STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

ILLINOIS-AMERICAN WATER COMPANY	)	
	)	Docket No. 11-0767
Proposed general increase in water and sewer rates.	)	

INITIAL BRIEF OF ILLINOIS-AMERICAN WATER COMPANY

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I. EXECUTIVE SUMMARY

This rate case is virtually all investment driven—investment Illinois-American Water Company ("IAWC" or "Company") has made and must continue to make in water and wastewater facilities, infrastructure replacement and business systems. Since its last rate increase in Docket 09-0319, IAWC has held overall operations and maintenance expenses flat. From the last rate case test year, 2010, through the test year in this proceeding (the year ending September 30, 2013), however, IAWC projects it will invest approximately $190 million in capital projects needed to sustain adequate and reliable service, such as the Peoria water treatment facility and the Business Transformation project to replace antiquated information technology systems. Thus, the investment in rate base is by far the most significant driver of IAWC's proposed rate increase of $34.357 million.

IAWC's water and wastewater operations are subject to federal, state and local laws and regulations, which control environmental protection, health and safety, water quality, water allocation rights, and collection, treatment and discharge of wastewater through monitoring and reporting requirements. Two key federal environmental regulations include the Clean Water Act of 1972 and the Safe Drinking Water Act of 1974, as reauthorized in 1986. IAWC must also comply with a wide range of Illinois and local regulatory requirements in multiple locations, such as those related to groundwater and surface water sources, replacing and expanding water main distribution systems and multiple discharge points. Given the nature of IAWC's business, and particularly because it involves supplying water for human consumption, any potential non-compliance with environmental laws or regulations (whether or not within the control of IAWC) represents a relatively greater risk for IAWC as compared to electric, gas and other non-water industry entities.

In order to meet its investment needs, it is critical that IAWC be given the opportunity to obtain the necessary capital on reasonable terms. The record supports a return on equity of 11.25% as recommended by IAWC's expert. However, simply leaving the current return on equity as-is, at 10.38%, would strike an appropriate balance between ratepayer and shareholder interests. The current return on equity (and the previous authorized return on equity of 10.35%) have led to robust investment (to meet the environmental requirements discussed above as well as replace aging infrastructure and modernize its systems, IAWC has invested almost $400 million in the last five years), and produced a climate conducive to future investment. The Commission should encourage investment, not discourage it. But to compete for investor capital in the open market with comparable utilities (and have an opportunity to earn its allowed return), IAWC must receive an authorized return sufficiently adequate to attract capital at reasonable terms. On the other side of the equation, ratepayers are entitled to rates that are no higher than necessary to reasonably compensate investors and attract future investment. An authorized return on equity of 10.38% would balance these interests and is consistent with recent authorized returns in neighboring jurisdictions.

Securing the investment capital to meet these needs, however, will become more difficult if IAWC's return on equity fails to account for the risks these requirements impose. Regulatory commissions in other jurisdictions have recognized that the American Water utilities they regulate must compete for capital, and have addressed this reality in their rate of return recommendations. Already this year, for example, the New Jersey Public Utilities Commission authorized a return on equity for New Jersey American Water of 10.15%, the Tennessee commission set a return on equity of 10% for Tennessee American Water, and the Missouri commission set a return on equity for Missouri American Water of 10%. Late in 2011, the

Pennsylvania commission allowed a return on equity for Pennsylvania American Water of 10.25% Even Illinois electric utilities participating in the Energy Infrastructure Modernization Act (EIMA), 220 ILCS 5/16-108.5, can obtain a 10.05% return of equity (Docket 11-0721) under the statute's formula return on equity. In fact, IAWC's evidence shows that, because water utilities in general, and IAWC specifically, currently face greater investment risk relative to electric, combination electric and gas and natural gas utilities, if IAWC's return on equity was calculated using the EIMA formula return on equity as a starting point, IAWC would be entitled to at least a 10.11% return on equity.

Staff and IIWC's recommended returns on equity of 9.42% and 9.3%, respectively, disregard the fact that IAWC must compete for capital not only with its affiliates, but in the capital markets generally. Neither party can answer this question: if an investor can obtain a 10.15% return in New Jersey, what incentive does an investor have to seek a return of 9.42% or lower in Illinois? To be sure, IAWC's parent will provide the necessary capital for IAWC to maintain safe, adequate and reliable service. But it is difficult to justify, on economic grounds, any additional investment beyond that needed to meet minimum regulatory requirements, when returns available in other jurisdictions encourage American Water to invest there instead.

Staff's recommendation to impute to IAWC the more highly leveraged capital structure of its parent is similarly problematic. Staff's imputed capital structure violates Section 9-230 of the Public Utilities Act ("Act" or "PUA")), 220 ILCS 5/9-230, by imputing the more financially risky capital structure of the parent. IAWC's forecasted capital structure is the appropriate capital structure to make certain the Company's operations and investments are financed at the lowest weighted average cost of capital. Holding constant the Company's degree of business risk, IAWC's proposed higher equity ratio lowers the cost of each capital component. IAWC's proposed capital structure will enable the Company to raise capital on reasonable terms in most market conditions, and for that reason should be adopted.

Investment in IAWC also is critical now, when the Company is experiencing a significant and continuing trend of declining water consumption. That declining usage has a considerable impact on IAWC's water sales, such that IAWC's revenues have fallen short of expected levels. This also poses a concern with respect to IAWC's ability to accomplish its capital investment program. IAWC must stand ready to provide and deliver water to customers if and when called upon, and the Company maintains significant infrastructure to provide that service. It is no surprise, then, that the majority—nearly 94%, in fact—of IAWC's costs are fixed. Despite this, under the traditional ratemaking paradigm, IAWC will *only* recover its costs if the level of water usage upon which its rates are premised is actually achieved. But IAWC can no longer anticipate increased water sales; IAWC's projections in this case show residential water sales declining *annually* by nearly 2%.

IAWC has reflected this declining usage in its test year projections of water sales. But to address this emerging business reality over the long term, IAWC has proposed a mechanism which would "decouple" the Company's recovery of its fixed costs of water utility service from the volume of water it actually sells. This mechanism—the Revenue Adjustment Clause—is a similar to the Rider VBA recently approved by the Commission for Peoples/North Shore. It will provide IAWC with a measure of revenue stability in the face of the declining usage trend IAWC has and expects to continue to experience, and should be approved by the Commission.

At the same time that it seeks to recover its significant capital investments, the Company is committed to controlling its operating expenses. The Company recognizes the importance of operational efficiency and of reducing the level of rate increases experienced by ratepayers, and it also recognizes Commission concern in recent rate cases about cost levels, for example, for items like Service Company fees. Responding to the Commission's concerns, the Company has held overall operations and maintenance expense flat since its last rate case. IAWC has implemented an organizational restructuring intended to streamline IAWC's management, which has resulted in cost reductions. Service Company fees have increased by less than 1% annually from the actual amount incurred in 2010, the last rate case test year. Rate case expense has increased by less than 3% over prior case actual amounts, and some components, such a legal expense, have declined significantly. In short, IAWC has demonstrated in this case that it has taken cost control seriously.

The following summarizes other key issues in the case:

- *Business transformation.* IAWC's technology systems have become antiquated and need to be replaced. The Business Transformation program encompasses the development and 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. IAWC's capital investment in this important project should be included in rate base, as Staff agrees.

- *Pension asset.* IAWC seeks to include in rate base a "pension asset" that reflects, for ratemaking purposes, the amount by which its pension contributions exceed the level of accrued pension expense IAWC collects in base rates (the FAS 87 amount). The pension asset is symmetrically converse to the rate base deduction taken when FAS 87 amounts are greater than pension contributions. In light of this symmetrical approach to ratemaking, the Commission should approve IAWC's pension asset.

- *Cash working capital.*

    - Staff proposes an adjustment to determine cash working capital based on FAS 87 pension expense and not actual contributions amounts. Actual contributions should be used because they represent actual amounts to be paid, and so impact the Company's actual cash working capital needs.

    - The AG proposes an adjustment to eliminate the effect of prepayment of Service Company fees. This adjustment should be rejected, as Staff agrees, because the Commission has approved the agreement reflecting the arrangement for prepayment of these fees as reasonable and rejected the same adjustment in IAWC's last rate case.

- o The AG proposes to use an estimated proxy 21-day collection lag. This adjustment should be rejected, as Staff agrees, because the 21-day collection lag is arbitrary. IAWC has presented a lead/lag study reflecting actual, calculated collection lags. The Commission recently has reaffirmed its preference for use of the actual calculated collection lags.

- *ADIT – FIN 48*. The dispute over FIN 48 amounts centers on the question of whether the utility should be subject to a disincentive to take uncertain tax positions that ultimately benefit ratepayers. Consistent with the ratemaking treatment of FIN 48 liabilities by other regulatory jurisdictions, IAWC has removed from its test year balance of Accumulated Deferred Income Taxes ("ADIT") the balance of FIN 48 liabilities. IAWC's treatment is appropriate for two reasons: (1) it provides the utility with an incentive to pursue the uncertain tax position which, if successful, will result in a ratepayer benefit (through higher tax deductions and so lower current tax expense, as well as a lower rate base upon which rates are determined); and (2) it recognizes that FIN 48 amounts are not ADIT as they are not "cost free" sources of capital.

- *Management Audit Costs*. Pursuant to Section 8-102 of the Act, IAWC seeks to recover the costs incurred as a result of the management audit of the fees charged to IAWC by its affiliated Service Company, ordered by the Commission in Docket 09-0319. IAWC has incurred the cost of the fees charged by the auditor and other incremental costs for the audit, including legal and consultant fees. Recovery of the audit costs, amortized over five years with the unamortized balance in rate base, is appropriate in light of the plain language of Section 8-102 of the Act and Commission precedent. Staff agrees with IAWC's position.

II. BACKGROUND

A. Nature of Operations

IAWC is a corporation organized and existing under the laws of the State of Illinois with its principal office in the City of Belleville, Illinois. IAWC currently owns, operates and maintains potable water production, treatment, storage, transmission and distribution systems and wastewater collection, pumping and/or treatment systems for the purpose of furnishing water and wastewater service for residential, commercial, industrial, resale and governmental users in various districts. IAWC serves approximately 308,000 customers in 126 communities in Illinois.

It is a wholly owned subsidiary of American Water Works Company, Inc. ("American Water" or "AWW"), a holding company that owns the stock of water and sewer subsidiaries operating in 20 states.

B. Procedural History

On October 27, 2011, IAWC filed with this Illinois Commerce Commission ("Commission" or "ICC") new and/or revised tariffs for water and sewer service. The Company requests that the Commission approve the rate increases for each of its rate areas as set forth in IAWC Initial Brief Appendix A. The proposed changes will in total affect approximately 308,000 customers in the following rate areas: Zone 1 (Alton/Cairo/Champaign/Chicago Metro/Interurban/Peoria/Pontiac/South Beloit/ Sterling/Streator), Lincoln, Pekin and Chicago-Metro Sewer. In conjunction with the filing of its tariffs, the Company filed the schedules and other materials required under 83 Illinois Administrative Code Part 285 (83 Ill. Adm. Code Part 285.) The Company's proposed rates were suspended on December 7, 2011 and resuspended on March 21, 2012.

Leave to Intervene in this proceeding was granted to the People of the State of Illinois, by and through the Attorney General ("AG"), the Illinois Industrial Water Consumers ("IIWC"), the Federal Executive Agencies ("FEA"), Bond-Madison Water Company, the Village of Bolingbrook, and the Cities of Champaign and Urbana and the Villages of Savoy, St. Joseph, Sidney and Philo ("Cities and Villages") (collectively, "Intervenors").

An evidentiary hearing was held on May 15-17, 2012. Appearances at the hearing were entered by counsel for IAWC, the Commission's Staff, the AG, IIWC, FEA, Bond-Madison Water Company, the Village of Bolingbrook and the Cities and Villages. The record was marked "Heard and Taken" on May 17, 2012.

During the course of the proceeding, Staff and Intervenors raised various issues relating to IAWC's proposed tariffs and Part 285 materials. Those issues raised that are now resolved are set forth in IAWC Initial Brief Appendix B. Those issues which remain contested are addressed below.

III. PROPOSED TEST YEAR

The test year in this proceeding is a future test year consisting of the twelve-month period ending September 20, 2013. No party has opposed use of this future test year.

IV. RATE BASE

A. Business Transformation Costs

IAWC's technology systems have become antiquated and need to be replaced. The Business Transformation program addresses that need. It encompasses the development and system-wide deployment of new, integrated information technology ("IT") 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. (IAWC Exs. 1.00 (Rev.) (Teasley Dir.), p. 11; 9.00 (Twadelle Dir.), p. 2.) Replacement of the Company's antiquated IT systems will enhance IAWC's customer service and billing capabilities, and permit it to more efficiently comply with regulatory changes such as those currently under review in pending Docket 06-0703 related to the Commission's Part 280 Rules (83 Ill. Adm. Code Part 280). (IAWC Ex. 1.00 (Rev.), p. 11.)

The Business Transformation ("BT") program has four primary areas of focus: (1) replacement of legacy IT systems at or near the end of their useful lives; (2) promotion of operating excellence, efficiency and economies of scale; (3) enhancement of the customer experience; and (4) increasing employee effectiveness and satisfaction. (IAWC Ex. 9.00, p. 2.) There are three projects that comprise the core of the BT program: (1) an Enterprise Resource Planning System; (2) an Enterprise Asset Management System; and (3) a Customer Information

System. (Id., pp. 2-3.) The BT program will impact myriad facets of the Company's operations, including human resources, finance and accounting, supply chain and procurement management, management of asset lifestyles (including the design, construction, commissioning, operations, maintenance and decommissioning or replacement of plant, equipment and facilities), work management for both customer service field work and transmission and distribution system work, billing and personal data about customers (including billing rates, water consumption, associated charges and meter information) and strategy for managing and nurturing interactions with customers. (Id.) Given its breadth, the BT program can be fairly characterized as "a unique capital project in both scope and complexity." (Id., p. 2.)

The total estimated cost of the Business Transformation program enterprise-wide is $300 million. (IAWC Exs. 9.00R (Rev.) (Twadelle Reb.), p. 2; 5.00SUPP (Kerckhove Supp. Dir.), p. 15.) That cost is being charged (via the Service Company monthly bills) to each of American Water's regulated subsidiaries, including IAWC, based on their respective customer counts in accordance with the approved Service Company Agreement. (IAWC Ex. 9.00, p. 3; Illinois-American Water Co., Order, Docket 04-0595 (Oct. 19, 2005), p. 2.) IAWC's resultant share of the cost is $28.9 million. (IAWC Ex. 5.00SUPP, p. 15.) IAWC has made the determination to capitalize those amounts. (Id., p. 16.)

It is expected that the new Business Transformation IT systems will be deployed from 2012 to 2013. (IAWC Ex. 9.00R ((Rev.),) p. 2.) IAWC has therefore included a level of investment in Business Transformation in its rate base that is consistent with the anticipated deployment dates of those systems and the Company's use of a test year ending September 30, 2013. (IAWC Ex. 4.00 (Grubb Dir.), p. 2.) (IAWC also is requesting recovery of depreciation expense for the Business Transformation assets included in its rate base and to recover associated test year operating expenses such as hardware maintenance and lease costs and software maintenance costs. (Id., pp. 2-3.)) The resulting revenue impact associated with IAWC's proposed ratemaking treatment of its investment in Business Transformation for the test year is approximately $3.4 million. (IAWC Ex. 5.02SUPP, pp. 1-2.) For the average residential customer, that investment equates to about 58 cents per month. (IAWC Ex. 4.00, p. 6.)

The Investment in Business Transformation Is Prudent, Reasonable and Properly Included in Rate Base.

An item is properly included in rate base if it represents an investment that is prudently incurred and the related assets are used and useful in providing utility service during the test year. 220 ILCS 5/9-211. See also Business & Prof. People for the Pub. Interest v. Ill. Commerce Comm'n, 146 Ill. 2d 175, 221 (1991) ("BPI II"). In addition, the associated cost must be reasonable. 220 ILCS 5/9-101; 220 ILCS 5/9-201(c) (requiring fixation of "just and reasonable rates"); Aqua Illinois, Inc., Order, Docket 03-0403 (Apr. 13, 2004), p. 22 (finding the components of rates must themselves be just and reasonable). Capitalizing large-scale IT systems replacements is consistent with past Commission practice. See, e.g., Apple Canyon Utility Co., Order, Docket 09-0548/0549 (Sept. 9, 2010), p. 9 (approving inclusion in rate base the cost of new customer billing and accounting programs and finding the existing systems need to be replaced); Illinois Power Co., Order, Docket 93-0183, 1994 Ill. PUC LEXIS 139 (Apr. 6, 1994), **23-28, 45-50 (approving inclusion in rate base of utility's Customer Information System Project which entailed the replacement of its existing customer information system with one more technologically advanced and finding "[t]he Company's evidence concerning the increased efficiency and the improved customer service that would result from these features justifies the inclusion of the costs of these features in rate base."). As discussed below, and as agreed by Commission Staff, IAWC's investment in Business Transformation is prudent, the level of cost associated therewith reasonable, and the Business Transformation assets used and useful in the test year.

Investment in Business Transformation Is Prudent.

There is ample record evidence Business Transformation is necessary. IAWC's IT systems were implemented in the early 1990s and 2000s. (IAWC Ex. 9.00, p. 5.) Those systems are used by the Company's various business departments, but are not integrated. In addition, they have limited automation and functionality. (Id.) Accordingly, American Water undertook a comprehensive analysis of its current IT systems, the results of which indicated it has fully maximized the software and systems used by its operating companies by implementing significant customizations or workarounds, in part, to meet requirements and expectations the original software is not equipped to support. (Id., pp. 4-6; IAWC Ex. 9.01 (Comprehensive Planning Study).) That comprehensive analysis further demonstrated the current IT systems have reached a point where additional customizations would be inefficient and increasingly costly to maintain. (Id.) As such, wholesale replacement of those antiquated IT systems is warranted.

Replacement is necessary for another reason. IAWC's customers today expect more functionality than they once did, and more functionality than IAWC's existing IT systems can readily support. (IAWC Ex. 9.00, p. 6.) Business Transformation will enable IAWC to meet the demand. (Id., pp. 6, 14-15.) The BT systems are anticipated to provide a host of benefits to IAWC and its customers. (Id., pp. 13-15.) In sum, the Business Transformation program is both necessary and beneficial. (Id., p. 15.)

Notably, no party to this proceeding disputes the need for the Business Transformation program or its merits. That is, not a single line of testimony has disputed—or even questioned—the need for IAWC to modernize its IT systems. Indeed, even AG witness Ralph C. Smith—the only witness who takes issue with Business Transformation—concedes it is necessary. (AG Exs. 2.0 C (Rev.) (Smith Dir.), p. 17 and 4.0 C (Rev.) (Smith Reb.), pp. 5-6; IAWC Ex. 5.00R (2d (Rev.)) (Kerckhove Reb.), p. 18 (citing IAWC-AG 4.09 and 4.10 (Mr. Smith agreeing in discovery that IAWC requires customer information, customer service and customer billing systems which eventually need to be replaced)).) As such, the Commission should find IAWC's investment in Business Transformation to be necessary and prudent.

The Level of Business Transformation Costs Is Reasonable.

Business Transformation also was prudently undertaken at a reasonable cost. American Water conducted extensive analyses of potential service providers, used competitive bidding processes to select key service providers and negotiated "not to exceed" fixed fee arrangements to ensure effective cost control. (IAWC Ex. 9.00, pp. 7-10.) American Water has carefully managed the BT costs at every stage to provide customers and other stakeholders with the greatest value at a reasonable cost. (Id., p. 15.) Further, IAWC is an active participant in the Business Transformation program. IAWC employees are necessarily involved to ensure IAWC's business needs are properly served at all stages of the program. (Id., p. 12.) IAWC's participation permits the Company to update its antiquated IT systems in a cost effective manner.

Consistent with the Service Company Agreement, Business Transformation costs are incurred by the Service Company and are charged to IAWC at the Service Company's cost. (IAWC Ex. 5.00SR (Rev.) (Kerckhove Sur.), p. 12.) That is, there is no additional cost component added by the Service Company. (Id.) Those costs appear as a line item on the monthly invoice IAWC receives from the Service Company. (Id.) IAWC then makes the determination whether to capitalize those allocated costs for accounting and ratemaking purposes based on the ratemaking and accounting considerations most appropriate for the Company as a regulated Illinois public utility. (Id.)

When considering the BT costs, it is important to remember the Business Transformation program is driven by necessity, not by cost reductions. As stated, American Water's comprehensive analysis made evident the Company's current IT systems have limited functionality, require a significant number of customizations or manual workarounds, and its current IT systems have reached a point where additional customizations would be inefficient and increasingly costly to maintain. (IAWC Exs. 9.00, pp. 4-6; 9.01.)

Like its merits, there is no dispute in this proceeding that the total level of Business Transformation costs is reasonable. As such, the Commission should find that cost level reasonable.

The Business Transformation Systems Are Used and Useful in the Test Year.

There also is no question the new Business Transformation systems are used and useful in the test year. In fact, it is anticipated those systems will be deployed from 2012 to 2013 and have a useful life of 10 to 12 years. (IAWC Exs. 9.00R (Rev.), p. 2; 5.00R 2d (Rev.), p. 23.) The record shows that the components of the BT systems will be in service as follows: the Enterprise Resource Planning system is anticipated to be deployed enterprise-wide by August 2012; the Enterprise Asset Management system and Customer Information System will be deployed in three waves in 2013, and with those systems being deployed to IAWC in March 2013. (IAWC Ex. 9.00R (Rev.), p. 2.) As such, the Commission should find the Business Transformation assets used and useful in the test year.

Staff and IAWC Agree that Business Transformation Should Be Included in Rate Base.

Staff and IAWC agree in all respects regarding the appropriate ratemaking treatment to be afforded the Company's investment in Business Transformation. (See ICC Staff Ex. 10.0 (Hathhorn Reb.), pp. 9-12; IAWC Ex. 5.00SR (Rev.), pp. 6-8.) Moreover, Staff agrees all of the AG's adjustments should be rejected:

Q. Do you agree with the AG's adjustments?

A. No. I do not believe that the evidence supports that the Company should receive no cost recovery for the new computer systems required for customer information, customer service and customer billing necessary in order to provide utility service. . . . [T]he Company's rebuttal position reflects cost savings anticipated due to BT implementation, cost reductions for non-regulated affiliates' use of BT, and a correction of inadvertent errors. . . . Finally, the Company's test year reflects full retirement of the old computer systems that the BT program will replace. (Co. Responses to Staff DRs DLH-6.01 and DLH-6.02) Adopting the AG adjustments, then, would result in the unreasonable position that the Company should receive no cost recovery for computer systems necessary in providing utility service.

(ICC Staff Ex. 10.0, pp. 11-12, lines 233-56.)

The AG's Recommended Wholesale Disallowance of the Investment in Business Transformation Should Be Rejected.

Only the AG objects to IAWC's proposed ratemaking treatment of the Business Transformation investment. And not just part of it, *all* of it—AG witness Mr. Smith recommends the *entire program cost* be disallowed. That is, the AG would eliminate the entire Business Transformation investment from IAWC's revenue requirement notwithstanding Mr. Smith's acknowledgment that the program is needed. (See AG Ex. 2.0 C (Rev.), p. 17; AG Ex. 4.0 C (Rev.), pp. 5-6.)[1]

Mr. Smith recommends disallowing in full IAWC's investment in Business Transformation because he believes "[r]atepayers should not be asked to fund these investments unless and until there is a reasonable assurance of savings, efficiencies, or improvements in service." (AG Ex. 2.0 C (Rev.), p. 29, lines 655-57.) But that is not the standard by which plant investments are evaluated in Illinois. IAWC is aware of no regulatory requirement that

[1] All references to the direct and rebuttal testimony submitted by Mr. Smith are to the corrected, revised versions of that testimony filed by the AG on the Commission's e-Docket system on June 5, 2012. In addition, all references to Mr. Smith's direct testimony, AG Ex. 2.0 C (Rev.), are to the Confidential version of that testimony, as the pagination and line numbering in the Confidential and Public versions of the testimony differ.

quantifiable benefits must be proven and captured in the revenue requirement before the revenue requirement of the expenditure may be collected from ratepayers. (IAWC Ex. 5.00R (2d (Rev.)), p. 19.) Indeed, Mr. Smith cites none. As stated, the legal standard for determining whether Business Transformation costs should be borne by ratepayers is whether the Company's investment is reasonable and prudent and whether the assets will be used and useful during the applicable rate case period. See 220 ILCS 5/9-211. Staff agrees. (ICC Staff Ex. 10.0, p. 11.) As explained above, the record confirms Business Transformation and the related costs are reasonable and prudent and the new systems will be used and useful in the test year. Because he simply ignores the legal standard in Illinois for recovery of plant investment (as well as the record evidence), Mr. Smith's recommendation should be accorded no weight.

Next, Mr. Smith argues the Business Transformation costs should be excluded from rate base because the costs of the program to American Water's regulated subsidiaries is allegedly "disproportionate" to that of its regulated subsidiaries. (AG Ex. 4.0 C (Rev.), p. 5.) Initially, Mr. Smith argued there had been "no allocation" of such costs to American Water's non-regulated affiliates. (IAWC Ex. 5.00SR (Rev.), p. 13, lines 286-88 (quoting AG Ex. 2.0 (Rev.), p. 28, line 633).) When IAWC pointed out that his contention was wrong and IAWC's non-regulated affiliates will, in fact, share some Business Transformation costs (IAWC Ex. 5.00R (2d (Rev.)), pp. 16-17), Mr. Smith corrected his prior testimony to state that there has been only a "minimal" allocation of "only a small fraction" of Business Transformation costs to IAWC's non-regulated affiliates. (AG Exs. 2.0 C (Conf.), p. 28, line 636; 4.0 C, p. 4, line 83.) Yet, Mr. Smith's correction does not make his position any more valid. Again, that position is contrary to the standard in Illinois for rate base additions. See 220 ILCS 5/9-211.

Moreover, Mr. Smith's contention remains contrary to the record evidence. He claims it does not "seem realistic that none of the Business Transformation related systems would be used for American Water Works' non-regulated subsidiaries," (AG Ex. 2.0 C (Rev.), p. 24, lines 534-37), and he goes on to surmise that "[a]spects of the Business Transformation related systems are likely to be used eventually for American Water Works' non-regulated subsidiaries," (id., p. 25, lines 550-52.) His opinions simply ignore the record. Business Transformation and the related new IT systems were specifically designed to accommodate the needs of American Water's *regulated* utility companies. (IAWC Ex. 9.00R (Rev.), p. 8.) This is because, IAWC's non-regulated affiliates own and operate separate finance, accounting, management, customer service, and customer billing systems, which satisfy the operational needs of those affiliates in those areas. (Id., p. 9.) As such, the functionality associated with the Business Transformation systems was not designed for use by the non-regulated affiliates and, therefore, the usefulness of those new systems to them will be limited. (Id., p. 8.) Mr. Smith either refuses to believe or chooses to ignore that record fact.

The AG's Alternative Proposals Also Should Be Rejected.

Mr. Smith proposed several alternatives to his extreme position that all Business Transformation costs should not be included in rate base. First, he recommends that IAWC be limited to recovery of its original cost estimates for Business Transformation submitted with the Company's initial filing. (AG Ex. 4.0 C (Rev.), p. 9.) Yet, that recommendation does not reflect appropriate Commission practice, the reality of the costs, or the facts of this case. IAWC updated its test year projection of the Business Transformation costs subsequent to its original October 27, 2012 filing, as it was permitted to do per the Commission's future test year rules, see 83 Ill. Adm. Code 287.30(a), and the case schedule agreed to by the parties and approved by the ALJ. Mr. Smith asks the Commission to simply ignore that updated information. But elsewhere, he argues that it is appropriate to use more current information. With respect to IAWC's projected test year utility plant in service Mr. Smith states, "the further out the projections, the more likely that changes will occur. Adjusting the Company's forecasted amounts based on more current actual information . . . is appropriate." (AG Ex. 4.0 C (Rev.), p. 13, lines 286-89.)

Mr. Smith next alternatively recommends reducing the Business Transformation costs to reflect an allocation to IAWC's non-regulated affiliates in proportion to those affiliates' "historical use of information technology services" or to their level of revenue. (AG Ex. 4.0 C (Rev.), p. 9.) Mr. Smith does not quantify this recommendation. He provides no support for what he believes IAWC's non-regulated affiliates' supposed historical IT systems use is. Moreover, as explained above, that is not the standard for rate base additions in Illinois, see 220 ILCS 5/9-211, a standard of which Mr. Smith is not entirely sure (see Tr. 682). It is also further evidence that Mr. Smith either refuses to believe or chooses to ignore that, because the new BT systems were not designed for use by the non-regulated affiliates, its use by them will be limited. (IAWC Ex. 9.00R (Rev.), p. 8.)

Mr. Smith next alternatively argues non-recurring Business Transformation stabilization costs should be removed from the test year. (AG Ex. 4.0 C (Rev.), p. 9.) Such costs should be treated no differently than the stabilization costs associated with other capital projects—they are typically rolled into the project costs as part of the total capital project cost. (IAWC Ex. 5.00SR, p. 17.) Mr. Smith provides absolutely no reason to depart from such treatment.

Finally, Mr. Smith alternatively proposes the imputation of estimated Business Transformation cost "savings" in IAWC's rates. (AG Ex. 4.0 C (Rev.), p. 9.) This proposal is baseless for a host of reasons. To begin with, the "savings" he seeks to impute are derived from estimates that extend beyond the test year. Moreover, Mr. Smith's proposal misconstrues the information that he relies on—it refers to costs and *benefits*, not costs and savings. A statement that the Company will realize a certain value of benefits does not necessarily translate into dollar-for-dollar *savings*. Applying the preliminary estimates of benefits from outside of the test period as cost offsets to IAWC's revenue requirement overstates their value and fails to take into account the costs and trade-offs that will be necessary to achieve those benefits. It simply ignores the fact that estimated Business Transformation "benefits" are not "savings" but estimated cost increases avoided. Business Transformation is not a cost reduction program. Rather, the benefits estimates represent cost increases that will be reduced or mitigated when compared to the cost to continue to use antiquated IT systems.

Further, this recommendation ignores the fact that IAWC *did* incorporate into its updated filing projected cost reductions due to organizational restructuring undertaken in anticipation of the implementation of Business Transformation. (IAWC Ex. 1.00SUPP (Teasley Supp. Dir.), pp. 2-3.)

Next, Mr. Smith is effectively proposing that an *acceleration* of preliminary estimates of Business Transformation benefits (from outside the test year) be imputed in IAWC's rates. This is because Mr. Smith falsely assumes that significant cost savings will be realized by IAWC upon initial deployment of the new IT systems and introduction of new business processes. That is not the case. Cost benefits cannot begin to be recognized until the BT systems are deployed and employees are fully trained on the new systems. (IAWC Ex. 5.00R (2d (Rev.)), p. 21.) As those savings will only accrue over time, rates should not reflect such savings until they legitimately arise or can be forecast with reasonable certainty. Mr. Smith agrees with this in principle when, as stated above, he recognizes that, "the further out projections, the more likely changes will occur." (AG Ex. 4.0 C (Rev.), p. 13, lines 286-89.)

Finally, if IAWC attempted to quantify specific cost savings now, any such estimates would be preliminary and of limited predictive value. (IAWC Ex. 9.00R (Rev.), pp. 3-4.) To the extent Business Transformation does produce long-term productivity savings, they will manifest themselves as the new BT systems are fully implemented. (Id., p. 7.) In other words, all other things being equal, Business Transformation should produce lower operating costs that will be reflected in future rate cases. (IAWC Ex. 5.00R 2d (Rev.), p. 21.)

In sum, IAWC needs to upgrade is necessary due its outdated and aging IT systems. (Id.) The Business Transformation program initiated to address and remedy that deficiency is driven by business necessity, not cost savings. Business Transformation may mitigate future cost increases, but it would be speculative to quantify this and cost reductions are anyway secondary to the purpose of Business Transformation. There simply is no need to speculate on possible quantifiable cost savings at this stage. This and all of Mr. Smith's recommendations related to IAWC's Business Transformation investment should be rejected and the Commission should approve the inclusion of IAWC's cost of Business Transformation in rate base.

B. Pension Asset

IAWC seeks to include in rate base $9,575,288 related to its pension contributions described as a "pension asset." Inclusion of this amount in rate base is appropriate because it properly reflects, for ratemaking purposes, the timing difference between the level of accrued pension expense IAWC collects in base rates (the Statement of Financial Account Standard No. 87 ("FAS 87") amount, as explained below) and the amount of the Company's actual pension contributions. When the FAS 87 expense amount collected from ratepayers exceeds the contribution amounts, the Commission consistently approves a reduction in rate base reflecting the difference. See, e.g., Illinois-American Water Co., Order, Docket 09-0319 (Apr. 13, 2010), Appx. A, p. 2; Illinois-American Water Co., Order, Docket 07-0507 (July 30. 2008), Appx. A, p.

3; Illinois-American Water Co., Order, Docket 92-0116 (Feb. 9, 1993), Appx. A. See also Aqua Illinois, Inc., Order, Docket 04-0442 (Apr. 20. 2005), Appx., p. 5; Consumers Illinois Water Co., Order, Docket 03-0403 (Apr. 13, 2004), Appx. A, Sch. 3; Central Illinois Light Co., Order, Dockets 01-0465/0530/0637 (Mar. 28, 2002), Appx. A, Sch. 3; Consumers Illinois Water Co., Order, Dockets 00-0337/0338/0339 (Jan. 31, 2001), Appx. B-K; 92-0116. Conversely, when IAWC's pension contributions exceed what the Company may collect through rates, as is projected to occur in this case, the Commission should approve an increase to rate base. Such complementary ratemaking treatment is appropriate considering, over time, the utility's pension contribution amounts and its pension expense accrual amounts will be the same. (IAWC Ex. 6.00R (Rungren Reb.), p. 22.) In other words, this treatment properly accounts for the timing difference between pension contribution and collection of expense in rates. Further, it encourages utilities to contribute to their plans. In light of this symmetrical approach to ratemaking, the Commission should approve IAWC's pension asset.

There are two ways that pension costs can be measured for ratemaking purposes. The first is the accrual method set forth in FAS 87. Illinois-American Water Co., Order, Docket 92-0116 (Feb. 9, 1993), p. 20; Inter-State Water Co., Order, Docket 94-0270 (Apr. 19, 1995), 1995 Ill. PUC LEXIS 283, **59-61. FAS 87 was developed by the Financial Accounting Standards Board in 1987 to establish a standardized method, for financial reporting purposes, of determining pension cost associated with a particular period of employee service. Illinois-American Water Co., Order, Docket 92-0116, p. 20; Inter-State Water Co. at *61-62. The other method is based on the funding requirements of the federal Employee Retirement Income Security Act, 29 USCS § 1002, et seq. ("ERISA"). The Commission has expressed a "strong preference" for the accrual method under FAS 87. See Illinois-American Water Co., Order, Docket 02-0690 (Aug. 12, 2003), p. 24; Inter-State Water Co. at *60.

However, although the Commission uses the accrual method for ratemaking purposes, it is federal law (ERISA) that determines the actual cash funding, or contribution amount, that the utility is required each year to pay into a pension plan. This amount typically differs from the FAS 87 amount, although, over time, FAS 87 amounts and ERISA contribution amounts will be the same. (IAWC Ex. 6.00R, p. 22.) In a typical year, however, the amounts are usually different.

Consistent with Commission precedent, IAWC presently records its accrued amount of pension expense in accordance with FAS 87. (IAWC Ex. 6.00 (Rev.) (Rungren Dir.), p. 5.) The Company's pension plan, however, is funded in accordance with the requirements of ERISA. (Id.) In both 2010 and 2011, the Company's pension funding contribution amounts exceeded FAS 87 amounts. (IAWC Ex. 6.00R, p. 21.) IAWC anticipates its contribution amounts will continue to exceed FAS 87 amounts in 2012 and 2013. (Id.) Staff agrees IAWC's test year level of pension contributions will be greater than the test year level of FAS 87 expense, and that the Company's test year projection of pension funding contributions represents amounts IAWC projects it will actually expend in the test year. (IAWC Cross Ex. 12 (IAWC-ICC 2.08 and 5.13).) Accordingly, in the test year (and in the years preceding it), the Company's shareholders and bondholders will fund that level of IAWC's pension contributions which the Company will not recover from ratepayers through rates—IAWC's pension asset. As such, applying a ratemaking approach symmetrical to the Commission's practice outlined above, IAWC has included in its test year rate base $9,575,288, which reflects IAWC's current pension funding levels. (IAWC Exhibit 6.00SUPP (Rungren Supp. Dir.), p 5; Sch. B-2.22 (First (Rev.)).)

Despite the symmetry of IAWC's proposed ratemaking treatment afforded its pension asset, both Staff and the AG recommend the Commission exclude the pension asset from rate base. Staff's recommended disallowance is premised on its belief "the appropriate ratemaking treatment [of the pension asset] is driven by the determination of what party funded the difference between the FAS 87 expense and ERISA contribution." (ICC Staff Ex. 10.0 (Hathhorn Reb.), pp. 3-4, lines 63-65.) Because Staff believes there is no evidence in this case that the pension asset was created by other than ratepayer funds, it believes removal of the entire asset from rate base is appropriate. (Id., p. 3.)

Staff's contentions are misplaced, however, because the source of funds is not the relevant question when determining the appropriate treatment of IAWC's FAS 87 and pension contribution amount differences. Rather, the issue here is simply one of a timing difference, with the pension asset being the appropriate ratemaking treatment of the difference between amounts accrued as pension expense under FAS 87 and pension funding contributions. (IAWC Ex. 6.00R, p. 21.) As explained, when the timing is such that FAS 87 amounts exceed contribution amounts, a rate base deduction has been approved. Fairness dictates, then, that the converse timing difference be treated symmetrically—that when ERISA contribution amounts exceed FAS 87 amounts, a rate base increase is appropriate. Staff presented no reason in this case to treat these symmetrically converse situations differently.

Staff's contentions also are far too narrow. Staff relies on North Shore Gas Co., et al., Docket 11-0280/0281, Nicor, Dockets 04-0779 and 95-0219, and Commonwealth Edison Co., Dockets 05-0597, 07-0566 and 10-0467 to support its position "[t]he 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 requiring rate base recovery." (ICC Staff Exhibit 2.0 (Hathhorn

Dir.), pp. 4-5, lines 90-92.) However, none of those dockets concern the precise timing difference which created the pension asset at issue in this case. (IAWC Ex. 6.00R, pp. 23-25.) As explained, IAWC's pension asset results from the difference in plan funding and the amounts which IAWC is permitted to collected in base rates per FAS 87. Accordingly, it is neither the result of a wholly discretionary contribution on IAWC's part, nor prefunding of the plan with ratepayer funds, nor unexpected returns on the plan assets previously funded by ratepayers, which were the circumstances underlying the pension assets at issue in the referenced dockets. (Id., pp. 24-25.) Staff's proposed disallowance fails to recognize that IAWC must actually pay these contributions amounts in the test year. (Id., p. 22.)

Finally, even accepting Staff's premise that a showing of shareholder funding is a condition precedent to recovery on IAWC's pension asset (it is not), Staff's contention that there has been no such showing in this case is incorrect. If the amount contributed to the Company's pension plan exceeds the FAS 87 expense amount in the income statement that the calculation of the revenue requirement is based on, then, unless the Company is earning a return on common equity greater than that which it is allowed, the only source to fund the pension contribution amount above the FAS 87 expense amount is shareholders. (IAWC Ex. 6.00SR (Rungren Sur.), pp. 6-7.)

Like Staff, the AG takes the position that IAWC should not recover a return on its pension asset. (AG Ex. 2.0 C (Rev.), p. 54.) However, the AG takes Staff's argument one step further and contends that AWW's pension plan was underfunded as of December 31, 2011 is evidence the pension asset was not investor-supplied. (AG Ex. 4.0 C (Rev.), pp. 23-24.) Yet, AWW's pension funding status—whether overfunded or underfunded—simply is not relevant to the calculation of IAWC's pension asset. (IAWC Ex. 6.00R, p. 38.) The pension plan is an external trust and is not included on IAWC's balance sheet. (Id.) Thus, the funding level of the pension trust is not appropriate for consideration in determining rates. (Id.) In other words, the AWW Pension Plan Actuarial Report's unfunded pension position and ERISA Funding Position Funding shortfall amounts are not determinative of whether, for ratemaking purposes, IAWC has a pension asset. Rather, the Company's pension asset is calculated based on IAWC's share of FAS 87 pension expense and its share of ERISA contributions. (Id.)

IAWC submits that the Commission has two alternatives to the ratemaking treatment afforded IAWC's pension asset. First, the Commission can (and should) adopt a symmetrical approach to ratemaking and include IAWC's pension asset in its rate base. If, however, the Commission does not approve recovery on the pension asset, it should permit recovery *of* it; it should authorize IAWC to use the pension funding contribution amount, rather than the FAS 87 amount, as the Company's test year level of pension expense. (IAWC Ex. 6.00R, p. 22.) No party disputes the accuracy of IAWC's projected test year pension contribution amounts, or the prudency of the contributions. As such, this approach would at least provide IAWC with recovery of the actual test year amount that it expects to contribute to the pension plan. (IAWC Ex. 6.00SR, p. 6.)[2] Use of this approach would increase pension expense by $4.447 million to $7.584 million.

Policy considerations also demand encouraging appropriate pension plan funding. That is, the Commission should encourage pension contributions, not penalize utilities and their shareholders for making them, especially at a time when plans are underfunded. Nor should the

[2] A third alternative would to symmetrically not reduce rate base when FAS 87 amounts exceed ERISA funding amounts. (IAWC Ex. 6.00R, p. 22.) In prior cases, however, IAWC and the Commission have not adopted this approach because amounts by which FAS 87 exceeds pension contributions have been deducted from rate base. This alternative would have the Commission issue an Order recognizing the symmetry between the situation in which FAS 87 amounts exceed pension contributions and the situation in this case, thereby providing guidance for future proceedings. (IAWC Ex. 6.00SR, pp. 8-9.)

Commission discourage utilities from complying with their pension funding obligations. See, e.g., Commonwealth Edison Co., Order on Reh'ing, Docket 05-0597 (Dec. 20, 2006), p. 20 (citing Final Order (July 26, 2006), p. 39) (recognizing the utility's pension asset and approving partial recovery on the same, finding it did not want utilities to neglect their pension obligations in light of the seriousness of underfunding). For these reasons, the Commission should approve inclusion of IAWC's pension asset in rate base, and thereby permit a recovery on its pension contribution.

C. Cash Working Capital Issues

In this case, IAWC has proposed to include approximately $3,503,000 of cash working capital in rate base. (IAWC Ex. 6.02SR) The purpose of including cash working capital in a utility's rate base is to compensate the utility's investors for providing the funds required for those day-to-day business operations which require a cash outlay during the lag time between the provision of service and the receipt of revenues associated with that service. (IAWC Ex. 6.00R (Rungren Reb.), p. 29.) The compensation provided to the investors through the cash working capital allowance is similar to the compensation provided to the investors for any other non-depreciable capital outlay. Thus, cash working capital is determined by an analysis of revenues received and expenses paid by the Company, i.e., the actual cash flows in and out. (Id., p. 19.)

The amount of required cash working capital can be determined in various ways. In Illinois, under 83 Illinois Administrative Code Part 285, the cash working capital calculation may be based on a lead-lag study. 83 Ill. Adm. Code § 285.2070. The cash working capital amount may also be calculated using a formula based on operating expenses. See Aqua Illinois, Inc., Order, Docket 03-0403 (Apr. 13, 2004), p. 4 (cash working capital amount calculated as 1/8 of operating expenses, less certain adjustments). As directed in its last rate case, Docket 09-0319, IAWC performed a lead-lag study in this case to support the proposed cash working capital allowance. Lead-lag studies are used to analyze the lag time between the date customers receive service and the date that customers' payments are available to a company, offset by a lead time during which the company receives goods and services, but pays for them at a later. (IAWC Ex. 6.00R, pp. 29-30.) The "lead" and the "lag" are both measured in days. (Id., p. 30.) The annual test year cash expenses are then divided by 365 days to determine a daily cash working capital. (Id.) The daily amount is then multiplied by the dollar-weighted lead and lag days to determine the amount of cash working capital required for operations. (Id.) The resulting amount of cash working capital is then included as part of the company's rate base. (Id.) IAWC's lead-lag study was based on the most recent data available as required by the Commission in Docket 09-0319. (Id., p. 31.)

In the present case, AG witness Ralph C. Smith (AG Ex. 2.0 C (Rev.), pp. 48-54) recommends adjustments to cash working capital based on: (i) an assertion that the Company's revenue collection lag should be 21 days (the collection lag approved in IAWC's last rate case, Docket No. 09-0319); and (ii) an assertion that IAWC's prepayment of Service Company fees is commercially unreasonable and should not be reflected in the cash working capital amount. Of note, Staff disagrees with Mr. Smith's collection lag adjustment and proposal to adjust the payment lag to the Service Company, stating "the evidence in the instant proceeding supports the collection lag days as proposed by the Company" and "the evidence in this proceeding supports the Company's position to base the payment lag on prepayments to the service company." (ICC Staff Ex. 9.0-C (Kahle Reb.), pp. 8-9.)

ICC Staff witness Daniel G. Kahle recommends using pension expense from the Company's Schedule C-2 rather than the projected qualified pension contribution under ERISA guidelines for the test year ending September 30, 2013 used by the Company. (ICC Staff Ex. 1.0

(Kahle Dir.), pp. 8-10.) The recommendations by Mr. Smith and Mr. Kahle should be rejected, for the reasons set forth below.

1. Pension Expense

Staff witness Mr. Kahle recommends using pension expense from the revenue requirement in the cash working capital calculation rather than the contribution to the pension fund as proposed by IAWC. (ICC Staff Exs. 1.0, pp. 8-10; 9.0-C, pp. 6-8.) Mr. Kahle explains his position by stating that the "recovery of pension expense, as reflected in the revenue requirement, is an expense of providing utility service" and "a contribution to the pension trust fund is not." (ICC Staff Ex. 9.0-C, p. 6, lines 126-28.) He further states that "[i]ncluding the contribution to the pension fund in cash working capital would allow IAWC to recover, in rates, an amount that is not a cost of providing utility service and would allow two different measures of pension costs to be considered in the ratemaking process." (Staff Ex. 9.0-C, pp. 6-7, lines 132-34.) Mr. Kahle's recommendation should be rejected because he ignores the amount of cash that IAWC actually expects to contribute to its pension trust in compliance with ERISA. In other words, IAWC's cash working capital amount should be based on available actual information.

As Staff acknowledged in discovery, IAWC's test year pension contribution amounts represent actual cash payments the Company projects to payout in the test year, and so it is the appropriate basis for determining cash working capital. (IAWC Ex. 6.00SR (Rungren Sur.), pp. 2-3.) Pension expense in the revenue requirement represents the income statement portion of FAS 87 expense. Pension contributions, on the other hand, are cash that is to be contributed to the pension trust in accordance with ERISA provisions, including the minimum amount required by law, and includes both the income statement and capital portions of pension funding. (IAWC Ex. 6.00R (Rungren Reb.), p. 20.)

Items that are not reflected in the revenue requirement are still reflected in the cash working capital calculation. IAWC does not include in its revenue requirement amounts for purchased water or wastewater treatment revenues and expenses, yet they are included in the statement of cash working capital because they represent cash flow for the Company. IAWC is required to pay for purchased water and for wastewater treatment and collect from customers the associated revenues. Although purchased water and purchased wastewater treatment are removed from the revenue requirement, purchased water and purchased wastewater treatment are considered in the statement of cash working capital. (IAWC Ex. 6.00SR, pp. 2-3.)

Mr. Kahle claims that IAWC's proposal is overly complicated has no merit. In the event the Company has not made, or is not projected to make, pension contributions in the test year, then the cash working capital amount would simply be zero. Further, in years when the pension funding amount is less than FAS 87, IAWC would agree to use the pension funding amount then as well to determine cash working capital. (Id., pp. 4-5.) In sum, Mr. Kahle's adjustment ignores the cash funding amount for pension required by law and should therefore be rejected.

2. Collection Lag

IAWC has customers who pay late, and there is a cost to IAWC associated with these late payments. (IAWC Ex. 6.00R, p. 32.) When a customer pays late, IAWC does not receive timely revenues from that customer to provide service and must obtain the equivalent funds necessary for working capital (i.e., cash working capital) from some other source. (Id.) IAWC, however, continues to pay its employees and vendors for services in a timely manner. Therefore, the costs related to late payments represent a cost to IAWC associated with having to fund necessary services (i.e., through cash working capital) when payments are not made on time. (Id.) The effect of late payments is included as part of the cash working capital calculation through the collection lag component. (Id.) The collection lag portion of the revenue lag was calculated using the Company's actual history of revenue collection from July 1, 2010 to June 30, 2011. (Id., p. 31.) The collection lag for the Company's districts ranged from 23.53 days to 47.05 days. (Id.)

Despite IAWC's use of actual calculated collection lags, the AG asserts the Commission should use the 21-day collection lag approved in IAWC's last rate case, Docket 09-0319, in the current case. (AG Ex. 4.0 C (Rev.), pp. 16-18.) However, the AG's position should be rejected. First, the 21-day lag represents an arbitrary lag amount. As the Commission found (on rehearing) in Dockets 09-0306-0311 (cons.), it is appropriate to use actual collection lag information to determine cash working capital requirements. Central Ill. Pub. Serv.Co. et al., Order on Reh'ing, Dockets 09-0306-0311 (Nov. 4, 2010), pp. 49-56. Staff agrees with IAWC's proposed collection lag calculation, noting "the Company's method has been accepted by the Commission in many other proceedings; for example, the Company's most recent rate case (Docket No. 09-0319), Ameren Illinois Company's most recent electric and gas rate cases (Docket No. 09-0306 (cons.) and Docket No. 11-0282.); and Nicor Gas Company (Docket No. 08-0363)." (ICC Staff Ex. 9.0-C, p. 9, lines 186-91.) Further, as Staff unequivocally expressed, "the evidence in the instant proceeding supports the collection lag days as proposed by the Company." (Id.)

Mr. Smith admits that the 21-day collection lag is nothing but a proxy for a properly calculated collection lag, which, in his own words, is an "approximation of what the actual lag is for customers who pay their utility bills . . . ." (AG Ex. 4.0 C (Rev.), p. 18, lines 429-30.) IAWC, by contrast, has prepared a lead-lag study in this case that provides *actual* calculated collection lags based on *actual* customer payments and there is no "unreasonable" assumption used to determine collection days for the cash working capital as Mr. Smith asserts. (IAWC Ex. 6.00R, p. 32.) In Central Illinois Light Company d/b/a AmerenCILCO, Dockets 09-0306-0311, the Commission agreed that the actual weighted-average number of collection days should be used in the determination of cash working capital costs. Order on Reh'ing, Dockets 09-0306-0311 (Nov. 4, 2010), p. 56. In this case, the Company performed a lead/lag study to reflect the twelve months ended June 30, 2011, in response to the Commission's Order in Docket 09-0319, which directed the Company to use in its next rate case lead/lag study data that is more contemporaneous with the Company's test year. (IAWC Ex. 6.00R, p. 33.) Therefore, rather than rely upon Mr. Smith's arbitrary use of a 21-day collection lag, the Commission should utilize IAWC's actual calculated collection lags based on the updated lead-lag study in this case.

The Commission's concern in the last case was that IAWC's lead-lag study was outdated. Order, Docket 09-0319 (April 13, 2010), p. 18 (finding "[t]here are benefits to having an updated lead/lag study; however the existing record does not contain such a study".) That concern led to the adoption of the 21-day estimate, as the Commission had no viable alternative to IAWC's lead-lag study for determining the cash working capital requirement. Id. That concern has been resolved in this case with IAWC's new lead-lag study, therefore, there is no need to resort to estimation. The 21-day collection period recommended by Mr. Smith is not an average of any payment data, nor does it reflect any real or measured customer payment pattern. Mr. Smith has provided no study, analysis, actual data, or other empirical evidence that supports the conclusion that the 21-day period is representative of IAWC's collection pattern. Mr. Smith simply assumes that 21 days is an appropriate proxy for the Company's actual collection lag, without providing supporting analysis. In fact, at the evidentiary hearing in this proceeding, he admitted he did not factor in the 2-day grace period in IAWC's tariffs. (Tr. 724.) For these reasons, Mr. Smith's recommendation to impose an arbitrary 21-day collection lag should be disregarded.

3. Service Company Prepayments

Mr. Smith asserts that IAWC's prepayment to the Service Company for services is not commercially reasonable and that the cash working capital calculation should be adjusted to remove this calculation. (AG Ex. 2.0 C (Rev.), p. 52.) Mr. Smith's assertion, however, does not recognize that the Commission-approved agreement between IAWC and the Service Company ("Service Company Agreement") requires prepayment of Service Company fees, and that this approach eliminates a Service Company overhead cost that IAWC would otherwise be required to pay as a part of the cost for services provided. (IAWC Ex. 6.00R, p. 34.) Staff witness Mr. Kahle recommends that Mr. Smith's adjustment be rejected as well. (ICC Staff Ex. 9.0-C, p. 9.) The Commission rejected the same adjustment in IAWC's last rate case, stating "while that argument may be correct as far as it goes, there are other consequences to consider." Order, Docket 09-0319 (Apr. 13, 2010), p. 18.

Unlike other vendors, the Service Company provides services at cost. It has no retained earnings or other internally generated funds with which to provide working capital to fund the services it provides to IAWC prior to receipt of payment for those services. (IAWC Ex. 6.00R, p. 34.) Thus, at the time the Service Company Agreement was prepared, there were essentially two options for addressing the Service Company's need to obtain funds in order to provide the necessary funds to finance the services required by IAWC. (Id., pp. 34-35.) One option was to have the operating utilities, such as IAWC, prepay for Service Company services. The other option would have been to require the Service Company to obtain cash working capital and include the related cost in the overheads added to the cost for services provided to IAWC and other operating subsidiaries. (Id., p. 35.) In the Service Company Agreement, the option to have the operating utilities, including IAWC, prepay for Service Company services was used.

As the Service Company is an affiliate of IAWC, the Company was required to obtain Commission approval of the Service Company Agreement. (IAWC Ex. 6.00R p. 35.) The current Service Company Agreement, which includes a provision for pre-payment for monthly services, has been approved by the Commission twice: on July 19, 1989, in Docket 88-0303, and again on October 19, 2005, in Docket 04-0595. In approving the Service Company Agreement, including the prepayment provision, the Commission found that the Service Company Agreement was reasonable and in the public interest. If the approved Service Company Agreement had not required prepayment for services, IAWC's cost to obtain services from the Service Company would have been different. (Id., p. 36.) As noted above, modification of the prepayment terms of the Service Company Agreement would have required that IAWC pay as overhead the cost incurred by the Service Company to obtain working capital needed to provide services. (Id.) Thus, the prepayment terms are reasonable and should not be modified.

The terms of the Service Company Agreement determine the actual method by which IAWC pays the Service Company. (Id., p. 37.) IAWC does in fact prepay Service Company charges, and this prepayment is reflected in IAWC's lead-lag study and cash working capital calculation. Because the prepayment term is included in the Service Company Agreement, IAWC would be required to continue to prepay its Service Company fees, even after a ratemaking adjustment. (Id.) However, IAWC would no longer recover the cost associated with the prepayment, and thus, would be penalized for continuing to comply with the requirements of the Commission-approved Service Company Agreement. This would deny IAWC the opportunity to recover a cost prudently incurred in providing service. Illinois law prohibits this. Citizens Util. Bd. v. Ill. Comm. Comm'n, 166 Ill. 2d 111, 121 (1995).

Because IAWC's prepayment of Service Company fees represents its actual, Commission-approved practice, Mr. Smith's recommendation is nothing more than a request to impose an arbitrary and theoretical lead period on IAWC that does not reflect IAWC's actual circumstances. Prepaying Service Company costs is also a prudent business practice. IAWC commonly prepays certain types of vendors, such as lessors, taxing authorities, insurers, trade organizations (dues), and providers of information technology support services and maintenance agreements. These prepayments are in accord with industry practice related to the particular service involved. (IAWC Ex. 6.00R, p. 36.) Thus, in addition to the fact that the Service Company Agreement was approved by the Commission, there is no commercial basis to support the argument that the prepayment terms are unreasonable.

Mr. Smith claims that, based on information from other jurisdictions, adopting his adjustment does not in fact cause the utility to be charged more by the Service Company. (AG Ex. 4.0 C (Rev.), pp. 20-21.) This misses the point. The utility would still have to follow the terms of the agreement and prepay the Service Company, so the adjustment simply bars recovery of cost by the utility.

Moreover, Mr. Smith simply cherry-picks jurisdictions with favorable outcomes for his recommendation. He cites to Pennsylvania and West Virginia as alleged evidence that his recommended adjustment is "routinely applied" by IAWC's utility operating affiliates in other jurisdictions (AG Ex., 2.0 C (Rev.), pp. 53-54) but fails to demonstrate why the Commission should ignore its Docket 09-0319 Order and blindly adopt the decision of a regulatory body in another state under a different regulatory environment. In fact, his position that such adjustments are "routinely applied" is wrong; a similar adjustment as proposed by Mr. Smith in this case was just rejected in Tennessee American Water Company's ("TAWC") rate case, Tennessee

Regulatory Authority, Docket 10-00189. In that case, an intervenor proposed an adjustment that management fees should not be prepaid. Tennessee American Water Co., Order, No. 10-00189, 2012 Tenn. PUC LEXIS 76, **235-38 (Tenn. Reg. Auth. Apr. 27, 2012).[3] TAWC's contract with the Service Company is the same as IAWC's and requires prepayments. Id. at 113. The Tennessee Commission rejected the adjustment, finding it appropriate to include the prepayment of management charges. Id. at 114-15.

Finally, Mr. Smith's position ignores that this "Commission is under no obligation to consider the ratemaking practices employed in other jurisdictions." North Shore Gas Co./Peoples Gas Light & Coke, Order, Docket 07-0241 (Feb. 5, 2008), p. 152. It need not consider them here then. Mr. Smith fails to demonstrate a methodology used in Pennsylvania or West Virginia is appropriately used in Illinois. He does not address whether these jurisdictions feature different test years, different conditions of service, different accounting rules or different ratemaking practice. He does not address the regulatory environment in Pennsylvania. He does not even cite to any specific case in West Virginia, let alone a single fact pertaining to one. Thus, there is no basis for his proposed importation of those states' practices to Illinois. See Antioch Milling Co. v. Pub. Serv. Co. of N. Ill., 4 Ill. 2d 200, 210 (1954) (excluding evidence of differing rates where the party failed to demonstrate that the utilities being compared were sufficiently similar to warrant comparison).

Moreover, a closer look at the 1993 Order from Pennsylvania American Water Company's ("PAWC") rate case, Docket No. R-922428, on which Mr. Smith apparently relies, shows that the Pennsylvania Commission found PAWC "failed to quantify any benefit to its customers which would justify *prepayment* to AWWSC, and what is at issue here are

[3] Also *available at* http://www.tn.gov/tra/orders/2010/1000189mb.pdf.

prepayments . . . ." (AG Ex. 2.3, p. 47 (Pennsylvania American Water Co., Order, Docket R-922428 (June 7, 1993), p. 23).) The 1993 PAWC decision is thus distinguishable from IAWC's current case because IAWC has explained, repeatedly, the benefits to ratepayers as a result of an arrangement featuring prepayments to the Service Company—avoiding a Service Company overhead cost that IAWC would otherwise have been required to pay, and pass along to ratepayers, as part of the cost for services provided. The Commission recognized this very scenario in IAWC's last rate case, stating, "[b]ecause the Service Company Agreement allows the Service Company to pass its costs directly on to IAWC, Illinois-American could not actually avoid the cost and ratepayers would ultimately be responsible for the costs. As a result, the Commission *sees no benefit* to ratepayers from modifying the cash working capital requirement. . . ." Order, Docket 09-0319 (April 13, 2010), p. 18 (emphasis added).

As a result, the record in this case demonstrates that it is appropriate for IAWC's cash working capital calculation to reflect its actual payment practices with respect to Service Company fees. IAWC is contractually required to prepay the Service Company for services, and the Commission has determined that this is a reasonable approach. Id., p. 35. The Commission therefore, should reject Mr. Smith's proposed adjustment as contrary to Illinois law and Commission policy.

4. Current and Deferred Income Taxes

In his rebuttal schedules, Staff witness Mr. Kahle combined current and deferred income taxes in his cash working capital calculation. (See Staff Exs. 1.0, Sch. 1.8 ZN; 9.0-C, Sch. 9.8 ZN(C).) IAWC notes this is a departure from his methodology in his direct testimony. Mr. Kahle provides no explanation for combining current and deferred income taxes, nor an explanation for the resulting impact on IAWC's rate base. As a result of his sudden switch in methodology, the rate base for Zone 1 alone is reduced by approximately $430,000. The

Commission should reject this unexplained switch. It is not appropriate to combine deferred and current taxes. Deferred and current taxes are calculated independently. Deferred taxes require no cash outlay. Therefore, the use of zero lag days is appropriate for determining the expense lead associated with deferred income taxes. As a result, deferred taxes are properly excluded from the calculation of cash working capital.

D. ADIT – FIN 48

The question of the appropriate treatment of "FIN 48" liabilities, which are amounts associated with uncertain tax positions (as explained more fully below), is one of first impression for the Commission. The dispute over these FIN 48 amounts centers on the question of whether the utility should be subject to a disincentive to take uncertain tax positions that may ultimately benefit ratepayers. Consistent with the ratemaking treatment of FIN 48 liabilities by other regulatory commissions, and sound ratemaking policy, IAWC has removed from its test year balance of Accumulated Deferred Income Taxes ("ADIT") the balance of FIN 48 liabilities. The effect of this is to not deduct the FIN 48 amounts from rate base when the balance of ADIT is deducted from rate base. IAWC's treatment is appropriate for two reasons: (1) it provides the utility with incentive to pursue the uncertain tax position which, if successful, will result in a ratepayer benefit (through higher tax deductions, which produce lower current tax expense and an increased deferred tax amount, which would be deducted from rate base as ADIT); and (2) it recognizes that FIN 48 amounts are not ADIT as they are not "cost free" sources of capital.

The AG and Staff believe the Company's FIN 48 liabilities of approximately $1.5 million are of the same character as ADIT and should therefore be deducted from rate base, for the same reason ADIT is deducted from rate base (i.e., because ADIT represents a source of cost-free capital to the utility), although Staff proposes to "mitigate" this by allowing IAWC to recover the amount of FIN 48 interest. (ICC Staff Ex. 9.0-C, pp. 10-11; AG Ex. 2.0 C (Rev.), pp. 66-67.)

Both the AG and Staff's proposals, however, eliminate the incentive (and in fact provide a disincentive) to taking uncertain tax positions. As discussed below, those positions should be rejected.

Circumstances Giving Rise to FIN 48 Liabilities.

As explained by IAWC witness James I. Warren (IAWC Ex. 13.00R (Warren Reb.), p. 5), FIN 48 (an acronym for Financial Accounting Standards Board Interpretation No. 48) is an accounting pronouncement issued in 2006 that instructs public companies how to analyze, quantify and account for the consequences of tax positions taken by the taxpayer that are likely to be disputed and ultimately disallowed by the taxing authorities. In determining the amounts of applicable deductions, or other tax items, questions of the interpretation of the tax rules may naturally arise. (Id., p. 9.) An entity may take a position on these questions of interpretation that is favorable to it, e.g., by claiming a larger deduction, knowing that the taxing authority may disagree. The taxing authority may then, after an audit, reject the interpretation and require that the related additional tax be paid. (Id., p. 10.) The amount of tax that IAWC and its outside auditors have concluded "more likely than not" will eventually be paid (but has not been paid yet) to taxing authorities in connection with the uncertain position must be reflected on the utility's balance sheet as a tax liability. (Id., p. 11.) If, as expected, the uncertain amounts are repaid to the taxing authority, they must be repaid with applicable interest and penalties. (Id.) [4]

In describing the characteristics of FIN 48 amounts, Mr. Warren compared them to ADIT using the example of a distribution line built at a cost of $1 million, depreciable over 20 years on

[4] As Mr. Warren explained, the FIN 48 evaluation process is extremely rigorous. Not only does IAWC's internal tax department analyze the positions and assess the risk levels, but also, its external auditors and auditors' tax experts thoroughly review the results of the Company's process and often challenge its conclusions. At the end of the process, the Company and its external auditors generally reach a consensus as to the amount of additional tax likely to be paid with respect to each uncertain tax position. (IAWC Ex 13.00R, p. 10.)

an accelerated basis. (IAWC Ex. 13.00R, pp., 6-7.) The utility will claim accelerated depreciation on its tax return and, by virtue of that fact, reduce its tax liability. The reduction in the utility's tax liability will give rise to the practical equivalent of a loan from the government—an ADIT loan. The loan will be paid back in the later years of the distribution line's useful life when no additional tax depreciation is available because it has all been claimed. Because the loan is repaid to the government by the filing of future tax returns, there is no interest associated with it. It remains interest-free as long as it is outstanding. (Id., p. 7.)

By contrast, if the utility decides to deduct the entire cost of the distribution line in the year it is placed in service, the deduction will reduce its tax liability for that year. Although this would be an incorrect tax position, it would also produce a governmental loan—one larger than the loan created by claiming accelerated depreciation. This can be considered a FIN 48 loan. Upon audit, the IRS will disallow the tax deduction to the extent it exceeds the permissible level of depreciation and require the utility to pay back a substantial portion of the loan (i.e., the non-ADIT loan portion) immediately. Thus, the mechanism for repaying the loan has nothing to do with future tax returns. It depends on an IRS assessment after an audit of an already-filed tax return.

In early 2008, it became apparent that the IRS had favorably changed its previous position on accounting for units of property relative to certain tax deductions for repairs. IAWC therefore applied for and received permission to change its method of accounting. The primary purpose of that change was to use larger units of property in the identification of repairs for tax purposes and, thereby, increase its tax deductions. (IAWC Ex. 13.00R, pp. 12-14.) The Company classified a portion of these increased deductions as uncertain. (Id., p. 14; Tr. 696-97.)

These uncertain amounts were then classified as tax liabilities—the FIN 48 amounts at issue. (IAWC Cross Ex. 8 (FIN 48), p. 5.)

Taking Uncertain Tax Positions Benefits Ratepayers.

IAWC's change in accounting method to increase repairs deductions benefits its ratepayers. When the increased permissible repair deductions made possible by the accounting method change reduce the Company's tax liability, the tax reduction is reflected in the Company's ADIT balance as incremental cost-free capital. This additional ADIT balance is used as an offset to rate base, thereby passing on to customers the benefit of the cost-free capital created by the method change. (IAWC Ex. 13.00R, p. 19.) If, contrary to the expectations of the experts, the Company is able to prevail in the assertion of an uncertain tax position, at that point the loan would be re-characterized as an ADIT loan and customers would enjoy an incremental rate base deduction in the next rate proceeding. (Id., p. 22.) Obviously, if the Company never asserts its uncertain position, this incremental zero-cost capital cannot come into being. Consequently, it is in the customers' best interests for the Commission to encourage such positions. (Id.)

Both Staff and the AG agree with this point—that taking uncertain tax positions can benefit ratepayers. As Staff witness Mr. Kahle states, "[u]nder the Company's proposal, if the IRS does not disallow the tax deduction associated with the FIN 48 reserve, customers would not receive the benefit of the deferred tax credits until the first rate case after tax returns are no longer subject to IRS review and adjustment." (ICC Staff Ex. 9.0-C, p. 11.) AG witness Mr. Smith also agrees that, if the utility is successful on its uncertain position, its ratepayers can benefit. (Tr. 705-06.)

Because of the Potential Ratepayer Benefit, the Commission Should Not Eliminate IAWC's Incentive to Take Uncertain Tax Positions.

Both the Company and Staff agree that IAWC's incentive should be to take uncertain tax positions. Staff witness Mr. Kahle testified, "[t]he Company should still have an incentive to make uncertain tax positions." (ICC Staff Ex. 9.0, p. 13.) This makes sense given the ratepayer benefits discussed above. However, both the AG and Staff's proposal to include FIN 48 amounts in the ADIT balance, and so reduce rate base by those amounts, eliminate this incentive.

The expectation is that the FIN 48 amounts will be repaid. With the FIN 48 amounts included in a rate base deduction as part of ADIT, as the AG and Staff propose, IAWC's rate base is lower than it otherwise would be. If, as expected, the FIN 48 amounts are remitted to the taxing authorities, IAWC will no longer have the FIN 48 funds, but will still have the rate base deduction until the next rate case. Thus, IAWC would actually be better off not taking the uncertain tax position at all, even though taking such a position benefits ratepayers. Staff's proposal to allow recovery of an unspecified interest amount does not "mitigate" the impact of including FIN 48 in ADIT, a reduction of rate base of $1.529 million. Even Staff's proposal creates a significant disincentive to pursuing uncertain tax positions that would be accounted for as FIN 48 amounts.

Other jurisdictions addressing this issue have recognized the importance of maintaining the incentive to utilities to take uncertain tax positions. For example, in In the Matter of Union Electric Company, d/b/a AmerenUE's Tariffs to Increase Its Annual Revenues for Electric Service, Case No. ER-2008-0318, Missouri Staff proposed to treat all FIN 48 liabilities as ADIT and reduce rate base accordingly. Order, Case No. ER-2008-0318, 2009 Mo. PSC Lexis 71, *86

(Mo. PSC Jan. 27, 2009).[5] AmerenUE argued FIN 48 liabilities should be excluded from ADIT. The Missouri Commission agreed: "Both ratepayers and shareholders benefit when AmerenUE takes an uncertain tax position with the IRS, because saving money on taxes benefits the company's bottom line and reduces the amount of expense the ratepayers must pay." Id., p. 55. The Commission concluded, "[t]he best way to encourage AmerenUE to continue to take uncertain tax positions is to treat the company fairly in the regulatory process." Id. It found treating FIN 48 liabilities as ADIT is unfair to the utility because "[i]f the ultimate outcome before the IRS matches the FIN 48 analysis . . . there would be no deferral of tax and no means by which AmerenUE would recover the amount that reduced rates, but was not actually realized by the company." Id.

Kentucky regulators have cited the rationale of the Missouri Commission to also distinguish FIN 48 liabilities from ADIT. In Application of Kentucky-American Water Company For An Adjustment of Rates, Case No. 2010-00036, the Kentucky Attorney General argued the utility's FIN 48 liabilities represented a source of zero-cost capital that should be treated as ADIT and passed through to ratepayers. Order, Case No. 2010-00036, 2010 Ky. PUC LEXIS 1479, **29-30 (Ky. Pub. Serv. Comm'n Dec. 14, 2010).[6] The Kentucky Commission observed that "[f]ew regulatory commissions have addressed this issue in contested proceedings," but those that have "have been reluctant to apply the rate-making treatment that the AG proposes." Id., p. 19. Citing AmerenUE and a Washington Utilities and Transportation Commission decision,[7] the Kentucky Commission rejected the AG's adjustment. "If the IRS

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[5] Also *available at* https://www.efis.psc.mo.gov/mpsc/commoncomponents/view_itemno_details.asp?caseno=ER-2008-0318&attach_id=2009011572.

[6] Also *available at* http://psc.ky.gov/order_vault/Orders_2010/201000036_12142010.pdf.

[7] Washington Util. & Transp. Comm'n v. Pugent Sound Energy, Inc., Dockets UE-090704 and UG-09075, slip op. at 70 (Wash. UTC Apr. 2, 2010).

ultimately allows the deduction . . . ratepayers and shareholders will benefit from the tax deferral. If the IRS disallows Kentucky-American's deduction, Kentucky-American has stated it will not seek recovery for interest and penalties imposed by the IRS and the ratepayers will not be negatively affected." Id., p. 20. Thus, it clear that (1) utilities should be encouraged to take uncertain tax positions; and (2) the ratemaking treatment of those tax positions should not create a disincentive to taking them.

The AG and Staff's Proposal to Include the FIN 48 Amounts in the ADIT Balance Should Be Rejected because FIN 48 Amounts Are Not a Cost Free Source of Capital.

On the surface, FIN 48 liabilities share similar characteristics with conventional ADIT liabilities. Both can be considered a "loan" from the government. The critical distinction, however, is that FIN 48 amounts are not interest-free—when, as expected, they are repaid, they must be repaid with interest and penalties, if applicable. (IAWC Ex. 13.00SR (Warren Sur.), p. 3.) Thus, unlike ADIT, FIN 48 liabilities cannot be considered a source of cost-free capital. (Id.) Staff recognizes that interest can accrue on the FIN 48 amounts. (ICC Staff Ex. 9.0-C, p. 13.) AG witness Mr. Smith also recognizes the possibility that interest and penalties can accrue. (Tr. 702; AG Ex. 4.0 C (Rev.), p. 30.) And the FIN 48 pronouncement itself requires that interest and, if applicable, penalty amounts be recorded. (IAWC Cross Ex. 8, p. 4.) Thus, its is clear that, unlike ADIT, FIN 48 amounts do have a cost.

FIN 48 amounts are also, for financial reporting purposes, expressly not to be classified as ADIT. (IAWC Cross Ex. 8, p. 5; Tr. 709-10.) Thus, it is not appropriate to simply recommend the same treatment. FIN 48 liabilities are also *not* like customer advances or deposits. Advances and deposits are funds contributed by customers. FIN 48 amounts are not. The portion of a tax deduction giving rise to a FIN 48 liability is effectively a loan from the government: but for the tax deduction, the utility (and its ratepayers) would have paid more taxes.

While the immediate effect of the deduction is more cash for the utility, a liability must be recognized to account for the fact that it is "more likely than not" that the deduction will be disallowed and whatever taxes not paid before must be paid now, along with interest (and penalties, if applicable).

There is no equitable principle that justifies providing a benefit to ratepayers for the temporary use of funds that did *not* come from ratepayers and which are likely to be repaid with penalties and interest. When IAWC pays these funds to the government, as it more likely than not will, under the AG and Staff's approach, ratepayers will get to keep the rate base deduction, until the next rate case, but IAWC will not get to keep the underlying funds. Therefore, Staff and the AG's proposals should be rejected.

E. Utility Plant in Service – Forecast Additions

Staff proposed in direct testimony to reduce IAWC's forecasted additions to utility plant-in-service ("UPIS") for the years ending September 30, 2012 and September 30, 2013 to reflect the Company's historical gross capital spending pattern for planned capital expenditures for the years 2009, 2010, and 2011. (Staff Ex. 1.0 (Kahle Dir.), p. 10.) Staff argued that the plant additions are forecasted amounts and are subject to change as the data supporting them is updated going forward. AG witness Mr. Smith adopted this proposal on rebuttal. (AG Ex. 4.0 C (Rev.) (Smith Reb.), pp. 13-16.) At the same time, however, Staff withdrew its proposed adjustment, following IAWC's explanation in rebuttal testimony. Thus, the AG is the only party still pursuing this adjustment.

Mr. Smith summarily concludes that, because the budget-to-actual forecast approach was accepted by IAWC and the Commission in past rate cases, "[t]here is no valid reason for changing that [] method in the current IAWC case." (AG Ex. 4.0 C (Rev.), p. 14, lines 314-15.) He maintains that Staff's adjustment made in IAWC's last rate case should be used in the current case despite the fact that Staff has withdrawn this proposed adjustment. Mr. Smith's recommendation should be rejected for the reasons stated below.

Mr. Smith's adjustment was determined by comparing actual to forecast gross capital expenditures, which include developer-funded and other contributed amounts. Yet, IAWC has no control over the timing or amount of developer funded or contributed spending amounts. (IAWC Exs. 3.00R (Rev.) (Kaiser Reb.), pp. 2-4; 5.00R (2d (Rev.)) (Kerckhove Reb.), p. 4.) Developer funding is related to projects completed by real estate developers and other similar interests and contributed to IAWC. These individuals or companies design and construct projects based upon their specific investment goals, the real estate market, and other outside influences such as financing, local zoning and permitting. (IAWC Ex. 3.00R (Rev.), pp. 2-3.) Similarly, IAWC does not control the timing of Illinois Department of Transportation projects, which often result in contributed property. As a result, developer and contributed projects can cause IAWC's actual gross capital expenditures to vary from the budgeted amount. These projects also are included in Customer Advances and Contributions in Aid of Construction ("CIAC") (Sch. B-15) and not included in rate base. (IAWC Exs. 3.00R (Rev.), pp. 3-4; 5.00R (2d (Rev.)), pp. 4-5.) For these reasons, developer-funded and other contributed projects, which are not included in rate base, should not be included in the determination of IAWC's actual-to-budget capital spending ratios.

The appropriate comparison is to IAWC's net capital expenditures, which shows IAWC's actuals exceeding budget over the 2009 - 2011 period. (IAWC Exs. 3.00R (Rev.), p. 2; 5.00R (2d (Rev.)), pp. 4-5.) Since, on a net basis, IAWC's actual capital expenditures exceed budget over the 2009 - 2011 period, there is no basis for an adjustment under Mr. Smith's methodology.

IAWC's test year forecast for UPIS is accurate, and IAWC's full amount of projected UPIS should be reflected in rate base.

F. Unamortized Management Audit Costs

As discussed in Section IV.C infra, IAWC has incurred necessary costs related to the management audit ordered by the Commission, pursuant to Section 8-102 of the Public Utilities Act, in Docket 09-0319 and undertaken in Docket 10-0366. The audit costs represent reasonable, prudent and necessary expenditures to support and facilitate the performance of that audit. Under Section 8-102 of the PUA, they are to be "recovered as an expense through normal ratemaking procedures." 220 ILCS 5/8-102. Accordingly, IAWC proposes to amortize the estimated cost of the audit, $1,114,100, over five years, and to reflect in rates an amortization amount of $222,820, as well as a return on the unamortized balance.

AG witness Mr. Smith proposes to remove the entire unamortized balance of management audit costs from rate base because, in his words, "rate case expense" is not allowed in rate base to earn a return for investors. (AG Ex. 2.0 C (Rev.) (Smith Dir.), p. 67, line 1578.) His adjustment results in a $353,000 reduction. (Id.) It appears Mr. Smith's recommendation stems from his mistaken belief that IAWC's Section 8-102 management audit costs are "rate case expense," the unamortized balance of which is not included in rate base. The costs associated with the Section 8-102 management audit are not rate case expense; they are separate and distinct from the rate case and would be incurred whether or not IAWC filed a rate case (and, in fact, were incurred for an entirely separate docket). (IAWC Exs. 7.00R (Bernsen Reb.), p. 8; 7.00SR (Bernsen Sur.), p. 15.) Thus, they do not constitute rate case expense. Rather, as recognized by Staff witness Mike Ostrander (ICC Staff Ex. 11.0, pp. 9-10), they are Commission-mandated costs recoverable under Section 8-102 of the Act. The Commission has routinely permitted inclusion of the unamortized balance of management audit costs in rate base.

See Central Ill. Pub. Svc. Co., Docket 90-0072, 1990 Ill. PUC LEXIS 625, at *36 (Nov. 28, 1990); Central Ill. Light Co., Docket 90-0127, 1991 Ill. PUC LEXIS 17, at **36-37 (Jan. 16, 1991). As Staff noted, unamortized management audit costs were included in rate base in the following dockets: Docket 87-0695 (Illinois Power Company); Docket 90-0072 (Central Illinois Public Service Company); and Docket 90-0127 (Central Illinois Light Company). (ICC Staff Ex. 11.0, p. 10.). In Docket 90-0072 the Commission found:

> While Section 8-102 of the Act does specifically state whether or not these carrying costs shall be recovered through rates, the Commission believes that to deny the Company an opportunity to recover such costs over a five year amortization period would unduly dilute the effects of the statutory directive that management audit expenditures be recovered through rates. The Commission concludes that CIPS' proposal to include unamortized management audit costs in rate base should be allowed in order to provide the Company with an opportunity to recover the capital costs associated therewith.

Central Ill. Pub. Svc. Co., Docket 90-0072, 1990 Ill. PUC LEXIS 625, at **39-40. Thus, because the audit costs are statutorily mandated costs, it is appropriate to include the unamortized balance in rate base to allow shareholders to earn a return on those amounts. Mr. Smith's adjustment should be rejected.

G. Proposed Rate Base

1. Original Cost Determination

Staff recommends, and IAWC does not oppose, "that the Commission conclude and make a finding in the Order in this proceeding that the Company's June 30, 2011 plant balance of $1,304,723,156 is approved for the purpose of an original cost determination subject to any adjustments ordered by the Commission in this proceeding." (ICC Staff Ex. 9.0 (Kahle Reb.), p. 5, lines 106-10; IAWC Ex. 6.00SR (Rungren Sur.), pp. 1-2.)

2. Proposed Rate Base

The Company's recommended Total Company rate base is $717,190,629, as shown on IAWC Initial Brief Appendix A. The rate bases for each Rate Area are shown on the designated pages of IAWC Initial Brief Appendix A.

V. OPERATING REVENUES AND EXPENSES

A. Forecast Sales Volumes – Declining Customer Usage

Usage by IAWC's residential customers has declined by 2.89 gallons per customer per day, or by approximately 1.90% per year for the last eight years. (IAWC Ex. 8.00 (Naumick Dir.), pp. 3-4.) Usage by IAWC's commercial customers has similarly declined by 8.59 gallons per customer per day, or by approximately 1.08% per year for the same period. (Id., p. 4.) As such, IAWC necessarily adjusted its projected test year level of present rate revenues to reflect that significant and continuing trend of declining residential and commercial customer water usage.

Specifically, the Company used a declining residential and commercial customer usage model to forecast test year sales for those customer classes. (IAWC Ex. 5.00 (Rev.) (Kerckhove Dir.), p. 9.) Company witness Rich Kerckhove explained in detail how the model functioned. (Id., pp. 9-10; IAWC Ex. 5.00SUPP (Kerckhove Supp. Dir.), pp. 13-14.) IAWC's approach consisted of a two-step process. First, the Company segregated out and examined that portion of annual usage not impacted by weather, or "base" usage. (IAWC Ex. 5.00 (Rev.), p. 9.) It accomplished this by examining usage per customer per day data for the non-summer months of January through April of each year 2003-2011 to develop a trend line. (IAWC Ex. 5.00SUPP, p. 13.) Using the resulting regression equation, the Company determined the linear "base" usage per customer per day for each month January 2003 through December 2010, and continued that trend through December 2013. (Id., pp. 13-14.) Next, IAWC determined customer usage that is impacted by weather and layered that usage atop the "base" usage. (Id., p 14; IAWC Ex. 5.00 (Rev.), p. 10.) It accomplished this by first subtracting the trend line amounts calculated in step one from the actual usage per customer per day for the years 2003 through 2011. (IAWC Ex. 5.00SUPP, p. 14.) IAWC then averaged the remaining summer, weather-related usage for those periods and added that average back to the respective "base" amount for 2011 through 2013. (Id.; IAWC Ex. 5.00 (Rev.), p. 10.) The results of IAWC's analysis demonstrate a continuing annual usage decline across all of IAWC's service territories. (IAWC Ex. 8.00, p. 3.)

Company witness Gary A. Naumick, who has extensive experience related to national water consumption trends (IAWC Ex. 8.00, pp. 2-3), testified the declining usage trend is not surprising. As he explained, the increasing prevalence of high efficiency or "low flow" plumbing fixtures and more efficient appliances such as dishwashers and washing machines contributes to the decline in water consumption. (Id., p. 4.) When a customer replaces such a fixture or appliance the new model will use less water than the one replaced. And, new homes will have more efficient water fixtures and appliances. (Id.) Recent federal regulations have *mandated* the manufacture of water efficient toilets, showerheads and faucets and water-using appliances. (Id., pp. 4-6; IAWC Ex. 8.01.) Federal regulation in this area will further increase the prevalence of water efficient household appliances and thus continue to drive down residential water consumption. (Id., p. 5.) Overall, with all other factors being equal, a typical residential household in a home with new fixtures and appliances would use *35% less water* for indoor purposes than a non-retrofitted home built prior to 1994. (Id.) Further, according to the U.S. Census Bureau's 2005-2009 American Community Survey, over 80% of existing homes in Illinois were built prior to 1990. (Id., p. 9.) Those homes would have been constructed with more water-intensive plumbing fixtures and appliances than are now available. (Id.) As such, it is clear that water efficient fixtures will continue to drive down usage. (Id.)

In addition to the increasing prevalence of water efficient plumbing fixtures and appliances, increasing customer conservation ethic and utility conservation measures also attribute to the declining usage trend experienced by IAWC. (IAWC Ex. 8.00, p. 4.) This is because, as awareness of water and energy efficiency increases, customers may replace plumbing fixtures and appliances with more efficient models before the older models require replacement, and may further reduce their water consumption by changing their water use habits. (Id., p. 6.) Indeed, the 2.89 gallon per customer per day decline IAWC has experienced with respect to residential customer usage can be achieved by subtle changes in customer behavior such as running the dishwasher 5 times per week rather than 7. (Id.) For IAWC's part, the Company has taken numerous steps to promote consumer conservation activities, including providing customers with educational literature and initiating workshops, community events, conferences and speaking engagements related to conservation. (Id., p. 10.) These conservation initiatives and the resulting awareness also attribute to the declining usage experienced by IAWC. (Id., p. 4.)

IAWC's declining usage experience is not unique to the Company. Mr. Naumick has studied water usage trends for other American Water subsidiaries and, for those states with climates similar to that of Illinois, has found the operating companies in those states are also experiencing declining usage. (IAWC Ex. 8.00, pp. 6-8.) In fact, in the 12 such states Mr. Naumick studied, *all* have experienced declining usage ranging from 1.09% to 2.47% per year. (Id.; IAWC Ex. 8.02.) Thus, IAWC's own experience falls in the middle of that range. Moreover, Mr. Naumick also has found the declining usage trend is *industry-wide*, relying on industry literature finding "'[a] pervasive decline in household consumption has been determined *at the national and regional levels*'" (Id., pp. 8-9 (quoting Coomes, Paul, et al., "North America Water Usage Trends Since 1992." (Water Research Foundation, 2010)) (emphasis added)), and describing the decline experienced as the "new normal" (IAWC Exs. 8.00R (Rev.) (Naumick Reb.), p. 15; 8.02R, p. 2 (American Water Works Assoc., "Declining Demand Likely to Continue Beyond Recession." *Streamlines* (Aug. 23, 2011))). Based on this, IAWC expects the declining usage trend to not only continue, but also *accelerate* as a result of the increased prevalence of water efficient fixtures and conservation initiatives. (IAWC Ex. 8.00, pp. 9-10.)

While IAWC acknowledges there are environmental and operational benefits from lower water usage by residential and commercial customers, currently, there is an economic *disincentive* to the Company to sell less water in its service territories. (Id., p. 10.) Nevertheless, IAWC is fully committed to preserving natural resources and to encouraging the benefits of conservation, while continuing to provide safe, adequate and reliable utility service in accordance with its regulatory obligations. (Id.) The Commission's recognition in this case of the decline in water usage IAWC is experiencing will support this goal. (Id., pp. 11-12.) IAWC's test year projection of present rate revenues reflects all of these factors. Therefore, it should be approved.

AG witness Scott J. Rubin acknowledges "there may be a declining long-term trend in consumption." (AG Ex. 1.0 (Rubin Dir.), p. 8.) And, he concedes advancements in water-using technologies, water conservation programs and reductions in household occupancy rates may reduce water usage levels. (IAWC Ex. 8.01R, pp. 5-7 (IAWC-AG 2.08, 2.09 and 2.10).) Nevertheless, he attacks the methodology underlying IAWC's declining usage analysis for a host of reasons. But, for all of Mr. Rubin's rhetoric, it is apparent he fails to see the forest for the trees. That is, despite his nit-picking IAWC's analysis, one thing remains clear: IAWC is experiencing significant and continual declining customer usage. Criticizing that IAWC's analysis could have been more robust, as Mr. Rubin does, does not make the trend any less apparent. Indeed, Mr. Rubin's *own* regression analysis suggests such a trend exists. (AG Ex. 1.01 (the customer usage regressions plotted by Mr. Rubin plainly shows a strong downward trend).) Moreover, for his part, Mr. Rubin did not prepare a consumption forecast in this case. (IAWC Ex. 8.01R, pp. 1-3 (IAWC-AG 2.01, 2.01, 2.03).) Instead, he proposes using IAWC's 2011-2012 usage forecast simply because that forecast to him "appeared to be a less extreme result" than IAWC's test year forecast. (Id., p. 1 (IAWC-AG 2.01); AG Ex. 1.0, pp. 3-4.) This is not, however, a basis to discard IAWC's comprehensive projection model. Finally, Mr. Rubin contends IAWC has not provided sufficient reasons to assume residential consumption will continue to decline. That contention simply is not credible, given the record evidence that an undeniable trend is affecting the *entire water industry* and will continue to do so. In sum, to ignore the declining usage trend IAWC continues to experience would be inappropriate and result in an improper and invalid consumption forecast.

B. Current Rate Case Expense

IAWC estimates that the total cost to prepare and present the instant rate case is $2,716,921. (Sch. C-10 First Revised, p. 1.) That total level of expense encompasses the projected cost of four studies prepared in connection with the rate case filing—a Cost of Service Study, a Direct Demand Study, a Depreciation Study and a Lead/Lag Study—as well as the cost of an independent audit of the Company's test year projections, the fees and expenses of outside counsel and technical experts retained to prepare, litigate and support IAWC's request for an increase in rates, and additional, incremental expenses incurred by IAWC which the Company would not otherwise incur but for the filing of the proceeding at hand. (IAWC Ex. 7.00 (Bernsen Dir.), p. 11.)

In response to the Commission's directive to the Company in IAWC's last rate case to fully document its efforts to control rate case expense, Order, Docket 09-0319 (Apr. 13, 2010), p. 80, and to assist the Commission and its Staff in determining the justness and reasonableness of certain components of IAWC's rate case expense pursuant to the mandate of Section 9-229 of the Public Utilities Act, 220 ILCS 5/9-229, IAWC submitted extensive testimony and documentation in this proceeding supporting its projected level of the current rate case expense. (IAWC Exs. 1.00 (Rev.) (Teasley Dir.), pp. 18-19; 7.00 (Bernsen Dir.), pp. 11-18; 7.00SUPP (Bernsen Supp. Dir.), pp. 3-5; 7.00R (Bernsen Reb.), pp. 2-4; 7.00SR (Bernsen Sur.), pp. 2-11; 7.03SR.)

IAWC's testimony discusses at length IAWC's continual efforts to control rate case expense, evinced by its repeated use of fixed fee or "not-to-exceed" arrangements with outside counsel and external consultants and by its negotiating a 29% reduction in external legal fees relative to IAWC's last rate case, among other efforts. (IAWC Exs. 7.00, pp. 11, 13-14; 1.00, pp. 18-19.) Moreover, although the Company performed two studies in connection with this case which it did not prepare in connection with its last rate case (the Direct Demand Study and the Depreciation Study), IAWC's overall current rate case expense reflects an increase of *only 3%* above the actual level of expense incurred in the last case. (IAWC Ex. 7.00SUPP, pp. 3, 5.) IAWC submits these measures and outcomes make clear the Company's continual cost control efforts when it comes to rate case expense.

In addition to the substantial testimony addressed above, the Company also provided Commission Staff with over 700 pages of requests for proposals ("RFPs"), RFP responses, engagement letters, contracts, invoices and other documentation supporting the rate case expense actually incurred by the Company throughout the course of this proceeding, as well as that expected to be incurred through the final stages of it. (IAWC Ex. 7.03SR.) The Commission should find IAWC's total level of rate case expense of $2,716,921 just and reasonable, and it should specifically and expressly find just and reasonable the amounts expended by IAWC to compensate attorneys and technical experts to prepare and litigate this general rate case filing encompassed in that total level of expense, per Section 9-229.

Staff essentially agrees. With one substantive exception, Staff recommends the Commission approve IAWC's requested level of rate case expense and find the amounts of compensation for attorneys and technical experts to be just and reasonable pursuant to Section 9-229.[8] (ICC Staff Ex. 16.0 Supp. (Rev.) (Ostrander Supp. Reb.), pp. 5-6.) The difference between the Company's projected level of rate case expense and Staff's recommended allowed level of the expense relates to $280,000 of the expense, representing the costs of consultants engaged by IAWC to assist with the filing. Specifically, Staff recommends the Commission (1) disallow the cost of IAWC's regulatory consultant, SFIO Consulting, Inc. ("SFIO"); (2) reduce the recoverable hourly rate of the Company's expert tax witness, James I. Warren; and (3) disallow any recovery for consultants not yet engaged as of the date of the Company's rebuttal filing. (ICC Staff Exs. 11.0 (Ostrander Reb.), p. 3; 16.0 Supplemental (Rev.), pp. 3-4; IAWC Cross Ex. 5 (IAWC-ICC 8.03).) The AG also proposes certain adjustments. As explained below, they should be rejected.

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[8] Staff's recommendations related to IAWC's rate case expense are not reflected on Staff's schedules related to the revenue effect of Staff's adjustments. Compare ICC Staff Sch. 9.5(C) with ICC Staff Ex. 16.0 Supp. (Rev.), Sch. 16.1 Update (Conf.) and IAWC Cross Ex. 3 (IAWC-ICC 8.01 (attaching ICC Staff Ex. 11.0, Sch. 11.3 Revised)) and IAWC Cross Ex. 4 (IAWC-ICC 8.02 (attaching ICC Staff Ex. 11.0, Sch. 11.2 Corrected)).)

SFIO's Fee Is Just, Reasonable and Recoverable.

Staff does not contend SFIO's fee is unreasonably high (it is not). Rather, Staff recommends disallowance of the fee because it contends SFIO's services are duplicative of that of IAWC management and outside counsel. Staff questions what value SFIO's services add to the rate case process. (ICC Staff Ex. 3.0 (Ostrander Dir.), p. 3.) The AG recommends disallowance of SFIO's fee for the same reason. (AG Exs. 2.0 C (Rev.), p. 77; 4.0 C (Smith Reb.), p. 35.) Both Staff and the AG's contentions are incorrect. SFIO provides valuable insight into IAWC's case preparation and prosecution. Its principal consultant has over 30 years of regulatory experience in Illinois, which experience complements that of IAWC management and outside counsel by bringing additional perspectives to the analysis of rate case issues. (IAWC Ex. 7.00R, pp. 2-3.) Moreover, SFIO provides *different* services—based on SFIO's education and extensive utility experience—than the attorneys and other technical experts utilized by IAWC in this case. Specifically, SFIO provides strategic advice from a global perspective and acts as a "sounding board" for the Company and other experts. SFIO is closely attuned to policy issues because of its day-to-day involvement in, and monitoring of, all major proceedings at the ICC. (IAWC Ex. 7.00SR, p. 2.) Further, SFIO prepares summaries and analyses of issues as they arise in the case, and provides alternatives and strategies for addressing those issues. SFIO reviews and comments on select testimony and data request responses as directed by the Company. (Id.) Although the Company's other experts also perform some of these tasks, each may do so for a different reason, and to offer a different perspective depending on each consultant's area of expertise. (Id.) In sum, the services SFIO performs are necessary for the Company to successfully prepare and litigate its case. (Id., p. 3.)

Notably, despite recommending disallowance of SFIO's fee on the ground that consultant's services add questionable value to this proceeding, Staff undertook tasks similar to the services provided to IAWC by SFIO to assist it in litigating this case. Staff witness Mike Ostrander testified at the hearing that, as part of the Commission's Staff, he stays abreast of Commission decisions in rate cases other than those to which he is assigned, as that helps him better perform his job. (Tr. 596-97.) He agreed it is helpful for regulated utilities to do the same. (Tr. 598.)

Staff also recommends disallowance of SFIO's fee based on its contention "no tangible evidence" of SFIO's insights and perspectives has been provided. (ICC Staff Ex. 11.0, p. 3.) The AG likewise asserts that "no witnesses or work product have been filed by SFIO." (AG Ex. 4.0 C (Rev.), p. 34.) This contention is misplaced for myriad reasons. First, "tangible" evidence of SFIO's value *has* been provided. IAWC produced both its contract with SFIO as well as SFIO's invoices through the time of the evidentiary hearing which clearly indicate the services that consultant provides. (IAWC Exs. 7.03SR, pp. 321-22, 442-50, 516, 518, 580, 582-84, 728; 7.00SR, p. 4.) Certainly, those documents are "tangible evidence."

Next, in demanding such "tangible evidence," Staff and the AG are adding a requirement to the Public Utilities Act where one does not exist. Neither the plain language of Section 9-229 (specifically related to rate case expense) nor any other authority deems only "tangible evidence" sufficient to support the reasonableness of rate case expense. Staff and the AG have cited no authority that does. As such, their contention is legally baseless.

Moreover, despite contending that some "tangible" "work product" must be filed by a consultant as evidence of their worth, both Staff and the AG admit that individuals who review testimony and provide input, but who nevertheless do not themselves file testimony can provide value. At the evidentiary hearing, Mr. Ostrander agreed that individuals who review testimony but do not file it, such as his supervisor and legal counsel, nevertheless provide value. (Tr. 603-

04.) Similarly, Mr. Smith agreed that both he and his client (ultimately, Illinois' tax payers) receive a benefit from review of testimony by individuals in his office who do not themselves file testimony. (Tr. 690-92.) That Staff and the AG deem the filing of testimony or other "tangible" "work product" a condition precedent to recovery of a consultant's fee represents a double standard. IAWC is entitled to the review of its testimony those parties find valuable in preparing theirs. Thus, SFIO's fee is just, reasonable and should be recoverable.

Staff's Adjustment to Mr. Warren's Hourly Rate Is Not Appropriate.

AG witness Mr. Smith submitted testimony in this proceeding recommending a host of tax-related adjustments based on adjustments allegedly made in other jurisdictions, (see generally AG Exs. 2.0 C (Rev.), pp. 58-67, 83-96; 4.0 C (Rev.), pp. 26-32, 37-48), and propounded numerous related data requests on the Company. In response, IAWC engaged the services of Mr. Warren, a highly credentialed attorney and CPA and who specializes in tax issues related to regulated public utilities and who has been providing tax services primarily to utility industry clients for over 30 years, including to other American Water operating companies. (IAWC Ex. 13.00R (Warren Reb.), pp. 1-3; Tr. 779.) Staff recommends disallowance of a portion of Mr. Warren's total estimated expense because it takes issue with Mr. Warren's hourly rate. (ICC Staff Ex. 16.0 Supp. (Rev.), pp. 3-4.) Specifically, Staff recommends imputing for Mr. Warren the rate of the CPA engaged by IAWC to review its test year forecasts in this case (because, Staff alleges, any CPA has knowledge of FIN 48 issues). (Id., p. 4.) Such an adjustment is inappropriate. The plain language of Section 9-229 does not direct the Commission (or its Staff) to determine the just and reasonable *hourly rate* of an attorney or technical expert. Rather, it requires the Commission to evaluate "amount[s] expended," 220 ILCS 5/9-229, not hourly rates. Notably, the Commission regulates *utilities*, not attorneys or experts. The total level of expense related to Mr. Warren's services is unquestionably reasonable given the size and complexity of the adjustments proposed by Mr. Smith—potentially totaling several million dollars. (IAWC Ex. 7.03SR, pp. 700-701 (JMO-10.02).) Thus, the total amount expended to compensate Mr. Warren is not only just and reasonable, but, in IAWC's judgment, represents tremendous value to both the Company and ratepayers. (IAWC Ex. 7.03SR, pp. 700-01 (JMO-10.02).) Staff's adjustment to Mr. Warren's hourly rate is contrary to the law and should be rejected.

Staff's adjustment also is baseless. It ignores the services provided IAWC by Mr. Warren in this case are not comparable to those provided by the referenced CPA. For example, it ignores that Mr. Warren is an attorney. It also ignores his education, expertise and years of experience. Mr. Ostrander admitted at the hearing that professionals with different levels of experience or expertise warrant different hourly rates. (Tr. 594.) It ignores that Mr. Warren was retained to address more than solely FIN 48 issues, another point to which Mr. Ostrander conceded at the hearing. (Tr. 609.) Moreover, it ignores the CPA hired to audit IAWC's forecast may in fact charge more to address complex tax issues. Most importantly, it ignores the question of efficiency: whether Mr. Warren's education and experience enable him to address complex tax issues with precision and in less time than the CPA, such that the "amount expended" by IAWC for his services may be more reasonable than an amount expended for someone with a lower rate who requires more time to address the issues. Indeed, Mr. Ostrander does not contend all CPAs can answer a complex question regarding FIN 48 in the same amount of time, correctly, or with the same level of detail, regardless of level of skill, education or years in practice. (IAWC Ex. 7.00SR, p. 9 (citing IAWC- ICC 7.16).) And he agrees hourly rate is not the only factor to consider in determining the total level of an expense. (Tr. 608.) Yet, that is the *only* factor he apparently evaluated in recommending partial disallowance of the cost IAWC has incurred for Mr. Warren's services.

Finally, although IAWC does not concede it is appropriate, or lawful under Section 9-229, for the Commission's Staff to engage in an evaluation of attorney and expert *hourly rates*, Mr. Warren's hourly rate is nonetheless reasonable. Mr. Warren has provided his services to IAWC at a discounted rate, yet his undiscounted rate is at or below the rate of other senior lawyers in his practice area. (IAWC Ex. 7.03SR, pp. 700-01 (JMO-10.02).) Moreover, he has a rare combination of relevant skill sets and, due to his training, education and experience, he is able to provide necessary services more efficiently (i.e., in less time) than other consultants who lack his skill set. (Id.) Mr. Warren's testimony at the evidentiary hearing made this fact plain. In response to a line of questioning by counsel for the AG, Mr. Warren was able to immediately recite—without the aid of anything other than his own memory—not only the complicated approach to consolidated tax savings applied by *six* separate states, but also the legal basis therefore, i.e. whether utility commission discretion, judicial decree, etc. (Tr. 790-98.) In short, the record makes clear his hourly fee is wholly justified.

The Commission should not allow its Staff and the parties to engage in the hourly rate evaluation Staff undertook in this case with respect to Mr. Warren's fee; Section 9-229 does not contemplate such an analysis. Staff's unwarranted and baseless recommendation related to Mr. Warren's cost should be rejected.

The Cost of Post-Rebuttal Consultants Is Just, Reasonable and Necessary.

While Staff presents no direct testimony in this regard, it appears to have limited the Company's recovery of consultant-related rate case expense to the cost of those consultants engaged at the time of the Company's rebuttal filing. (See ICC Staff Ex. 16.0 Supp. (Rev.), Sch. 16.1 Update (Conf.).) That is improper. IAWC explained that its projected level of rate case expense for consultants anticipated the engagement of consultants necessitated in light of issues raised by Staff or the intervening parties during the latter stages of the proceeding, based on the pendency of the case and IAWC's experience in prior rate cases. (IAWC Exs. 7.00SR, p. 10; 7.03SR, p. 703 (JMO-IAWC 10.04).) Indeed, throughout the course of this proceeding, AG witness Mr. Smith repeatedly inexplicably reserved the "right" to continue to "explore" various issues at the evidentiary hearing (and, indeed through briefing), despite the case schedule agreed to by the parties (including the AG) and approved by the ALJ. (See, e.g., AG Exs. 2.0 C (Rev.), p. 9, n.4 (various rate base adjustments), p. 71 (rate case expense), pp. 96-97 (Service Company fees); 4.0 C (Rev.), p. 3 (cost of capital), p. 34 (rate case expense), pp. 36-37 (Service Company fees).) In fact, at the eleventh hour, Staff and the AG sought and were granted the opportunity to introduce as evidence in this proceeding the Audit Report prepared by NorthStar Consulting Group in pending Docket No. 10-0366. (See Notice of ALJ Ruling (May 15, 2012).) Utilization of the Audit Report could require IAWC's engagement of a consultant to respond to the Audit. (IAWC Ex. 7.00SR, p. 10.) Thus, the Company must project a level of rate case expense which anticipates the cost of late-engaged experts. Recovery of such expense should not be denied.

Incremental Service Company Labor Is a Recoverable Component of Rate Case Expense.

As discussed, IAWC's total projected level of rate case expense for this case includes the incremental cost of Service Company and temporary personnel to prepare and litigate the rate case, including preparation of the revenue requirement, testimony, discovery responses, necessary analyses during the course of the proceeding and the final tariffs, as well as participation at the evidentiary hearing. (IAWC Ex. 7.00, p. 14; IAWC Sch. C-10 First Revised ("Revenue Requirement").) These costs are the costs for services which are incremental to normal job duties; they are costs the Company otherwise would not incur but for the filing of a rate case. (IAWC Ex. 7.00R, p. 9.) Moreover, they are direct charged to IAWC and are charges above what would be included in annual Service Company fees. (Id.) An example would the cost of the time expended on this case by Company witness Karen Cooper, a Service Company employee who serves as Manager, Business Services for the Service Company's Customer Service Center ("CSC"). (IAWC Ex. 15.00R (Cooper Reb.), p. 1.) Ms. Cooper's job responsibilities do not include assisting in the preparation and litigation of IAWC's rate cases. (Id.) Nevertheless, Ms. Cooper's participation as a witness in this case was necessitated by certain allegations raised by Staff related to the CSC.

Despite this, AG witness Ralph Smith contends this component of IAWC's rate case expense should be disallowed because "work on rate cases by IAWC and affiliated Service Company personnel is a normal job function . . ." and thus would result in a double counting of test year labor costs. (AG Exs. 2.0 C (Rev.), p. 77; 4.0C, p. 34.) Mr. Smith's recommendation reflects his ignorance of or disregard for the record facts discussed above. It should be rejected.

Amortization of Rate Case Expense Accords with Common Practice and Is Appropriate.

IAWC proposes to amortize rate case costs typically incurred in each rate case filed by the Company (such as legal fees) over 2.5 years, as that is the amount of time the proposed rates are expected to be in effect. (IAWC Ex. 7.00, pp. 11-12.) The Company proposes to amortize the cost of certain studies (such as the Depreciation Study) over 5 years, as those studies are not expected to be presented in the Company's next rate filing. (Id., p. 12.)

In addition, IAWC included with its test year level of rate case expense the unamortized balance of rate case expense from its prior case, re-amortized over the appropriate period. (Id.) AG witness Mr. Smith concedes this practice has been sanctioned by the Commission: "the Commission has found in prior cases that approved rate case cost can be capitalized and amortized, [thus] unamortized amounts remaining from prior rate cases can be re-amortized in subsequent rate cases." (AG Ex. 2.0 C (Rev.), pp. 71-72, lines. 1651-53.) Nevertheless, he takes issue with this amortization approach, and recommends prospectively what he dubs a "normalized" treatment of rate case expense. (Id., pp. 72- 76; AG Ex. 2.2, Sch. C-3.)

Mr. Smith's recommendation is inconsistent with Commission precedent and Illinois law. The Illinois Appellate court recently upheld the Commission's longstanding practice of including the unamortized balance of prior rate case expense in the current rate case expense amount. People ex rel. Madigan v. Ill. Commerce Comm'n, 964 N.E.2d 510, 520, 522, 523-24 (1st Dist. Dec. 9, 2011). See also Illinois-American Water Co., Order, Docket 09-0319 (Apr. 13, 2010), pp. 71-72. As such, under this clear authority, the Company is entitled to recover in the current rate case the unamortized rate case expense from its prior rate case. Mr. Smith's recommended "normalized" treatment of rate case expense should be rejected.

C. Management Audit Costs

Pursuant to Section 8-102 of the Public Utilities Act, 220 ILCS 5/8-102, the Commission in Docket 09-0319, Amendatory Order (May 5, 2010), pp. 1-2, ordered a management audit ("Audit") of the fees charged to IAWC by its affiliated Service Company. The Commission opened Docket 10-0366 relating to the same. An independent auditor, NorthStar Consulting Group ("NorthStar"), was selected by the Commission to perform the Audit. In the course of the Audit, NorthStar conducted over 65 interviews of IAWC and Service Company employees in Belleville, Illinois, Alton, Illinois and Woodcrest, New Jersey and issued over 400 data requests. (IAWC Ex. 4.00 (Grubb Dir.), p. 14.) IAWC provided nearly 11,000 pages of information and documents to NorthStar in response. (Id.) NorthStar caused the Audit Report to be filed on January 11, 2012 (see Notice of Admin. Law Judges Ruling of May 15, 2012, p. 1), and IAWC filed a Response on February 10, 2012.

IAWC has incurred the cost of the fees charged by NorthStar. (IAWC Ex. 4.00, p. 15.) This amount, as set forth in the contract between NorthStar and the Commission, is $392,100. In addition to that cost, IAWC also has incurred other incremental costs for the Audit including:

(1) charges for the services of outside counsel retained to represent IAWC in the Audit process and Docket 10-0366 (estimated at $250,000) (id.);

(2) charges for the services of an outside audit support consultant retained to assist IAWC in responding to the Audit and to serve as a liaison between IAWC and NorthStar, in order to facilitate the timely completion of the audit process in the six month required timeframe. The audit support consultant monitored and tracked the audit process, provided support to IAWC personnel in preparing for the Audit, responding to NorthStar's requests for information, and responding to the Audit Report, and provided other support as required (estimated at $211,000) (id.; AG Cross Ex. 8, p. 2); and

(3) incremental charges for internal services (including Service Company services) specific to the management audit, such as charges for time to prepare for and participate in interviews and respond to data requests, costs to provide workspace for NorthStar and data room management, and other administrative charges related to providing NorthStar the information it requested throughout the course of the Audit and in reviewing and responding to the final Audit Report prepared by NorthStar (estimated at $261,000) (IAWC Ex. 4.00, p. 15).

The total estimated cost of the Audit is $1,114,100. (Id.) IAWC is proposing to amortize that total cost over five years, and to reflect in rates an amortization amount of $222,820, as well as a return on the unamortized balance.

The Audit costs are incremental costs of, and are incurred solely as a result of, the Audit. They represent reasonable, prudent and necessary expenditures to support and facilitate the performance of the Audit. Staff agrees that the full amount of the proposed Audit costs are recoverable. (ICC Staff Ex. 11.0 (Ostrander Reb.), p. 11; IAWC Cross Ex. 4 (IAWC-ICC 8.02).) No party disputes that IAWC may properly recover NorthStar's fee amount of $392,000. The AG, however, proposes that the Audit costs other than NorthStar's fee be disallowed.

Recovery of the costs of a management audit ordered under Section 8-102 of the Act are clearly authorized by that Section, which states, "The cost of an independent audit shall be borne initially by the utility, but shall be recovered as an expense through normal ratemaking procedures." 220 ILCS 5/8-102. Thus, the Act itself expressly provides for recovery of "the cost of an independent audit." Consistent with this language, the Commission's Amendatory Order in Docket 09-0319 and its Initiating Order in Docket 10-0366 require IAWC to initially bear the "cost of the Audit" and to recover the same through normal ratemaking procedures. See Amendatory Order, Docket 09-0319 (May 5, 2010), p. 1 ("The cost of the management audit shall be initially borne by Illinois-American and recovered through normal ratemaking procedures."); Initiating Order, Docket 10-0366 (June 10, 2010), p. 2 ("The cost of the Audit shall be initially borne by IAWC and recovered through normal ratemaking procedures.").

Under the plain language of Section 8-102 and the Docket 09-0319 and 10-0366 Orders, the full amount of IAWC's cost incurred related to the Audit, including NorthStar's fee and legal, consulting and incremental Service Company costs, should be recovered in rates. This is confirmed by a number of past orders of the Commission authorizing utility recovery of reasonable and prudently incurred audit-related costs.

In Docket 90-0007, the utility sought recovery of costs related to a Section 8-102 management audit. See Peoples Gas Light & Coke Co., Order, Docket No. 90-0007, 1990 Ill.

PUC LEXIS 593, *52 (Nov. 9, 1990). The Commission found the utility entitled to recover all incremental costs of the audit:

> The Commission intends to follow the dictates of Section 8-102 of the Public Utilities Act. The Commission concludes that it must allow Respondent to recover the incremental costs incurred by it in connection with the management audit through normal ratemaking procedures. It is consistent with the purpose of Section 8-102 for the Commission to adopt an interpretation which allows utilities the full recovery of audit costs which are initially incurred by the utility.

Id.

In Docket 90-0072, the utility sought recovery for charges for the services of an outside consultant to support it in the Section 8-102 management audit process, as well as printing charges incurred to duplicate the independent auditor's report for use by utility personnel. Central Ill. Pub. Svc. Co., Order, Docket No. 90-0072, 1990 Ill. PUC LEXIS 625, *36 (Nov. 28, 1990). The Commission agreed the costs were recoverable:

> In the instant case, CIPS' contention that the consulting and printing costs were prudently incurred as a necessary part of the audit process is not disputed. Though initially incurred prior to the test year, a ratable portion of these prudent and necessary one-time audit costs, like those assessed by the independent auditor, should be recovered…

Id. at **37-38.

In Docket 90-0127, the utility proposed recovery of Section 8-102 audit costs, including rent incurred to provide working space for the independent auditor and Commission Staff, and costs associated with refurbishing that space. Central Ill. Light Co., Docket No. 90-0127, Order, 1991 Ill. PUC LEXIS 17, **36-38 (Jan. 16, 1991). Further, the utility sought recovery of fees for "outside counsel to review the management audit agreement between CILCO, Touche Ross and the Commission, and to provide advice and assistance to the Company in responding to particular issues that arose during the audit." Id. at *39. The Commission approved recovery. Id. at **39-40.

In Docket 90-0128, Commission again allowed recovery of legal fees for outside counsel associated with a Section 8-102 management audit. Contel of Ill., Inc., Order, Docket No. 90-0128, 1991 Ill. PUC LEXIS 18, **80-81 (Jan. 16, 1991). The Commission found "legal expenses are part of the Company's management audit costs." Id. at *81.

In Docket 91-0010, the utility sought recovery of approximately $322,000 in incremental costs associated with implementation of an independent auditor's recommendations made pursuant to Section 8-102 of the Act. See North Shore Gas Co., Order, Docket No. 91-0010, 1991 Ill. PUC LEXIS 636, **27-29 (Nov. 8, 1991). The Commission, relying on Section 8-102, found:

> the Public Utilities Act does not explicitly or implicitly limit recovery of audit costs to fees paid to the management auditor. Consistent with that interpretation, *the Commission has consistently allowed recovery of costs other than auditor fees, including audit implementation costs*. Therefore, the Commission will allow Respondent to recover all incremental costs of the audit.

Id. at **28-29 (emphasis added). Thus, the plain language of Section 8-102 and numerous Commission orders require that IAWC's full amount of Audit costs, which are necessary and prudent costs of the Audit, be recovered.

D. Adjustment Related to Customer Service Center Alton, IL Facility

Staff witness Mr. David Sackett proposes a reduction to test year depreciation expense by $44,120, related to a 2007 expansion of the Alton facility that the Service Company incurred $2.8 million in capitalized costs related to the expansion. He claims that the $44,120 is IAWC's allocated test year portion of the depreciation related to the $2.8 million. He therefore concludes, "[s]ince IAWC has not provided any proof that the costs included in this amount do not include AWR costs . . . the full amount of this cost should be excluded in this case." (ICC Staff Ex. 16.0 (Sackett Reb.), p. 34, lines 744-46.) As IAWC witnesses Mr. Rich Kerckhove and Ms. Karen Cooper both explained, AWR paid increased rent after the second expansion and only a small portion of the total expansion was related to AWR's facilities. (IAWC Exs. 5.00SR (Kerckhove Sur.), p. 6; 15.00SR (Cooper Sur.) p. 8.) In other words, AWR does not occupy the entire space associated with the expansion, so the disallowance is overstated. (IAWC Ex. 15.00SR, p. 8.) Therefore, the adjustment is not appropriate.

Further, Mr. Sackett arrived at his adjustment of $44,120 based on an error contained in a Company data request response, which provides a depreciation expense amount of $44,120 in the test year for the 2007 expansion. (IAWC Ex. 5.00SR, p. 7.) However, only $10,268 of depreciation expense is included in the budget and, consequently, in the rate case test year. (Id.) The difference results from $2,079,772 of capitalized costs that are fully depreciated in 2012. A corrected response was provided to Staff. (Id.) Accordingly, Mr. Sackett's proposed adjustment is not appropriate.

E. Proposed Operating Income and Revenue Requirement

On a Total Company basis, additional annual revenue of $34,356,329 is needed to afford IAWC the opportunity to earn a reasonable rate of return, as shown on IAWC Initial Brief Appendix A. The operating income statement for each Rate Area is shown on the designated pages of IAWC Initial Brief Appendix A.

VI. COST OF CAPITAL AND RATE OF RETURN

A. Capital Structure

1. Overall Capital Structure

IAWC's forecasted average capital structure for the test year ending September 30, 2013 is comprised of 0.26% short-term debt, 49.23% long-term debt and 50.51% common equity. (IAWC Exs 6.00R (Rungren Reb.), p. 2; 6.03SR.) Staff witness Janis Freetly argues, "[u]sing this equity ratio could produce a rate of return that would violate Section 9-230 of the Act." (ICC Staff Ex. 6.0 (Freetly Dir.), p. 8.) Staff therefore proposes an imputed capital structure comprised of 1.30% short-term debt, 56.70% long-term debt and 42.00% common equity. (Id., p. 9.) Staff does *not* propose that IAWC actually take action to achieve this capital structure, only that this imputed capital structure be used "for ratemaking purposes," even though IAWC's actual capital structure is what will finance rate base. (Tr. 620, 622.)

As discussed by IAWC witness Scott Rungren, Staff's imputed capital structure violates Section 9-230 of the Public Utilities Act, 220 ILCS 5/9-230, by imputing the more highly leveraged and more financially risky capital structure of AWW to the calculation of IAWC's weighted average cost of capital. (IAWC Ex. 6.00R, pp. 2-3.) Notably, Staff made *no attempt* to refute Mr. Rungren's testimony in this regard. Despite testifying that IAWC's actual capital "could" produce a return on equity that "would violate Section 9-230 of the Act," Ms. Freetly essentially refused to address the capital structure issue in rebuttal. (ICC Staff Ex. 14.0 (Freetly Reb.), p. 2.) The entirety of her response to Mr. Rungren is this: "Because I am not an attorney, and on the advice of counsel, I will not respond to the legal arguments presented by Mr. Rungren regarding the proper interpretation of Section 9-230. Therefore, Staff attorneys will be addressing the legal issues with regard to Section 9-230 in the briefs to be filed in this docket." (ICC Staff Ex. 14.0, p. 2, lines 20-23.) Under cross-examination, Ms. Freetly *agreed* with the core principles cited by Mr. Rungren for rejection of an imputed capital structure. (Tr. 629-32.) While it thus appears that capital structure may no longer be a disputed issue, IAWC will nevertheless address this issue as if it is, reserving the right to address whatever position Staff has on Section 9-230 that it may present for the first time in its brief.

Contrary to Mandating Use of AWW's Capital Structure, Section 9-230 Prohibits It.

Section 9-230 states:

> In determining a reasonable rate of return upon investment for any public utility in any proceeding to establish rates and charges, the Commission shall not include

> any (i) incremental risk [or] (ii) increased cost of capital . . . which is the direct or indirect result of the public utility's affiliation with unregulated or nonutility companies.

220 ILCS 5/9-230.

Staff does not identify or quantify any "incremental risk" or "increased cost of capital" which is the "direct or indirect result" of IAWC's affiliation with unregulated or nonutility companies. (IAWC Ex. 6.00R, p. 5.) Staff merely cites an appellate court case (Citizens Utility Board v. Ill. Commerce Comm'n, 276 Ill. App. 3d 730, 744 (1st Dist. 1995)) where the court noted that when a holding company owns a utility, "the capital structure of the regulated utility can be manipulated to include excessive equity to inflate the rate of return." (ICC Staff Ex. 6.0, p. 8, lines 146-52.) Staff takes this case to mean that whenever a utility has a higher equity ratio than that of its parent company, "Section 9-230 requires that it be established that there is no manipulation going on, and that was not established by [IAWC]." (Tr. 625.)[9]

The plain language of Section 9-230 of the Public Utilities Act requires that the utility's stand-alone capital structure and risk be used as a starting point in determining its cost of capital. 220 ILCS 5/9-230. Any "incremental risk" inuring to the utility due to its affiliation with unregulated or nonutility companies must be excluded from the determination of the utility's cost of capital. Id. In other words, Section 9-230 precludes imputing to the utility the risk of affiliated companies. This is consistent with the principle that the Commission sets rates for the utilities within its jurisdiction based on each utility's risk and costs of capital, and not the risk level or cost of capital of unregulated affiliates or holding companies. (IAWC Ex. 6.00R, p. 7.)

[9] If, as Staff suggests, a 1995 appellate court decision requires a showing of "no manipulation," it is somewhat strange that this interpretation has never been announced until now—roughly 17 years after the appellate decision.

It is Ms. Freetly's, not IAWC's, proposal that violates Section 9-230 of the PUA by imputing incremental risk to IAWC. (Tr. 631.) Supposing it were true, as Staff argues, that IAWC "needs to provide an analysis demonstrating that IAWC has higher risk than AWW to justify the higher common equity ratio for the utility" (ICC Staff Ex. 6.0, p. 9, lines 157-59), at hearing, Staff *admitted* that IAWC faces greater operating risk than AWW (Tr. 629.) Ms. Freetly agreed that IAWC faces the operating risk of a water utility. (Tr. 626-27.) These risks include wet summers, unforeseen maintenance expense, spikes in power and chemical costs, and so forth. (Tr. 627.) Each American Water utility faces it own unique operating risk since the factors that impact operating risk vary across jurisdictions. (Tr. 627, 628.) If IAWC were the only utility owned by AWW, the operating risk profile of the separate entities would essentially be identical. (Tr. 627.) But AWW's operating risk profile reflects the risk of all of its regulated subsidiaries. (Tr. 628.) If one subsidiary goes bankrupt, AWW's overall loss would be mitigated as long as the other utilities remained financially viable. (Tr. 628.) In this respect, AWW's ownership of multiple utilities is a form of diversification that allows it to mitigate its operating risk. (Tr. 628.) IAWC, of course, cannot mitigate its operating risk in this fashion; it bears 100% of whatever its operating risk is. (Tr. 628.) And since IAWC cannot diversity its operating risk, its operating risk profile is greater than that of its parent. Ms. Freetly conceded this point in the following response during cross-examination:

> Q. But the point being, the parent's operating risk is lower than the operating risk Illinois-American faces as a stand-alone entity.
>
> A. I suppose so.

(Tr. 629, lines 18-21.)

Ms. Freetly also agreed that, "to the extent the parent's capital structure is imputed to Illinois-American, the operating risk that the parent company bears is also being imputed." (Tr.

629, lines 1-5.) This would seem to fly in the face of Section 9-230's prohibition that "the Commission shall not include any . . . incremental risk . . . which is the direct or indirect result of the public utility's affiliation with unregulated or nonutility companies." 220 ILCS 5/9-230. The statute makes no distinction between greater or lesser "incremental" risk. The ultimate point, however, is that the evidence establishes what Staff argues must be established to use IAWC's capital structure: that IAWC's operating risk is greater than that of its parent.

Staff's imputed capital structure would have the additional effect of imputing AWW's greater level of financial risk to IAWC. Financial risk is largely a function of the capital structure. (Tr. 630.) That is, a higher level of debt in the capital structure is generally perceived as increasing the level of financial risk. (Tr. 630.)[10] Ms. Freetly conceded during cross-examination that imputing AWW's more highly-leveraged capital structure imposes greater financial risk to IAWC:

> Q. Let's back up and make sure we're on the same page here. The debt in the parent company's capital structure is 57 percent, correct?
>
> A. Yes.
>
> Q. And the debt in Illinois-American's capital structure is approximately 49 percent, correct?
>
> A. Yes.
>
> Q. So by imputing the parent company's capital structure to Illinois-American, the effect of that is to impute a capital structure that reflects more risk, correct?
>
> A. Yes.

(Tr. 630, line 20 - 631, line 11.)

[10] Ms. Freetly acknowledges that as the reliance on debt as a source of capital increases, so does the risk of default. "Beyond a certain point, a growing dependence on debt as a source of funds increases the overall cost of capital." (ICC Staff Ex. 6.0, p. 3, lines 52-53.)

Staff also agrees that IAWC's affiliation with AWW produces tangible benefits to ratepayers. For example, by virtue of ownership by AWW, IAWC has the ability to obtain financing through American Water Capital Corporation ("AWCC"). (Tr. 631.) Ms. Freetly agrees that "Illinois-American's affiliation with the parent company is a benefit insofar as it mitigates the effect of financial risk that Illinois-American would have as a stand-alone entity." (Tr. 632, lines 8-12.) IAWC also has the ability to issue (and in fact has issued) its own debt when it has been able to obtain financing more cheaply than it could through AWCC. (Tr. 631.) To the extent AWW's risk increases, which would cause its cost of debt to also increase, IAWC retains the option to issue its own, lower cost debt. (Tr. 631-32.) Setting rates with a capital structure that disregards IAWC's lower financial risk, relative to its parent company, would be in direct conflict with the legislature's directive that IAWC's cost of capital exclude any "incremental risk" or "increased cost of capital" resulting directly or indirectly from its affiliation with AWW.

<u>There Is No Evidentiary Basis for Use of an Imputed Capital Structure.</u>

Staff offers no evidence that AWW has manipulated IAWC's capital structure; no explanation of how much equity in IAWC's capital structure would be "excessive"; and no quantification of the extent to which use of IAWC's capital structure would allegedly "inflate" its rate of return.

Ms. Freetly believes that "the Commission should not determine the overall rate of return from a utility's actual capital structure if the Commission concludes that capital structure adversely affects the overall cost of capital." (ICC Staff Ex. 6.0, pp. 3-4, lines 54-56.) It stands to reason that in order to determine whether IAWC's actual capital structure "adversely affects" its cost of capital, one would need to calculate the cost of capital based on IAWC's actual capital structure. Ms. Freetly admits that she "did not perform any analyses using IAWC's stand-alone capital structure" and that she "did not assess the reasonableness of IAWC's proposed test year capital structure with respect to its impact on IAWC's weighted average cost of capital." (IAWC Ex. 6.00R, p. 10 (quoting responses to IAWC-ICC 2.14 and IAWC-ICC 1.82).) At hearing, Ms. Freetly admitted that she knew using an imputed capital structure would reduce IAWC's cost of equity, simply by virtue of the mathematics of applying a return on equity to a capital structure containing less equity. (Tr. 623-24.)

The Commission has expressly refused to adopt an imputed capital structure absent any material facts that a utility's capital structure was manipulated. GTE North Inc., Order, Docket 93-0301 (Oct. 11, 1994), 1994 Ill. PUC LEXIS 436 **106-07. Merely concluding that because the capital structure of a utility contains more common equity than its parent, it must have been manipulated, is not, by itself, evidence of manipulation. Id. In this case, Staff presents *no* evidence to suggest that AWW is "manipulating" IAWC's capital structure. Ms. Freetly agrees that the mere fact a utility's capital structure contains more equity than its parent is not evidence that the parent is, in fact, manipulating the utility's capital structure. (Tr. 624.) The different capital structures are merely "something to investigate." But when asked, "What did you do to investigate whether there was any manipulation?," Ms. Freetly responded, "Well, I didn't establish that there was manipulation." (Tr. 625.)

As Mr. Rungren explained, even assuming that use of IAWC's capital structure results in a higher cost of capital, Staff provides no evidence that a higher cost of capital would result in an excessive return to AWW. (IAWC Ex. 6.00R, p. 8.) A higher equity ratio, all else being equal, signifies a higher amount of common equity that earnings will be divided by in the calculation of the earned return on common equity. (Id.) Holding the allowed return on common equity constant, it is not necessarily true that earnings would increase by a higher percentage than common equity. (Id.) Thus, infusing additional equity into IAWC's capital structure would not necessarily increase the return that AWW earns on its investment in IAWC. (Id.)

There is no economic incentive for AWW to inflate the common equity component of IAWC's capital structure to increase AWW's earnings. AWW's and IAWC's incentives are aligned to maintain reasonable costs of capital. (Id., p. 9.) IAWC's risk profile decreases as the Company increases its common equity ratio. (Id.) This will improve AWW's risk-return profile and lower the debt financing costs to AWW and IAWC's financing affiliate, AWCC. (Id.) This will allow AWCC to offer lower rate debt financing to IAWC. (Id.) In addition, further improvement to IAWC's risk profile will attract direct debt financing offers that may be lower than debt financing rates offered by AWCC. (Id.) Therefore, the economic benefits of a higher equity component in the Company's capital structure will be in the form of lower debt and equity costs to IAWC. (Id.)

IAWC's Forecasted Capital Structure Should Be Used to Establish Its Cost of Equity.

IAWC manages its capital structure independently from AWW, constructing its own financing plan with respect to the amounts and timing of debt and equity issuances. (IAWC Ex. 6.00R, p. 8.) In managing its capital structure, the Company's goal is to maintain a reasonable weighted average cost of capital in light of the various operating risks it faces. (Id.) In addition, IAWC assesses its capital structure for reasonableness against that of other publicly traded water utilities. (Id.)

The Commission has previously recognized that AWW's equity ratio may be lower than IAWC's. In IAWC's divestiture case, Docket 06-0336, Condition 9 states: "For three years following the date of this Order, IAWC will maintain its equity-to-capital ratio between 40% and 50%. If the equity-to-capital ratio falls outside of this range, IAWC will notify the Commission in writing within 30 days." Order, Docket 06-0336 (June 27, 2007), p. 25. Also, Condition 1 required AWW to have an equity ratio of at least 45% at the time of divestiture. Id., p. 24. The Order essentially was allowing IAWC an equity ratio of 50%, but only requiring AWW to have an equity ratio of at least 45%. Thus, the Commission recognized that AWW and IAWC could have divergent equity ratios, and that IAWC's could be higher.

In this case, IAWC's proposed capital structure is consistent with that of other water companies. For example, in the recent Aqua Illinois rate case, Aqua Illinois proposed, and the Commission authorized, a capital structure that contained an equity ratio of 53.31%, notwithstanding its parent company equity ratio of 43.40%. Aqua Illinois, Inc., Order, Docket 11-0436 (Feb. 16, 2012), p. 11. Ms. Freetly's imputed equity ratio of 42%, however, is almost five percentage points lower than that of the average equity ratio of her water utility sample as of 2010, which is 46.99%. (IAWC Ex. 6.00R, p. 15.)

As Mr. Rungren explained, the negative impact on the Company's costs of capital, both debt and common equity, if IAWC were to increase its debt ratio from 48.68% up to 56.70%, would be significant. (IAWC Ex. 6.00R, p. 12.) There is a substantial difference in credit quality between debt ratios of 48.68% and 56.70%. (Id., p. 15.) A debt ratio of 56.70% would substantially increase IAWC's financial risk, which would result in significant increases to IAWC's debt and common equity costs. (Id.) The appellate court case cited by Ms. Freetly recognized that a higher level of financial leverage increases a firm's costs of capital: "A corporation with a higher percentage of debt-financed capital will need to pay more for both its debt and its equity than a corporation with a greater proportion of equity capital, if all other risk factors are equal." Citizens Util. Bd. v. Ill. Commerce Comm'n, 276 Ill. App. 3d 730, 744 (1st Dist. 1995). Staff's capital structure would result in an increase to both IAWC's cost of debt, due to lower credit ratings, and to its cost of common equity, as investors would demand higher returns to compensate them for IAWC's increased risk. (Id., p. 14.)

IAWC's forecasted capital structure should be used in this case. IAWC's forecasted 50.51% common equity ratio is the appropriate proportion of equity in the capital structure to make certain the Company's operations and investments are financed at the lowest weighted average cost of capital. Holding constant the Company's degree of business risk, a higher equity ratio lowers the cost of each capital component. IAWC's proposed capital structure will enable the Company to raise capital on reasonable terms in most market conditions, and for that reason should be adopted.

2. Balance of Short-Term Debt

IAWC proposes a balance of short-term debt of 0.26% of total capitalization, net of Construction Work in Progress ("CWIP") accruing Allowance for Funds Used During Construction ("AFUDC"), based on projections from IAWC's 2011-2013 business plan. (IAWC Exs. 6.00R, pp. 17, 27; 6.03SR.) Staff proposes, and AG witness Mr. Smith adopts, a short-term debt balance of 1.30% based on an average of projected balances plus an amount intended to represent the difference between IAWC's historical projected and actual short-term debt balances. (ICC Staff Ex. 6.0, pp. 4-5; AG Ex. 4.0 C (Rev.), p. 2.) As Mr. Rungren explained, however, historic short-term debt balances have no relevance to the calculation of the Company's projected test year short-term debt balances. (IAWC Ex. 6.00R, p. 27.) The best data to use for the Company's test year short-term debt balances are the projections from IAWC's 2011-2013 business plan. (Id.) Thus, using an historical short-term debt ratio results in a disconnect between the Company's planned financing activities and their impact on future levels of short-term debt. (IAWC Ex. 6.00SR (Rungren Sur.), p. 16.) In addition, short-term debt balances have greater volatility than the Company's sources of permanent capital, such as long-term debt and common equity. (IAWC Ex. 6.00R, p. 27.) Thus, there are time periods in which short-term debt projections were higher than actual balances, and other time periods where short-term debt projections were lower than actual balances. (Id.) Ms. Freetly and Mr. Smith ignore all these facts and, therefore, Staff's recommendation should be rejected.

Mr. Smith recommends using Staff's proposed short-term debt ratio of 1.30% as the floor, stating this may require an upward adjustment to keep in line with the short-term debt ratios approved in IAWC's two most recent rate cases, Dockets 07-0507 and 09-0319. (AG Ex. 4.0 C (Rev.), p. 2.) However, as Mr. Smith admitted in his direct testimony, the Commission added short-term debt to the Company's proposed test year balance in its last rate case, which increased the ratio from 0.15% to 2.83%. (AG Ex. 2.0 C (Rev.), pp. 14-15.) The dollar amount of short-term debt associated with the 2.83% ratio was $20,619,678. (IAWC Ex. 6.00R, p. 28.) However, the Company's *actual* average balance of short-term debt during the test year (2010) was $4,774,062. (Id.) Thus, the adjustment recommended by Mr. Smith and accepted by the Commission in that case actually *overstated* the Company's actual average short-term debt balance by $15,845,616, or almost 332%. (Id.) This result undermines the basis for Mr. Smith's, as well as Staff's recommended adjustment to IAWC's short-term debt balance in this case.

In sum, Mr. Smith fails to explain how IAWC has understated its short-term debt in the current case, or why his adjustment will not overstate short-term debt as it did in the last case. He simply states that it appears the Company has understated the amount of short-term debt because IAWC's test year short-term debt ratio is 0.26% of total capitalization. (AG Ex. 2.0 C (Rev.), p. 15.) Therefore, his recommendation should be disregarded.

B. Cost of Debt

The Company proposes a cost of long-term debt of 6.04%. Staff agrees. (IAWC Ex. 6.03SR; ICC Staff Ex. 14.0, Sch. 14.1.) The Company proposes a cost of short-term debt of

0.76%, which represents the projected cost of short-term debt in the test year. (IAWC Ex. 6.03SR.)

C. Cost of Common Equity

Regulated utilities finance the plant, property and equipment necessary to provide service through investor-supplied debt and equity capital for which a reasonable return must be paid. The return paid to investors is part of a regulated utility's cost of doing business. While the costs of debt and preferred stock are directly observable, the cost of common equity is not. It must be estimated based on observable market information. In establishing an authorized return on equity for IAWC, the Commission must attempt to discern the return necessary to adequately compensate current investors and attract future investment.

The rate of return testimony offered in this proceeding places the Commission in the familiar place of determining a return on equity based on the Company's recommendation (11.25%) and the unreasonably low recommendations offered by Staff (9.42%) and Intervenors (9.3%). The tendency in this situation is for the Commission to fashion a return on equity somewhere in between. IAWC suggests that there is an easier solution in this case: the Commission could leave return on equity where it currently is, at 10.38% as authorized in Docket 09-0319. The evidence fully supports such an outcome.

There is no legal requirement for the Commission to authorize a specific return on equity. Its discretion in this area is broad, limited only by the constitutional constraints articulated in Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. 679 (1923) and Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944). Bluefield established that "[a] public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties . . . ." 262 U.S. at 692. Whereas Bluefield focused on the utility's perspective, Hope focused on that of the investor: "[t]he return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital." 320 U.S. at 603.

No party disputes that Illinois utilities compete with utilities in every other jurisdiction for a limited supply of investor capital. A utility whose investment risk is higher than that of another utility must be able to properly compensate investors for taking on that greater risk. Since IAWC is a riskier investment than Illinois gas or electric utilities, investors require a higher return on IAWC's common equity, or a return commensurate with that required on an investment comparable in risk to that of IAWC. If IAWC is not given the opportunity to earn a higher return, current investors will flee to other utilities (or other industries); future investors will never come.

Between April 2010 and February 2012, the average authorized return on equity for regulated affiliates of IAWC was 10.13%. (IIWC/FEA Ex. 1.0 (Gorman Dir.), p. 7.) IIWC notes that "[h]alf of the observations were 10.20% or lower." (Id., p. 7, line 94.) The converse, then, is that half of the authorized returns exceeded 10.20%. This year, the New Jersey Public Utilities Commission authorized a return on equity for New Jersey American Water of 10.15%. New Jersey American Water Co., Order, Docket WR 11 070460, 2012 N.J. PUC LEXIS 128, *8 (NJ Bd. Pub. Utils. May 1, 2012).[11] Similarly, commissions in Iowa, Tennessee and Missouri set a return on equity of 10.30%, 10% and 10% for Iowa American Water, Tennessee American

[11] Also *available at* http://www.nj.gov/bpu/pdf/boardorders/2012/20120501/5-1-12-5A.pdf.

Water and Missouri American Water, respectively. Iowa American Water Co., Order, Docket RPU-2011-0001, 2012 Iowa PUC LEXIS 45, *5 (Iowa Utils. Bd. Feb. 23, 2012)[12]; Tennessee American Water Co., Order, Docket 10-00189, 2012 Tenn. PUC LEXIS 76, *267 (Tenn. Reg. Auth. Apr. 27, 2012)[13]; Missouri-American Water Co., Order, Docket WR-2011-0337, 2012 Mo. PSC LEXIS 248 (Mo. PSC Mar. 7, 2010) (approving Feb. 24, 2012 Settlement)[14]. In late 2011, the Pennsylvania commission allowed a return on equity for Pennsylvania American Water of 10.25%. (IIWC Ex. 1.0, p. 7, Table 2.) And it is important to note that if IAWC's return on equity was calculated using the formula return now available to Illinois electric utilities under the Energy Infrastructure and Modernization Act, 220 ILCS 5/16-108.5, the formula would produce a return of at least 10.11%. (IAWC Ex. 10.00SR (Rev.) (Ahern Sur.), p. 4.)

There should be no dispute that authorized returns influence investment decisions. In April 2010, the Commission authorized IAWC the opportunity to earn a return on equity of 10.38%. Order, Docket 09-0319 (Apr. 13, 2010), pp. 113, 207. Later that month, the Indiana commission authorized an ROE of 10% for Indiana American Water. Indiana American Water Co., Order, Docket 43680, 2010 Ind. PUC LEXIS 155, *145 (Ind. Util. Reg. Comm'n Apr. 30, 2010).[15] The Missouri Commission authorized a 10% return for Missouri-American a few months later. Missouri American Water Co., Order, Docket WR-2010-0131, 2010 Mo. PSC

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[12] Also *available at* https://efs.iowa.gov/efiling/groups/external/documents/docket/094181.pdf.

[13] Also *available at* http://www.tn.gov/tra/orders/2010/1000189mb.pdf.

[14] Also *available at* https://www.efis.psc.mo.gov/mpsc/commoncomponents/view_itemno_details.asp?caseno=WR-2011-0337&attach_id=2012014723.

[15] Also *available at* https://myweb.in.gov/IURC/eds/Modules/Ecms/Cases/Docketed_Cases/ViewDocument.aspx?DocID=0900b6318012dd6f. IAWC notes that in a recent rate order, Indiana American Water received an authorized return on equity of 9.7%. Indiana American Water Co., Order, Docket 4022, 2012 Ind. PUC LEXIS 178, *107 (Ind. Util. Reg. Comm'n June 6, 2012), *available at* http://www.in.gov/iurc/2328.htm. IAWC considers this result to simply confirm how unreasonably low the recommended returns of Staff and IIWC are.

Lexis 595 (Mo. PSC Jun. 16, 2010) (approving May 24, 2010 Settlement).[16] The favorable investment climate in Illinois relative to other states has led to actual and planned investment of approximately $190 million in Illinois through the end of the test year in this proceeding.

Against this backdrop, Staff and IIWC/FEA recommend much lower returns on equity. This is not a mere coincidence. Nor is it the product of reliable methods reasonably applied. Their returns on equity are artificially depressed. Any return on equity below IAWC's current authorized return of 10.38% is unreasonable and could impair the ability of IAWC to attract the capital necessary to fulfill its planned investment needs.

Staff and IIWC/FEA attempt to justify their recommendations by observing that capital costs in the market generally have declined since 2010, as evidenced by decreasing bond yields and other factors. Even if this premise were assumed to be true, IAWC's cost of equity surely has not declined by 100 basis points (or more) since its last case. New Jersey declined slightly between 2010 and 2012, from 10.30% to 10.15%. (See IIWC/FEA Ex. 1.0, p. 7; New Jersey American Water Co., Order, Docket WR 11 070460 at *8.) And the Tennessee commission re-authorized the 10% return in 2012 that it originally authorized in 2011 (which in turn had declined slightly from 10.2%). (See IIWC/FEA Ex. 1.0, p. 7; Tennessee American Water Co., Order, Docket 10-00189 at *267.) Illinois would clearly become an outlier jurisdiction if the Commission accepted the return on equity recommended by either Staff of IIWC/FEA in this proceeding (all the more so because, as explained by IAWC witness Pauline M. Ahern, Staff's recommended return on equity results in an effective authorized return on common equity for IAWC of only 8.32% (IAWC Ex. 10.00R, p. 2)).

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[16] Also *available at* https://www.efis.psc.mo.gov/mpsc/commoncomponents/view_itemno_details.asp?caseno=WR-2010-0131&attach_id=2010021341.

As discussed by Ms. Ahern, notwithstanding lower interest rates, the cost of common equity has actually risen as the equity risk premium has risen. (IAWC Ex. 10.00 (Rev.) (Ahern Dir.), p 72.) The U.S. continues to recover slowly and uncertainly from the Great Recession of 2008 and 2009. (IAWC Ex. 10.00R (Ahern Reb.), p. 2.) Interest rates continue to fall in response to the Board of the Federal Reserve System's vow to keep the fed funds rate at its current level or 0.00% - 0.25% through late 2014. (Id., p. 2.) In doing so, the Fed stated "Most participants judge that the current outlook—for a moderate pace of economic recovery with the unemployment rate declining only gradually and inflation subdued—warranted exceptionally low levels of the federal funds rate at least until late 2014." (Id., pp. 2-3, lines 45-48.) In addition, U.S. Treasury and Moody's public utility bond yields have continued to fall. (Id., p. 3.)

Actual yields on 30 year U.S. Treasury Bonds have fallen 158 basis points from 4.69% in April 2010, the month in which IAWC's current authorized common equity cost rate of 10.38% was ordered, to 3.11% in February 2012. (Id.) On a forecasted basis, Blue Chip Financial Forecasts ("Blue Chip") reports that the consensus forecast yields on 30 year U.S. Treasury Bonds have fallen 188 basis points from 5.30% on April 1, 2010 to 3.42% on March 1, 2012, both for the furthest quarter forecasted each month. (Id.) Similarly, the yields on Moody's A-rated and Baa-rated public utility bonds fell during the period from 5.84% to 4.36% (148 basis points) and from 6.22% to 5.02% (120 basis points), respectively. (Id.)

In short, the decrease in bond yields has been coupled with an increase in the volatility of the stock market as measured by the VIX Index,[17] which measures the implied volatility of Standard & Poor's ("S&P") 500 index options. (Id.) Thus, notwithstanding lower interest rates, the cost of common equity actually has risen as the equity risk premium has risen. (Id., p. 4.)

[17] VIX is the ticker symbol for the Chicago Board Options Exchange Market Volatility Index.

IIWC/FEA concede that "at an absolute minimum, Illinois-American's cost of common equity is no higher today than it was in its last case . . . ." (IIWC/FEA Ex. 1.0, p. 4, lines 62-62.) Yet IIWC/FEA's constant growth Discounted Cash Flow model results of 11.24%, when adjusted to exclude from the proxy group a utility for which *negative* earnings has been forecast, is within 1 basis point of Ms. Ahern's recommendation. (See Id., p. 32.) IIWC/FEA goes on to rationalize why IAWC's cost of equity is now lower, but it is important to recognize that even IIWC/FEA acknowledges that there is record support for an return on equity "no higher" than 10.38%.

The Record Supports a Common Equity Cost Rate of 11.25%.

Ms. Ahern, a Principal with AUS Consultants, recommends an overall rate of return of 8.65% using the estimated capital structure ratios[18] and senior capital cost rates at September 30, 2013 and her updated common equity cost rate recommendation of 11.25%. (IAWC Ex. 10.00R, p. 53.) Ms. Ahern's recommendation is based on an assessment of market-based equity cost rates of nine publicly traded companies of relatively similar risk. (IAWC Ex. 10.00 (Rev.), pp. 31-32.) She employed market-based cost of common equity models to the proxy group data: the single-stage constant growth Discounted Cash Flow ("DCF") Model, the Risk Premium Model ("RPM") and the Capital Asset Pricing Model ("CAPM"). (Id., p. 4.)

Discounted Cash Flow Model

The median result of the single-stage DCF model is 9.96% for the nine water companies in Ms. Ahern's proxy group. (IAWC Ex. 10.00 (Rev.), p. 45.) In arriving at a conclusion of a DCF-indicated common equity cost rate for the proxy group, Ms. Ahern relied upon the median of the results of the DCF, due to the wide range of DCF results as well as the continuing volatile

[18] IAWC's forecasted capital structure is comprised of 0.26% short-term debt, 49.23% long-term debt and 50.51% common equity. (IAWC Ex. 6.03SR.)

capital market conditions and to not give undue weight to outliers on either the high or the low side. (Id.) The median is a more accurate and reliable measure of central tendency, and provides recognition of all the DCF results. (Id.)

Ms. Ahern utilizes the single-stage constant growth DCF model because it is the most widely utilized version of the DCF used in public utility rate regulation. (Id., p. 36.) It is widely utilized because utilities are generally in the mature stage of their lifecycles and not transitioning from one growth stage to another. (Id.) This is especially true for water utilities. (Id.) All companies, including utilities, go through typical life cycles in their development, initially progressing through a growth stage, moving onto a transition stage and finally assuming a steady-state or constant growth stage. (Id.) However, the U.S. public utility industry is a long-standing industry, dating back to approximately 1882. (Id., pp. 36-37.) The standards of rate of return regulation of public utilities date back to the previously discussed principles of fair rate of return established in the Hope and Bluefield decisions of 1944 and 1923, respectively. (Id., p. 37.) Hence, the public utility industry in the U.S. is a stable and mature industry characterized by the steady state or constant-growth stage of a multi-stage DCF model. (Id.)

The regulated economics of the utility industry further reflect the features of this relative stability and demand maturity. Their returns on capital investment, i.e., rate base, are set through a ratemaking process and not determined in the competitive markets. This characteristic, taken together with the longevity of the public utility industry at large, all contribute to the stability and maturity of the industry, including the water utility industry. (Id.)

Although IAWC's currently authorized ROE was based in part upon a non-constant growth DCF, the Commission does not require use of a non-constant growth DCF in all cases. Rather, the Commission has recently indicated that the type of DCF model used should be determined in each case. In Peoples Gas' 2009 rate case, the Commission relied, in part, upon the average of the result of the companies' rate of return witness' constant growth DCF model and the result of a Staff non-constant growth DCF model in determining the final authorized return on equity in that proceeding. Peoples Gas Light and Coke Co., et al., Order, Docket 09-0166/0167 (Jan. 20, 2010), pp. 124-26. Consequently, there is no basis for applying multi-stage growth versions of the DCF model to determine the common equity cost rates of mature public utility companies, such as water utilities. (IAWC Ex. 10.00 (Rev.), p. 38.)

Risk Premium Model

Ms. Ahern's application of the RPM model produced a common equity cost rate of 10.41%—slightly above the Company's current authorized return. (IAWC Ex. 10.00 (Rev.), p. 56.) The RPM is based upon the basic financial principle of risk and return, namely, that investors require greater returns for bearing greater risk. (Id., p. 45.) The RPM recognizes that common equity capital has greater investment risk than debt capital, as common equity shareholders are last in line in any claim on a company's assets and earnings, with debt holders being first in line. (Id.) Therefore, investors require higher returns from common stocks than from investment in bonds, to compensate them for bearing the additional risk. (Id., pp. 45-46.)

While investors' required common equity return cannot be directly determined or observed, it is possible to directly observe bond returns and yields. (Id., p. 46.) According to RPM theory, one can assess a common equity risk premium over bonds, either historically or prospectively, and then use that premium to derive a cost rate of common equity. Moreover, the cost of common equity equals the expected cost rate for long-term debt capital plus a risk premium over that cost rate to compensate common shareholders for the added risk of being unsecured and last in line for any claim on the corporation's assets and earnings. (Id.)

Capital Asset Pricing Model

CAPM theory defines risk as the co-variability of a security's returns with the market's returns as measured by beta (**β**). (IAWC Ex. 10.00 (Rev.), p. 58.) A beta of less than 1.0 indicates lower variability relative to the overall market while a beta greater than 1.0 indicates greater variability. The CAPM assumes that all other risk, i.e., all non-market or unsystematic risk, can be eliminated through diversification. The risk that cannot be eliminated through diversification is called market, or systematic, risk. In addition, the CAPM presumes that investors require compensation only for those systematic risks which are the result of macroeconomic and other events that affect the returns on all assets. The model is applied by adding a risk-free rate of return to a market risk premium, which is adjusted proportionately to reflect the systematic risk of the individual security relative to the total market as measured by beta. (Id.)

Because both ratemaking and the cost of common equity are prospective, the risk-free rate for Ms. Ahern's CAPM analysis is based on the average consensus forecast reported in the August 1, 2011 Blue Chip of the expected yields on 30-year U.S. Treasury bonds for the six quarters ending with the fourth calendar quarter 2012. (Id., p. 60.)

Numerous tests of the CAPM have measured the extent to which security returns and betas are related as predicted by the CAPM confirming its validity. (Id., p. 59.) The empirical CAPM ("ECAPM") reflects the reality that, while the results of these tests support the notion that beta is related to security returns, the empirical Security Market Line ("SML") described by the CAPM formula is not as steeply sloped as the predicted SML. In view of theory and practical research, Ms. Ahern applied both the traditional CAPM and the ECAPM to the companies in the proxy group and averaged the results. (Id.) The risk-free rate adopted for both applications of the CAPM is 4.67%. (Id., p. 60; IAWC Ex. 10.11.)

Staff's ROE Recommendation Is Flawed and Unreasonably Low.

Staff's recommended cost of common equity ("ROE") of 9.42% violates the economic principle of opportunity cost, meaning the return given up or foregone by investing in one investment as opposed to an alternative investment of comparable risk. (IAWC Ex. 10.00SR (Rev.), p. 2.) Likewise, Ms. Freetly's recommended 9.33% ROE, should the Company's revised RAC be adopted, and 9.19%, should Staff's revised RAC be adopted, result in effective authorized ROEs for IAWC of 8.35% and 8.24%, respectively. These returns are applied to a capital structure containing significantly greater financial risk than IAWC's actual capital structure. As discussed by Ms. Ahern, there is little incentive for American Water to invest in IAWC if the parent could forego ROEs of 9.42%, 9.33% or 9.19% on alternative investments with business and financial risks comparable to the actual business and financial risks which IAWC faces. (Id.)

Staff's analyses are flawed in several material respects. First, Ms. Freetly's use of a non-water utility sample group is not appropriate for determining the cost rate of common equity for IAWC. (IAWC Ex. 10.00R, p. 6.) Moreover, her exclusion of American Water and SJW Corp. from her water sample group results in the exclusion of valuable insight into the cost of common equity for the water industry as a whole. (Id.)

Second, in her DCF analysis, Ms. Freetly relied upon a non-constant growth DCF model, even though the utility industry, and specifically the water utility industry, is a stable and mature industry. (Id.)

Third, in her CAPM analysis, Ms. Freetly relied upon an historical spot 30-year U.S. Treasury bond yield as the risk-free rate, rather than an actual projection of the 30-year U.S. Treasury bond yield, and failed to include the ECAPM to account for the fact that the SML as described by the traditional CAPM is not as steeply sloped as the predicted SML. (Id.) In addition, her analysis does not include a business and financial risk adjustment nor a flotation cost adjustment as discussed in Ms. Ahern's direct testimony. (Id.)

Staff's Proxy Group Is Flawed.

Ms. Freetly's use of a non-water utility sample group is inappropriate because the water utility industry faces unique investment risks relative to the electric, combination electric and gas and natural gas utility industries. (IAWC Exs. 10.00R, p. 7; 10.02; 10.03.) In addition, IAWC's 2010 capital intensity as measured by net plant divided by total operating revenues of $3.70 relative to $2.08 for the non-water utility sample group indicates significantly greater capital intensity and thus greater risk. (IAWC Exs. 10.00R, p. 7; 10.05R, p. 1.) Also, it is clear that based upon total debt to earnings before interest, taxes, depreciation and amortization, before-income tax interest coverage and earned returns on common equity for the ten years ending 2010, IAWC is clearly more risky, notwithstanding a 2010 depreciation rate similar to that of Ms. Freetly's non-water utility sample. (IAWC Exs. 10.00R, p. 7; 10.05R, pp. 3-5.) Using a proxy group comprised of non-water utilities for an ROE analysis for a water company, like IAWC, cannot reflect specific water industry risk, and is therefore inadequate for water utility cost of capital purposes. (IAWC Ex. 10.00R, p. 7.) Thus, Ms. Freetly's non-water utility sample group is neither reflective of the unique risks of water utilities in general, nor of IAWC specifically.

The Evidence Does Not Support the Use of a Non-Constant DCF.

Ms. Freetly relies upon a non-constant growth DCF model, in part, to arrive at her recommended common equity cost rate of 9.42%. However, she has not provided sufficient evidentiary support for her non-constant growth model in this case. Ms. Freetly utilizes the non-constant growth DCF model based on her belief that "the average 3-5 year growth rates for her Water and Utility samples are not sustainable over the long-term." (ICC Staff Ex. 6.0, p. 15, lines 272-74.) She provides the following three reasons: (1) "[i]n theory, no company could sustain indefinitely a growth rate greater than that of the overall economy;" (2) "since utilities in particular are generally below-average growth companies, the sustainability of an above average growth rate is particularly dubious;" and (3) "[g]iven that the average growth rate for my Water sample companies was greater than the overall growth expectations for the economy, the sustainability of the average 3 - 5 year growth rates for my Water sample is unlikely." (ICC Staff Ex. 6.0, p. 15, lines 280-87.) However, these conclusions are not supported by academic literature or empirical evidence.

As Ms. Ahern explained, it is neither necessary nor appropriate to use a non-constant version of the DCF model because utilities are generally in the mature stage of their lifecycles and not transitioning from one growth stage to another. (IAWC Ex. 10.00R, p. 8.) While all companies go through typical growth cycles (progressing from an initial high growth stage through a transitional stage and finally assuming a steady-state or constant growth stage), the U.S. public water utility industry is in the steady-state or constant growth stage. (Id., pp. 8-9.) The regulated economics of the water utility industry further reflect the features of this relative stability and demand maturity. Contributing to the stability and maturity of the public water utility industry is the fact that their returns on capital investment, or rate base, are set through a ratemaking process and not determined in the market place. Hence, there is no basis for applying non-constant growth versions of the DCF model to determine the cost rate of common equity of mature public utility companies. Under the circumstances of this case, the constant growth model is most appropriate. (Id., p. 9.)

Moreover, there is no empirical evidence from which one could conclude that any individual company, especially relatively stable and mature utility companies, will grow at the average historical or projected growth rate of the U.S. economy. The average growth in the U.S. economy is just that, an average. Some companies will grow faster and some will grow more slowly. IAWC Exhibit 10.06R shows nominal Gross Domestic Product ("GDP") for the years 2001 - 2010 as a whole and by industry. From 2009 - 2010, nominal GDP grew 3.83% and 4.73% on average for the nine years ending 2010. In contrast, the construction component of nominal GDP declined 5.93% from 2009 - 2010 and grew a meager 0.34% on average for the nine years ending 2010. The utilities component of nominal GDP grew 2.83% from 2009 - 2010 and an average 6.14% for the nine years ending 2010. Hence, utilities experienced greater than average growth during the past decade. (Id., pp. 9-10.)

Five-year growth rate projections in earnings per share ("EPS") made by security analysts are reasonable to use in a constant growth, single stage DCF. Security analysts' forecasts take into account historical information as well as all current information likely to impact the future, which is critical since both cost of capital and ratemaking are prospective. (Id., p. 10.) Moreover, there is no empirical evidence that investors would discount or disregard analysts' estimates of growth in earnings per share. (Id., p. 12.) Investors are presumptively aware of all publicly available information, including the many available security analysts' earnings growth forecasts. Investors are also aware of the accuracy of past forecasts, whether for earnings or dividend growth or interest rates. Investors have no knowledge of the accuracy of a forecast at the time of their investment decision. Whether a forecast is accurate can only be known after the period being forecast has elapsed. Hence, security analysts' earnings projections should be used in a cost of common equity analysis. They should be used because security analysts' earnings growth rate projections are available to investors and investors know whether and to what degree these projections are accurate. (Id., p. 13.) Staff would have the Commission ignore this reality by disregarding the largest influence on individual investors, who own approximately 54% of all the common shares, on average, of the companies in Ms. Ahern's proxy group of nine water companies. (See IAWC Ex. 10.08.) Rate of return analysts who attempt to emulate investor behavior should not ignore how investors behave.

Staff Uses an Improper Risk-Free Rate in Its Risk Premium Analysis.

Ms. Freetly's application of the CAPM is flawed in two specific respects: (1) the use of a historical yield on 30-year U.S. Treasury bond as the risk-free rate; and (2) the failure to apply the ECAPM to account for the fact that the SML as described by the traditional CAPM is not as steeply sloped as the predicted SML.

Ms. Freetly utilized a 3.03% February 1, 2012 effective yield on 30-year U.S. Treasury Bonds as the risk-free rate in her risk premium or CAPM analysis. (IAWC Ex. 10.00R, p. 14.) This is not appropriate as Ms. Freetly's use of a spot 30-year U.S. Treasury Bond yield is inconsistent with both the prospective nature of the cost of capital and ratemaking because it merely provides a snapshot of yields at a point in time. Prospective yields may be derived from various forecasts that are widely and readily available, such as the forecasted 30-year U.S. Treasury Bond (note) yields. (Id.) Ms. Ahern derived a forecasted yield of 3.42% based upon the consensus forecast of about 50 economists for the six calendar quarters ending with the second calendar quarter of 2013. (IAWC Exs. 10.00R, p. 15; 10.09R.) Investors are more likely to rely on this information than information on spot yields.

Ms. Freetly also failed to apply the ECAPM to account for the fact that the SML as described by the traditional CAPM is not as steeply sloped as the predicted SML. (IAWC Ex. 10.00R, p. 15.) The SML is a graphical depiction of the CAPM risk-return relationship, where the vertical axis depicts increasing returns and the horizontal axis depicts increase risk as measured by beta. The intercept of the vertical axis represents the required return on an asset with zero risk (or a zero-beta asset), meaning a return equal to the risk-free rate. The SML slopes upward as beta (risk) increases. As beta increases, the required return increases, consistent with the financial precept of risk and return, i.e., that investors require a greater return for bearing greater risk. (Id.) In other words, the traditional CAPM does not fully capture the greater returns required by increased risk. (Id., p. 16.)

As a result of these factors, Ms. Freetly's recommended overall rate of return, combined with her proposed capital structure, would result in a grossly inadequate allowed return on common equity when applied to IAWC's actual common equity ratio.

IIWC/FEA's Recommendation Is Flawed and Unreasonably Low.

Mr. Gorman recommends a ROE of 9.30% based on the average results of three variations of the DCF model and the CAPM model. (IIWC/FEA Ex. 1.0, p. 36.) His recommendations should be rejected because he, too, bases his results on a flawed proxy group and improper risk-free rate. Mr. Gorman also downplays or ignores DCF results that are not convenient to his recommendation.

Mr. Gorman's Use of a Gas Utility Proxy Group Is Inappropriate.

Mr. Gorman's use of a gas utility proxy group is inappropriate because the water utility industry faces unique investment risks relative to the electric, combination electric and gas and natural gas utility industries. (IAWC Exs. 10.00R, p.31; 10.02; 10.03.) Using a proxy group comprised of natural gas distribution companies for an ROE analysis for a water company, like IAWC, cannot reflect specific water industry risk, and is therefore inadequate for water utility cost of capital purposes. (IAWC Ex. 10.00R, p. 31.) Mr. Gorman's gas utility proxy group results are not reflective of the unique risks of water utilities in general, let alone IAWC specifically.

Additionally, Mr. Gorman's water proxy group includes a *negative* 1.15% constant growth DCF result for Middlesex Water Company because the single security analysts' forecast of EPS growth for Middlesex is a *negative* 1.15%. (Id., pp. 31-32.) Since it is illogical that investors would invest with the expectation of losing money, Mr. Gorman's DCF result is not meaningful.

Mr. Gorman's DCF Analyses Are Flawed.

Mr. Gorman derived an average constant growth DCF model cost rate of 10.18% for his water proxy group and a median of 10.36%. (IIWC/FEA Exs. 1.0, p. 21, Table 5; 1.5.) Ms. Ahern recalculated Mr. Gorman's average and median constant growth DCF results excluding Middlesex. (IAWC Exs. 10.00R, p. 32; 10.17R.) They are 11.06% and 11.24%, respectively. (Id.)

Nevertheless, Mr. Gorman concludes that the constant growth DCF result for his water proxy group is unreasonably high because it reflects a growth rate which he claims "is far too high to be a reasonable or reliable estimate of a long-term sustainable growth rate." (IIWC/FEA Ex. 1.0, p. 21, lines 384-85.) His conclusion is premised on a belief that projected growth in GDP "represents a ceiling, or high-end, sustainable growth rate for a utility over an indefinite period of time" because the dividend growth for the market as a whole tracked the GDP growth rate during the period 1926 through 2008. (Id., p. 22, lines 401-02.) Those reasons, however, are not persuasive.

Mr. Gorman's citation to Morningstar, Inc.'s study SBBI - 2009 to support using GDP growth as a maximum sustainable growth rate bears no weight on this case. The study reported in the SBBI - 2009 relates growth in the earnings and dividends of the stock market as a whole to GDP growth from 1926 - 2008. (IAWC Ex. 10.00R, p. 34.) Since the stock market as a whole, whether measured by the New York Stock Exchange or the S&P 500, is a broad based representation of all the common stocks traded in the U.S., it stands to reason that the earnings and dividends of the market as a whole would track GDP growth. However, neither the SBBI - 2009 nor Mr. Gorman provide any empirical support that the earnings and dividends of utility companies, in general, or water companies, in particular, or indeed any specific company or industry, track GDP growth. (Id., pp. 34-35.)

Moreover, as with Ms. Freetly, Mr. Gorman has provided no empirical evidence that in the third stage of a multi-stage DCF analysis any company, especially relatively stable and mature utility companies, would grow at the average growth rate of the U.S. economy. (Id., p. 35.) In addition, it is a mismatch to use five- to ten-years growth in GDP as a proxy for the years eleven through perpetuity. There is no evidence that a five- to ten-years growth rate in GDP accurately represents the in perpetuity growth rate in GDP. Hence, there is no valid rationale for undertaking a multi-stage DCF analysis. (Id.)

Mr. Gorman's sustainable growth DCF methodology also is flawed. He calculates sustainable growth for each company in his water proxy group based upon 3-5 year projections from Value Line. (IIWC/FEA Ex. 1.8.) His allowance for growth caused by the sale of new common stock above book value also is based upon the five-year growth in shares from 2010 through 2014 - 2016. (IAWC Ex. 10.00R, p. 35.) Hence, Mr. Gorman's sustainable growth methodology is a short-term forecast, no longer than the security analysts' five-year forecasts of EPS growth used in his first consensus analysts' growth constant growth DCF analysis. (Id., pp. 35-36.) Moreover, he provides no empirical support that "sustainable growth" accurately represents investors' expected growth.

In addition, the sustainable growth methodology is inherently circular because it relies upon an expected ROE on book common equity, which is then used to establish a common equity cost rate related to the market value of the common stock which, if authorized, will become the expected ROE on book common equity. (Id., p. 36.) Mr. Gorman's 9.58% sustainable growth constant growth DCF result, which forms the basis, in part, of his recommended allowed DCF derived ROE on book common equity, is lower than the expected average Value Line ROE of 10.57% for the same proxy group used to derive his recommended allowed ROE. (Id.)

Mr. Gorman's sustainable growth DCF ignores the basic principle of rate base/rate of return regulation—namely, that the cost of equity which will be authorized in this proceeding will be applied to the jurisdictional *book value* rate base of IAWC and become the allowed future earned return on book common equity, i.e., the expected ROE component of the sustainable growth method. (Id., p. 37.) There is no need to reject the empirical evidence of the proven reliability of analysts' forecasts of EPS by turning to either a sustainable growth constant growth or a multi-stage DCF model. (Id.)

IIWC/FEA's Capital Asset Pricing Model Uses Flawed Inputs.

Mr. Gorman's application of the CAPM is flawed for three reasons: (1) his derivation of the market equity risk premium is incorrect; (2) his "forward-looking" equity risk premium is not really a prospective equity risk premium; and (3) he fails to utilize the ECAPM in addition to the traditional CAPM.

Mr. Gorman's market equity risk premium is the difference between the arithmetic mean 1926 - 2010 total return on large company stocks of 11.9% and the arithmetic mean 1926 - 2010 total return on long-term government bonds of 5.9% from the SBBI - 2011 which results in a 6.0% market equity risk premium. (IAWC Ex. 10.00R, p. 38.) The correct derivation of the historical market equity risk premium is the difference between the total return on large company stocks of 11.9% and the arithmetic mean 1926 - 2010 income return on long-term government bonds of

5.2%, resulting in a market equity risk premium of 6.7%. Hence, as Ms. Ahern testified, the correct historical market equity risk premium is 6.7% and not 6.0%. (Id.)

Nor is Mr. Gorman's "forward-looking" equity risk premium truly forward-looking. Mr. Gorman derived his "forward-looking" equity risk premium by merely adding a current consensus analysts' inflation projection to the SBBI - 2011 long-term historical arithmetic mean real market return for the years 1926 - 2010. (Id., p. 39.) It is not appropriate to try and match a current forecast of inflation, 2.3% from Blue Chip, with an average real market return over a period of 85 years. Investors would not attempt to do such a thing. Rather, they would be influenced by a forecast such as that published by Value Line, which is widely subscribed to and is available in the business reference section of most libraries. A more appropriate method of deriving the prospective equity market return is based upon Value Line's projected 3-5 year market appreciation potential, which when converted to an annual rate plus the market's median expected dividend yield results in a forecasted total annual market return of 16.30% for the thirteen-weeks ending February 17, 2012. (Id.) This methodology yields a truly prospective market return which is based upon public information relied on by investors. (Id., p. 40.)

Additionally, Mr. Gorman should have included an ECAPM analysis in deriving his CAPM-based common equity cost rate. (Id.) As discussed above in response to Staff's recommendation, the empirical Security Market Line (SML) described by the traditional CAPM is not as steeply sloped as the predicted SML. Ms. Ahern explained low-beta securities earn returns somewhat higher than the CAPM would predict, and high-beta securities earn less than predicted. Hence, both the traditional CAPM and ECAPM should be used in deriving a CAPM-based common equity cost rate. Ms. Ahern recalculated Mr. Gorman's water companies using correctly derived historical and projected market equity risk premiums result in the following:

the traditional CAPM result is 10.42%, the ECAPM result is 11.17%. (IAWC Ex. 10.19R.) The average of both cost rates is 10.80%. (Id.).

The Authorized Return on Equity in this Case Should Be at least 10.38%.

To reduce the Company's current authorized return on equity below 10.38% would be unreasonable. Although the record supports a higher return on equity of 11.25% as recommended by Ms. Ahern, leaving the current return on equity as-is would strike an appropriate balance between ratepayer and shareholder interests. The current return on equity led to robust investment since the last rate case, and produced a climate conducive to future investment. The Commission should encourage investment, not discourage it. But to compete for investor capital, IAWC must receive an authorized return sufficiently adequate to attract capital at reasonable terms. An authorized return on equity of 10.38% would balance these interests and is consistent with recent authorized returns in neighboring jurisdictions.

D. Proposed Rate of Return

The Company requests that the Commission authorize an overall rate of return of no less than 8.21%, as shown in the following table:

Class of Capital	% of Total	(%) of Cost	Weighted Cost (%)
Short-Term Debt, net	0.26%	0.76%	0.00%
Long Term Debt	49.23%	6.04%	2.97%
Common Equity	50.51%	10.38%	5.24%
Overall Rate of Return			8.21%

VII. COST OF SERVICE AND RATE DESIGN

A. Cost-of-Service Study

The Company revised its Cost of Service Study ("COSS") to remove the allocation of contract customer costs for the combined Zone 1 and Chicago Metro service area. (Tr. 222.) By removing these customers, IAWC then classified contract customer revenue as Other Water Revenue, and allocated this revenue across the remaining tariff customer classes, thus reducing the cost of service for those classes. (Tr. 222-23.) This change more accurately reflects the benefits of contract customers and appropriately allocates the benefit of having contract customers in IAWC's system. (IAWC Ex. 11.00SR (Herbert Sur.), p. 12.) Moreover, showing the full cost to serve contract customers in the COSS is effectively an exercise in futility as contract rates are less than full-tariff rates. (Id., p. 13.)

Though removing contract customer more accurately portrays reality, IIWC and FEA disagree with the COSS revision. By removing contract customers, IIWC and FEA believe the COSS distorts the allocation of costs to the remaining customer classes and raises the possibility of other customers subsidizing contract customers' cost of service. (IIWC/FEA Ex. 4.0 (Collins Reb.), p. 6.) Mr. Collins also claims that the revised COSS allocates an addition \$2.3 million in costs to Zone 1. (Id.) Mr. Collins' claims should be rejected.

Any concern of other classes subsidizing contract customers is unfounded. Because the contract customers' revenue exceeds the incremental costs to serve these customers, the contract customers are *contributing* towards the fixed costs of the system, as is reflected in the revised COSS. (Tr. 225; see also IAWC Ex. 11.00SR, p. 13); Northern Illinois Water Corp., Docket 89-0176, 111 PUR 4th 223, 1990 Ill. PUC LEXIS 150 at *73 (1989); Inter-State Water Co., Docket 94-027, 161 PUR 4th 535, 1995 Ill. PUC LEXIS 283 at *182-3 (1994). These incremental costs include the short-term variable costs of power and chemicals. (Tr. 232.) Further, Mr. Collins' concerns that Zone 1 was allocated \$2.3 million in costs mistakes additional costs for the same level of revenue applied to Zone 1. In response to IIWC-3.1, the company allocated the same level of costs to the Zone 1 stand-alone COSS as it did to the direct COSS. (IAWC Ex. 11.00SR,

p. 13.) However, the data request used the consolidated Zone 1 and Chicago Metro revenues. (Id.) Because of this disparity, Mr. Collins incorrectly perceived an additional $2.3 million cost allocation.

The Company's revised COSS, as supported by Mr. Herbert, correctly reflects the cost to serve IAWC's customers and accurately reflects the reality of recovering those costs.

B. Consolidation of Zone 1 and Chicago Metro Rate Areas

The Company proposes consolidating the non-production related costs of Chicago Metro and Zone 1 districts. (IAWC Ex. 11.00 (Herbert Dir.), p. 15.) Consolidating these two districts will move IAWC's rates towards single tariff pricing, a policy explicitly endorsed in the Commission's Docket 07-0507 Order and consistent with IAWC's consolidation of Champaign and Sterling into Zone 1 in Docket 09-0319. (IAWC Ex. 5.00 (Rev.) (Kerckhove Dir.), p. 21.) Order, Docket 07-0507 (July 30, 2008), pp. 94-98. Staff supports the consolidation, finding it beneficial by spreading capital improvements costs over a larger customer base, lowering rate case expense, and lowering administrative expenses. (ICC Staff Ex. 4.0 (Boggs Dir.), p. 10.)

Though the consolidation is supported by IAWC and Staff, IIWC and FEA argue that the consolidation should be rejected because it ignores the concept of consolidation, the geographical distinctness of each service area, and the different zonal class structures. (IIWC/FEA Ex. 4.0 (Collins Reb.), p. 2-3.) As a result, IIWC and FEA believe the consolidation will erode system efficiency by creating subsidies between the two districts. (Id., p. 4.) This position should be rejected.

The IIWC/FEA position appears to ignore the Commission's history of approving consolidation of IAWC's rate zones, stretching back to the consolidation of the Zone 1 service area over time. See, e.g., Docket 07-0507 (approving the consolidation of Sterling and Champaign). Any apparent disparity between Chicago Metro and Zone 1's zonal class structures is minor and does not affect consolidated pricing. (IAWC Ex. 11.00SR (Herbert Sur.), p. 9.) Zonal class differences currently exist within the Zone 1 consolidated areas, and this will not change with the addition of Chicago Metro. (Id., p. 9.) Further, any difference in base cost and capacity costs of non-production costs between Zone 1 and Chicago Metro is reflected in IAWC's cost allocation. (Id., p. 10.) Finally, any assertion that the consolidation will result in subsidies eroding system efficiency is completely unfounded, unsupported, and contrary to IAWC precedent. (Id.) The Commission recently approved consolidating IAWC's Champaign and Sterling service districts. (Id., p. 9.; see also IAWC Ex. 11.00R (Herbert Reb.), p. 15.) No witness in this case testified that "efficiencies" have "eroded" as a result.

The evidence supports consolidating the two service areas, and the proposed rate design adequately allocates cost recovery to the appropriate classes. The Commission should approve the consolidation of Chicago Metro and Zone 1.

C. Proposed Customer Charges

The Company proposes, based on its cost of service study, customer charges set at a level to recover the full amount of fixed customer costs. These costs include meter reading, customer billing, customer accounting, allocable portion of administrative and general expenses, and other customer-service-related functions.

As a matter of policy, the Commission has consistently supported the recovery of a greater portion of a utility's fixed costs through the customer charge across all types of utility service. See Commonwealth Edison Co., Order, Docket 10-0467 (May 24, 2011), p. 232; see also Nicor Gas Co., Order, Docket 08-0363 (Mar. 25, 2009), p. 90-91; Central Illinois Public Service Co., et al., Order, Docket 07-0585-0590, p. 238.). In Commonwealth Edison, the Commission explained that it "recognized the importance of recovering fixed costs predominantly through fixed charges…." Commonwealth Edison, Order, Docket 10-0467 (May

24, 2011), p. 232. Similarly in Nicor Gas, the Commission noted, "[T]he combination of increasing the fixed customer charge and decreasing the volumetric charges for fixed cost recovery is essentially a revenue neutral exercise." Nicor Gas Co., Order, Docket 08-0363 (Mar. 25, 2009), p. 90 (relying on Order, Docket 07-0585-0590).

The Commission has stated this policy in IAWC's previous two rate cases. In Docket 07-0507, the Commission requested IAWC to "consider proposing rates whereby a greater portion of its fixed costs will be recovered through the customer charge for each rate class." Illinois-American Water Co., Order, Docket 07-0507 (July 30, 2008), p. 122. The Commission echoed this sentiment in its Order in Docket 09-0319, when it noted, "From a rate design perspective, all other things being equal, the Commission believes it is preferable for fixed costs to be recovered through fixed charges, and for variable costs to be recovered through variable charges, such as usage charges." Illinois-American Water Co., Order, Docket 09-0319 (Apr. 13, 2010), p. 170.

Pursuant to these policy directives, the Company proposes to recover all customer costs through customer charge and make all customer charges uniform across the state, except for the Chicago Metro and Lincoln ⅝-inch meter customer charges. The proposed customer charges will recover the Company's fixed costs incurred to serve all customers, regardless of use or physical customer location. (IAWC Ex. 5.00 (Rev.) (Kerckhove Dir.), p. 21.)

Though the Company's proposed customer charges move IAWC towards the goals set forth in the Commission's prior orders, other parties claim that the proposed customer charges over-recover customer costs. Staff, for instance, claims that the over recovery is due to IAWC setting rates for the ⅝-inch meter "without regard to the revenues that Customer Charges for meter sizes larger than ⅝ inch" would generate." (ICC Staff Ex. 12.0 (Boggs Reb.), p. 5.) Staff also faults the Company for increasing its customer charges for meters larger than ⅝-inches at different meter ratios, or meter equivalents, than the American Water Works Association ("AWWA") meter factor approach. (Id., p. 7.) Similarly, the AG criticizes IAWC's proposed customer charges for failing to use "meter equivalents" to calculate the service cost and billing and collection cost per meter. (AG Ex. 3.0 (Rubin Reb.), p. 11-12.) Both bases for rejecting the proposed customer charges are misguided.

The Company's proposed customer charges represent a balanced approach to recover customer costs. The Company designed the cost-based ⅝-inch customer charge to fully recover those customers' costs since 92% of residential customers have ⅝-inch meters. (IAWC Ex. 11.00SR (Herbert Sur.), p. 5.) To look to 8% of residential ratepayers to subsidize the recovery of costs to serve ⅝-inch meter customers is contrary to the basic regulatory principle of cost causation. Further, an over recovery for meters larger than ⅝-inches is based on the calculation of larger meter charges using the meter capacity ratios (or meter equivalents). (Id., p. 6.) This approach is endorsed by Mr. Boggs (and was approved by the Commission in the last IAWC rate case). (Id.) The Commission should not set a precedent of allowing the majority of residential ratepayers to forego paying their cost of service.

Contrary to the AG's "one-size-fits-all" approach, IAWC correctly applied the appropriate ratio for each category of costs. As shown on IAWC Ex. 11.01SR, IAWC applied the "meter equivalents" to the ⅝-inch meter cost to determine the larger meter cost by size. Importantly, the Company applied the "service equivalents" to the ⅝-inch *service costs* to determine the service cost by meter size. (IAWC Ex. 11.01SR.) The Company did not use any equivalents to increase the billing and collection costs by meter size because IAWC's cost to bill a 4-inch customer is the same as a ⅝-inch customer (i.e. it is a 1:1 ratio for meter to billing costs, for ⅝-inch meters to 10-inch meters). (Id.; see also IAWC Ex. 11.00SR, p. 4.) Applying "meter equivalents" to *non-meter* costs of the customer charge is effectively using a "hypothetical ratio" to artificially depress the customer charge.

The meter equivalent methodology used by IAWC also conformed to the methodology used in the Company's last rate case. (IAWC Ex. 11.00SR, p. 7.) IAWC increased the existing customer charges by a uniform percent consistent with the relationship among the meter sizes. (Id.) For example, the capacity for a ⅝-inch meter is 20 gallons per minute (gpm) while the capacity for a 4-inch meter is 500 gpm. Therefore, the meter equivalent or meter capacity ratio used by the Company was 25, since the 4-inch meter's capacity is 25 times more than the ⅝-inch meter. (Id., p. 4.) Utilizing any other methodology, including the AWWA meter factor approach, would be deviate from past IAWC precedent.

To the extent the Company's customer charges over-recover costs for larger meters, such a result would be consistent with the Commission's policy discussed above. Finally, the Commission should not approve the customer charges proposed by Staff, including the increase of South Beloit's customer charge, or proposed by IIWC and FEA. These rates are contrary to the Company's cost of service study for customer costs, and are contrary to the Commission-approved methodology used by the Company. The Commission should instead look to its precedent and approve the Company's proposed rate design.

D. Proposed Usage Charges

The Company proposes usage charges that appropriately recover the remaining revenue not recovered by IAWC's proposed customer charges. Though the Company's methodology is not contested, the shifting of cost recovery from customer charges to usage charges is in dispute. Staff recommends higher usage charges to recover the increased revenue requirement from lowering the customer charge. (ICC Staff Ex. 12.0 (Boggs Reb.), p. 11.) Staff contends that this rate design will allow customers to "control the increases in their water bills by conserving water usage." (Id., p. 11, lines 204-05.) This methodology, however, results in significant rate increases to the third and fourth consumption block customers. Mr. Boggs' proposed rate design disproportionately increases Other Water Utility and Industrial customer usage rates by 48.25% and 42.92%, respectively. (IAWC Exs. 11.00SR (Herbert Sur.), p. 7; 11.00R (Herbert Reb.), p. 7.) These increases are more than *twice* the average overall increase of 18.42% (IAWC Ex. 11.00R, p. 7; see also ICC Staff Ex. 4.0, Sch. 4.1, p. 1), or what Mr. Boggs characterizes as the "appropriate price signals to users of the largest volume of water." (ICC Staff Ex. 12.0, p. 12.) Such drastic increases, contrary to the rate principle of gradualism, should not be approved.

Staff's proposed rates also under recover the Company's required water cost of service. Staff's proposed usage charges, contrary to Mr. Boggs' rebuttal testimony, produces $235,863,477 in revenue, short of the Company's revenue requirement. (Cf. IAWC Ex. 11.00R, p. 7.; ICC Staff Ex. 12.0, p. 11.) IAWC's rate design appropriately produces its required cost of service, $235,941,089. (IAWC Ex. 11.00R, p. 7.) Staff neither explains why its designed rates do not recover IAWC's cost of service, nor how the Company would recover the $77,612 difference. With the unexplained shortfall and the disproportionate increases to the third and fourth consumption block customers, the Commission should approve IAWC's proposed usage charges.

E. Public Fire Protection Charges for Consolidated Zone 1 and Chicago Metro

The Company proposes a public fire protection charge for the Zone 1 and Chicago Metro consolidated service area that recovers slightly more than the cost of service. (IAWC Ex. 11.00R, p. 10.) Though Staff recommends a public fire protection charge for Chicago Metro, as a stand-alone district, that recovers slightly more than the cost of service, Staff recommends for the public fire protection rates for the consolidated district to equal its cost of service. (ICC Staff Ex. 4.0, p. 46.) As shown from IAWC Ex. 11.03R, IAWC's proposed Zone 1 and Chicago Metro consolidated rates recover approximately 3.86% above the cost of service. (IAWC Ex. 11.03R, p. 1.) By recovering the cost of service, even with the slight over-recovery, IAWC's fire protection charges "reflect the costs associated with providing fire protection service" (220 ILCS 5/9-223(a)), and should be approved.

F. Public Fire Protection Charges for Chicago Metro

The Company did not propose any increase to the Chicago Metro Public Fire Protection Charges if the Zone 1 and Chicago Metro consolidation is not approved. (IAWC Ex. 11.01 (Herbert Dir.), Sch. A.) An increase was not required since Chicago Metro's current rates currently recover 99.78% of this service territory's costs of service. The .22% shortfall equates to only $9,568 of revenue. (Id.) To "correct" this shortage, however, Staff recommends increasing Chicago Metro's rates by .44%, to recover 100.22% of the costs. (ICC Staff Ex. 4.0 (Boggs Dir.), p. 46.) Mr. Boggs claims this increase is necessary to conform the public fire protection rates to Section 9-223(a) of the Act. (ICC Staff Ex. 12.0 (Boggs Reb.), p. 13.) To bolster this argument, Mr. Boggs claims this charge would be spread over 44,000 customers, thus the impact on bills would be minimal. (Id.) Section 9-223(a) of the Act requires fire protection charges to "reflect the costs associated with providing fire protection service for each municipality or fire protection district." 220 ILCS 5/9-223(a). Public Fire Protection Charges for Chicago Metro meet this statute by reflecting the costs associated with providing fire protection service. Unlike the Staff's proposed Lincoln public fire protection charge that does not reflect the costs of service, the Chicago Metro fire protection charge reflects the costs of service by recovering 99.78% of these costs. The Commission should reject Staff's recommended increase.

G. Public Fire Protection Charges for Lincoln

To ensure that the Lincoln service area fully pays its cost of service, IAWC proposes to increase the Lincoln Public Fire Protection charges. Though Staff encourages the Company to recover the full cost of service from the Chicago Metro service area, Mr. Boggs recommends that the increase to the Lincoln Public Fire Charges be rejected. (ICC Staff Ex. 12.0 (Boggs Reb.), p. 13.) Staff proposes to limit the increase to 27% from the 53.8% IAWC proposed, based on unacceptable bill impacts. (ICC Staff Ex. 12.0, p. 14.) The plain language of Section 9-223(a), however, is that "Any fire protection charge imposed *shall reflect the costs* associated with providing fire protection service for each municipality or fire protection district." 220 ILCS 5/9-223(a) (emphasis added). In other words, there is not the exception in the statutory language that Mr. Boggs suggests. His recommended charges simply do not "reflect the costs" of fire protection. However, irrespective of the statute, when viewed in dollar terms, IAWC's proposed increase in the monthly fire protection charge per customer is only $2.35, from approximately $3.83 to $6.18, which is not unreasonable. (IL.L.C.C No. 24, Section No. 3, First Revised Sheet No. 3; Proposed IL.L.C.C No. 24, Section No. 3, Third Revised Sheet No. 3.) Further, IAWC's proposed rate is, in a dollars sense, similar to the Chicago Metro's current fire protection charge of $6.55 (which is not proposed to increase). (IL.L.C.C. No. 24, Section No. 2, First Revised Sheet No. 3.) Therefore, the Commission should approve IAWC's increase of the Lincoln Public Fire Charge.

H. Revenue Allocation: Large Other Water Utility Service Class

The Large Other Water Utility Service class comprises customers with contracted rates. (IAWC Ex. 11.00R (Herbert Reb.), p. 17.) Because these customers have contracted rates, their rates cannot be raised outside the terms of the agreement. (Id.) Irrespective of these Commission-approved contractual obligations, IIWC and FEA recommend unilaterally raising this class's rates to recover the full cost of service. (IIWC/FEA Ex. 4.0 (Collins Reb.), p. 4.) IIWC and FEA's recommendation, however, creates an inaccurate and unreliable rate design.

Increasing contract customer rates beyond the terms of contract is an attempt by IIWC and FEA to artificially increase revenue received by IAWC that will never be recovered from Large OWU customers. As explained by Mr. Herbert, most Large OWU contracts include provisions for annual increases that were built into the Company's future test year projection of current revenues. (IAWC Ex. 11.00SR (Herbert Sur.), p. 11.) An example of such a contract provision is contained in the confidential exhibit to Mr. Herbert's surrebuttal testimony. (IAWC Ex. 11.00SR, p. 11; see also IAWC Ex. 11.02SR.) Because the Company correctly allocated revenue to these customers after reviewing their contracts, the Commission should adopt IAWC's rates.

I. Adjusting Rate Elements of Declining Block Rate Schedule

The Company proposes increases to the commodity charges for Non-Residential Metered General Water Service and the University of Illinois. The Company, however, varied the increases in the commodity charges by rate block to generally move each customer class to its allocated cost of service. (IAWC Ex. 11.00R (Herbert Reb.), p. 19.) In lieu of the varied increases, IIWC and FEA propose adjusting the rate elements by a uniform percentage to coincide with the increased revenues granted by the Commission in this case. (IIWC/FEA Ex. 2.0 (Collins Dir.), p. 24.) A uniform percentage adjustment, however, would not move revenues more in-line with the allocated cost of service. (IAWC Ex. 11.00SR (Herbert Sur.), p. 14.) Further, Mr. Collins' recommendation is based upon his concerns with IAWC's COSS, which are unfounded as is discussed above. Therefore, the Commission should adopt the varied increases in commodity charges by rate blocks.

VIII. TARIFF TERMS AND CONDITIONS

A. Revenue Adjustment Clause

As the Commission is well aware, IAWC must operate its source of supply, treatment and transmission and distribution systems to provide water service to its customers whether those customers use no water in a given month or 100,000 gallons of water. (IAWC Ex. 14.00R (Rev.) (Heid Reb.), p. 5.) In other words, IAWC must stand ready to provide and deliver water to customers if and when called upon, and the Company maintains a significant infrastructure to provide that service. (Id.) It is no surprise, then, that the majority—nearly 94%, in fact—of IAWC's costs are fixed. (Id.) Despite this, under the traditional ratemaking paradigm, IAWC's revenues, and, thus its ability to recover its costs, are directly dependent upon its customers' water usage. (Id., p. 6.) Therefore, IAWC will *only* recover its costs if the level of water usage upon which its rates are premised is actually achieved. (Id.)

IAWC, however, has experienced a significant and continuing trend of declining usage in water consumption. (See Section IV.A supra.) That declining usage has a considerable impact on IAWC's water sales. (IAWC Ex. 4.00 (Grubb Dir.), pp. 17-18.) This is not a theory; it is a reality. The declining usage results from changes in usage due to federal and state water efficiency standards, increased customer installation and use of more efficient plumbing and water-using appliances, and heightened interest in natural resources, including water, conservation—all which are factors outside utility control. (IAWC Ex. 8.00 (Naumick Dir.), pp. 3-10.) Moreover, as the interest in and adherence to water conservation measures grows and the presence of more efficient plumbing fixtures and appliances increases, IAWC can no longer anticipate increased water sales. In fact, IAWC's projections in this case, based on a study of usage, show residential water sales declining *annually* by nearly 2% (1.08% for commercial usage). (IAWC Ex. 4.00, pp. 17-18.) To address this emerging business reality, IAWC has proposed a mechanism which would "decouple" the Company's recovery of its fixed costs in providing water utility service to its customers from the volume of water it actually sells. (IAWC Exs. 14.00R (Rev.) (Heid Reb.), p. 4; 4.00, p. 18.) This mechanism—the Revenue Adjustment Clause ("RAC")—will provide IAWC with a measure of revenue stability which will enable it to champion water conservation measures without the fear of undermining business interests in the face of the declining usage trend IAWC has and expects to continue to experience.

What the RAC Is and How It Functions.

The RAC is a transparent decoupling mechanism that would enable IAWC to recover on a current basis the level of revenue the Commission authorized the Company to recover in the preceding rate case—no more and no less. It is symmetrical in that it accounts for both the over- and under-recovery of that revenue requirement. (IAWC Exs. 14.00R (Rev.), pp. 2-3; 4.00, p. 18.) In other words, the RAC will not have any impact whatsoever on IAWC's overall revenue requirement.

The tariff in IAWC Exhibit 14.02R, pp. 1-9, is the RAC. Its function is simple. Under the RAC, the levels of revenue and production expense (i.e. for fuel, power and chemical) authorized by the Commission in this case constitute "base" levels. Going forward, the actual monthly levels of revenue and production expense will be booked and compared to those base levels. At the end of twelve months, the difference between the base revenue level, net of base production costs, and the actual revenue level, net of actual production costs, will be determined. The Company will then file with the Commission on an annual basis a request to issue a refund to customers or to collect a surcharge, as the case may be, reflecting that difference. Metered customers will receive the corresponding refund or surcharge in its entirety on their next monthly bill. (IAWC Exs. 4.0, pp. 18-19; 14.02R.) The refund or surcharge will not exceed -5% or +5% of any customer's water bill for the applicable 12-month period. (IAWC Exs. 14.00R (Rev.), p.

31; 14.02R.) In this way, customer bill impact is mitigated. (IAWC Ex. 14.00R (Rev.), p. 31.) To the extent the difference exceeds the 5% cap, the excess will be deferred to a future period with interest at the AFUDC rate. This entitles customers to a refund, over time, of any revenues collected above the Commission-approved level. (Id.) In sum, the function of the RAC ensures that IAWC recovers its required level of revenue as sanctioned by the Commission—no more and no less—while also ensuring IAWC's customers pay the amount of fixed cost contribution authorized to be included in their monthly bills—again, no more and no less. (Id.)

The RAC Is Necessary.

Inasmuch as the traditional ratemaking model is premised on the establishment of properly recoverable costs and a projection of a volume of sales over which those costs will be recovered, it fails that goal when the actual sales volume is less than the projection used to set rates. (IAWC Ex. 14.00R (Rev.), p. 7.) Recent history has proven that to be the case for IAWC. The Company is experiencing a significant trend of declining annual water sales—of 1.90% for its residential customers, and of 1.08% for its commercial customers. (IAWC Exs. 4.00, pp. 17-18; 8.00, pp. 3-4.) Other variables also outside IAWC's control, including weather and changing customer numbers, contribute to the Company's inability to forecast with precision its test year level of water consumption. (IAWC Ex. 14.00R (Rev.), pp. 7-14.) The RAC effectively eliminates the resulting concerns related to the process of projecting the pro forma water sales volumes used to establish IAWC's rates. (Id., p. 8.) Fixed costs remain the same regardless of sales volumes. The RAC recognizes this. It ensures the Company receives, and customers supply, the level of required revenue approved by the Commission—no more and no less—despite the decline in usage, the unpredictability of weather and changes in customer numbers. (Id.)

Illinois Law and Commission Practice and Policy Support Approval of the RAC.

The Commission may adopt a decoupling mechanism. There is no question this Commission's authority "embraces more than the authority to approve rates fixed in terms of dollars and cents." City of Chicago v. Illinois Commerce Comm'n, 13 Ill. 2d 607, 611 (1958). That authority extends to implementing "pragmatic adjustments" as part of the Commission's ratemaking function. Id. at 618; North Shore Gas Co., et al., Order, Docket 07-0241/0242 (Feb. 5, 2008), pp. 144-45 ("[I]t is well-settled that the Commission sets rates in two ways; by base rates and by an automatic adjustment clause, i.e. the rider mechanism."). The Commission recently found the whole of the case law on the issue settles the question of its authority to adopt decoupling mechanisms. North Shore Gas Co., et al., Order, Docket 07-0241/0242 (Feb. 5, 2008), pp. 139-40 (reviewing case law).

A growing number of state utility commissions—this Illinois Commission included—have approved revenue decoupling mechanisms, such as the RAC or a straight-fixed variable rate design, in recognition that such mechanisms have identifiable benefits for both ratepayers and utilities. (IAWC Ex. 14.00SR (Rev.) (Heid Sur.), pp. 9-10.); North Shore Gas Co., et al., Order, Docket 07-0241/242 (Feb. 5, 2008), p. 152 (finding the Commission "cannot deny that decoupling mechanisms are increasingly coming into use across the nation"; Commonwealth Edison Co., Order, Docket 10-0467 (May 24, 2011), p. 232 (recognizing "the importance of recovering fixed costs predominantly through fixed charges"); Nicor Gas Co., Order, Docket 08-0363 (Mar. 25, 2009), pp. 90-91; Central Illinois Public Service Co., et al., Order, Dockets 07-0585-0590 (Sept. 24, 3008), p. 238; Illinois-American Water Co., Order, Docket 07-0507 (July 30, 2008), p. 122; Illinois-American Water Co., Order, Docket 09-0319 (Apr. 13, 2010), p. 170. See also New York Pub. Serv. Comm'n, Opinion, Cases 03-E-0640, 06-G-0746, 256 PUR 4th 477, 2007 N.Y. PUC LEXIS 125, **1-3 (Apr. 20, 2007) (requiring energy utilities to develop and implement decoupling mechanisms in the face of heightened energy efficiency and declining usage). In fact, at least two water utilities have in place decoupling mechanisms similar to the RAC intended to address conservation and declining usage. See Long Island American Water Co., Opinion, Cases 07-W-0508, 05-W-0339, 263 PUR 4th 440, 2008 N.Y. PUC LEXIS 89 (New York Pub. Serv. Comm'n, Mar. 5, 2008) (approving Revenue Adjustment Clause); California-American Water Co., Decision 08-02-036, Order, 2008 Cal. PUC LEXIS 72 (California Pub. Util. Comm'n, Feb. 28, 2008 (approving Water Revenue Adjustment Mechanism). This Commission should continue that progressive trend.

Docket 07-0241/0242 "present[ed] the Commission with its first introduction to decoupling mechanisms." Id., p. 138. In that case, North Shore Gas Company and the Peoples Gas Light & Coke Company proposed a Volume Balancing Adjustment mechanism ("Rider VBA") which (like the RAC) adjusts customer prices such that the utilities' revenues are held constant despite changes in customer consumption brought about by increasing interest in conservation measures, changing weather trends and the utilities' involvement in resource efficiency programs, among "other events." Id., pp. 138-39. The function of the RAC is nearly identical to that of Rider VBA. As the Commission explained:

> In its operation, Rider VBA would have two primary functions. First, Rider VBA would increase rates to account for margin revenues which the Utilities would be unable to collect, in a given month, due to changes in customer usage. Second, Rider VBA would lower rates to account for any over-recovery of margin revenues by the Utilities, in a given month, due to customer usage changes. These rate increases and decreases would occur under Rider VBA by operation of a mathematical formula that is applied to the margin revenues that will have already been fixed and approved by the Commission in this proceeding. Thus, Rider VBA involves no more than periodic adjustments to a rate that is fixed and approved by the Commission and with such adjustment as determined by application of a set mathematical formula.

North Shore Gas Co., et al., Order, Dockets07-0241/242 (Feb. 5, 2008), p. 151.

Specifically (again, like the RAC), the mechanism proposed by those utilities credits or surcharges customers for any over- or under-recoveries of revenue. North Shore Gas Co., et al., Order, Docket 11-0280/0281 (Jan. 10, 2012), p. 163. The Commission found Rider VBA was not only appropriate under Illinois law, but also warranted by the changing business realities facing the utilities. It further found the mechanism warranted by the decline in usage per customer experienced by the utilities as a result of many factors, including increased conservation measures and energy efficiency initiatives and changing weather and prices. Id., pp. 150-53.

Just this year, the Commission affirmed its findings in Docket 07-0241/0242 when it approved Rider VBA on a permanent basis. North Shore Gas Co., et al., Order, Docket 11-0280/0281 (Jan. 10, 2012), p. 163. In so doing it reiterated "[s]ome of the problems that Rider VBA was originally intended to protect the utilities from were the reality of fixed costs against a backdrop of a diminishing customer base and resulting revenue losses as well as revenue losses attributable to the implementation of aggressive energy efficiency programs." Id. Notably for the purposes of this case, the Commission identified as an additional benefit of Rider VBA that it "reduces the reliance on forecasting customer and usage to set rates . . . [thereby] prevent[ing] harm to either the ratepayer or the utility from usage that deviates from the average." Id. It found immaterial to its approval of Rider VBA whether the decoupling mechanism prompted the utilities to spend more on energy efficiency. Id., pp. 163-64. In approving Rider VBA on a permanent basis, the Commission concluded the mechanism stabilizes the utilities' revenues and ensures that customers neither over- nor underpay the utilities' Commission-approved revenue requirement. Id., p. 164.

Staff and Intervenors' Concerns Regarding the RAC Are Misplaced.

Staff and Intervenors the AG and IIWC recommend outright rejection of the RAC on a number of grounds, all of which ignore the record evidence and the applicable precedent. As such, those arguments are misplaced and should be rejected. Each is addressed in turn.

Changing Business Realities Warrant the RAC.

Staff witness Ms. Harden argues IAWC has not presented any "unusual circumstances" that would warrant adoption of the RAC. (ICC Staff Ex. 5.0 (Harden Dir.), p. 2.) That is not the case. The record evidence shows that the significant annual decline in customer usage, unpredictability of weather and changes in customer numbers make the accurate establishment of projected pro forma sales volumes problematic. (IAWC Ex. 14.00R (Rev.), p. 14.) Notably, that is *precisely* one of the reasons the Commission approved Rider VBA. It found:

> Rider VBA reduces the reliance on forecasting customers and usage to set rates. Staff Exhibit 6.0, pp. 4-5. The forecasts are inevitably incorrect each year, and they are only correct on average. Thus, Rider VBA prevents harm to either the ratepayer or the utility from usage that deviates from the average. It also protects ratepayers in the event the utilities generate or choose a forecast that underestimates sales volumes. Id., at 9. Absent Rider VBA, such a forecast set rates too high and unjustifiably increases revenues and profits to the Utilities. Id. With Rider VBA, such a forecast is ineffective at increasing profits, because over collections are refunded to customers.
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> weather affects customer usage and decoupling means that customers do not overpay when weather is colder than normal or underpay when weather is warmer than normal. Decoupling also addresses load changes, including declining load attributable to energy efficiency. . . . Decoupling will take the effects of efficiency into account together with other factors, notably weather, that affects load and promote distribution rate stability for customers and the Companies.

North Shore Gas Co., et al., Order, Docket 11-0280/0281 (Jan. 10, 2012.), pp. 163-64.[19] Put

[19] Both the AG and IIWC take issue with IAWC's usage forecast in this proceeding and, at the same time, recommend rejection of the RAC, which would resolve their concerns regarding projected consumption by adjusting revenues for forecast inaccuracy. Thus, their positions in this regard are inconsistent. (IAWC Ex. 14.00R (Rev.), p. 13.)

simply, the record demonstrates the time is ripe for implementation of the RAC.

Nevertheless, Ms. Harden maintains declining usage, weather and changing customer numbers are not "new issues" which would warrant the RAC. (ICC Staff Ex. 5.0, p. 10, lines 235-36.) She argues IAWC has not explained why the RAC is needed now when IAWC has been able to function without that decoupling mechanism until the present. (ICC Staff Ex. 13.0 (Harden Reb.), pp. 2, 4-5.) But simply because the RAC has not been in place before does not mean circumstances do not warrant its adoption in this case. Indeed, the Commission has only recently considered decoupling mechanisms, beginning in 2007 when Rider VBA was first proposed. North Shore Gas Co., et al., Order, Docket 07-0241/0242 (Feb. 5, 2008), p. 138. It noted in that docket Rider VBA presented it with a case of first impression, id., p. 152, yet it nevertheless approved the mechanism, id., p. 151-52. Further, like the energy utilities at issue in that docket, climate, demographic, political and economic shifts impacting IAWC and the water industry have been considerable, yet water rate structures have not adapted.

Ms. Harden acknowledges declining usage is a reality. (ICC Staff Exs. 5.0, p. 9; 13.0, p. 6 (citing IAWC Ex. 4.00, pp. 17-18).) Yet, she states (without basis or quantification), "the approximate 1% decline in annual usage . . . is quite small" and, as such, does not justify the RAC. (Id., p. 9, lines 215-16.) In fact, the record demonstrates a nearly 2% annual residential usage decline. (IAWC Exs. 4.00, pp. 17-18; 8.00, pp. 3-4.) That annual decline is not small at all, especially considering that it compounds over the two- to three-year period rates are expected to be in effect. (IAWC Ex. 14.00SR (Rev.), p. 5.) Also, Ms. Harden acknowledges the Commission adopted Rider VBA due in part to a substantial customer usage decline. (ICC Staff Ex. 5.0, p. 10.) See also North Shore Gas Co., et al., Order, Dockets 07-0241/0242 (Feb. 5, 2008), p. 150 ("The record in this case persuades the Commission that Rider VBA is appropriate as it reflects the particulars of declining and variable customer usage patterns and the concomitant revenue recovery impacts for [the utilities]. The same reason exists for the adoption of the RAC here. Because Ms. Harden ignores this, her wholesale rejection of the RAC should be dismissed.

The RAC Does Not Remove the Incentive to Control Costs.

Both Staff and IIWC contend the RAC should be rejected because it reduces IAWC's incentive to control costs. (ICC Staff Ex. 5.0 (Rev.), p. 11; IIWC/FEA Ex. 2.0, p. 10.) This argument is misplaced. The RAC only impacts revenues, and the refund or surcharge amounts are net of production costs. Therefore, IAWC remains at risk for fluctuations in fixed costs or unit production costs. (IAWC Ex. 14.00R (Rev.), p. 19.) As such, the Company's management must actively and efficiently manage the cost elements that comprise IAWC's total cost of service. (Id., p. 19.) Thus, these claims should be rejected.

The RAC Does Not Discourage Conservation.

Both Staff and IIWC also contend the RAC discourages voluntary water conservation efforts on the part of customers because it imposes a surcharge when their consumption levels decline. (ICC Staff Ex. 5.0 (Rev.), p. 11; IIWC Ex. 2.0, p. 11.) But it is traditional use of volumetric rate designs to recover fixed costs that implies that a utility can reduce those costs if customers reduce their usage. (IAWC Ex. 14.00R (Rev.), p. 21.) In reality, that is not the case. Instead, the price signals customers receive under the RAC will be *more* aligned with the reality of the provision of water utility service. (Id., p. 22.) Moreover, even if customers use less water, because the utility's costs are fixed in the short-term and revenues are predominately volumetric, it is still necessary for them to pay for the fixed costs. (IAWC Ex. 14.00SR (Rev.), p. 17.) Finally, Staff and IIWC's contention in this regard ignore there are myriad environmental and operational benefits from lower water usage, including the maintenance of source water supplies. (IAWC Ex. 8.00, p. 11.)

The AG also presents a conservation-related argument against the RAC. AG witness Mr. Rubin contends IAWC has presented no conservation rationale for the RAC and, moreover, that it is not engaged in aggressive water conservation efforts. (AG Ex. 1.0 (Rubin Dir.), p. 15.) That statement ignores the record evidence. IAWC presented ample evidence that conservation measures—both its own and regulatory ones—are a significant driver of the need for decoupling. (IAWC Ex. 8.00, pp. 4-6; 10.) Further, the Commission has made clear decoupling mechanisms need not be solely tied to conservation measures to be appropriate. North Shore Gas Co., et al., Order, Docket 07-0241/0242 (Feb. 5, 2008), pp. 163-64. Rider VBA was not conditioned on the utilities increasing their energy efficiency initiatives. The RAC also should not be so conditioned.

The RAC Does Not Impact IAWC's Financial Risk.

Staff recommends a downward adjustment of 23 basis points to IAWC's cost of equity should the Commission adopt the RAC as proposed by the Company on rebuttal, because the RAC promotes revenue stabilization which, Staff alleges, provides the Company greater assurance that its authorized rate of return will be earned. (ICC Staff Ex. 14.0 (Freetly Reb.), pp. 8-9.) However, that adjustment should be rejected as ad hoc and arbitrary. Staff provides no empirical support quantifying its 23 basis points as reasonable. Nor could it. Studies have concluded that there is no measurable difference in the volatility of equity risk premiums or in systematic risk as measured by beta due to the presence of a decoupling mechanism. (IAWC Exs. 10.00R (Ahern Reb.), pp. 20-21; 10.11R.) Thus, there is simply no empirical evidence that the magnitude of impact of a decoupling mechanism on a common equity cost rate can be quantified. (IAWC Ex. 10.00SR (Rev.) (Ahern Sur.), p. 3.) This is most likely due to the myriad factors collectively affecting investor perceptions of risk. (IAWC Ex. 10.00R, p. 21.)

Moreover, Staff's contention on rebuttal that the return on equity deduction should be increased from 10 basis points to 23 basis points is based on a simplistic calculation of revenues IAWC could have collected had the RAC been in effect in prior years. (ICC Ex. 14.0, pp. 8-9.) This calculation ignores IAWC's usage projection in this case, which is intended to provide an accurate projection reflecting declining usage such that amounts surcharged or refunded would be smaller than in the past. (IAWC Ex. 6.00SR (Rungren Sur.), pp. 12-13.) As such, Staff's baseless attempt to quantify such an impact should be accorded no weight.

In fact, in other jurisdictions where a decoupling mechanism similar to the RAC has been approved for a water utility, there has been no reduction to the authorized rate of return on common equity to reflect the existence of that mechanism. (IAWC Ex. 10.00R, p. 21.) Indeed, in making permanent Rider VBA, the Commission also did not impose any return of equity deduction. As such, Staff's contrary adjustment should be rejected.

In sum, the RAC is a decoupling mechanism designed with symmetry, transparency, and accountability for collecting IAWC's Commission-approved revenue requirement—no more, no less. IAWC has compellingly and sufficiently demonstrated that the RAC is warranted and works to the benefit of both IAWC and its customers. As the Commission has recognized, "[a]ll market participants, including the Utilities need to be part of a concerted effort to change the status quo. And, in the process, the current regulatory structure may also have to be re-examined and better tuned to accept new factual realities and policy objectives." North Shore Gas Co., et al., Order, Docket 07-0241/0242 (Feb. 5, 2008), p. 152. The record evidence demonstrates the RAC is the proper regulatory response for all of the changing business realities impacting IAWC.

IX. OTHER ISSUES

A. Staff Recommendations regarding Section 7-101 of the Public Utilities Act Should Be Rejected.

The affiliate interest issues in this case arise from Staff witness Mr. David Sackett's allegation that IAWC, "via AWWSC," is lending aid and support to AWR in the marketing and solicitation of a water line protection program, doing "indirectly" what the Commission forbade directly by not approving an affiliated interest agreement in Docket 02-0571. Mr. Sackett recommends that the Commission: (1) open a proceeding to investigate whether IAWC violated Section 7-101[20] of the Act; (2) direct the investigation to include whether the IAWC-AWWSC affiliated interest agreement ("Service Company Agreement") approved in Dockets 88-0303 and 04-0595 is in the public interest; (3) determine whether penalties are appropriate if IAWC is found to have violated Section 7-101; and (4) direct IAWC to provide "proof" that AWR does not enjoy access to ratepayer information. (ICC Staff Ex. 15.0 (Sackett Reb.), p. 30.)

The record establishes that there is a complete lack of legal or factual support for these recommendations. The recommendations should be rejected in their entirety because:

- Staff's allegations are based on a wholesale disregard of the legal and functional separation among IAWC, AWWSC and AWR, as well as the Commission's recognition that it does not have jurisdiction over line protection programs offered by unregulated affiliates.

- AWWSC operates the call center in a manner that ensures compliance with Illinois law and Commission orders, and prevents subsidization of AWR.

- IAWC is not providing the services to AWR that IAWC requested to provide in Docket 02-0571 or otherwise.

- There is no legal or factual basis to investigate whether the approved Service Company Agreement remains in the public interest.

[20] As is relevant here, Section 7-101(3) provides that "No . . . contract . . . for the furnishing of any service . . . made with any affiliated interest . . . shall be effective unless it has first been filed with and consented to by the Commission . . . ." 220 ILCS 5/7-101(3). Additionally, "Every contract or arrangement not consented to or excepted by the Commission as provided for in this Section is void." Id.

- There record is sufficient to establish that IAWC has not violated Section 7-101. Another investigation is not needed.

The facts pertinent to Staff's allegations and recommendations are largely undisputed. AWWSC provides call center services to IAWC and other American Water utilities at call centers located in Alton, Illinois and Pensacola, Florida. (Tr. 145-46.) The Commission approved the provision of this service (and others) to IAWC in Docket 04-0595. AWR maintains a separate call center at the Alton facility, which is staffed with AWR employees. (IAWC Exs. 15.00R (Cooper Reb.), p. 5; 1.00SR-Part 2 (Teasley Sur.), p. 3.) The costs to operate and maintain the call center on behalf of IAWC and its regulated affiliates are charged to IAWC and its affiliates based on the number of calls received by each entity's dedicated, toll-free number. (IAWC Ex. 1.00SR-Part 2, pp. 3-4.)

It is undisputed that AWWSC call center agents do not market AWR products to IAWC customers. (Tr. 532, 651; IAWC Ex. 1.00SR-Part 2, pp. 4, 6.) For example, if an IAWC customer calls to establish service, inquire about a bill or report a service problem, no attempt is made to sell the customer an AWR line protection program. (See Tr. 532; IAWC Cross Ex. 1 (IAWC-ICC 1.47).) On rare occasions, however, a caller to the IAWC number will inquire about water line protection products or services. (IAWC Ex. 15.00R, pp. 4-5.) When this happens, AWWSC call center agents are trained to transfer the caller to the AWR call center, or provide the caller with AWR's web address or telephone number. (Id., pp. 4-5; 1.00SR-Part 2, p. 3; ICC Staff Ex. 15.0, p. 24.) .) IAWC witness Karen Cooper explained, out of 4,147,159 customer calls answered by the CSC in total in 2011, there were 2,928 calls transferred to AWR, or 0.06% of the total. (IAWC Ex. 15.00R, p. 5.)

To further ensure that the activities of IAWC and AWR are kept separate, AWWSC does not keep track of which IAWC customers are also customers of AWR. (IAWC Ex. 15.00SR

(Cooper Sur.), pp. 6-8.) The only way AWWSC knows whether a utility customers has a line protection program – from AWR or any other provider – is if the customer volunteers this information. (IAWC Ex. 15.00R, p. 9.) For example, if a customer calls to report a problem that requires issuance of an emergency leak investigation service order, and the customer also volunteers (without prompting by the call center agent) that the customer has a line protection program, the agent may note this information on the service order. (Id., p. 8.) This enables the technician responding to the service order to, for the customer's convenience, advise the customer who to contact if the problem exists on the customer's service line. (IAWC Ex. 2.00R 2d (Rev.) (Suits Reb.), p. 4.) However, as with call transfers, this happens rarely - for IAWC, over 1.9 million service orders were issued in 2010-11, but only 74 were orders that noted a customer had a service line protection program. (IAWC Ex. 15.00SR, p. 2).

It is these two practices – transferring calls to AWR and noting on service orders whether the customer has a line protection program – that Mr. Sackett alleges violate Section 7-101. (ICC Staff Ex. 15.0, pp. 21-30.)

Staff's Allegations Are Based on a Wholesale Disregard of the Legal and Functional Separation among IAWC, AWWSC and AWR.

AWWSC May Provide Separate Services to IAWC and AWR.

Staff acknowledges that IAWC does not directly provide services to AWR. (IAWC Cross Ex. 1 (IAWC-ICC 1.07).) Rather, Staff's claims are predicated on an "agency" theory that "when AWWSC interacts with IAWC ratepayers on behalf of IAWC, they are functioning as an agent of the utility. Thus, their actions are equally subject to Commission jurisdiction as are those of IAWC employees." (ICC Staff Ex. 7.0, p. 7, lines 139-42.) Based on this agency theory, Staff charges that IAWC is supporting AWR through a "corporate arrangement that uses AWWSC to provide services to AWR rather than IAWC providing them directly." (Id., p. 8, lines 181-83.) In other words, under Staff's "agency" theory, if an AWWSC employee provides services to an Illinois customer as an "agent" of IAWC, that AWWSC employee is also acting as an "agent" of IAWC when he/she provides services to any other American Water affiliate, such as call center employees providing services to Pennsylvania American or New Jersey American. Under Staff's theory, AWWSC provides all these services to these other entities as "agents" of IAWC.

Staff's "agency" theory has absolutely no foundation, in law or in common sense. Even if AWWSC call center representatives are assumed to be acting as "agents" of IAWC when they receive calls to IAWC's toll-free number, the scope of any "agency" in this context is limited to just that: answering calls on behalf of IAWC. (IAWC Ex. 1.00R (Teasley Reb.), pp. 5-6.) No evidence has been produced, nor an argument even made, that IAWC has authorized or directed AWWSC to support AWR on IAWC's behalf. Moreover, the approved Service Company Agreement expressly contemplates that AWWSC may also perform services as an "agent" of other regulated and unregulated affiliates. (ICC Staff Exs. 7.00, Attachment A, p. 12, § 5.1; 15.0, pp. 8-9.) See also Illinois-American Water Co., Order, Docket 04-0595 (Oct. 19, 2005), p. 2. That AWWSC provides call center services on behalf of IAWC does not preclude AWWSC from also providing services to AWR and it is not doing so as an "agent" of IAWC.

Thus, whether AWWSC is an "agent" of IAWC is of no relevance in determining whether IAWC provides services to AWR (it does not; as explained below, *AWWSC*—and not IAWC—transfers calls or issues service orders as a convenience to IAWC's customer, when a customer reports that they have a service line protection program). Whether AWWSC provides services to AWR is also irrelevant. Put simply, Staff has not shown that an agency relationship exists between IAWC and AWR – i.e., that one entity is providing services to the other. That one agent (AWWSC) may in theory have two principals (IAWC and AWR) for whom the agent provides separate and distinct services does not make the principals "agents" of each other.[21] See Illinois Assoc. of Remittance Agents v. Powell, 122 Ill. App. 2d 322, 328-29 (4th Dist. 1970) (finding banks properly serve as agents of the Secretary of State in issuing vehicle license plates and as agents of applicants in exacting fees for processing applications for the same, noting "[t]here is nothing unusual in any person or corporation serving two principals in a given transaction where the services to each are consistent with his duty to each and the interest of neither is disparaged.") In any event, Mr. Sackett admitted that his theory of "agency" has no foundation in the law and reflects merely his own "layman's" interpretation. (Tr. 479, 482; IAWC Cross Ex. 1 (IAWC-ICC 1.25.)) As a legal matter and as a practical matter, Mr. Sackett's layman's theory cannot provide a basis for a finding of a statutory violation.

It is undisputed that the Commission has approved the "corporate arrangement" of which Mr. Sackett complains. The agreement approved in Docket 04-0595 plainly discloses that AWWSC will provide services not only to IAWC, but also to other regulated and unregulated affiliates. Illinois-American Water Co., Order, Docket 04-0595 (Oct. 19, 2005), p. 2. And the Commission has expressly recognized that these services include call center services. Id. Staff cannot point to a single provision of the Service Company Agreement that AWWSC or IAWC have failed to honor.

The Commission Has Acknowledged It Does Not Regulate Line Protection Programs Offered by the Unregulated Affiliates of a Utility.

Staff acknowledges that AWWSC and AWR are not public utilities. (Tr. 520; ICC Cross Ex. 1 (IAWC-ICC 1.12-1.13).) It follows (and Staff concedes) that AWWSC and AWR are not

[21] Mr. Sackett acknowledged as much when he agreed that when he is on duty with the Marine Corps, he is an agent of the Marines, takes direction from the Marines and acts on behalf of the Marine Corps. When is performing his job for the ICC, he is an agent of the ICC. The fact that Captain Sackett is an agent of the Marine Corp., and Mr. Sackett is an agent of the ICC, does not make the Marine Corps and the ICC "agents" of each other. (Tr. 651-54.)

subject to the Commission's general supervisory jurisdiction. (IAWC Cross Ex. 1 (IAWC-ICC 1.12-1.13, 1.25).) The Commission's jurisdiction is limited to the *utility's* transactions with its affiliates. Indeed, Section 7-101 places no limitations at all on the activities of affiliates. It is only when a utility seeks to provide services to, or receive services from, an affiliate that Commission approval is required. See 220 ILCS 5/7-102(c).

In AGL Resources, Inc. et al., Docket 11-0046, Nicor Gas and its affiliated service company (Nicor Services) sought re-approval of an affiliated interest agreement. See Order, Docket 11-0046 (Dec. 7, 2011), pp. 38-39. Under the Nicor arrangement, the utility had its own call center where utility employees would take calls. Id., p. 40. After the utility employee handled the utility portion of the call, the same employee would try to sell the customer a gas line protection program offered by the service company and, if successful, earned a commission paid by the service company. Id.

The Commission approved a modified version of the Nicor agreement that required the *utility* to quit soliciting on behalf of its affiliate. Id., pp. 66, 78. But the Commission did *not* order the *service company* to stop offering a line protection program. In fact, throughout the Commission's Order, the Commission emphasized that it could not and would not insert itself into the affairs of an unregulated affiliate:"[A]s [Nicor Gas] underscores, neither [Nicor Services] nor its services have been placed under our statutory authority." Id., p. 57. The Commission recognized that "with respect to the public interest, [Nicor Services] could, in theory, vitiate the misleading nature of the [Nicor Services] and [Nicor Gas] solicitations by revising its sales scripts to eliminate the false impressions currently conveyed. However, as [Nicor Gas] has adamantly and correctly maintained, the Commission has no authority over [Nicor Services] . . . ." Id., p. 71. Thus, "since the Commission has no authority over [Nicor Services], we have no power to terminate its customer enrollments or establish conditions for continued enrollment." Id., p. 76.

In light of the statutory limits of the Commission's jurisdiction, the Commission does not concern itself with the activities of unregulated affiliates, *except* to the extent those activities involve utility property or personnel:

> Although the Commission concurs with NG that 'there is no authority under the Act for the Commission to regulate the affiliate's product,' no such regulation is intended in this Order. [Nicor Services] and [the Gas Line Comfort Guard line protection program] are not subject to our jurisdiction. [Nicor Gas], however, and its affiliate transactions and its reorganizations are squarely within our purview. This Order constrains only the conduct and property of the utility. Evidence pertaining to [Nicor Services] and [Gas Line Comfort Guard] is material here only insofar as it demonstrates what the *utility* is doing and how *utility* property is being used.

Id., p. 70 (emphasis in original) (footnotes omitted).

Here, despite Staff's suggestion that IAWC has run afoul of Section 7-101 for the same reasons as the Nicor companies, the record evidence establishes otherwise. Unlike Nicor Gas, IAWC does not operate its own call center. (IAWC Ex. 1.00 (Rev.) (Teasley Dir.), p. 25.) Unlike Nicor Gas, IAWC employees do not handle customer calls. Id. And unlike Nicor Gas, neither IAWC nor AWWSC solicits *any* caller, let alone every caller, with a sales pitch for AWR products and services. (IAWC Ex. 1.00SR-Part 2, p. 6.) AWR handles its own calls, using its own employees, at its own call center. (IAWC Exs. 15.00R, p. 5; 1.00SR-Part 2, p. 3.) AWR also pays the appropriate share of its shared call center costs. (IAWC Ex. 15.00R, p. 7.) Although a *de minimis* number of calls to IAWC are transferred to AWR, as discussed below, this is done to *prevent* the use of utility-dedicated resources for non-regulated activities, and otherwise for the convenience of the utility's customer (whereas Staff's preference would be to simply terminate the call (Tr. 476-77, 480-81)).

<u>AWWSC Operates the Call Center in a Manner that Ensures Compliance with Illinois Law and Commission Orders, and Prevents Subsidization of AWR.</u>

What Staff witness Mr. Sackett mischaracterizes as the "indirect" provision of services "via AWWSC" is in reality the *direct* provision of *two different services* to *two different entities*. AWWSC provides services directly to IAWC per the approved Service Company Agreement, which include handling calls for IAWC. AWWSC provides different services to AWR, under different agreements, which Staff concedes are not subject to Commission approval. (Tr. 521.) As discussed below, contrary to "circumventing" the Commission's prior orders in Docket 02-0517, the AWWSC call center is operated in a manner to ensure compliance.

Mr. Sackett agrees that IAWC and AWR have (and should have) separate telephone numbers. (Tr. 511.) He acknowledges that AWWSC is authorized to provide call center services to IAWC. (Tr. 520-21.) He agrees that AWWSC may also provide services to AWR. (Tr. 521.) And the physical co-location of the AWR call center within the Alton facility is not a violation of Section 7-101, in Mr. Sackett's opinion. (Tr. 514.) In fact, he concurs that sharing the costs of the call center *decreases* costs allocated to IAWC ratepayers. (IAWC Cross Ex. 1 (IAWC-ICC 1.49).)[22]

So what is the problem? Mr. Sackett testified about a call he made to the IAWC toll-free number in February 2012. "I don't know the exact thing that I said, but I did ask the person, told the person I was interested in finding out information about service line protection programs . . . ." (Tr. 463.) Mr. Sackett made this call "because I was concerned the customers would be misled into thinking that the product was offered by the utility as is often the case with these types of

[22] While Mr. Sackett tried to backtrack under cross-examination, he conceded in discovery responses that having IAWC and AWR share some of the costs of the call center actually decreases costs to IAWC. (Tr. 514; IAWC Cross Ex. 1 (IAWC-ICC 1.49).)

programs, and I wanted to clarify whether or not they would be getting corrected by the customer service representative." (Tr. 463-64.) According to Mr. Sackett, the representative responded, "[Y]es, we have such a product. Let me transfer you." (Tr. 464.) The time it took to transfer the call was "an instant . . . a split second." (Tr. 471.)

According to Mr. Sackett, *IAWC* violates Section 7-101 whenever *AWWSC* transfers callers to AWR or provides AWR's phone number or website. (Tr. 481.) If an IAWC customer asks about AWR, Mr. Sackett believes they should not be given any contact information or transferred. "I don't think that the utility has any business offering customers to an unregulated affiliate without the Commission's approval." (Tr. 479.) In addition to refusing to provide information, AWWSC call center agents "need to correct the misperception that may have occurred that lead the customer to call the water utility about an affiliated company's product." (Tr. 480.) This would involve educating the customer "to understand that AWR is not a regulated affiliate." (Tr. 475.)

First, it is important to note that AWWSC is not "offering" customers to AWR when it transfers them pursuant to a direct inquiry by the customer him/herself. Furthermore, Mr. Sackett also proposes a potentially expensive solution, educating the customer, in search of a non-existent problem. To do what Mr. Sackett suggests would confuse customers and increase call center costs. Mr. Sackett agrees that "a great many customers don't understand what an 'affiliate' is or what 'regulated business' means . . . ." (Tr. 475 (internal quotations added).) He agrees that "trying to explain these concepts to a customer might actually cause confusion to them," and that engaging in this explanation and dialogue would increase the length of calls. (Tr. 475-76.) He admits that simply transferring the caller or providing AWR's contact information could be accomplished more quickly than engaging in this dialogue. (Tr. 476.) Transferring a call takes only “an instant . . . a split second.” (Tr. 471.)

If the call center were operated as Mr. Sackett believes it should be, AWWSC call center agents would spend *more* time dealing with utility customers who inquire about AWR, not less. And for what purpose? To educate customers about “affiliates” and “regulated business”? To “correct their misperception” about services IAWC does or does not offer? To generate more calls to IAWC, as well as to the Commission, about the rudeness of call center agents who refuse to provide information? Mr. Sackett’s conclusion is completely at odds with his premise that ratepayer resources should not be used to support non-utility business.

Transferring an Illinois-American customer to AWR when the customer specifically asks about the AWR program is not a service to AWR; it is a service and convenience to Illinois-American’s own customers. The Company believes that if a customer raises the issue of an AWR program, or a water line protection program generally, it is good customer service to transfer the call to AWR or provide AWR’s phone number, rather than refuse to provide this readily available information. As Ms. Cooper testified, refusal to provide the information could confuse the customer and is not consistent with IAWC’s goal of providing superior customer service. (IAWC Ex. 15.00R, pp. 5-6.) Calls are transferred for the convenience of the customer, not as a means of “indirectly” benefiting AWR.

IAWC Is Not Providing Services to AWR, as Requested in Docket 02-0571 or Otherwise.

In Docket 02-0571, IAWC sought approval of an affiliated interest agreement that would have allowed IAWC to support AWR products and services. The Commission did not approve the agreement. Mr. Sackett repeatedly claims that IAWC is circumventing the Commission’s order by using AWWSC to do indirectly what the Commission has forbidden it to do directly. (ICC Staff Exs. 7.0, pp. 7-8; 15.0, p. 12.)

The problem with Mr. Sackett's position is that neither IAWC nor AWWSC are doing what IAWC asked permission to do in Docket 02-0571. The arrangement proposed in Docket 02-0571 would have allowed customers electing to purchase AWR products to have the option of either paying AWR for the service directly, or having AWR charges added to their utility bill. (Order on Reopening, Docket No. 02-0517 (Sept. 16, 2003), p. 12.) AWR charges do not appear on the bills of Illinois-American customers and Mr. Sackett admits to seeing no evidence that IAWC has included AWR charges on utility bills. (Tr. 509.)

In Docket 02-0571, IAWC also asked for approval to provide its customer list to AWR. Order on Reopening, Docket No. 02-0517 (Sept. 16, 2003), p. 12. Ms. Teasley confirmed that IAWC does not provide customer information to AWR. (IAWC Ex. 1.00SR-Part 2, p. 12.) Ms. Cooper confirmed that AWWSC does not provide IAWC customer information to AWR, either. (IAWC Ex. 15.00R, p. 7.)

Another requested approval was the use of joint marketing letters signed by IAWC's President. Order on Reopening, Docket No. 02-0517 (Sept. 16, 2003), p. 12. Mr. Sackett has seen no such letters. (Tr. 510-11.) In fact, there are none. (IAWC Ex. 1.00R (Teasley Reb.), pp. 4-5.)

IAWC also proposed to set up procedures whereby customers of AWR would be automatically flagged in IAWC's computer system. Order on Reopening, Docket No. 02-0517 (Sept. 16, 2003), p. 12. Ms. Cooper confirmed that this does not occur for Illinois customers. (IAWC Ex. 15.00SR, p. 3.) As explained earlier, a notation is made that a customer has a line protection program (whether from AWR or another provider) only when the customer volunteers this information. (Id.)[23]

[23] In direct testimony, Mr. Sackett claimed that during his visit to the Alton call center, he saw computer screens which showed whether IAWC customers were also enrolled with AWR. Ms. Cooper explained that the call center

Another aspect of the proposed arrangement would have had IAWC field representatives call AWR to notify them that the customer has a covered service line incident. Order on Reopening, Docket No. 02-0517 (Sept. 16, 2003), p. 12. Mr. Sackett tries to no avail to portray IAWC's leak investigation process as a similar type of "service" to AWR. He claims that service orders indicate whether a customer has a line protection program so that IAWC can determine "if the responsibility for these repairs is AWR's." (Staff Ex. 15.0, p. 29, lines 631-32.) This is incorrect. Mr. Suits and Ms. Cooper explained that whether a customer has a line protection program from any provider (AWR or otherwise) is noted on the service order if the customer provides this information. (IAWC Exs. 2.00R 2d (Rev.) (Suits Reb.), pp. 2-4; 2.00SR (Suits Sur.), p. 4; 15.00R, p. 8; 15.00SR, pp. 2-5.) Mr. Sackett agrees that prudent utility operations require IAWC to respond to emergency service orders for service line leak investigations; that IAWC has a duty to investigate service line leaks for all customers, regardless of whether they have a line protection program; and that it would not be appropriate to refuse to investigate leaks for customers that happen to have such a program. (Tr. 503.) He also acknowledges that the costs associated with leak investigations are incurred regardless of whether a customer has a line protection program, and that as a matter of good customer service, IAWC should let customers know whether it is the customer or the utility's responsibility to have the leak repaired. (Tr. 504.)

(continued…)

computer system shows whether a ratepayer is an AWR customer in certain states, but not Illinois. When asked, "Have you accounted for the possibility that you may have been mistaken about what you saw when you were at the call center?", Mr. Sackett admitted, "That's one possible conclusion, yes." (Tr. 501-02.) The other possible conclusion, according to Mr. Sackett, is that AWWSC doctored is computer system after Mr. Sackett's visit to the call center. (Mr. Sackett refused to say which conclusion is more likely. (See Tr. 502.))

There Is No Legal or Factual Basis to Investigate whether the Approved Service Company Agreement Remains in the Public Interest.

Despite the fact that neither AWWSC nor AWR are parties to this case, Staff criticizes IAWC for not "volunteering" to obtain information from these affiliates and turning it over to Staff: "[G]iven IAWC's failure to provide information regarding this matter in this case, which has deprived the Commission of a complete record, I recommend that that the Commission direct the investigation to include whether the IAWC-AWWSC AIA is still in the public interest." (IAWC Ex. 15.0, p. 39, lines 875-79.)

The rationale for demanding that IAWC obtain information from its affiliates, according to Staff witness Mr. Sackett, is this: "If the Commission cannot control the actions of the service company indirectly through IAWC then it is not in the public interest to allow this type of corporate arrangement to occur." (Tr. 339-42.)

It is disingenuous for Staff to argue that *any* interaction between IAWC or AWWSC, allegedly as "agent" for IAWC, and AWR (such as transferring a call or providing contact information when specifically requested by the customer to do so) is a violation of Section 7-101, and at the same time argue that IAWC should be subject to an investigation for *not* interacting with its affiliates to get information that IAWC does not have. The requested information concerns issues such as AWR's customer counts and financial information (IAWC Ex. 1.00SR-Part 2, p. 9), where AWR markets its products and services (Tr. 522-23), what costs AWR incurred in its call center expansion (Tr. 541) and AWR training practices and procedures (Tr. 541). Mr. Sackett was at a loss to explain what legitimate business reason IAWC would have to possess this information. (Tr. 541.)

Staff's post-hoc rationalization for how IAWC could have gotten information from AWR is that "[i]t can go through their service company with which they do have an agreement, request information about certain things that may pertain to the service that the service company provides to Illinois-American and therefore use that as a way to get information." (Tr. 544.) Yet Staff's entire case is built around a theory that IAWC interacts with its service company in a way that allows it do "indirectly" what the Docket 02-0517 Order prohibits it from doing "directly." (ICC Staff Ex. 7.0, p. 9.) Mr. Sackett has testified in this case, and others, that "utilities are precluded by Section 7-101 from interacting with their affiliates except through agreements approved by the Commission." (Tr. 548 (quoting his testimony in Docket 11-0561).) It is odd that his definition of "interaction" means one thing in the context of affiliate business practices, but something entirely different when it comes to IAWC's ability to provide information. IAWC would clearly have had to directly or indirectly "interact" with AWR to obtain the information Mr. Sackett requested.

In addition, even though the Service Company Agreement allows IAWC to "request information about certain things that *may pertain to the service that the service company provides to Illinois-American*" (Tr. 544 (emphasis added)), this is *not* what Staff requested. No conceivable reading of the Service Company Agreement gives IAWC the right to require AWWSC to provide information about AWR or any other affiliate that does not involve transactions with the utility. And, as Mr. Sackett admits, IAWC is not a party to agreements between AWWSC and AWR, nor are these agreements subject to Commission approval.

Moreover, Mr. Sackett's opinion that "If the Commission cannot control the actions of the service company indirectly through IAWC then it is not in the public interest to allow this type of corporate arrangement to occur" (Tr. 339-42) was thoroughly rejected in Docket 11-0046. "[A]s [Nicor Gas] underscores, neither [Nicor Services] nor its services have been placed under our statutory authority." Order, Docket No. 11-0046 (Dec. 7, 2011), p. 57. The notion that the approved Service Company Agreement should be re-opened to investigate the provision of service by an entity (i.e., AWR) not even a party to that agreement should be rejected as well.

The Record Is Sufficient to Establish that IAWC Has Not Violated Section 7-101. Another Investigation Is Not Needed.

Staff recommends that the Commission "open an investigation" to determine whether IAWC has violated Section 7-101. No purpose would be served by such an investigation, for one has already occurred. The Commission has before it a record that is more than sufficient to enable it to conclude that IAWC has not violated Section 7-101.

Staff's conclusions and recommendations are allegedly based on Mr. Sackett's personal interaction with the CSC, both by telephone and through a personal visit. IAWC also responded to 90 data requests related to Mr. Sackett's investigation, which included 360 subparts. In addition to narrative responses, the Company has produced over 1,700 pages of documents related to his investigation. (IAWC Ex. 1.00SR, p. 8.) No purpose would be served by opening an investigation to "re-plow the same fields." The facts the Commission needs to make its determination are before it. Another investigation is not necessary.

It is important for the Commission to know that Staff's recommendations are based not only on the details of Mr. Sackett's investigation disclosed in testimony and discovery, but also on details that were not. For example, it was not until Mr. Sackett was cross-examined that he chose to reveal that, as part of his investigation, he called both the IAWC and AWR call centers a "half a dozen" times. (Tr. 461.) He made notes during some of the calls; for others he just listened. (Tr. 461, 647.) None of these calls are discussed in Mr. Sackett's direct or rebuttal testimony, nor were they disclosed in response to discovery requests asking for this information. (See IAWC Cross Ex. 1 (IAWC-ICC 1.02).) The only call that Mr. Sackett chose to reveal in discovery occurred on February 7, 2012. (IAWC Cross Ex. 1 (IAWC-ICC 1.19).) Mr. Sackett wrote a note to document that call, but the note does not reveal any detail concerning the substance of the conversation. (IAWC Cross Ex. 1 (IAWC-ICC 4.04).) Mr. Sackett compiled three pages of notes concerning his calls, but apart from the top of one page, produced none of them. (Tr. 469.)

Mr. Sackett's investigation also included a February 16 visit to the Alton call center.[24] He described his observations in several emails, but the copies produced to IAWC are heavily redacted so as to conceal the pertinent details. (Tr. 497-99; IAWC Cross Ex. 1 (IAWC-ICC 1.23 supplemental response).)

It is reasonable to conclude that if Mr. Sackett had uncovered anything in his visit or telephone calls that would allegedly have constituted a statutory or Order violation, he would have documented it in his contemporaneous notes and referenced it in his testimony. Except for one call, out of about a half dozen that he made, Mr. Sackett did not do so.

It is also important to note that Staff's investigation was *not* a consequence of complaints to the Commission by IAWC customers, AWR customers or competitors of AWR. (Tr. 453.) Nor was it a consequence of complaints or inquiries by other Staff members. (Tr. 453.) There is no groundswell of confusion, frustration or curiosity about IAWC's interaction (or not) with its affiliates that warrants further investigation. The Commission should reject Mr. Sackett's recommendations.

B. Other Tax Issues

1. Bonus Tax Depreciation

IAWC files its federal income tax return as part of a consolidated tax group of which American Water Works Company is the common parent. (IAWC Ex. 13.00R (Warren Reb.), p.

[24] IAWC was given two days' notice that Mr. Sackett intended to visit the call center. (Tr. 489.)

4.) The consolidated tax group, for reasons described below, does not intend to take certain bonus depreciation tax deductions for 2011. AG witness Mr. Smith proposes that the Commission should find the "decision for IAWC to not utilize 2011 bonus tax depreciation to be imprudent from the ratepayers' perspective" and recommends that "appropriate recompense" be made. (AG Ex. 4.0 C (Rev.) (Smith Reb.), pp. 40-41.) He states, "IAWC ratepayers get no benefit from IAWC participating in the consolidated federal income tax return." (Id., p. 38.) Although he offers suggestions as to how that "recompense" could work, he has no specific recommendation and has not quantified his adjustment. His adjustment should be rejected because it ignores benefits that do accrue to IAWC and the reasonable basis for the consolidated tax group to not elect 2011 bonus depreciation.

Using the consolidated tax filing, the individual tax items for each corporation are aggregated and reflected on the first page of the return as consolidated items of income and deduction. The net consolidated taxable income or loss is computed and a tax calculated on this amount. (Id.) Companies forward to the parent their taxable amounts due. (IAWC Ex. 13.00R, p. 30.) Companies are also compensated to the extent they contribute tax benefits to the group. This produces a number of benefits for IAWC.

From a tax perspective, benefits do not occur every year for every group member, but individual members of the group benefit sufficiently often such that those times of benefit outweigh the times when there is a detriment. (IAWC Ex. 13.00R, p. 31.) For example, as Mr. Warren explains, IAWC incurred tax losses in 2008, 2009 and 2010 (see table at IAWC Ex. 13.00R, p. 34), some of which IAWC could not have used if IAWC had been not part of the consolidated group. (Tr. 831.) In certain of those years IAWC was compensated for an otherwise unusable tax loss because some other affiliate within the American Water group had taxable income. In other words, IAWC received benefits in those years as part of the consolidated group that exceeded benefits IAWC would have had on a standalone basis.

IAWC also benefits generally from the common ownership structure of which the consolidated tax grouping is part. (Tr. 830.) These benefits include the ability of IAWC to obtain capital at lower cost through the American Water Capital Corp. and the economies of scale achieved by obtaining services through the Service Company. (IAWC Ex. 1.00 (Rev.) (Teasley Dir.), pp. 19-20.)

IAWC cannot opt out of the AWWC consolidated federal income tax return. Under the applicable tax rules, if a group elects to file a consolidated federal income tax return, every commonly controlled domestic corporation must be included in that return. (IAWC Ex. 13.00R, pp. 31-32.) Since IAWC meets that tax definition of a commonly controlled corporation, it is impossible for it to opt out.

As IAWC witness Mr. Warren explained, the tax law permits taxpayers to claim depreciation deductions for tax purposes that exceed economic depreciation. This is done by allowing the use of accelerated calculation methods (i.e., declining balance, sum-of-the-years digits, etc.) and shorter depreciable lives. (Id., p. 24.) These "extra" depreciation deductions reduce the federal tax liabilities of these taxpayers that would otherwise have been due. Any "extra" depreciation deductions claimed in the early years of an asset's life are entirely offset by reduced depreciation deductions available in the later years of that asset's life.

Through accelerated depreciation, Congress intends to use the tax system to extend loans to taxpayers that invest in plant and equipment. The loan is "extended" when accelerated depreciation is claimed and it reduces the taxpayer's tax liability. The loan is "repaid" when the asset continues to produce taxable revenues but there is no more tax depreciation. When this occurs, the taxpayer's tax liability increases. The Company was able to claim unusually large depreciation deductions in 2010 (a mostly-50% but part 100% bonus year). It will be able to do the same in 2012 (a 50% bonus year). (Id., pp. 25-26.) In 2011 (a full 100% bonus year), the Company can claim even more unusually large depreciation deductions. (Id., p. 26.)

The tax law specifically permits taxpayers to elect not to claim bonus depreciation in any year. (Id.) As of the end of 2010, the AWWC group had a consolidated net operating loss ("CNOL") carryforward of in excess of $1.2 billion. Part of that carryforward related to IAWC. AWWC management made the decision not to utilize 2011 bonus depreciation based on the potential adverse impact of the additional deductions on the CNOL carryforwards. (Id., p. 28.) AWWC management was concerned that the substantial amount of bonus depreciation to which the members of the AWWC group would be entitled with respect to 2011 capital additions would create a sizable CNOL for that year, thereby increasing the group's already considerable existing CNOL carryforward. (Id., p. 28-29.) The concern was that the AWWC group would be unable to generate sufficient consolidated taxable income within the carryforward period provided for in the tax law such that the augmented CNOL carryforward thereby created would be able to be used. Some portion of that CNOL carryforward would, therefore, expire unused. (Id., p. 29.) As a result, the decision was made to not take 2011 bonus depreciation.

AG witness Mr. Smith proposes that the Commission find this decision to be imprudent and that it compensate IAWC ratepayers for any adverse impact the decision might have. (AG Ex. 2.0 C (Rev.), pp. 89-90.) Mr. Smith, however, does not calculate any specific adjustment or otherwise explain how his recommendation should be quantified or implemented. Moreover, his recommendation should be rejected because the decision not to take 2011 bonus depreciation is prudent, and there are no adverse rate consequences to IAWC of making that decision.

It is incontrovertibly prudent for AWWC management to make tax decisions based on what is best for the entire group. The decision to not take bonus depreciation was made to promote the best tax outcome for the consolidated group as a whole. (IAWC Ex. 13.00R, p. 29.) As discussed above, individual members, including IAWC, benefit from participation in the consolidated tax group. If decisions were made based on the interests of individual members, the overall outcome for the group would be worse, and some other group member could be forced to bear an incremental tax burden—a "beggar thy neighbor" approach. (Id., p. 30.) Moreover, to the extent that Mr. Smith's testimony implies that IAWC could opt to determine its taxes on a stand-alone basis, it is incorrect. IAWC cannot "opt out" of the consolidated tax filing.

Moreover, bonus depreciation deductions would merely increase IAWC's net operating loss carryforward, and so they would have no current effect on the Company's cash flow or on its ADIT. (Id., p. 33.) ADIT, as discussed above, represents the extra cash that is produced by deferring tax that would, absent a specified deduction, be otherwise payable. (Id.) If the extra deduction merely increases a net operating loss carryforward, then there is no additional tax deferred. (Id.) In the current year, the same amount of tax, zero, is paid with or without the extra deduction. The deduction only produces a cash benefit when the carryforward is used to reduce a future tax liability. However, in the year in which the deduction is claimed, there is no cash benefit and, consequently, there should be no incremental ADIT.

For IAWC, net operating losses in 2008, 2009, 2010 and 2012 (which total $104,123,796) will entirely offset its taxable income in all of the other years (which totals $73,752,349), even without bonus depreciation. (Id., p. 34.) In short, it will pay no tax for the period. Had the Company claimed bonus depreciation with respect to its 2011 additions, it would not have paid any less tax. (Id.) It simply would have produced a larger CNOL carryforward. Thus, there would be no tax deferral and, critically, no incremental ADIT. (Id.)

Mr. Smith's recommendation also creates a concern about violation of tax normalization rules,[25] as Mr. Smith recognizes: in his direct testimony he states his potential "remedies" must be "computed in a manner that would not result in a violation of IRS normalization requirements." (AG Ex. 2.0 C (Rev.), p. 90, lines 2066-67.) Mr. Smith's proposal that this Commission order bill credits appears to be geared to produce a rate reduction to replicate what rates would have been had the Company claimed accelerated (i.e., bonus) tax depreciation it did not, in fact, claim. (IAWC Ex. 13.00SR (Warren Sur.), p. 7.) Bonus depreciation is clearly subject to the tax normalization rules. These rules limit the deferred tax balance that can reduce rate base to the amount of deferred taxes that have been reflected in cost of service. (Id., p. 7-8.) Since any imputed deferred taxes attributable to bonus depreciation would not have been so reflected in the cost of service, it is Mr. Warren's view that such imputation would create a patent tax normalization problem. (Id., p. 8.) As a general proposition, in the tax normalization world, you cannot do indirectly what you cannot do directly. (Id.)

The tax law imposes a draconian penalty on taxpayers violating these rules. (Id.) Specifically, a utility violating the depreciation normalization rules will be ineligible prospectively to claim accelerated tax depreciation (including bonus depreciation) on any of its jurisdictional assets. (Id.) This ineligibility applies to existing assets as well as to new additions. The utility will have to use regulatory depreciation lives and methods for tax purposes. Thus, such a utility will generate no additional deferred taxes and, thereby, be denied

[25] The Commission has long recognized the importance of adhering to the normalization rules and the severity of the penalty for violating them. See Central Illinois Light Co., Docket 60044, 1976 Ill. PUC LEXIS 22, *15-18 (July 14, 1976); Ill. Commerce Comm'n On Its Own Motion: Investigation into the appropriate accounting treatment of the deferred tax reserve resulting from changes in statutory income tax rate, Docket 83-0309, 1985 Ill. PUC LEXIS 5, 69 P.U.R.4th 353 (Sept. 18, 1985.)

the cost-free funding they represent. (Id.) For these reasons, the AG's concerns about bonus depreciation should be rejected.

2. Domestic Production Activities Deduction

AG witness Mr. Smith recommends calculation of an additional tax deduction for IAWC, on a "stand alone" basis, known as the Domestic Production Activities Deduction or DPAD (also referred to as the Section 199 deduction, for the section of the federal tax code). (AG Ex. 4.0 C (Rev.), pp. 41-45.) The DPAD is a very complex mechanism Congress came up with to provide a tax subsidy for certain production (as opposed to service) activities. (IAWC Ex 13.00R, p. 35.) Essentially, it is a deduction equal to 9% of the lesser of (1) taxable income (before considering the DPAD) produced by the eligible activity or (2) taxable income of the taxpayer. A key consideration is that the DPAD is not available if there is no taxable income. (Id., p. 36.)

Mr. Smith does not actually calculate a DPAD deduction for IAWC (AG Ex. 4.0 C (Rev.), p. 45), or explain how it would be applied, given that the DPAD is limited to production activities, and does not encompass transmission or distribution of water. (Tr. 712.) IAWC engages in both production and transmission/distribution activities, and Mr. Smith suggests that only activities that "clearly qualify" should be included in his proposed DPAD. (Tr. 744.) He does not, however, explain how "clearly qualifying" activities would be identified or applied. For these reasons alone, his recommendation should be rejected.

Moreover, the DPAD is unavailable for the consolidated group. Under the applicable tax requirements of Section 199, where there is a consolidated tax group, the DPAD is calculated as though the group were a single company. (IAWC Ex. 13.00R, p. 36.) The regulations then require the allocation of that "single company" computation to each of the members of the group based on each one's eligible activity taxable income. Under this statutory scheme, there must be a "group" DPAD for any member to have one. And, because the AWWC group has no taxable income, regardless of how much eligible activity income any member produces, there is, under the statute, no DPAD. (Id.)

Notwithstanding the fact that, under the tax law, so long as there is no consolidated taxable income, no AWWC affiliate has or can have a DPAD, Mr. Smith proposes to impute one anyway. In addition to the fact that there is no DPAD deduction available for the consolidated group, however, there would be no DPAD available for IAWC on a standalone basis. As IAWC witness Mr. Warren explained, reviewing IAWC's actual and projected taxable income for the period 2006 through 2013 indicates that IAWC will have a net tax loss for the entire period. (Id., pp. 39-40.) Since IAWC has no positive taxable income during the period, there would, on a stand-alone basis, be no DPAD. Thus, even were this Commission inclined to impute a non-existent DPAD in this case, there would be nothing to impute.

3. Consolidated Tax Savings Adjustment

Mr. Smith appears to propose in rebuttal testimony that the Commission consider the importation into Illinois ratemaking of consolidated tax savings—tax benefits produced by operations that have nothing whatsoever to do with the provision of regulated services to Illinois customers and of expenditures that those customers do not bear. (AG Ex. 4.0 C (Rev.), pp. 45-48.) The proposal suggests the Commission should depart from longstanding practice in its treatment of income taxes. In particular, the Commission has long recognized that utilities in a consolidated tax group may determine taxes for ratemaking purposes on stand-alone basis. Citizens Utilities Co. of Ill., Docket 80-0468, 1981 Ill. PUC LEXIS 23, *22-29 (May 27, 1981). Mr. Smith does not calculate or quantify any actual adjustment for his recommendation. Nor does he explain (1) how his "adjustment" would be determined or (2) how the Commission should go about considering such a departure.

Mr. Smith's concerns appear driven by the fact that IAWC has, for ratemaking purposes, calculated federal income tax expense in the test year, but AWW does not project making tax payments in the test year, as a result of tax operating loss carryforwards. (IAWC EX. 13.00SR, p. 11.) But differences between tax expense calculated for ratemaking and per books tax payments are nothing new in Illinois. See Union Electric Co., Order, Docket 58738, 1974 Ill. PUC LEXIS 4 (October 23, 1974). Because there are such differences routinely, Illinois computes ADIT to reflect the deferral of tax payments, and deducts the ADIT amount from rate base in recognition of the fact that the deferred payments are non-investor supplied funds. See Citizens Utils. Co. of Ill., Order, 1981 Ill. PUC LEXIS 23, **22-29 (May 27, 1981); Central Ill. Light Co., Order, Docket 60044, 1976 Ill. PUC LEXIS 22, **15-18 (July 14, 1976). Mr. Smith's proposal would introduce the possibility that IAWC's revenue requirement would be changed due to the activities of out-of-state affiliates.

Mr. Smith's basis for his adjustment is primarily that tax savings adjustments are made in other jurisdictions in which AWWC affiliates operate. (Tr. 713-14.) However, he neglects to mention that the jurisdictions he references in which such adjustments are routinely employed (New Jersey, Pennsylvania, West Virginia, Texas and Indiana) are *the only* jurisdictions in the country in which that is the case. In other words, 5 do—but 47 don't (including D.C. and FERC). Mr. Smith admits he does not have comprehensive knowledge of how many jurisdictions do not utilize such tax savings adjustments. (Tr. 714.) In other words, he bases his proposal on the practice of AWW affiliates in a minority of jurisdictions. Mr. Smith fails to explain why the atypical practice in this minority of jurisdictions should be applied in Illinois. See Antioch Milling Co. v. Pub. Serv. Co. of Ill., 4 Ill. 2d 200, 210 (1954) (excluding evidence of differing rates where there was no demonstration the utilities being compared were sufficiently similar to warrant comparison); North Shore Gas Co./Peoples Gas Light & Coke, Order, Docket 11-0280/0281 (Jan. 10, 2012), p. 137 ("The Commission is completely uninformed as to the decisions from . . . other jurisdictions where [it has] no evidence that circumstances are comparable. Such comparisons are not relevant.").

X. CONCLUSION

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

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Respectfully submitted,

Illinois-American Water Company

By: *_/s/ Albert D. Sturtevant____________*

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CERTIFICATE OF SERVICE

I, Albert D. Sturtevant, certify that on June 15, 2012, I caused a copy of the foregoing *Initial Brief of Illinois-American Water Company* to be served by electronic mail to the individuals on the Commission's Service List for Docket No. 11-0767.

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