Docket No. 11-0767
ICC Staff Exhibit 2.0

DIRECT TESTIMONY

of

Dianna Hathhorn
Accountant

Accounting Department
Financial Analysis Division
Illinois Commerce Commission

Illinois-American Water Company

Proposed General Increase in Water and Sewer Rates

Docket No. 11-0767

March 1, 2012

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Witness Identification

Q. Please state your name and business address.

A. My name is Dianna Hathhorn. My business address is 527 East Capitol Avenue, Springfield, Illinois 62701.

Q. By whom are you employed and in what capacity?

A. I am an Accountant in the Accounting Department of the Financial Analysis Division of the Illinois Commerce Commission ("Commission").

Q. What is the function of the Accounting Department of the Illinois Commerce Commission?

A. The Accounting Department's function is to monitor the financial condition of public utilities as part of the Commission's responsibilities under Article IV of the Illinois Public Utilities Act ("Act") and to provide accounting expertise on matters before the Commission.

Q. Please describe your background and professional affiliation.

A. I am a licensed Certified Public Accountant. I earned a B.S. in Accounting from Illinois State University in 1993. Prior to joining the Commission Staff ("Staff") in 1998, I worked as an internal auditor for another Illinois state agency for approximately 3.5 years. I also have 1.5 years experience in public accounting for a national firm.

Q. Have you previously testified before this Commission?

A. Yes, I have.

Q. What is the purpose of your testimony in this proceeding?

A. The purpose of my testimony is to propose adjustments to Illinois-American Water Company's ("IAWC" or the "Company") rate base or operating statement concerning incentive compensation, pensions, and Business Transformation costs. I also provide recommendations concerning the Company's proposed Revenue Adjustment Clause Rider ("Rider RAC").

Q. Are you sponsoring any schedules as part of your direct testimony?

A. Yes. I prepared (or supervised the preparation of) the following schedules for the Company, which show data as of, or for the test year ending, September 30, 2013:

Schedule 2.01	Incentive Compensation Adjustment
Schedule 2.02	Pension Asset Adjustment
Schedule 2.03	Business Transformation Costs Adjustment (Confidential and Public Versions)

Unless identified with a specific rate zone, the following discussion of schedules and issues apply to all rate zones. Issues that are specific to only water or sewer operations are presented separately.

Attachments

Q. Have you included any attachments as part of your direct testimony?

A. Yes. I have included the following attachments:

Attachment A	Company Responses to Staff Data Request ("DR") DLH-15.01 and DLH-16.02
Attachment B	Company Revised Response (Public) to Staff DR DLH-15.02
Attachment C	Company's Rider RAC with Staff Proposed Revisions

Incentive Compensation Adjustment

Q. Please describe ICC Staff Exhibit 2.0, Schedule 2.01, Incentive Compensation Adjustment.

A. Schedule 2.01 reflects my proposed adjustment to reduce the Company's labor expenses for a portion of incentive compensation inadvertently left out of the Company's Schedule C-2.9. In response to Staff DR DLH-1.22, the Company stated it was its intention to remove all incentive compensation from the test year.

Pension Asset Adjustment

Q. Please describe ICC Staff Exhibit 2.0, Schedule 2.02, Pension Asset Adjustment.

A. Schedule 2.02 reflects my proposed adjustment to remove the pension asset proposed for rate base recovery by the Company since the Company has presented no evidence that the pension asset was created by anything other than ratepayer funds. Accordingly, my adjustment removes the impact of the pension asset from rate base for each rate zone. (ICC Staff Exhibit 2.0, Schedule 2.2)

Q. The Company states that a rate base increase is appropriate since currently IAWC is funding more into its pension plans under Employee Retirement Income Security Act ("ERISA") requirements than the amount IAWC is collecting in rates under Statement of Financial Accounting Standards ("SFAS") 87. (IAWC Ex. 6.00, p. 5, lines 103-106.) Is it correct that the rate recovery of a pension asset is simply based on comparisons of ERISA versus SFAS 87 funding amounts?

A. No. I believe IAWC misunderstands prior Commission orders on this issue when it states, "IAWC is not aware of any docket in which the Commission has disallowed inclusion in rate base of a pension asset created by such circumstance [of ERISA funding requirements being greater than SFAS 87 amounts]." (Company response to Staff DR DLH-1.10) The basic debate of the many Commission orders on this subject

concerns where the utility acquired the funds that created the pension asset for which it is requesting rate base recovery. In the absence of evidence to the contrary, the Commission has repeatedly found, as discussed below, that such funds, in this case the funding based on ERISA requirements over SFAS 87, are provided by ratepayers and therefore there is no basis to provide shareholders a return on such funding through inclusion of the pension asset in rate base.

Q. What is the basis for your assertion that the pension asset was not created by shareholder funds?

A. The Company provided no evidence of shareholder funding of the pension asset. Rather, the pension asset has been funded from normal operating revenues collected from utility ratepayers and represents funds supplied by ratepayers, as evidenced by the Company's responses to Staff DRs DLH-15.01 and DLH-16.02 (Attachment A). The only source of funds provided in those responses is "reduced earnings available to its shareholders" and overhead charges paid to American Water Works Services Company ("Services Company") as Service Company fees. These are both normal operations of the Company rather than any special external contribution source to the pension plan. Since the pension asset was funded by normal operations, rather than provided by shareholders, shareholders should not earn a return on it.

Q. Did the Commission address the pension asset issue in the prior Peoples Gas Light and Coke Company and North Shore Gas Company ("Peoples/North Shore") consolidated gas rate cases?

A. Yes, several times. In the Peoples/North Shore 2011 rate case, Docket Nos. 11-0280/11-0281 (Cons.), the Commission found that, consistent with its decisions in prior Peoples/North Shore's 2007 and 2009 rate cases,[1] the accrued other post-employment benefits ("OPEB") liability should be deducted from rate base but that the pension balances should not be recognized in the determination of rate base (regardless of whether they are assets or liabilities).[2] The Commission was clear when it concluded:

> Unlike the situation in Docket 05-0597, the Utilities have not shown that Peoples Gas' pension asset was created with shareholder funds. Without that evidence, there is no reason to believe that the pension asset is funded by any source other than ratepayers….The Commission finds no support in the record to allow for the inclusion of Peoples Gas' pension asset in rate base which in turn would allow shareholders to earn a return on ratepayer supplied funds. (Docket Nos. 09-0166/09-0167 (Cons.), Order, January 21, 2010, p. 36)

Q. Has the Commission addressed the issue of pension asset treatment in other ratemaking proceedings?

[1] Docket Nos. 09-0166/09-0167 (Cons.), Order, January 21, 2010, pp. 35-37 and 07-0241/07-0242 (Cons.), Order, February 5, 2008, p. 36.
[2] Docket Nos. 11-0280/11-0281 (Cons.), Order, January 10, 2012, p. 33.

A. Yes, the Commission has addressed the issue in rate cases involving Northern Illinois Gas Company ("Nicor Gas") Docket Nos. 04-0779 and 95-0219 and Commonwealth Edison Company ("ComEd") Docket Nos. 05-0597, 07-0566, and 10-0467.

In Docket No. 04-0779 and Docket No. 95-0219, Nicor Gas sought to increase utility rate base for the amount of a prepaid pension asset. In both cases the Commission found that the pension asset was created by ratepayer-supplied funds, not by shareholder-supplied funds. The Commission concluded that ratepayers should not be denied the benefits associated with the previous overpayment for pension expense which they funded. Accordingly, the Commission concluded that the pension asset should be eliminated from rate base.

In the three cited ComEd rate cases, the Commission did not allow a pension asset in rate base but did allow for the recovery of a return on a pension prepayment in the revenue requirement. In the most recent of the three cases, this amount was further limited to the extent the Company demonstrated ratepayer benefits. [3]

[3] Docket No. 05-0597, Appellate Order, pp. 28-29, September 17, 2009; Docket No. 07-0566, September 10, 2008 and Docket No. 10-0467, Order, May 24, 2011, pp. 50-51.

Business Transformation ("BT") Costs Adjustment

Q. Please describe ICC Staff Exhibit 2.0, Schedule 2.03, BT Costs Adjustment (Confidential and Public Versions).

A. Schedule 2.03 reflects my proposed adjustment to remove BT program costs for: (1) estimated cost savings that will occur due to implementation of the new computer systems, (2) hardware lease costs that will not be incurred until after the test year, and (3) reduced Service Company management fees due to non-regulated affiliates' use of the BT system.

Q. What is the BT program?

A. The Company states that BT refers to the system-wide deployment of new, integrated information technology systems and the process of implementing the new systems in a manner that properly aligns business processes with the increased capabilities of the new systems. The core of the BT program is three projects: Enterprise Resource Planning, Enterprise Asset Management and the Customer Information System. The Company discusses the BT and its subsystems extensively in IAWC Ex. 9.0.

Q. Please describe part one of your adjustment, for BT cost savings.

A. This part is a placeholder for the Company's update to be made March 9, 2012. The Company stated in its Revised Response to Staff DR DLH-15.02 that it recently determined that it will be able to achieve certain reductions in test year levels of utility operation and maintenance ("O&M") expense through organizational changes made in anticipation of the implementation of BT solutions. (Attachment B) I recommend the Company explicitly identify in a separate schedule in its update the amount of reduced O&M, by rate zones, due to implementation of BT; and further, provide all supporting calculations and workpapers of such amounts at the time it files its update.

Q. Please describe part two of your adjustment, for hardware lease costs.

A. The Company acknowledged in its response to DR AG-4.1 that it inadvertently included in operating expense hardware lease costs that will not be incurred by the end of the test year. The Company stated it intends to remove this amount in its update filing. I calculated the adjustments by rate zones using the allocation factors for the BT plant in service amounts from the Company's response to Staff DR DLH-1.02.

Q. Please describe part three of your adjustment, for non-regulated affiliates' BT costs.

A. The Company acknowledged in its responses to DRs DLH-19.01 and 19.02 that its non-regulated affiliates will access two parts of the BT system, known as "myCareer Solutions" and "Customer Relationship and Billing", and calculated the test year amount of reduced Service Company fees to be charged to IAWC's rate zones accordingly. However, the Company provided no rationale why the adjustments for the Customer Relationship and Billing non-regulated use should be reduced by half, as reflected on the Company's response to Staff DR DLH-19.02. Therefore, my adjustment reflects a 100% allocation of both non-regulated BT system costs.

<u>Rider RAC Recommendations</u>

Q. Please describe your recommendations to the Company's proposed Rider RAC.

A. Staff witness Harden (ICC Staff Ex. 5.0) addresses whether the Commission should adopt Rider RAC. It is her recommendation that the Commission reject this proposed rider. In the event that the Commission decides to adopt Rider RAC, however, I provide several recommendations regarding the Rider RAC tariff that the Company should file. My proposed revisions to the Company's proposed Rider RAC are presented in legislative style in Attachment C. These changes reflect revisions

presented to the Company in Staff DR DLH-16.01, which were clarified or otherwise uncontested except for two subjects which I explain below.

Q. Please provide a summary of changes to Rider RAC presented in the Company's response to Staff DR DLH-16.01 for items of agreement.

A. A summary of my proposed changes to Rider RAC with which the Company has indicated agreement is as follows:

1. Add definition of Production Cost using ICC account numbers;
2. Add definition of Actual Revenues using ICC account numbers;
3. Use standard format for defining variables in Surcharge Credit ("SC %") equation;
4. Clarify timing of first informational filing and effective date of first SC%;
5. Clarify twelve month period to be measured in first SC% period;
6. Add date allowing corrections to be filed to informational sheet;
7. Add date requiring special permission request;
8. Clarify that SC% amounts greater than 5% or less than -5% shall be excluded from future recovery or refund;
9. Define Reconciliation Adjustment;
10. Add dates when statement of Reconciliation Adjustment must be filed;
11. Require a rate of return report be filed at the time of filing its statement of Reconciliation Adjustment; and
12. Require the Company to file a petition and testimony to initiate an annual reconciliation proceeding to determine the accuracy of the statement of Reconciliation Adjustment.

Q. What is the first subject in the Company's response to Staff DR DLH-16.01 with which you disagree?

A. I disagree with the Company's proposed edits to the Rider RAC tariff that would apply if the Reconciliation Adjustment results in a surcharge or credit percentage ("SC%") revenue collection that is below the Targeted Amount ("TA") as set in the formula. The Company proposed edits that would allow it to collect the shortfall of the Rider RAC revenue under the TA amount from ratepayers. However, the Company's direct testimony states, "If the Company under collects the RAC revenue, no adjustment to collect this under collection will be proposed by the Company." (IAWC Ex. 4.00, p. 19, lines 421-423) Therefore, the Company's edits regarding collection of an under recovery in the Reconciliation Adjustment appear unnecessary and my proposed language below (included in Attachment C, Section B, the first paragraph) should be adopted.

> <u>The Reconciliation Adjustment, if resulting in a refund, shall be refunded in rates effective March 1 annually. If the Reconciliation Adjustment results in SC% revenue collected below the Target Amount (TA), such amounts shall be forfeited by the Company and not recovered from ratepayers.</u>

Q. What is the second subject in the Company's response to Staff DR DLH-16.01 with which you disagree?

A. I disagree with the Company's opposition to conducting an annual internal audit. The Company is incorrect that no other reconciliation requires either an internal or external audit. The Company is correct that its own purchased water, purchased sewage treatment and Qualifying Infrastructure Plant Surcharge Rider ("QIP") do not require audits.

However, these mechanisms were established years ago prior to the more recent wave of automatic rate mechanisms approved by the Commission. The Commission has required annual internal audits with defined audit scopes in many recently approved riders, including:

- Peoples/North Shore Rider Volume Balancing Adjustment Riders;
- Peoples Infrastructure Cost Recovery Rider;
- Commonwealth Edison Company Advanced Metering Program Adjustment;
- All uncollectibles expense riders adopted pursuant to Section 19-145 and 16-111.8 of the Act;
- All energy efficiency and demand response riders adopted pursuant to Sections 8-103 and 8-104 of the Act; and
- All purchased electricity riders adopted pursuant to Section 16-111.5 of the Act.

Therefore, consistent with the recent practice of the Commission requiring annual internal audits in automatic rate mechanisms, my proposed language below (included in Attachment C) should be adopted.

> <u>Section C Audit</u>
>
> <u>The Company shall annually conduct an internal audit of the distribution revenue requirements recovered or refunded pursuant to this rider. The internal audit shall determine if: 1) the actual amount of revenues that exceed or fall short of any approved Target Revenue (TA) collected through base rate distribution charges are correctly reflected in the calculations; 2) the revenues are not collected through other approved tariffs; 3) Rider RAC adjustments are being properly billed to customers; and 4) Rider RAC revenues are recorded in the appropriate accounts. The above list of determinations does not limit the scope of the audit. The Company shall submit the audit report to the Commission's Manager of the Accounting Department, no later than May 1 of each year. Such report shall be verified by an officer of the Company.</u>

Q. Do you have a final recommendation regarding Rider RAC?

A. Yes, I do. Should the Commission approve Rider RAC, I recommend the Company be required to file with its compliance filing the per Order Production Cost, per Order Water Sales, and Target Revenues for each of its districts. The Company provided these amounts based upon the data in its direct case in response to Staff DR DLH-17.01. Therefore, I recommend the following language below (included in Attachment C) be adopted.

> Section D Compliance Filing
>
> The Company shall submit as a public document, in any rate case compliance filing, the per Order Production Cost, per Order Water Sales, and Target Revenues for each district arising from the approved revenue requirement in the rate case.

Conclusion

Q. Does this question end your prepared direct testimony?

A. Yes.