October 3, 2011, Antioch Golf Club Community Association intervened, but did not file testimony.

At the January 25 and 26, 2011 evidentiary hearing in this matter, witnesses for Utilities, Inc., Staff, and the AG testified.

This Initial Brief will summarize issues that have been resolved between Utilities, Inc. and Staff. The brief will also address contested issues that remain between Staff and the AG. Staff reserves the right to address any issues not addressed herein in its Reply Brief.

II. ARGUMENT

A. Rate Base

The Companies stated in surrebuttal testimony that they are not contesting the

[1] Only Ferson Creek and Harbor Ridge filed tariffs for rate increases in sewer rates.

revenue requirement recommended in Staff's rebuttal testimony. (Company Ex. 5.0, pp. 1-2) Therefore the Commission should adopt rate base for each Company as reflected in ICC Staff Ex. 9.0.

Uncontested Issues

Plant Retirements

Staff witness Ebrey proposed adjustments for Cherry Hill, Clarendon, Killarney, Ferson Creek Water, and Ferson Creek Sewer utilities concerning:

> 1) Retirement of plant that had not yet been removed from the utilities' books; and
>
> 2) Cherry Hill - the annual depreciation expense related to the retired plant that had not yet been removed from the company's books. (Staff Ex. 2.0, pp. 3-5.)

The Company accepted these adjustments. (Company Ex. 3.0, p. 7.)

Accumulated Depreciation

Staff witness Ebrey proposed adjustments to remove accumulated depreciation on previously retired plant. (Staff Ex. 2.0, pp. 13-15.) The Company accepted these adjustments. (Company Ex. 3.0, p. 7.)

Contributions in Aid of Construction ("CIAC")

Staff witness Ebrey proposed an adjustment to remove the effects of the amortization on CIAC which was not removed from the books of Harbor Ridge Sewer per the Order in Docket No. 94-0512. (Staff Ex. 2.0, p. 16.) The Company accepted this adjustment. (Company Ex. 3.0, p. 9.)

Pro Forma Plant Additions

Staff witness Ebrey proposed adjustments to update the pro forma plant additions for Cherry Hill, Killarney, and Harbor Ridge Water utilities based on responses to discovery, including revisions for Depreciation Expense and Accumulated Depreciation. (Staff Ex. 2.0, p. 16.) The Company accepted these adjustments. (Company Ex. 3.0, p. 8.)

Reclassification of Plant in Service

Staff witness Ebrey proposed adjustments to reclassify plant between the water and sewer utilities for Ferson Creek and Harbor Ridge based on responses to discovery (Staff Ex. 2.0, pp. 16-17.) The Company accepted these adjustments and also reflected the accumulated depreciation effect of the reclassification. (Company Ex. 3.0, p. 8.) Staff accepted that additional adjustment. (Staff Ex. 10.0, p. 2.)

Accumulated Deferred Income Taxes

Staff witness Ebrey proposed adjustments to Accumulated Deferred Income Taxes resulting from the changes to depreciation expense resulting from other Staff adjustments. (Staff Ex. 2.0, p. 17.) The Company accepted these adjustments. (Co. Ex. 3.0, p. 9.)

Abandoned Charmar Plant

Staff witness Ebrey made the following proposals regarding Charmar Plant that was abandoned:

> 1) Remove land easements and legal fees from plant in service that are associated with the abandoned plant;
>
> 2) Correct the accumulated depreciation as well as the “extraordinary depreciation” associated with the abandoned plant; and
>
> 3) Propose an amortization period of 15 years rather than 8.13 years as proposed by the Company for recovery of the abandoned plant costs.

Since the land easements associated with Charmar plant and the legal fees incurred to obtain the easements are no longer used and useful by the utility, Staff proposed that they be removed from plant in service. The Company recommended that the costs be reclassified to the Land and Land Rights account according to Accounting Instruction 24. (Co. Ex. 3.0, p. 7.) Staff pointed out that the costs were already recorded in accounts 302 (Franchises) and 303 Land and Land Rights so no reclassification was warranted. (Staff Ex. 10.0, p. 3.) The Company accepted Staff's adjustments in surrebuttal testimony. (Co. Ex. 5.0, p. 3.) Staff proposed adjustments to correct the Company's calculation of accumulated depreciation and its proposed "extraordinary depreciation" associated with the abandoned plant as well as to address the following concerns:

1) Estimated salvage and tax savings related to the property that was no longer being used should be considered;
2) Certain legal fees that were inappropriately included in plant accounts to be depreciated should be removed; and
3) Errors in the calculations should be corrected.

(Staff Ex. 2.0, pp. 7-10 and Staff Ex. 10.0, pp. 5-8.)

The Company proposed an alternative methodology (Staff Ex. 10.0, p. 7) to Staff's proposals for the computations of accumulated depreciation, which Staff accepted. (*Id*., p. 8.) However, the Company continued to take issue with certain legal fees Staff proposed be excluded from the calculation since they were unsupported. (*Id*.) The Company accepted Staff's adjustment for the Abandoned Charmar plant in surrebuttal testimony.

Staff proposed the use of a 15-year amortization period for the costs of undepreciated plant (rather than the 8.13 years proposed by the Company). (Staff Ex.

2.0, pp. 10-11.) The Company accepted this proposal. (Staff Ex. 10.0, p. 8.)

Staff witness Ebrey proposed that the retirement of the water treatment plant for Charmar be recorded according to the Uniform System of Accounts Accounting Instruction 27(H) because the retirement:

- Relates to the (unexpected) retirement of a major unit of property. The net treatment plant represents 37.12% of the Company's proposed rate base.[2]
- Since over two-thirds of the treatment plant has been in service less than 10 years, it can be concluded that this is an unexpected early retirement.
- The recording of the retirement by crediting "plant in service" and debiting "accumulated depreciation" by the original cost of the investment being retired would cause a serious depletion in the depreciation reserve. If the cost of the treatment plant was debited to the depreciation reserve for the full cost it would cause that account's balance to become a debit balance twice the current credit balance. Thus, such an entry would cause a serious depletion to the reserve account. (Staff Ex. 2.0, pp. 11-13.)

The Company accepted Staff's proposal for the accounting treatment of the retirement. (Company Ex. 3.0, p. 7.)

Contested Issues

<u>Cash Working Capital Adjustment</u>

For each utility, Staff witness Hathhorn proposed adjustments to working capital for the removal of real estate taxes and to incorporate the effects of other Staff-proposed adjustments to operating expenses. (Staff Ex. 1.0, pp. 7-8 and Sch. 1.08.) Staff accepted the Companies' calculations of their sewer and/or water working capital requirements using the 1/8th formula method based on the operating expenses presented in their filings. The Companies agreed that these adjustments should be updated to reflect the operating expenses approved by the Commission. (Co. Ex. 3.0, p. 2.)

[2] Cost of treatment plant ($169,950) – accumulated depreciation ($46,489) / Company proposed rate base ($332,676)

Staff disagrees with AG witness Mr. Michael Brosch that a zero cash working capital ("CWC") allowance should be adopted, since the "Companies have not presented any reliable study to support an amount for CWC that should be included in rate base." (AG Ex. 1.0, pp. 21-22.) As the Companies have explained, a lead-lag study would be cost-prohibitive based upon the revenues it would expect to generate versus the increased cost to rate case expense. (Co. Ex. 3.0, pp. 3-5.) Staff elaborated at the hearings that lead-lag studies often become controversial issues in rate cases, therefore, any possible negative cash working capital benefit to ratepayers is likely to be outweighed not only by the cost of the study, but by the cost of additional internal labor to analyze the study and respond to discovery, in addition to increased outside counsel costs. (*Tr.*, Jan. 26, 2012 at 249; 276.) Staff pointed out that the revenue requirement impact of the Company's proposal in this case is very small; for example, for Charmar it is less than 1% of the revenue requirement recommended by Staff and the Companies. (*Id.,* at 276-277.) Such an input to the cost of service model does not justify the potentially large costs the AG propose be incurred. Finally, the Companies are correct that the Commission has not rejected the use of the 45-day formula method for small water and wastewater utilities. (Co. Ex. 3.0, pp. 5-6.) Therefore, Staff recommends the Commission reject the AG's recommendation.

B. Operating Revenues and Expenses – Adjustments

As discussed above, the Companies stated in surrebuttal testimony that they are not contesting the revenue requirement recommended in Staff's rebuttal testimony. (Company Ex. 5.0, pp. 1-2) Therefore the Commission should adopt operating revenues and expenses for each Company as reflected in ICC Staff Ex. 9.0.

Uncontested Issues

Depreciation Expense

Staff witness Ebrey presented adjustments to Depreciation Expense to reflect the depreciation rates for Clarendon, Killarney, Ferson Creek Water and Sewer and Harbor Ridge Water and Sewer proposed by Staff witness William R. Johnson. (Staff Ex. 2.0, p. 5.) The Company accepted these adjustments. (Co. Ex. 3.0, p. 7.)

Add-On Taxes Adjustment

For each utility, Staff witness Hathhorn proposed adjustments to operating expense to remove public utility taxes from the revenue requirement. The taxes, which are an add-on charge to customers' bills, are not an actual operating expense of the utility and should not be included in tariffed rates. (Staff Ex. 1.0, p. 8 and Sch. 1.09.) The Companies did not oppose the adjustments. (Co. Ex. 5.0, p. 2.)

Consumer Price Index Adjustment

For each utility, Staff witness Hathhorn proposed adjustments to operating expenses to disallow the increases to test year expenses that are based on an inflation factor. Pro forma adjustments to a historical test year should be based upon known and measurable changes. Inflation factors are not known and measurable. (Staff Ex. 1.0, p. 9 and Sch. 1.10.) The Companies did not oppose the adjustments. (Co. Ex. 5.0, p. 2.)

Pro Forma Salaries and Benefits Adjustment

For each utility, Staff witness Hathhorn proposed adjustments to increase operating expenses to reflect the known and measurable costs of five additional personnel hired at Water Service Corporation ("WSC") hired after the WSC allocations of salaries and benefits to the test year were prepared. (Staff Ex. 1.0, p. 13 and Sch.

1.12.) The Companies did not oppose the adjustments. (Co. Ex. 5.0, p. 2.)

Legal Expense Normalization Adjustment

For Charmar only, Staff witness Hathhorn proposed an adjustment to decrease Charmar's legal expenses to reflect a more reasonable level expected to be incurred on an on-going basis. (Staff Ex. 1.0, p. 14 and Sch. 1.13 CM.) The Companies did not oppose the adjustments. (Co. Ex. 5.0, p. 2.)

Unaccounted-for-Water Adjustment

For Killarney only, Staff witness Hathhorn proposed an adjustment to decrease Killarney's maintenance expenses because the unaccounted-for water percentage exceeded the maximum as defined in Killarney's tariff. (Staff Ex. 1.0, p. 15 and Sch. 1.13 KI.) The Companies did not oppose the adjustments. (Co. Ex. 5.0, p. 2.)

Uncollectibles Expense Adjustment

For Harbor Ridge only, Staff witness Hathhorn proposed adjustments to decrease Harbor Ridge's uncollectibles expense at present rates to reflect the amounts at more reasonable levels expected to be incurred on an on-going basis. (Staff Ex. 1.0, p. 16 and Sch. 1.13 HR-S and HR-W.) The Companies did not oppose the adjustments. (Co. Ex. 5.0, p. 2.)

Contested Issues

Cash Working Capital Adjustment

For each utility, Staff witness Hathhorn proposed adjustments to working capital for the removal of real estate taxes and to incorporate the effects of other Staff-proposed adjustments to operating expenses. (Staff Ex. 1.0, pp. 7-8 and Sch. 1.08.) Staff accepted the Companies' calculations of their sewer and/or water working capital requirements using the 1/8th formula method based on the operating expenses presented in their filings. The Companies agreed that these adjustments should be updated to reflect the operating expenses approved by the Commission. (Co. Ex. 3.0, p. 2.)

Staff disagrees with AG witness Mr. Michael Brosch that a zero cash working capital ("CWC") allowance should be adopted, since the "Companies have not presented any reliable study to support an amount for CWC that should be included in rate base." (AG Ex. 1.0, pp. 21-22.) As the Companies have explained, a lead-lag study would be cost-prohibitive based upon the revenues it would expect to generate versus the increased cost to rate case expense. (Co. Ex. 3.0, pp. 3-5.) Staff elaborated at the hearings that lead-lag studies often become controversial issues in rate cases, therefore, any possible negative cash working capital benefit to ratepayers is likely to be outweighed not only by the cost of the study, but by the cost of additional internal labor to analyze the study and respond to discovery, in addition to increased outside counsel costs. (*Tr.*, Jan. 26, 2012 at 249; 276.) Staff pointed out that the revenue requirement impact of the Company's proposal in this case is very small; for example, for Charmar it is less than 1% of the revenue requirement recommended by Staff and the Companies. (*Id.,* at 276-277.) Such an input to the cost of service model does not justify the potentially large costs the AG propose be incurred. Finally, the Companies are correct that the Commission has not rejected the use of the 45-day formula method for small water and wastewater utilities. (Co. Ex. 3.0, pp. 5-6.) Therefore, Staff recommends the Commission reject the AG's recommendation.

Rate Case Expense Adjustment

Staff witness Hathhorn proposed adjustments to operating expenses for each utility to: (1) increase the amortization period for rate case expense from three years to five years since it is a more reasonable estimate of the time period that rates from this proceeding would be in effect for these Companies; and (2) adjust the estimated travel expenses to more reasonable levels consistent with recent rate cases of affiliates of the Companies. (Staff Ex. 1.0, p. 10 and Sch. 1.11.) In rebuttal testimony, the Companies updated their rate case expense estimate in Co. Ex. 3.3 and proposed to include $200 in travel costs per Company in rate case expense. (Co. Ex. 3.0, p. 12.) Staff agreed the updates provide a better estimate of the rate case expenses expected to be incurred than the costs in the Company's direct case, and that the Company's proposed reduced travel costs for rate case expense were a reasonable amount expected to be incurred for Company travel to the evidentiary hearing. (Staff Ex. 9.0, p. 7.)

Staff further testified that Section 9-229 of the Act requires the Commission to expressly address in its final order the justness and reasonableness of any amount expended by a public utility to compensate attorneys or technical experts to prepare and litigate a general rate case filing. Therefore, Staff recommended that the Companies provide several of its data request responses for the record in these cases. (Staff Ex. 1.0, pp. 12-13.) The Companies agreed and have sponsored Company Exhibits 3.3, 3.5, and 3.6 in support of the justness and reasonableness of their rate case expense request. Staff further recommends that the Commission make the following finding in its final order:

> The Commission finds that the amounts of compensation for attorneys and technical experts to prepare and litigate this

> proceeding, as adjusted by Staff, are just and reasonable pursuant to Section 9-229 of the Public Utilities Act (220 ILCS 5/9-229); total unamortized rate case expense in the following amounts per Company are approved for recovery:

Charmar	$118,763
Cherry Hill	$115,807
Clarendon	$115,703
Ferson Creek Sewer	$ 56,454
Ferson Creek Water	$ 57,664
Harbor Ridge Sewer	$ 58,106
Harbor Ridge Water	$ 58,667
Killarney	$116,773

(Co. Ex. 3.1, pp. 8 or 9)

AG witness Brosch testified that the Companies' method of inclusion of labor costs for Company employees in rate case expenses creates a problem of over-recovery of labor costs. (AG Ex. 1.0, p. 23, lines 487-489.) Staff disagrees with the AG. The Companies are correct that the test year capitalized salary costs related to internal labor are deducted from the salary amounts in the test year, therefore, no double-counting occurs. (Co. Ex. 3.0, p. 13-20.) In AG Cross Exhibit 2, Staff demonstrates line by line that there is no double-counting of internal labor in the test year. The Companies accomplish this by removing the costs of capitalized labor for capital projects from expenses, as well as the cost of employees' time working on rate cases outside of Illinois. (AG Cross Ex. 2, line 17; *Tr.*, Jan. 26, 2012 at 263.) For example, for Charmar, this results in a deduction of $1,342 in capitalized time, yielding $2,691 in test year internal labor charges. (*Id.*, lines 17-19.) Further, the WSC internal labor costs deferred for rate case recovery as detailed in Company Ex. 3.3 occurred post test year. (AG Cross Ex. 2, line 23; *Tr.*, Jan. 26, 2012 at 266-267.) Again, for Charmar, this means that the $79,339 of total internal labor charged to rate case expense (prior to amortization) occurred post 9/30/2010, and therefore none is included in the previously mentioned $2,691 of test year internal labor. (AG Cross Ex. 2, lines 19-23.) Staff has verified the Company's claim of no double counting of internal labor in rate case expense and test year labor charges. The AG has failed to provide sufficient evidence to support its claim that any further adjustments to rate case expenses are warranted.

C. Additional Accounting Recommendations

Accounting for Retirements

Staff witness Ebrey recommended that the Order in this proceeding order the Companies to:

1) Book retirements from plant in service as they occur throughout each year;

2) Provide the actual journal entries made to record all retirements addressed and approved in the final order of these proceedings to the Manager of Accounting of the Commission and file on e-docket within 60 days of the final orders in these rate cases (including those retirements ordered in prior rate cases);

3) Provide a report to the Manager of Accounting of the Commission and file on e-docket within 6-months of the order in these proceedings on the Company's process for identifying the dollar amount to be associated with retirements that takes into account all factors related to the plant to be retired; and

4) Complete the plant schedules as well as all other pages of ILCC Form 22 in their entirety and cease the shortcuts the Companies have taken in prior years' reports. (Staff Ex. 2.0, pp. 21-22.)

The Company agreed to these recommendations. (Company Ex. 3.0, p.9.) The

Company further clarified in surrebuttal testimony to analyze its tracking of small projects and retirement processes of the small projects and include its finding and recommendations in the report described in 3) above to address the issue of capitalized labor ("cap time"). (Company Ex. 5.0, p. 7)

Original Cost Determination

Staff witness Ebrey recommended that the Commission Order in this proceeding state:

> IT IS FURTHER ORDERED that the $326,456 original cost of water plant in service for Charmar Water Company at December 31, 2009, as reflected on Staff Schedule 10.03, is unconditionally approved as the water original costs of plant.
>
> IT IS FURTHER ORDERED that the $402,961 original cost of water plant in service for Cherry Hill Water Company at December 31, 2009, as reflected on Staff Schedule 10.03, is unconditionally approved as the water original costs of plant.
>
> IT IS FURTHER ORDERED that the $702,376 original cost of water plant in service for Clarendon Water Company at December 31, 2009, as reflected on Staff Schedule 10.03, is unconditionally approved as the water original costs of plant.
>
> IT IS FURTHER ORDERED that the $627,242 original cost of water plant in service for Killarney Water Company at December 31, 2009, as reflected on Staff Schedule 10.03, is unconditionally approved as the water original costs of plant.
>
> IT IS FURTHER ORDERED that the $1,335,221 original cost of water plant in service for Ferson Creek Utilities Company at December 31, 2009, as reflected on Staff Schedule 10.03, is unconditionally approved as the water original costs of plant.
>
> IT IS FURTHER ORDERED that the $1,910,182 original cost of sewer plant in service for Ferson Creek Utilities Company at December 31, 2009, as reflected on Staff Schedule 10.03, is unconditionally approved as the sewer original costs of plant.
>
> IT IS FURTHER ORDERED that the $966,972 original cost of water

> plant in service for Harbor Ridge Utilities, Inc. at December 31, 2009, as reflected on Staff Schedule 10.03, is unconditionally approved as the water original costs of plant.
>
> IT IS FURTHER ORDERED that the $199,135 original cost of sewer plant in service for Harbor Ridge Utilities, Inc. at December 31, 2009, as reflected on Staff Schedule 10.03, is unconditionally approved as the sewer original costs of plant.

(Staff Ex. 10.0, pp. 13-14.) The Company did not contest Staff's proposed Original Cost Determination. (Co. Ex. 5.0, p. 2.)

D. Rate of Return

Staff witness Janis Freetly presented the overall cost of capital and recommended a fair rate of return on rate base for Charmar, Cherry Hill, Clarendon, Killarney, Ferson Creek and Harbor Ridge. (Staff Ex. 3.0.) The Companies accepted Staff's 7.98% overall cost of capital recommendation. (Co. Ex. 3.0, p. 23.)

Weighted Average Cost of Capital
December 31, 2010

Staff Proposal

	Amount	Percent of Total Capital	Cost	Weighted Cost
Short-term Debt	$4,242,247	1.19%	3.08%	0.04%
Long-term Debt	$176,919,657	49.54%	6.65%	3.30%
Common Equity	$175,968,943	49.27%	9.43%	4.64%
Total Capital	$357,130,846	100.00%		
Weighted Average Cost of Capital				**7.98%**

A. Capital Structure

Since all of the Companies are wholly owned subsidiaries of UI, Staff proposed using UI's capital structure for the year ended December 31, 2010, comprised of 1.19% short-term debt, 49.54% long-term debt, and 49.27% common equity. (Staff Ex. 3.0, p. 3 and Schedule 3.1.)

Ms. Freetly calculated the balance of short-term debt in three steps. First, Ms. Freetly calculated the monthly ending net balance of short-term debt outstanding from June 2010 through June 2011. The net balance of short-term debt equals the monthly ending gross balance of short-term debt outstanding minus the corresponding monthly ending balance of construction-work-in-progress ("CWIP") accruing an allowance for funds used during construction ("AFUDC"), times the lesser of (a) the ratio of short-term debt to total CWIP for the corresponding month or (b) one. That adjustment recognizes the Commission's formula for calculating AFUDC assumes short-term debt is the first source of funds financing CWIP[3] and addresses the double-counting concern the Commission raised in a previous Order.[4] Second, Ms. Freetly calculated the twelve monthly averages from the adjusted monthly ending balances of short-term debt. Third, Ms. Freetly averaged the twelve monthly balances of short-term debt for July 2010 through July 2011. (Staff Ex. 3.0, pp. 4-5 and Schedule 3.2.)

Ms. Freetly adjusted the $180,000,000 balance of long-term debt outstanding on December 31, 2010 to reflect the unamortized debt expense incurred to issue the debt, which produces a long-term debt balance of $178,726,842. She then subtracted

[3] *Uniform System of Accounts for Water Utilities Operating in Illinois,* Accounting Instruction 19 Utility Plant - Components of Construction Cost (17). Long-term debt, preferred stock and common equity are assumed to finance CWIP balances in excess of the short-term debt balance according to their relative proportions to long-term capital.

[4] Order, Docket No. 95-0076 (Illinois-American Water Company, general rate increase), December 20, 1995, p. 51.

$1,807,185 to reflect the amount of long-term debt already incorporated in the calculation of AFUDC. This produced a long-term debt balance of $176,919,657. (*Id*., pp. 5-6.)

Ms. Freetly adjusted the $177,771,000 balance of common shareholders equity on December 31, 2010 by subtracting $1,802,057 to reflect the amount of common equity already incorporated in the calculation of AFUDC. This produced a common equity balance of $175,968,943. (*Id*., pp. 5-6.)

B. Cost of Debt

Ms. Freetly estimated that the Companies' cost of short-term debt is 3.08%, which equals a weighted average of the current Prime rate and LIBOR rate that the Companies pay on short-term borrowings. The weighted cost of short-term debt was calculated based on the proportions of the Companies' borrowings at the Prime rate and LIBOR during the short-term measurement period.

The Companies' embedded cost of long-term debt is 6.65%, which includes the annual amortization of debt expense to reflect straight line amortization of the unamortized balance over the remaining life of the outstanding issue of long-term debt. (Staff Ex. 3.0, p. 9 and Schedule 3.3.)

C. Cost of Common Equity

Ms. Freetly recommended a 9.43% cost of common equity for UI subsidiaries Charmar, Cherry Hill, Clarendon, Killarney, Ferson Creek and Harbor Ridge. She measured the investor-required rate of return on common equity for UI with the discounted cash flow ("DCF") and risk premium models. DCF and risk premium models cannot be directly applied to UI because its stock is not market traded. Therefore, Ms.

Freetly applied those models to water utility and public utility samples (hereafter, referred to as "Water sample" and "Utility sample," respectively).

Staff's Water sample consists of domestic corporations classified as water utilities within Standard & Poor's ("S&P") *Utility Compustat II* that have publicly traded common stock and the data needed to perform the cost of equity analysis. (Staff Ex. 3.0, p. 10.) To form the Utility sample, Staff began with a list of all domestic dividend paying publicly-traded corporations assigned an industry number of 4911, 4922, 4923, 4924, 4931 or 4932 in the S&P *Utility Compustat II* data base that have been assigned (1) an S&P credit rating of BBB or BBB-; (2) an S&P business risk profile score of "excellent;" and (3) and S&P financial risk profile of "intermediate," "significant," or "aggressive." Companies that did not have the data needed to perform the cost of equity analysis or were in the process of being acquired by another company or acquiring a company or similar size were not included in the Utility sample. (*Id.*, pp. 11-14.)

1. DCF Analysis

DCF analysis assumes that the market value of common stock equals the present value of the expected stream of future dividend payments to the holders of that stock. Ms. Freetly employed a non-constant-growth DCF ("NCDCF") model that reflects a quarterly frequency in dividend payments. (*Id.*, pp. 14-23.)

Ms. Freetly implemented the NCDCF model in this proceeding because the level of growth indicated by the average 3-5 year growth rates for her Water and Utility samples is not sustainable over the long-term. The average 3-5 year growth rate was 5.62% for the Water sample and 6.00% for the Utility sample, while Staff's estimate of the long-term growth rate was 4.61%. Since the near-term growth rates for the samples exceed the expected long-term overall economic growth rate, the sustainability of the average 3-5 year growth rates for the samples is unlikely. Further, Staff calculated the return on equity ("ROE") implied by the 3-5 year growth rates, based on the dividend payout and other data published in Value Line for each company in the Water and Utility samples. That calculation produced an average ROE of 19.34% for the Water sample and 14.05% for the Utility sample. In comparison, Value Line forecasts an implied average ROE for the 2014-2016 period of 10.18% for the Water sample and 10.13% for the Utility sample. Hence, it is unlikely that investors expect the sample companies to sustain a 19.34% or 14.05% rate of return on equity indefinitely. Consequently, Ms. Freetly implemented a multi-stage NCDCF analysis. (Staff Ex. 3.0, pp. 16-17.)

Staff witness Freetly modeled three stages of dividend growth. For the first five years, Ms. Freetly used market-consensus expected growth rates published by Zacks and Reuters as of September 29, 2011. For the second stage, a transitional growth period that spans from the beginning of the sixth year through the end of the tenth year, Ms. Freetly used the average of the first- and third-stage growth rates. Finally, for the third, or "steady-state," growth stage, which commences at the end of the tenth year and is assumed to last into perpetuity, Ms. Freetly calculated a 4.61% expected long-term nominal overall economic growth rate beginning in 2021; that growth rate was calculated using the expected real growth rate (2.6%) based on the average of the Energy Information Administration's ("EIA") and Global Insight's long-term forecasts of real gross domestic product ("GDP"), and the expected inflation rate (2.1%) based on the difference between yields on U.S. Treasury bonds and U.S. Treasury Inflation-

Protected Securities. She then combined the resulting 4.8% growth estimate with the 4.5% average nominal economic growth forecasted by EIA and Global Insight. (*Id.*, pp. 17-20.)

The growth rate estimates were combined with the closing stock prices and dividend data as of September 29, 2011. Based on these growth assumptions, stock price, and dividend data, Ms. Freetly's DCF estimate of the cost of common equity was 8.84% for the Water sample and 9.25% for the Utility sample. (*Id.*, p. 23 and Schedule 3.8.)

2. Risk Premium Analysis

According to financial theory, the required rate of return for a given security equals the risk-free rate of return plus a risk premium associated with that security. Staff witness Freetly used a one-factor risk premium model, the Capital Asset Pricing Model ("CAPM"), to estimate the cost of common equity. (Staff Ex. 3.0, pp. 23-36.)

The CAPM requires the estimation of three parameters: beta, the risk-free rate, and the required rate of return on the market. For the beta parameter, Ms. Freetly combined adjusted betas from Value Line, Zacks, and a regression analysis to estimate the beta of the Water and Utility sample. For the Water sample, the average Value Line, Zacks, and regression beta estimates were 0.70, 0.57, and 0.54, respectively. For the Utility sample, the average Value Line, Zacks, and regression beta estimates were 0.75, 0.77, and 0.72, respectively. The Value Line regression employs weekly observations of stock return data while both the regression beta and Zacks betas employ monthly observations. Since the Zacks beta estimate and the regression beta estimate are calculated using monthly data rather than weekly data (as Value Line uses), Ms. Freetly averaged those results to avoid over-weighting betas estimated from monthly data in comparison to the weekly data-derived Value Line betas. She then averaged the resulting monthly beta with the Value Line weekly beta, which produced a beta of 0.63 for the Water sample and 0.75 for the Utility sample. (*Id.*, pp. 30-35.)

For the risk-free rate parameter, Ms. Freetly considered the -0.01% yield on four-week U.S. Treasury bills and the 3.05% yield on thirty-year U.S. Treasury bonds. Both estimates were measured as of September 29, 2011. Forecasts of long-term inflation and the real risk-free rate imply that the long-term risk-free rate is between 4.3% and 5.5%. Thus, Ms. Freetly concluded that the U.S. T-bond yield is currently the superior proxy for the long-term risk-free rate. (*Id.*, pp. 27-29.)

Finally, for the expected rate of return on the market parameter, Ms. Freetly conducted a DCF analysis on the firms composing the S&P 500 Index. That analysis estimated that the expected rate of return on the market was 12.86% for the second quarter of 2011. (*Id.*, pp. 29-30.) Inputting those three parameters into the CAPM, Ms. Freetly calculated a cost of common equity estimate of 9.23% for the Water sample and 10.41% for the Utility sample. (*Id.*, p. 36 and Schedule 3.9.)

3. Staff Cost of Equity Recommendation

First, Ms. Freetly estimated the investor-required rate of return on common equity for the two samples from the results of the DCF and risk premium analyses for the samples. The average investor-required rate of return on common equity for the Water sample, 9.04%, is based on the average of the DCF-derived results (8.84%) and the risk-premium derived results (9.23%) for the Water sample. The average investor-required rate of return on common equity for the Utility sample, 9.83%, is based on the average of the DCF-derived results (9.25%) and the risk-premium derived results (10.41%) for the Utility sample. (Staff Ex. 3.0, p. 37.)

To assess relative financial risk, Ms. Freetly estimated the credit ratings implied by the key credit metrics that Moody's Investors Service ("Moody's") publishes for global regulated water utilities and regulated electric and gas utilities. Ms. Freetly compared three-year average financial ratios for UI and the Water sample to Moody's key credit metrics for global regulated water utilities. She compared the three-year average financial ratios for the Utility sample to Moody's key credit metrics for regulated electric and gas utilities. This analysis revealed that the financial ratios for UI are commensurate with a Baa2 rating, while the financial ratios are indicative of a level of financial risk that is commensurate with a Baa1 credit rating for the Water sample and a credit Baa3 rating for the Utility sample. The samples' implied credit ratings indicate that the Water sample has slightly less financial risk than UI and the Utility sample has slightly more financial risk than UI. Given the small difference between the implied credit rating of UI and the implied credit ratings of the samples, in Ms. Freetly's judgment, the average cost of common equity for the two samples is an appropriate estimate of the Companies' cost of common equity. Thus, the investor required rate of return on common equity for the Companies, 9.43%, is based on the average for the Water and Utility samples. (*Id.*, pp. 37-40.)

E. Rates

1. Billing Determinants

Staff agreed with the water billing units proposed by the Companies associated with the Base Facilities Charges (BFC) and the Usage Charges. The BFC and Usage

Charges water billing units are based on the respective number of bills that are sent out and on actual consumption data, respectively. (Staff Exs. 4.0, pp. 5 – 7 and 5.0, pp. 5 - 6) Also, the sewer BFC billing units are based on the number of bills that are sent out; therefore, these are the appropriate number of billing units to use in determining the sewer BFCs.

2. Cost of Service Study (COSS)

Staff agreed with the Companies' concern that a COSS would be too expensive for ratepayers because the cost would have to be allocated over a small number of customers, resulting in a significant adverse impact on customer bills. Thus, Staff believes it would not be in the best interests of the customers to incur the expense of a COSS. (Staff Exs. 4.0, pp. 8 – 9 and 5.0, pp. 7 - 8)

However, Staff suggested that there could be a feasible and less-costly COSS alternative that Staff and UI could jointly develop for use in future rate case fillings that would be more transparent and cost-based than the one discussed by UI in this proceeding. Specifically, Staff initially recommended the following:

1. The Commission should order UI to work with Staff to review and analyze UI's current method of cost of service and rate design methodology.

2. The Commission should order UI to develop a COSS with Staff for use in future UI rate cases.

3. The Commission should order that such review and analysis should be completed not less than six months prior to the next UI rate case filing.

(Staff Exs. 4.0, p. 9 and 5.0, pp. 8 – 9.)

In Companies witness Georgiev's rebuttal testimony, UI agreed to work with Staff to develop a COSS. The Companies, however, did not agree that it should be six months prior to the next rate case. The Companies stated the time frame was unrealistic as a decision to file a rate case may occur less than six months prior to filing a rate case. (UI Ex. 3.0, p. 21.)

Staff explained in Rebuttal Testimony that the COSS workshop parties would not necessarily reach a consensus on all outstanding issues, but could provide a good starting point for resolving differences and improving the accuracy of future COSSs upon which future rates could be set. Staff revised its recommendation that such a workshop should be completed within six months commencing from the date of the Final Order in this proceeding. Adoption of Staff's proposal would allow a maximum of six months to complete the workshop process. (Staff Ex. 11.0, pp. 4 – 5.)

In Surrebuttal Testimony, the Companies again only partly agreed with Staff to develop and streamline a procedure or process for a COSS. Companies witness Georgiev stated the terms of Staff's recommendations were unclear to the Companies. UI stated they are willing to review any schedules that Staff had developed related to a streamlined COSS to use in future filings. The Companies did not feel the deadline for completion of the workshop should be ordered by the Commission in this docket, but rather the deadline should be a subject of the workshop. (UI Ex. 5.0, p. 8)

Staff disagrees. A deadline must be ordered by the Commission to ensure that the task is accomplished and steps are taken to move the Companies toward cost based rates. Specific numbers will not be identified in the workshop but parties should reach an agreed format for a COSS and a method for the accounts to be maintained so the COSS input is useful in setting future rates for UI. Staff continues to recommend a six-month deadline to complete the COSS workshop process from the date of the Final Order in this docket.

3. Rate Design - Water

Since there is no COSS provided as a basis for rates in this case, Staff recommended setting water rates by increasing the BFCs and the Usage Charges based on AWWA Meter Factors. The rates should recover Staff's recommended revenue requirement. (Staff Exs. 4.0, p. 10 and 5.0, p. 9.)

Staff agreed with the Companies' proposals to recover a greater percentage of the revenue requirement from the Usage Charge so that customers are more able to control their monthly bill by adjusting their usage to match their budget. Staff increased the BFCs based on AWWA Meter Factors, where the allocation of costs among customer types was done through the application of Meter Factors. This approach relates the flow for meters larger than 5/8" to that of the volume of flow for a 5/8" meter. Staff used equivalent meter ratios expressed in terms of the ratio of related meter capacity for each meter size relative to a 5/8" meter size. The remaining revenue requirement increase is recommended to be recovered through the Usage Charges, which are the same for all meter sizes. (Staff Exs. 4.0, pp. 15 - 16 and 5.0, pp. 13 – 14.) Staff recommended that meter sizes should be consistent with the AWWA method from 5/8" meter through 6" meters. (Staff Ex. 4.0, p. 17.)

If there is any difference between the revenue requirement adopted by the Commission and Staff's revenue requirement, then Staff's proposed BFCs and Usage Charges should be adjusted by modifying the Companies' BFCs based on AWWA meter factors (based on the new revenue requirement) to recover the water revenue requirement adopted by the Commission. (Staff Exs. 4.0, p. 19 and 5.0, p. 18.)

4. Rate Design - Sewer

With respect to the Companies' proposed sewer rates, Staff accepted the proposed flat fee rate structure utilized by the Companies which included a separate sewer rate for customers using less than 1,000 gallons of water in a billing period. (Staff Ex. 5.0, p. 21) Also, Staff recommended that the Commission approve the Companies' proposed low usage rate to comply with the requirement of Section 8-306(h) of the Public Utilities Act (Act) to establish a sewer rate applicable to customers who use less than 1,000 gallons of water in any billing period. (*Id*., pp. 28 – 29.)

In Direct Testimony, however, Staff witness Rukosuev argued that the Companies' rates do not comply with Sec. 8-306(i) of the Act which mandates that the Company "must offer a separate meter to measure each service." (ICC Staff Exhibit 5.0, p. 30) Although there are no existing customers with separate meters, and no data is currently available to calculate separate rates, Staff recommended that the Commission order the Companies to revisit the Section 8-306(i) issue again in its next rate relief request. Without a rate that complies with this section of the Act, any customer who may install, or who may want to install, a separate meter will be deprived of the opportunity to have a lower sewer bill for the amount of water that does not flow through the sewer system. (*Id.* p. 30.) In Surrebuttal Testimony, the Companies agreed to submit tariff language for separate meters for water and sewer service in their next rate case. Companies witness Georgiev also stated that since there is no current data of such customers, the Companies cannot submit separate rates for these non-existent customers. Separate rates would be established once customers who fit this description actually exist. (UI Ex. 5.0, pp. 26.)

If there is any difference between the sewer revenue requirement adopted by the Commission and Staff, then Staff's proposed sewer BFCs should be adjusted by a uniform percentage to recover the sewer revenue requirement adopted by the Commission. (Staff Ex. 5.0, pp. 26 – 27.)

5. Bill Impacts

Staff maintains that the rate increases proposed by Staff are reasonable, supported by the evidentiary record, and should be adopted. In this proceeding, Staff presented evidence through several witnesses that supported the proposed level of revenue requirement. In fact, the Companies presented detailed evidence in this case regarding its specific operating and capital expenses, which Staff thoroughly reviewed.

When establishing the rates a public utility may charge its customers, the Commission considers the utility's operating costs, rate base, and allowed rate of return. *Citizens Utilities Co. v. Illinois Commerce Comm'n*, 124 Ill. 2d 195, 200, 529 N.E.2d 510, 512 (1988). Staff asserts that its thorough review of the Companies' cost of providing service revealed their current rates are insufficient to generate the operating revenue necessary to permit them to earn a fair and reasonable rate of return and to cover their expenses to operate and maintain their systems. Instead of addressing the underlying component of the Companies' testimony on operating or capital costs (*i.e.*, identifying specific expenditures that were unjustified, imprudent, and costs that could have been reduce rates), the intervenors chose instead to argue that rate shock or gradualism provides the Commission the authority to approve a revenue requirement that does not fully recover a utility's cost. Staff disagrees. Staff considered the financial impact of its proposed rates and made significant efforts to establish rates as low as possible, while ensuring each Company a fair and reasonable rate of return on investments. (Staff Exs. 4.0, pp. 19 – 22 and 5.0, pp. 32 – 34.)

The Companies' customers may experience rate shock under either Staff's or the Companies' proposals in this proceeding; however, the rates that Staff proposed for this rate case are based on Staff's proposed revenue requirement and are slightly lower than those proposed by the Companies. Although these average percentage increases might be considered steep in some circumstances, the increase is necessary in order for the Companies to recover its revenue requirement. (Staff Exs. 4.0, p. 22 and 5.0, p. 34.)

These large increases were based on record evidence and are cost-based. The bill impacts of these increases, unfortunately, cannot be spread over a large customer base because the service areas are small. Nor can the bill impacts be mitigated by moving costs to other customer classes as the Companies have largely just one customer class: residential. Where there are some commercial customers, however, there are typically very few. In other words, given the level of approved increases, the resulting high bill impacts cannot be ameliorated through traditional rate mitigation methods. Furthermore, because UI maintains a fractured corporate structure across many tiny systems, UI does not have the requisite economies of scale to spread it's across a larger customer base and result in lower rate increases.[5] Consequently, bill impacts cannot be effectively mitigated by spreading costs across all its 23 subsidiaries.

While Staff is mindful that the increases are not small and economic conditions are difficult, the Commission simply cannot deny a rate increase in its entirety because

[5] UI operates a total of 23 water and wastewater subsidiaries in Illinois.

the resulting rates are deemed "too high" by one or more parties. In fact, courts have rejected the argument that customers have a right to rely on continued below cost rates, holding in *Commonwealth Edison v. Illinois Commerce Commission*, that "there is no protected interest in the continuation of favorable utility rates." *Commonwealth Edison v. Illinois Commerce Commission*, 924 N.E.2d 1065, 1098 (2d Dist. 2009.)

In sum, Staff has presented extensive evidence supporting the reasonableness of its specific proposed levels of costs and rates, which demonstrate that Staff's proposed rate increase should be approved.

6. Miscellaneous Fees and Charges

Staff and the Companies agreed on all changes to the miscellaneous charges and tariff sheets. These include: (Staff Ex. 4.0, pp. 22 – 43)

- NSF Check Charge increase to $25 for the Companies
- New Customer Charge increase to $25 for the Companies
- Reconnection Charge increase to $37.50 for the Companies
- Establish an After Hour Call-Out Charge at $106 minimum for the Companies
- Establish an Annual Gross Revenue Tax equal to 0.1% for the Companies
- Ensure all Companies are on a monthly billing cycle
- Ensure all Companies have a specific Bill Form on file as a tariff sheet
- Update all tariff sheets to a uniform and standard presentation
- Remove Rider 1 from Charmar, Cherry Hill, Clarendon, Killarney and Ferson Creek
- Clear up other minor inconsistencies with the tariffs for the Companies

7. Staff's Response to the AG's Proposed Phase-in Plan.

The AG discusses the need to address the rate shock that would result from immediate implementation of the "extraordinarily large" rate increases that are being proposed by the Companies. (AG Ex. 2.0, p. 3.)

The AG's solution to rate shock, however, is to phase-in the recovery of each Companies' approved revenue requirement from this proceeding over a period of years, yet to be determined. (AG Ex. 1.0, pp. 4 – 15 and AG Ex. 2.0, p. 4-17.)

The problem is that Mr. Brosch's proposal will not allow for the full recovery of the approved revenue requirement of any of the Companies that the Commission would have deemed just and reasonable, until, potentially, several years from the issuance of the Commission's Order in this proceeding. (Staff Exhibit 11.0, p. 11)

> In establishing the rates that a public utility is permitted to charge its customers, the Commission must first determine the utility's revenue requirement. The components of the revenue requirement have frequently been expressed in the formula 'R (revenue requirement) = C (operating costs) + Ir (invested capital or rate base times rate of return on capital).'

BPI II, 146 Ill. 2d at 195-96.

The phase-in proposal may result in a level of revenues insufficient to operate and maintain the Companies' water and sewer systems in a safe, adequate, and reliable manner. (*Id. 13)*

Mr. Brosch's proposal is described at such a high level that it fails to address significant details needed to properly evaluate and implement a phase-in program. For example, by reading his Direct Testimony and Rebuttal Testimony, it is not obvious whether the period of years over which the Companies' authorized revenue requirements would be recovered is set in stone at this point in time. In fact, by reviewing Mr. Brosch's phase-in schedules, it is apparent that Mr. Brosch's proposal results in a different phase-in period for each utility. (AG Exhibit MLB-2.1 Revised, pp. 1-10.) This is problematic for a number of reasons.

First, it is unknown how that would affect the utilities' ability to provide utility service and its impact on the utility customers of each utility. Thus, the determination of an appropriate phase-in period would need to be vetted over the short period of time remaining in this proceeding. (Staff Ex. 11.0, p. 13.)

Second, there may be serious implementation issues pertaining to his proposal. For example, the Companies may need time to notify customers and educate them about how the phase-in plan would work. Consumer education is vital to the successful implementation of the plan. However, more importantly, the Companies may encounter serious difficulties in revising its information processing and customer service systems to accommodate Mr. Brosch's complicated proposal. Under the AG plan, there will be many rate periods with different rates for each. According to Mr. Brosch, there would be a series of tariffs that would for seven years have an annual anniversary date with revised higher prices. (*Tr.*, January 26, 2012, at 239.) Simply put, phase-in implementation costs may outweigh the benefits in the long run.

Furthermore, Mr. Brosch's proposal appears to make the assumption that all customers must participate in the phase-in program, stating "I do not propose in my testimony to allow customers a choice of prices, one set of prices being with phase-in and another set of much higher prices being without phase-in." (*Tr.*, January 26, 2012, at 230)

However, there may be customers who do not wish to pay lower rates now and then pay higher rates plus interest, later. Thus, the concern becomes one of whether such a program should require that all customers participate or if it is to be voluntary. If it is voluntary, should customers be allowed to sign up for the program, i.e. opt in, or request removal from the program; i.e., opt out? (*Id.* 14) This is an important component that has not been addressed in Mr. Brosch's proposal. It should not be up to the other parties to fill in the blanks for details that are needed for a well-thought-out program. (*Id.)*

Finally, Staff contends the recommendations made by the AG will move rates away from costs and violate the well-established Commission policy of basing rates, to the extent possible and reasonable, on cost. Moreover, both the AG and the Association ignore the plain language of the Act. The Act states that the charges for delivery service be based upon cost (220 ILCS 5/1-102), as follows:

> [Sec. 1-102(a) (iv) requires that] tariff rates for the sale of various public utility services are authorized such that they accurately reflect the cost of delivering those services and allow utilities to recover the total costs prudently and reasonably incurred[.]
>
> [and]
>
> [Sec. 1-102(d) (iii) requires that] the cost of supplying public utility services is allocated to those who cause the costs to be incurred.

Contrary to the plain language of the Act, the AG, for all intents and purposes, recommends that the Commission disregard any evidence on cost in this case by offering an incomplete and extreme form of a phase-in plan that stretches recovery of vetted costs over a decade.

It is not clear to Staff that such an atypical mitigation plan as proposed by the AG that defers approved rate increases to later periods, should be adopted at this time.

Even if there was, there are valid concerns as to: (a) such a plan's ability to truly ease the financial burden of higher rates upon customers; and (b) maintain safe, adequate and reliable utility service. With regard to the former, a customer who defers rate increases pays lower rates today at the cost of much higher rates in the future, particularly because they must pay back all deferred rate increases with interest. With regard to the latter concern, the reduction in revenues collected from customers may adversely impact the utility's ability to make necessary infrastructure investments to its water and sewer systems in a timely and adequate manner.

The Commission should not ignore the relevant evidence filed by Staff. The Commission has long recognized the importance of adhering to basic cost of service principles. Simply put, the AG's recommendation in this proceeding will move rates away from cost and violate the well-established Commission policy of basing rates, to the extent possible and reasonable, on cost. Indeed, in order to determine if a particular rate is "cost based," the Commission would, at the very least, need detailed information concerning the Companies' cost of providing service. Only armed with such information could the Commission even begin to determine whether a particular rate complies with the Act. The Commission must consider the revenues and expenses of the utility. Staff has presented extensive evidence supporting the reasonableness of its specific proposed levels of costs and rates, which demonstrated that Staff's proposed rate increase should be approved.

As noted earlier, key components of this proposal have not been presented by Mr. Brosch. It's unlikely that all the details of a phase-in proposal can be properly and adequately vetted by the parties in the remaining phases of this docket, even if such a proposal were legal, which has not, yet, been determined.

In sum, the goal of setting just and reasonable rates is paramount. Accomplishing that goal, however, requires a detailed analysis of the Companies' costs that underlie such rates. Staff has performed such an analysis. Staff's analysis indicated that the Companies' rates, which are presently in effect, are insufficient to generate the operating revenue necessary to permit the Companies to earn a fair and reasonable rate of return and to cover their expenses to operate and maintain their systems. Staff's proposed rates are intended to yield revenues sufficient to recover test year operating expenses and to produce a reasonable return on rate base.

F. Depreciation

Utilities, Inc. witness Lena Georgiev proposed moving Clarendon, Killarney, Ferson Creek, and Harbor Ridge from composite water and/or sewer depreciation rates to utilizing separate water and/or sewer depreciation rates for each primary account. (Exhibit No. 1.0R, p. 11, Clarendon Water Company – Water Depreciation Rates; Exhibit No. 1.0, p. 11, Killarney Water Company – Water Depreciation Rates; Exhibit No. 1.0, p. 11, Ferson Creek Utilities Company – Water and Sewer Depreciation Rates; and Exhibit No. 1.0, p. 12, Harbor Ridge Utilities, Inc. – Water and Sewer Depreciation Rates.)

Staff witness Johnson did not object to each Company's proposal to move to separate water and/or sewer depreciation rates by primary account; however, Staff proposed some minor adjustments to each Company's depreciation schedules. (ICC Staff Ex. 6.0, pp. 5-24.)

Utilities, Inc. witness Georgiev agreed with Staff's proposed depreciation adjustments. (Exhibit 3.0, pp. 11 and 21.)

The final proposed water and sewer depreciation rates are identified on ICC Staff Exhibit 6.0, Schedule 6.01 CWC, Schedule 6.01 KWC, Schedule 6.01 FCUC-W, Schedule 6.01 HRUI-W, Schedule 6.01 FCUC-S, and Schedule 6.01 HRUI-S.

1. Rules, Regulations, and Conditions of Service Tariffs

Utilities, Inc. witnesses Lena Georgiev and Dimitry Neyzelman proposed updated Rules, Regulations, and Conditions of Service Tariffs for water and/or sewer service for the Utilities, Inc. Companies (Charmar Exhibit 1.0, p. 13; CHWC Exhibit 1.0, p. 12; CWC Exhibit 1.0, p. 12; CWC Exhibit 1.4; KWC Exhibit 1.0, p. 12; KWC Exhibit 1.4; FCUC Exhibit 1.0, p. 12; FCUC Exhibit 1.4; HRUI Exhibit 1.0, p. 13; Exhibit 3.2; and Exhibit 5.2).

Staff witnesses William H. Atwood Jr., William R. Johnson, Thomas Q. Smith, and Jonathan M. Sperry proposed some minor changes to the Companies' proposed Rules, Regulations, and Conditions of Service Tariffs for water and/or sewer service. (ICC Staff Exhibit 6.0, p. 27; ICC Staff Exhibit 7.0, p. 5; ICC Staff Exhibit 8.0, p. 6; ICC Staff Exhibit 13.0, pp. 3-4; ICC Staff Exhibit 14.0, pp. 3-6; ICC Staff Exhibit 15.0, pp. 3-4; and ICC Staff Exhibit 16.0, pp. 5-.7)

The Companies agreed with Staff's proposed changes and incorporated them into the proposed Rules, Regulations and Conditions of Service tariffs for water and/or sewer service filed with its Surrebuttal Testimony as Exhibit 5.2. (Exhibit 3.0, pp. 22-24; Exhibit 5.0, p. 3.)

G. Affiliated Interests and HomeServeUSA

Staff addressed certain issues in its direct testimony regarding the gathering and sale of customer records to a company called HomeServeUSA. (Staff Ex. 12.0) Technically, the sale of these records was made by the Companies' affiliate, Water Service Corporation ("WSC"). (*Id*., p. 6) WSC employs all the personnel that perform the day-to-day operation of the Companies, pursuant to a Commission-approved Affiliated Interest Agreement ("AIA"). (Co. Ex. 5.0, p. 5) Because of this corporate arrangement, there is no clear dividing line to indicate where WSC ends and the Companies begin. (*Tr.*, Jan. 25, 2012, pp. 189 and 194) Staff contends that the gathering of the customer records for resale to HomeServeUSA, is an essential component of the day-to-day work performed by WSC for the Companies. (Staff Ex. 12.0, p.9) However, there is no provision made in the AIA specifically for this function. (*Tr.*, Jan. 25, 2012, p. 171) Additionally, there is no specific provision in the AIA for crediting the Companies for the additional costs or for the WSC revenues associated with the transactions. (*Id*.)

The Companies and WSC inappropriately engaged in the above-described transactions without first obtaining approval from the Commission. Such affiliate transactions are governed by Section 7-101 of the PUA, which requires utilities to seek approval for all services rendered to or by their affiliates. Following recent Commission Orders and testimony presented in this case, Staff recommends that the most appropriate remedy within the context of this docket is for the Commission to require an adjustment to revenue requirements, reflecting the revenues collected by WSC in these transactions. This amounts to an adjustment of [redacted] Staff Ex. 12.0, p. 17), which the Companies accept. (UI Ex. 5.0, p. 3)

I n addition, Staff recommends that the Commission issue a citation and notice to the other Utilities, Inc. of Illinois utility companies, ordering them to come before the Commission and show cause as to why they should not penalized. (Staff Ex. 12.0, p. 14)

Finally, Staff recommends that the Commission order the Companies to cease and desist from engaging in these unlawful transactions until two things occur. First, the Companies and WSC should seek and obtain Commission approval to engage in such transactions (perhaps through a petition to amend the existing AIA). Second, the disclosure of individual ratepayer records by a public utility (either directly or indirectly, as through an affiliate) should not be permitted without obtaining the customer's permission.

The Marketing Agreement and the Affiliated Interest Agreement

Staff witness Hathhorn describes the contract between WSC and HomeServeUSA, whereby WSC provides to HomeServeUSA (for monetary consideration) customer-level records on the Companies' ratepayers. (Staff Ex. 1.0, p. 25) This confidential contract is called the Marketing Agreement ("MA") and is attached to Staff Witness David Sackett's rebuttal testimony (Staff Ex. 12.0, p. 5) as Confidential Attachment A. [redacted] There has been no evidence from the Companies to show what costs were incurred. [redacted]

WSC also serves as the service company for Utilities, Inc., the parent of the

Companies. In Docket No. 08-0335, the Commission approved a virtually identical Affiliated Interest Agreement ("AIA") between each of the Companies and WSC. (Staff Ex. 12.0, Attachment B.) The AIA lists various services that WSC will perform for the Companies, and the AIA also specifies a cost allocation methodology associated with these services. Cost that can be directly attributed to one entity for which WSC provides services are billed directly to that entity; all other costs are pooled together by category and allocated to each entity based on a defined mechanism.[6] (Staff Ex. 12.0, Attachment B, pp. 3-4) The AIA does not list any services that the Companies are to provide to WSC. Accordingly, the AIA specifies no methodology for allocating the cost of services provided by the Companies to WSC, no procedure for imputing to the Companies revenues for such services, and no mechanism for WSC to reimburse the Companies for such services. Neither the Companies nor WSC informed Staff or the Commission about the marketing agreement between WSC and HomeServeUSA while they were seeking approval of the AIA agreements in Docket 08-0335 (*Tr.*, Jan. 25, 2012, p. 50)

Under the AIA, WSC provides many services to the Companies, including Billing and Customer Relations. WSC employees, acting on behalf of the Companies, sign ratepayers up for utility service. During this process, ratepayers provide their names and addresses to those WSC employees, as is necessary for the provision of utility service to those customers. (Co. Ex. 5.0, p. 5) It is this very same information that is then being resold by WSC to HomeServeUSA. Because the Companies pay for a portion of all costs not directly allocated elsewhere, such costs end up being absorbed largely by ratepayers. As noted above, arrangements like this make it virtually

[6] That mechanism is Equivalent Residential Customers ("ERCs")

impossible to determine where the service company ends and the regulated utilities begin.

The Requirements of Section 7-101 the Public Utilities Act

The Public Utilities Act ("Act") sets forth requirements pertaining to interactions between Public Utilities and their affiliates. It also provides guidelines for the Commission's jurisdiction.

Section 7-101(h)(3) of the Act sets forth requirements for utilities seeking to enter into contracts with affiliates to obtain Commission *pre-approval*:

> No management, construction, engineering, supply, financial or similar contract and *no contract or arrangement* for the purchase, sale, lease or exchange of any property or *for the furnishing of any service,* property or thing, *hereafter made with any affiliated interest*, as hereinbefore defined, *shall be effective unless it has first been filed with and consented to by the Commission* or is exempted in accordance with the provisions of this Section or of Section 16-111 of this Act. The Commission may condition such approval in such manner as it may deem necessary to safeguard the public interest. If it be found by the Commission, after investigation and a hearing, that any such contract or arrangement is not in the public interest, the Commission may disapprove such contract or arrangement. Every contract or arrangement not consented to or excepted by the Commission as provided for in this Section is void. (220 ILCS 5/7-101(h)(3) emphasis added)

This subsection does not apply solely to the provision of a service to an affiliate. The phrase "arrangement…for the furnishing of any service…with any affiliated interest" applies equally to the provision of services by the utility (or its agents). [7] The Commission has granted several petitions by utilities seeking approval to provide services to their affiliates and receive compensation for those services.[8]

[7] Furthermore, the Companies noted in their petition in Docket No. 08-0335 that the Companies' interactions with its affiliates are subject to Section 7-101 as quoted in Staff witness Sackett's rebuttal testimony 12.0, pp. 7-8; the petition did not specify where in section 7-101 this jurisdiction was established.

[8] Two of these cases are noted in Staff Ex. 12.0, p. 8 wherein Nicor Gas (Docket No. 00-0537), Peoples

Furthermore, Section 7-102(g) of the Act states:

> *No public utility may* use, appropriate, or *divert any of its* moneys, *property or other resources* in or *to any business or enterprise which is not, prior to such use, appropriation or diversion essentially and directly connected with or a proper and necessary department or division of the business of such public utility*; provided that this subsection shall not be construed as modifying subsections (a) through (e) of this Section. (ILCS 5/7-102(g) emphasis added)

Additionally, the Commission has recently decided that when the value of a service exceeds the cost that is paid by an affiliate, the affiliate is being subsidized by ratepayers. In its recent decision in Docket No. 11-0046, the Commission ordered Nicor Gas to stop soliciting on behalf of its affiliates. The Commission ruled that Nicor Gas was subsidizing its affiliate because the value of its solicitation services was benefitting shareholders, not ratepayers. *Order*, Docket No. 11-0046, (December 7, 2011) p. 55 ("The Commission concludes here that the right to market NS [Nicor Services] services to customers during utility business calls *has commercial value that exceeds* NG's [Nicor Gas'] *mere costs*, and *the transfer of that value without compensation constitutes a subsidy* for NS.") (Emphasis added.)

Providing Customer Information to an Affiliate is a Service under the Commission's jurisdiction

The remaining disputed affiliate issues in this case are whether: (1) agents of the Companies providing this customer information to WSC that, in turn, enables WSC to sell it to HS is a service; and (2) the Companies should get customers permission prior to releasing customers' information to any third party. The Companies have argued that they performed no such services. Rather, WSC did all the work. Thus, there was no need to include the work in the AIA, there are no costs associated with that work

Gas and North Shore Gas (Docket No. 06-540) requested specific permission to provide customer information to their affiliates amongst other services.

included in the Companies books, and there is no need to impute any revenues associated with this work. Staff contends that this is a service for several reasons. The Commission has twice approved the "provision of customer information" as a service as Staff witness Sackett noted in his rebuttal testimony.

> This concept first appeared in Nicor Gas' proposed Operating Agreement[9] in Docket No. 00-0537, and subsequently Peoples Gas and North Shore proposed this concept as a service to the Commission in Docket No. 06-0540….The Commission has recognized that the provision of "customer lists and other customer-related information" is a service when it approved these two agreements. Since the Commission has determined that this is a service, it must, by law, be approved and, if approved, the Companies must be compensated by their affiliate for it.
>
> (Staff Ex. 12.0, p. 8)

The Companies' witness notes that neither the Companies nor any of its affiliates were parties to the proceedings in which the Commission approved these services, so he (or she) was not "aware" of these provisions. (Co. Ex. 5.0, pp. 6-7) However, the Companies need not be parties to other dockets to know that what they are doing must be approved by the Commission.

Furthermore, while Section 7-204 primarily pertains to utility reorganization, it also addresses the protection of customer information.

> (6) An identification of all public utility assets or information in existence, such as customer lists, which the applicant plans to transfer to or permit an affiliated interest to use, which identification shall include a description of the proposed terms and conditions under which the assets or information will be transferred or used; (220 ILCS 5/7-204)

Finally, the Act and the Commission have kept electric and gas utility affiliates from providing information exclusively to an affiliate in this way, requiring equal access to customer information for all competitors. (Admin Rules Sections 450.20, 450.70,

[9] The Operating Agreement is essentially a two-way affiliated interest agreement that allows the utility to provide services for the affiliate with compensation. (Docket No. 00-0537)

550.20 and 550.70)

The customer information that WSC sells to HS is developed by agents of the Companies in the performance of their utility duties. Ratepayers divulge part of this information to WSC during the process of signing up for utility service. (Co. Ex. 5.0, p. 5) The other information provided is an internally-generated unique identifier. (*Tr*, Jan. 25, 2012, p. 66)

The customer information provided by WSC to HS is utility information, not affiliate information. Ratepayers provide this information to each Company when they sign up for utility service (Staff Ex. 12.0, p. 11), and WSC maintains this information as part of its duties in providing customer service on behalf of each Company. (Staff Ex. 12.0, Attachment B, pp. 2-3) The Billing and Customer Relations service that WSC performs on behalf of each Company is utility in nature and thus, the associated expenditures for these services are recovered from ratepayers. (Co. Ex. 1.0, p. 2)

According to the Companies' witness, Ms. Georgiev, the revenues that WSC receives from HS are "non-utility" in nature. (Co. Ex. 3.0, p. 6) Therefore, the Companies appear to believe that the customer information service that WSC provides to HS to be "non-utility" in nature. However, as noted above, the Commission has historically treated the provision of customer lists and customer-related information as a service for which the reimbursement of ratepayers is required. (Staff Ex. 12.0, p. 12)

If the provision of information is a service, then the Companies are required to obtain Commission approval and include a mechanism to reimburse ratepayers for this service. The Companies have done neither.

Any Revenues Received from the Provision of Customer Information should be Utility Revenues.

A utility should not be able to profit from its position and leverage its customers for profit unless those efforts offset the costs of providing utility service. Because the customer information is a utility asset, if the use of utility information for non-utility purposes results in revenues, those revenues should offset the cost of service to ratepayers. There currently is no mechanism in place to allow UI to credit these revenues back to it subsidiaries. Since there is no mechanism to credit these revenues back to the Companies, then the shareholders receive unjustified profits in excess of the rate of return. The only option is to credit these to ratepayers in a rate case such as this. (Staff Ex. 12.0, pp. 12-13)

The Companies can't provide services because they have no employees capable of providing services.

The Companies' witness Ms. Georgiev stated in her surrebuttal testimony that the Companies do not perform a service for the WSC because the Companies "have no employees who are capable of providing any services." (Co. Ex. 5.0, p. 5) This distinction is absurd because WSC employees are or can be agents of the Companies.

When asked when the Companies became aware that WSC was providing customer information to HS, the Companies responded that "*WSC employees* first became aware that Water Service Corporation was providing customer information to HomeServe when the MA was signed on December 16, 2008." (*Tr.*, Jan. 25, 2012, p. 47) Additionally, according to the AIA, the officers of WSC provide executive services for each of the Companies. (Staff Ex. 12.0, Attachment B, pp. 1-2) Thus, the officers of the Companies are either employees or agents of WSC and the revenue requirement in this case includes charges for their salaries.

The 2008 Annual Report, (ICC form 22) which each Company filed with the Chief Clerk's office on April 4, 2009, lists the officers of each company. [redacted], who was also the president of each Utilities, Inc. utility in 2008.

[redacted] The employee's salaries are paid (at least in part) by the ratepayers, but the service company's shareholders benefit from their actions. The Companies witness Ms. Georgiev is an employee of WSC whose salary is paid by ratepayers (*Tr.*, Jan. 25, 2012, p. 52) is testifying regarding the value of an arrangement that benefits the shareholders and not ratepayers.

The information provided by the WSC is publicly available.

WSC agreed to the MA, but the agreement does not cover several areas. First, according to the MA, a customer is defined as [redacted]

However, WSC does not provide utility services to any customer. WSC provides services to the *Companies*. The Companies provide "water and sewer service to utility customers within their respective service areas." (Co. Ex. 5.0, p. 5) WSC has no direct business relationship with utility customers and so the MA is based on the incorrect representation.

Second, the MA also requires that WSC assert that it is [redacted]

[redacted] The Companies cannot assert this because there is no legal permission granted to WSC. Staff does not believe that *not* legally *precluded* equates to being "legally *permitted*." At no time did the Companies request permission from the Commission. Therefore, WSC has no right to access and sell ratepayer information.

The Companies' witness asserts that "any 'customer-related information' obtained by WSC is provided by customers, not the Companies. WSC obtained this information from customers and provided it to the Companies." (Co. Ex. 5.0, p. 5) However, customers only give their information to WSC in order to sign up for water and sewer service. Neither WSC nor the Companies give their customers the option to deny an affiliate permission to take that information for profit. Perhaps they would not object. But customers are not informed that the call is being answered by the affiliate. This revenue is not counted in the revenue requirement; thus, it does not benefit ratepayers.

Finally, the Companies' witness claims that "the only information that WSC provides to Home is the postal address of utility customers and unique identification numbers which enable Home and WSC to track the payments due to WSC under the contract. Customers have not provided their addresses on a confidential basis, and such information is publicly available from other sources." (Co. Ex. 5.0, p. 7)

When asked in the hearing to clarify what sources she was referring to, Ms. Georgiev indicated that "postal addresses can be found in a telephone book, on the Internet, in county records." (*Tr.*, Jan. 25, 2012, p. 62) She also mentioned that if somebody is really interested in the addresses, they can "drive around in a certain area….[a]nd find all the different addresses in that particular area." (*Tr.*, Jan. 25, 2012,

p. 64)

The information provided by WSC to HS is *not* publicly available. The information from WSC has service addresses of all utility accounts and no addresses without utility services. This precision benefits WSC versus other information providers. However, such information is not available in phone book for any residence with an unlisted number (such as a home with only a cell phone).

Additionally, this service gives WSC an unfair advantage in this market where only the affiliate gets this virtually costless information. This unfair advantage allows WSC to produce this information for HS at little cost. Or WSC incurs costs to provide this information which increases the pool costs for all entities covered by the AIAs but the Companies do not receive a credit from WSC for this amount. (Companies' response to Staff DR DAS 01.01b) Either way, WSC is the low cost producer of customer information.

Ms. Georgiev testified that there are other companies "out there that their sole purpose is to gather information and sell it and then they can sell it by region or narrow it down to a particular service territory, and that would be public information as well." (*Tr*. Jan. 25, 2012, p. 63) Finally, when asked "And none of these public sources could provide a unique identifier because that comes only from Water Service Corp, correct?" She responded "Yes, that's an internally generated ID." (*Tr.,* Jan. 25, 2012, p. 66)

Despite her assertion that no other information besides postal address and unique identifier is required, the Companies provide no evidence that WSC does not provide names along with addresses. Ms. Georgiev admits that she has not reviewed the MA in detail and doesn't know exactly what has been provided by WSC to HS. (*Tr*.

Jan. 25, 2012, pp. 53-54) The only information precluded by the Companies privacy policies pertains to “confidential information which is defined as customer usage and credit history.” (Co. Ex. 5.0, p. 7) Thus, it is possible that utility account holders’ names have been provided along with the postal addresses and unique identification numbers. Therefore, the information provided by WSC is cheaper, more precise and more complete than any information publically available.

The Companies won’t provide services if they cannot keep the revenues for Shareholders.

The Companies claim that: “If 100 percent of the revenue from non-utility activities must be used to benefit customers by reducing utility costs and shareholders receive nothing for seeking out non-utility revenue opportunities, there is no reason to enter into such activity.” (Co. Ex. 5.0, p. 4)

If the Companies performed all the services that are currently provided by affiliates and sold the customer information to HomeServe directly, all that revenue should be included in the operating revenues.[10] The Companies are apparently implying that they set this up so that their shareholders retain 100% of the information’s value that derives solely because the Companies are utilities. If the Companies intend to serve their ratepayers through providing them with valuable warranty services, then they could credit the Companies above the line.

The Companies’ interactions with other affiliates do not concern the Commission. The Companies witness asserts that “WSC provides many services that are not approved, or required to be approved, by the Commission…. to affiliated utilities in 14 other states.” (Co. Ex. 5.0, p. 5) [redacted]

[10] Note that under this scenario, the profits of HS are not regulated as long as revenues offset rates.

[redacted] should be. Thus, the Commission has an interest in ensuring that the terms are equal for each utility or some utility could subsidize those not subject to Commission jurisdiction.

The Companies are confusing the agreement that Staff seeks the Commission to control with one that it does not have jurisdiction over. Staff is not asking the Commission to directly control transactions between the affiliate and a third party. Rather, Staff seeks to have the Commission preclude the provision of any service or the transfer of any asset from the Companies to any affiliate outside of those specific provisions in the AIA. The AIA does not allow for provision of services by the Companies on behalf of WSC nor does it authorize the transfer of any assets. Furthermore, the AIA clearly has no mechanism by which WSC can pay the Companies for either of these transactions. Thus it is impossible for these services and asset transfer to meet the requirements of the Act, which requires that affiliates compensate utilities for any and all services and assets.

The Companies' affiliates' interactions with other non-affiliates do not concern the Commission.

The Companies also assert that: "Mr. Sackett has not cited any language in the Public Utilities Act that precludes transactions between unregulated affiliates such as WSC and unaffiliated companies." (Co. Ex. 5.0, p. 5) When an affiliate uses utility assets to provide services to third parties, it violates the Act. The Act also precludes the transfer of assets to affiliates without Commission approval.

The Companies argue that "According to Mr. Sackett's broad view of the law, Commonwealth Edison commits a violation if it 'allows' Exelon Generation Services to provide generation services to an unaffiliated third party 'pursuant to an agreement not approved by the Commission.'" (Co. Ex. 5.0, p. 5) If Exelon used ComEd customer information to produce revenues, then the comparison would be more appropriate. However, the Act and the Commission have kept electric and gas utility affiliates from benefitting in this way, requiring equal access to information for competitors. (Ill. Admin. Rules Sections 450.20, 450.70, 550.20 and 550.70)

Recommendations

In sum, Staff recommends that based on reasons provided above that the Commission: (1) find that the Companies violated Section 7-101 of the Act by providing a service to their affiliate without authorization; (2) approve an adjustment to the Miscellaneous Revenues portion of the revenue requirement for each Company for revenues that they should have received from WSC during the test year; (3) prohibit all future release of customer information for non-utility purposes; (4) order each Company to retrieve its customer information from HS by requiring WSC to recover all Illinois ratepayer information from HS per the stipulation in section 9.1 of the MA; (5) require each UI utility in Illinois to include the above clause in all such agreements; and (6) open an investigation into all 18 other UI utilities in Illinois to determine whether similar are still in the public interest, given that there are no customer privacy protections and whether these UI utilities should be penalized.

III. CONCLUSION

For the reasons set forth *supra*, Staff respectfully requests that the Commission's Final Order in the instant proceeding reflect Staff's recommendations regarding the

Companies' proposed rate increases for water and sewer.

Respectfully submitted,

MICHAEL J. LANNON
JESSICA L. CARDONI

Counsel for the Staff of the Illinois Commerce Commission

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JESSICA L. CARDONI
MICHAEL J. LANNON
Office of General Counsel
Illinois Commerce Commission
160 N. LaSalle, Ste. C-800
Chicago, IL 60601
Phone: (312) 793-3305
(312) 814-4368
Fax: (312) 793-1556
E-mail: jcardoni@icc.illinois.gov
mlannon@icc.illinois.gov