STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

ILLINOIS-AMERICAN WATER COMPANY	:	
	:	
	:	No. 11-0767
	:	
Proposed general increase in water rates	:	

REPLY BRIEF OF THE ILLINOIS INDUSTRIAL WATER CONSUMERS AND THE FEDERAL EXECUTIVE AGENCIES

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DATED: June 28, 2012

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I.

INTRODUCTION

United States Steel Corporation-Granite City Works ("U.S. Steel"), the University of Illinois,

Air Products and Chemical Company ("Air Products"), participated in this proceeding as the Illinois Industrial Water Consumers ("IIWC"), together with the Federal Executive Agencies ("FEA"), referred to collectively as ("IIWC/FEA"). IIWC/FEA filed an Initial Brief in this proceeding and will reply to certain arguments of Illinois-American Water Company ("IAWC", "Company" or "Illinois American") and the Staff of the Illinois Commerce Commission ("Staff") in their Initial Briefs. The failure to reply to any particular argument or position of any party should not be considered as agreement with that position or argument unless otherwise specifically stated herein.

In the context of this Reply Brief, IIWC/FEA replies to and discusses arguments made and positions taken on the following subjects:

- Return on Common Equity
- Rate of Return
- Company Cost of Service Study ("COSS")
- Revenue Adjustment Clause
- Consolidation of Zone 1 with Chicago Metro Water District
- Large Other Water Utility Customers
- Declining Block Rate Schedule

In this Reply Brief, IIWC/FEA continue to recommend:

- the Company be authorized a return on common equity of 9.30% to 9.42%;
- the Company proposal to consolidate Zone 1 with Chicago Metro Water district be rejected:
- the Company's Revenue Adjustment Clause (RAC) be rejected;
- the Company's Class Cost of Service ("CCOS") study be adjusted to include Large Other Water Utility customers.

IIWC/FEA makes the arguments in support of these recommendations and its response to the Company and the Staff, as appropriate, below.

III.

COST OF CAPITAL/RATE OF RETURN

B. Return on Equity

In the Company's Initial Brief, it encourages the Commission to adopt the last authorized return on equity from Docket No. 09-0319 of 10.38% in lieu of weighing the merits of the arguments in this case. (IAWC Init. Br. at 77). The Company then argues that the change in capital costs, as observed from bond yields, do not support a reduction in its last authorized return on equity. (*Id.*).

The Company goes on to argue, erroneously, that Staff's and IIWC/FEA's methodologies are flawed and, therefore, if the Commission updates the return on equity it should find the Company's recommended 11.25% to be the most accurate and reasonable. (*Id.* at 82). All of these Company arguments are without merit, and should be disregarded for the reasons below.

1. Use of 10.38% ROE

IAWC suggests that the 10.38% represents a reasonable compromise between the "unreasonably low" return on equity recommendations of Staff (9.42%) and IIWC/FEA (9.3%) and the return on equity recommendation of its witness, Ms. Ahern. (*Id*.). It appears the Company now recognizes that the ROE of 11.25% recommended by its witness in rebuttal is "unreasonably high" and cannot be defended in the current environment of very low and declining capital costs. (*See*, Gorman, IIWC/FEA Ex. 1.0 at 3-5).[1]

In support of the adoption of a 10.38% return on common equity, IAWC points to several public utility commission decisions, in other jurisdictions, granting equity returns of less than 10.38% between 2010 and 2012. (*See*, IAWC Init. Br. at 78-79, citing Public Utility Commission decisions in which returns on common equity ranging from a high of 10.3% to a low of 10.0% between 2010 and 2012 were granted). These cases, while hardly a ringing endorsement of a return on common equity of 10.38%, clearly demonstrate that the 11.25% ROE, which the Company says is supported by the record, (*see*, IAWC Init. Br. at 82), is itself unreasonably high.

Furthermore, the Company overlooks the fact that the Ohio, Kentucky, New Jersey, Virginia and West Virginia Commissions all approved returns on common equity of 9.34%, 9.70%, 9.50%, and 9.75% respectively during the 2010-2012 time period. (Gorman, IIWC/FEA Ex. 1.0 at 7, Table 2). The Indiana Commission just awarded Indiana-American Water Company a 9.7% ROE.

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[1] Having all but abandoned its requested ROE, the Company does attempt to defend Ms. Ahern's ROE analysis in its Initial Brief arguing the 11.25% is justified by the record. (IAWC Br. at 82-85).

(*Indiana-American Water Company*, Indiana Docket No. 44022, Order, (June 6, 2012) at 35-36). Under IAWC logic, one could suggest that this demonstrates that a return on common equity of 10.38% is "unreasonably high".

The Company also overlooks or ignores the fact that the return on common equity approved in Docket 09-0319 was approved on the basis of an analysis offered by Staff, which was similar to the analysis offered by IIWC in that case. (*See*, *Illinois-American Water Company*, ICC Dkt. 09-0319, Order, (April 13, 2010) at 112 ("Docket 09-0319 Order") stating ". . . the Staff and IIWC recommendations are somewhat similar and both appear to be generally sound." The Commission adopted Staff's analysis in Docket 09-0319. (*Id*.). The Commission found that the analysis produced reasonable results. (*Id*.). In this case, Staff and IIWC/FEA have again used similar analyses. (*See*, ICC Docket 09-0319 Order at 60-63; Gorman, IIWC/FEA Ex. 1.0 at 11; Freetly, Staff Ex.6.0 at 34-35).

By suggesting that 10.38% would be a reasonable ROE in this case, the Company implicitly accepts the reasonableness of the analysis that produced the 10.38% in the first place. The analysis that produced that result in Docket 09-0319 is the same as, or similar to, the analyses that produced Staff's 9.42% return on common equity and IIWC/FEA's 9.30% return on common equity in this case based on updated data. Under such circumstances, it is reasonable for the Commission to use or rely on those analyses to approve a return on common equity for IAWC of 9.42% or 9.30%.

By endorsing the adoption of a return on common equity of 10.38%, the Company now implicitly recognizes that such analyses produced a reasonable result. The 10.38% approved in

Docket 09-0319 apparently helped produce a $190 million increase in investment in Illinois by IAWC. (*See*, IAWC Init. Br. at 79-80). Thus, a return on common equity produced by analyses that are the same or similar to the analyses used to develop the return on common equity adopted by the Commission in Docket 09-0319 should also produce Company investment in Illinois. The Commission should approve a return on common equity for IAWC of 9.30% to 9.42%.

The Commission did not find in the last docket that Ms. Ahern's DCF, CAPM and risk premium studies were appropriate, nor did it elect to adopt her return on equity adders for flotation cost and business risk. (*See*, Docket 09-0319 Order at 111-113). Ms. Ahern's recommendations and supporting conclusions for her 11.25% are based on the same flawed methodologies in this case that she offered in Docket No. 09-0319. Those methodologies were rejected by the Commission. (Docket 09-0319 Order at 111-113). Further, Staff's and IIWC/FEA's analyses in this case are similar to those they offered in 09-0319, and there the Commission found those analyses were generally sound and somewhat similar. (*See*, Docket 09-0319 Order at 112). In Docket 09-0319, the Company opposed Staff's and IIWC's recommended return on equity, just as it does in this case. (Docket 09-0319 Order at 103-104). For all these reasons, the methodologies supporting IAWC's last authorized return on equity of 10.38% in 09-0319, now support a return on equity of 9.30% to 9.42%. Therefore, IAWC's proposed return on equity should be rejected. The Staff's or IIWC/FEA's recommended return on equity should be adopted.

2. Decline in Bond Interest Rates

IAWC also argues that the observable decline in bond interest rates does not support Staff's and IIWC/FEA's findings that the Company's required return on equity is much lower in this case compared to the last case. (IAWC Init. Br. at 80). IAWC cites its witness Ms. Ahern's observation that equity costs have actually increased while bond yields have decreased. (*Id.* at 81) However, that testimony is based on Ms. Ahern's flawed and inaccurate conclusion that equity risk premiums are higher today than they have been in the past. (Gorman, IIWC/FEA Ex. 3.0 at 5-7). Because observable utility capital costs are significantly lower in this case than they were in the last case, IAWC's proposal for the Commission to again approve its last authorized return on equity of 10.38% is unjust and unreasonable. The IIWC/FEA return in this case (9.30%) reflects the current capital market costs, which are significantly lower than they were in Docket No. 09-0319. (Gorman, IIWC/FEA Ex. 1.0 at 3-5).

For these reasons, the Commission should reject IAWC's recommendations, adopting instead return on common equity of 9.30% to 9.42% a range of returns based on the principals and observations the Commission found just and reasonable in IAWC's last rate case.

3. Company Criticisms of Mr. Gorman's ROE Analyses

The Company argues that Mr. Gorman's ROE of 9.30% should be rejected. It notes that the recommendation is based on the average of the results of a Capital Asset Pricing Model ("CAPM") and the variations of the Discounted Cash Flow Model ("DCF"). (IAWC Init. Br. at 91). The

Company reasons that the results of Mr. Gorman's analyses are based on a flawed proxy group and improper risk-free rate. (*Id*.).

I) Proxy Group

IAWC argues that water utilities face unique investment risk relative to electric and gas utility companies. (*Id*.). Therefore, according to the Company, use of a gas utility proxy group does not reflect that unique risk and is not proper for determining a water utility return on common equity. (*Id*.).

However, the record here establishes that ". . . risk characteristics for the water industry are not so distinct that they fail to properly reflect similar risk experienced by other types of regulated utility operations." (Gorman, IIWC/FEA Ex. 3.0 at 3). Indeed, IIWC/FEA witness Gorman testified that gas and water utilities all must meet environmental regulations and modernize and expand their infrastructure. (*Id*.). Ratings agencies have lumped the water and gas industries together for credit quality forecasting purposes. (*Id*.). Gas and water companies have similar infrastructure investment in a system that consists of pipes and mains used to distribute their gas and water. (Gorman, IIWC/FEA Ex. 3.0 at 4). Furthermore, gas utilities may be somewhat riskier in that they face significant commodity cost recovery risk which water utilities do not have. (*Id*.). Indeed, the Company's proxy group argument in this case contradicts its argument in its last rate case, that the use of both a water proxy group and a utility proxy group helps to measure a reasonable return. (Order, ICC Docket 09-0319 at 89).

Thus, the use of a gas proxy group to assist in the measurement of IAWC's required return on common equity is reasonable. Furthermore, IIWC/FEA witness Gorman used a gas proxy group in his analyses in Docket 09-0319 and the Commission found his analyses, together with those of the Staff, to be generally sound. (09-0319 Order at 112). Under the circumstances, the use of a gas proxy group does not impair the reasonableness of Mr. Gorman's return on equity analyses.

ii) DCF Analyses

The Company claims that Mr. Gorman's DCF analyses are flawed primarily because the results of his constant growth DCF model are premised on the mistaken belief that the projected growth in the gross domestic product ("GDP") constitutes the high end growth rate for a utility. (IAWC Init. Br. at 92). (IIWC/FEA has essentially responded to this argument in their Init. Br. at 20. The Company is simply missing an important point that both IIWC/FEA witness Gorman and Staff witness Freetly found in both this case and in IAWC's last case. That is, the three- to five-year growth projections made by security analysts, may not be appropriate for the constant growth DCF model, if those three- to five-year growth rates are not reasonable estimates of long-term sustainable growth as required by the constant growth model. (Gorman, IIWC/FEA Ex. 1.0 at 21-24). Simply stated, the Company's constant growth DCF analysis is overstated and unreliable. This is because the Company relied on three- to five-year growth rates as long-term estimates of sustainable growth without a reasonable assessment of whether or not that growth can be sustained. Indeed, as IIWC/FEA witness Gorman demonstrated, three- to five-year growth rates are not sustainable and not appropriate for a constant growth DCF model. (*Id*.). Market literature and academic research support the notion that a maximum sustainable growth rate over time is the growth rate in the service area economy in which the utility operates. Since the utility's earnings growth is tied to its demands for utility services, service area growth is a reasonable projection of long-term sustainable growth. The U.S. GDP is a reasonable proxy for service area growth. The Company simply provided no competent rebuttal to that well-established academic, market practitioner and regulatory standard approach.

The Company also argues that Mr. Gorman's sustainable growth DCF methodology is flawed because it is based on three-five year projections from Value Line. (IAWC Init. Br. at 93). The Company's arguments with respect to the reliability of the sustainable growth model are simply without merit. As noted by IIWC/FEA witness Gorman, the reliability of the sustainable growth DCF model largely depends on whether or not the parameters used in that model reasonably reflect investor growth outlooks. *Value Line* is a source used by all parties in this proceeding in cost of capital studies. (*See*, Staff Init. Br. at 36-37; IIWC/FEA Init. Br. at 14, 17; and Ahern, IAWC Ex. 1.00 Rev. at 31-32, 39, and 45). *Value Line*'s projections of the sustainable growth parameters out over the next three to five years are reasonable measures of parameters that will influence investors and it is reasonable to believe that they do reflect investor growth outlooks. While the sustainable growth model may not be appropriate on its own, it is appropriate to support the estimates made by multi-stage growth DCF analyses using security analysts' growth projections. Therefore, the Company's arguments in this case are simply without merit.

iii) CAPM Analysis

The Company is also critical of Mr. Gorman's capital asset pricing model. (IAWC Init. Br. at 94). It specifically says the CAPM is flawed for three reasons. First, the derivation of the market equity risk premium is incorrect. Second, the forward-looking risk premium is not really a prospective equity risk premium. Third, Mr. Gorman failed to use the ECAPM in addition to the traditional CAPM. (IAWC Init. Br. at 94-95). All of the Company's arguments are without merit. As Mr. Gorman noted in his direct testimony, the Company's estimate of the market risk premium is not reliable and is overstated. (Gorman, IIWC/FEA Ex. 1.0 at 47-48). Hence, its use of a market risk premium that substantially over-estimates investor expectations does not produce a reliable or meaningful CAPM return estimate. Also, the Company provided little to no credible support that Mr. Gorman's use of historical data to derive investors' outlooks of the future is without merit. Further, Mr. Gorman's use of a risk premium type methodology to make projections of market outlooks for expected returns on the market is reasonable. The Company's apparent reliance on only a DCF method of estimating the market's forward-looking required return contradicts its own studies in this case attempting to estimate a utility-required return using both DCF and risk premium methodologies. Therefore, the Company's arguments on a market risk premium methodology are without merit.

Finally, the Company's use of an ECAPM analysis is flawed for the reasons outlined in IIWC/FEA's Initial Brief at 22. For all these reasons, the Company's criticisms of Mr. Gorman's CAPM studies are without merit and should be disregarded.

IV.

COST OF SERVICE AND RATE DESIGN

A. Cost of Service Study

The Company's Brief continues to support the Company's significant modification to its cost of service study offered in its rebuttal case compared to the study it offered in its direct case. (IAWC Init. Br. at 96-97). In rebuttal, IAWC modified the treatment of contract customers in its class cost of service study. (Collins, IIWC/FEA Ex. 4.0 at 5-7). Additionally, in its direct case, the Company recognized contract customers as a class of customers in its class cost of service study. (IAWC Init. Br. at 97). However, in its rebuttal case, even though no party objected to its treatment of contract customers in direct, IAWC made a significant modification by eliminating contract customers from its COSS study, and classified the revenue paid by these customers as a component of "Other Water Revenue." (*Id.*). This Other Water Revenue was then allocated across all remaining tariff classes to reduce the cost of service for those classes. (IAWC Init. Br. at 96-97).

The Company alleges that this rebuttal modification more accurately reflects the benefits of contract customers, and appropriately allocates the benefit of having contract customers in IAWC's system. (*Id.* at 97). The Company goes on to state in its initial case, its effort to fold the cost to serve contract customers in the cost of service study is effectively an exercise in futility as contract rates are less than full tariff rates. (*Id.* at 96-97).

The Company's significant modification of its direct case cost of service study offered in its rebuttal case, is significantly flawed and should be rejected. The Company's arguments in its Brief are erroneous and do not support this substantial modification to its direct case class cost of service study. Importantly, while the Company's class cost of service study offered in its direct case contains some errors as described below, it was largely uncontested.

The flaws in the Company's logic and in its rebuttal case cost of service study are discussed below.

First, the Company claims that its modification more accurately reflects the benefits of contract customers and allocates those benefits across other classes. (IAWC Init. Br. at 97). This is erroneous. The Company's modified cost of service study does not directly measure the benefits and costs of contract customers. Rather, its rebuttal COSS simply pretends these customers do not exist. (Collins, IIWC/FEA Ex. 4.0 at 5).

Second, in its rebuttal COSS, the Company ignored contract customers' base load and extra capacity loads on the system, and therefore did not accurately measure the base and extra capacity loads of all customers on the system. (*Id*. at 6). As a result, it did not, and could not, accurately allocate its costs based on base and extra capacity customers' load. Because the Company's measurement of its customers' actual test year loads was flawed, its cost allocation was biased and unreliable. Without accurately estimating its cost of providing service to its remaining customers, it could not then properly measure the benefits and costs associated with retaining contract customers on the system via discounted prices. As such, the Company's claim that its modified rebuttal case cost of service study more accurately measures the benefits of contract customers is erroneous.

Third, the cost and benefits of contract customers were accurately measured by the Company in its direct case COSS. In its direct case COSS study, the Company did allocate its costs across all customers based on all customers' base and extra capacity demands on the system. (*Id*.). At that point, the determination could be made as to how much discount is offered to contract customers, because the cost to serve other classes was reasonably measured, and the allocation of discounts was transparent. This direct case COSS then more properly measures the direct incremental cost other customers must pay to retain the benefit of contract customers on the system. The Company's modification to its cost of service study in rebuttal makes this determination of costs and benefits non-transparent and inexact, because the cost to serve all customers is not properly and accurately measured. Therefore, the efficiency and the integrity of the cost of service model were eroded substantially in the Company's rebuttal COSS.

This is true because in rebuttal, the Company at no point accurately measured its cost of service for full tariff rate customers before it allocated the discount offered to contract customers. As such, there is no way to measure the actual allocation of the contract customer discount to other classes of customers. Therefore, there is no way to determine whether or not the reallocation of the discount to contract customers to full tariff customers is just and reasonable and ensures that all customers receive an allocated share of the benefit associated with contract customers.

Further, there is no way to determine how much, if any, benefit contract customers provided to the system based on the Company's rebuttal cost of service study. The variable cost of providing service to all customers, including contract customers is not directly measured by IAWC in its rebuttal case. Again, the IAWC rebuttal case excludes base volume and, therefore, does not accurately measure its variable costs. Therefore, the amount of economic contribution the discount customers make to the system is clearly defined under the Company's revised rebuttal cost of service study. The same is not true under the traditional COSS the Company offered in its direct case.

Finally, IIWC/FEA also observed that the Company's significant change in its cost of service resulted in a substantial allocation of $2.3 million for Zone 1 without any change in customer makeup or load profiles. (IIWC/FEA Ex. 4.0 at 6). The Company claims in its Brief that IIWC/FEA mistake the addition of $2.3 million in cost ". . . for the same level of revenue applied to Zone 1". However, that claim is without merit. The problem with the Company's rebuttal cost of service study is allocation of costs between customer classes, not the revenue produced from the customers. It is not a matter of identifying additional revenue available for the Chicago Metro area to serve Zone 1. Rather, the Company's rebuttal cost of service did not accurately measure cost of service to Zone 1 customers, therefore it is not possible to determine whether or not Zone 1 customers' rates already fully recover the Company's test year cost of service. (*Id*.). The Company's distortion of combining the cost of service studies for the two zones into a single zone produced an inaccurate and variable cost of service estimate for both zones. For these reasons, use of IAWC's rebuttal cost of service study should be rejected, and use of the cost of service study presented by IAWC in its direct testimony should be approved.

B. Consolidation of Chicago Metro Water District into Zone 1

In its Initial Brief the Company continues to encourage the Commission to approve the consolidation of Chicago Metro and Zone 1. (IAWC Init. Br. at 98-99). However, in its continued encouragement the Company disregards the distinct differences between the rate zones. The Company dismisses any notion that such consolidation will erode system efficiencies. (*Id.*) Finally, the Company continues to base the consolidation on the flawed theory that what the Commission has done in past rate proceedings must be repeated in the current rate proceeding. (IAWC Init. Br. at 98).

1. Chicago Metro Water and Zone 1 are Two Distinct Districts

As stated in its Initial Brief, IIWC/FEA continue to point out that Chicago Metro and Zone 1 have very different customer compositions and therefore different zonal class structures. (IIWC/FEA Init. Br. at 26-27; Collins, IIWC/FEA Ex. 4.0 at 2-3). The Company simply argues that any apparent disparity in zonal class structures is minor and therefore does not affect consolidated pricing. (IAWC Init. Br. at 98-99). However Company witness Herbert's own cost studies show that Zone 1 consists of 68.8% residential and commercial customers, while Chicago Metro Water consists of 79.7% residential and commercial customers. In addition, Zone 1 consists of 3.4% industrial customers and 1.2% large industrial customers, while Chicago Metro Water does not have any large industrial customers and consists of only 0.4% industrial customers. (Collins IIWC/FEA 4.0 at 2-3). These "minor" differences produce very different load characteristics and very different base and extra capacity costs for each district. (IIWC/FEA Init. Br. at 26-27).

While the percentage differences might not seem so large, they are definitely not minor. Customers that have a higher than average peak rate water use and thus low load factors , such as residential and commercial classes of customers, require larger capacity pumps, pipes, as well as other system facilities. Customers that have equal total volume of use and high load factors, such as industrial class customers, who take water at a uniform rate, do not require the same infrastructure. (Collins, IIWC/FEA Ex. 4.0 at 3). Due to this significant difference, a zone with higher concentration of residential and commercial customers, such as Chicago Metro, will have different base costs (costs associated with average water use) and extra capacity costs (costs associated with water use in excess of average) than a zone, such as Zone 1, with a lower concentration of residential and commercial customers. (*Id.*). These differences should not be considered minor. They demonstrate the consolidation of Zone 1 and the Chicago Metro District is not appropriate in this case.

IIWC and FEA are not the only parties to oppose consolidation in this case. The Village of Bolingbrook also opposes consolidation correctly arguing that the Company has demonstrated the consolidation is not in the best interest of customers. (*See,* Village Init. Br. at 4-9).

2. Price Signals will be Distorted and will Erode System Efficiency

The Company claims that any assertion the consolidation will erode system efficiency is unfounded, unsupported and contrary to IAWC precedent but fails to provide any serious analysis on the subject save their one argument that consolidation has been done in the past. (IAWC Init. Br. at 99).

Despite the Company's contention otherwise, consolidated pricing in this instance will result in price subsidies to customers in high-cost districts at great cost to customers in low-cost districts. The rate subsidies erase economic incentive for customers in higher cost districts to be more efficient in placing demands on the water system because the prices they pay do not accurately reflect the cost of delivering the water service. (Collins, IIWC/FEA Ex. 2.0 at 4). The result, customers with subsidized prices imposing greater inefficient demand on the system further increasing the cost on the lower cost district. (*Id.*).

In addition to the erosion of customer efficiency, the Company will suffer from the same efficiency fate. If all costs are averaged across all districts the incentive to control costs in a high cost district is greatly reduced because it will not stand out as a cost outlier. (*Id.* at 5). The consolidation of Chicago Metro and Zone 1 ignores the principle of cost causation.

3. Prior Commission Orders have not been Ignored

The Company continues to cite prior Commission action in ICC Docket 09-0319 as a reason to rubberstamp the proposed consolidation in this instance. (IAWC, Init. Br. at 98).

First, IIWC/FEA understands the Commission found the consolidation of the Champaign and Sterling districts with Zone 1 to be reasonable based on the record evidence in Docket 09-0319 and therefore approved the consolidation. (*Illinois American Water Company*, Docket 09-0319 at 154).[2] All decisions made by the Commission must be made based on the merits of record evidence in each

[2] IIWC/FEA witness Brian Collins did not oppose the consolidation of the Champaign and Sterling service districts with Zone 1.

case. Commission decisions are not res judicata. *(Mississippi River Fuel Corp. v. Illinois Commerce Comm'n*, 1 Ill. 2d 509, 513 (1953)).

Company witness Herbert agreed on cross examination that the utility has the burden of demonstrating the reasonableness and appropriateness of proposed changes in its rates. (May 15, 2012 Tr. at 218). While the Company may have justified a proposed consolidation in Docket 09-0319 it does not excuse them from justifying the proposed consolidation in this docket. Despite the Commission ruling in a prior case, the Company still has the burden to demonstrate the reasonableness and appropriateness of its proposed consolidation of Chicago Metro Water District and Zone 1 in this case. (*See,* 220 ILCS 9-201(c)). The Company has not met its burden, the consolidation of Chicago Metro Water and Zone 1 should be rejected.

4. Staff's Mistaken Support for Consolidation of Metro Water District Into Zone 1

Staff also supports consolidation of Zone 1 and the Chicago Metro Water District contending the arguments of IIWC/FEA witness Collins against such consolidation "ignore rewards that consolidation affords all ratepayers." (Staff Init. Br. at 68). Unfortunately, Staff fails to identify any evidence in this proceeding that identifies or discusses in any way the "rewards" that are allegedly afforded to all customers from such a consolidation. (*See,* Staff Init. Br. at 67-71). Staff opines that the "advantages" of consolidation include having a larger customer base over which to spread plant and operating expense costs. Staff simply dismisses the fact that this "advantage" would be derived from the misallocation of the Company's cost of service and would produce rates that are not just and reasonable. Staff's "advantage" produces winners (customers who are subsidized and benefit from the unjust and unreasonable rates) and losers (customers who provide the subsidy to the winners). Staff is left with arguing that the Commission has approved single tariff pricing for IAWC in prior dockets, relying on pure speculation, that if the Chicago Metro Water District and Zone 1 remain separate, rate impacts that may result from future construction replacement projects for either Zone 1 or Chicago Metro "could become problematic." (Staff Init. Br. at 68-69).

Staff goes so far as to improperly rely on and cite to, testimony presented in another case as support for consolidation here. (*See*, Staff Init. Br. at 69). Apparently the record in this case is so devoid of evidence the Staff is forced to rely on evidence which is not part of the record in this case to support its position. The Commission must base its decision on the evidence in this record, not the evidence presented from the record in another case. Findings and decisions of the Commission must be based exclusively on the record evidence in this case. (*See*, 220 ILCS 5/10-103)).

Staff argues that the Commission has approved consolidation and single tariff pricing for IAWC rate divisions in past cases. (Staff Init. Br. at 69). However, Staff overlooked or ignores the fact that the Commission has previously determined that only ". . . in certain circumstances, standardization of rates and implementation of the single tariff pricing or 'STP' group is appropriate." (*Illinois-American Water Company*, ICC Dkt. 02-0690, 2003 Ill. PUC Lexis 685 at *305 (August 12, 2003)). Circumstances in this case have not been shown to justify the consolidation of Zone 1 and Chicago Metro Water District. Indeed, in the Docket 02-0690 case, the Commission stated "[o]ne factor the Commission believes must be considered before implementing standardized rates or incorporating the rate area into a single pricing group is whether the resulting rates bear a reasonable relationship to cost of service." (*Id*. at *306). Given the flaws in the Company's rebuttal cost of service study, one cannot determine whether the rates resulting from the consolidation of Zone 1 and the Chicago Metro Water District bear a reasonable relationship to cost of service.

The Commission has also noted, as IIWC/FEA and others have argued here, that ". . . different types of sources of supply can result in significantly different costs." (*Id*.). The Commission has also concluded that differences in water sources mitigate against consolidation and single tariff pricing. (*See*, *Illinois-American Water Company*, ICC Docket 90-0100, 1990 Ill. PUC Lexis 612 (November 20, 1990) at *38-39). Water supply sources in Chicago Metro Water District and Zone 1 are substantially different. In this case, the record shows that the sources of water supply for the Chicago Metro District and Zone 1 are substantially different. (*See*, Village Init. Br. at 6; *see, also*, Ahern, IAWC Ex. 10.00 Rev. at 23).

In that same case, the Commission stated that "Despite the potential benefits, imposing STP can result in very large increases for some types of customers in some districts." (*Illinois-American Water Company*, ICC Dkt. 02-0690, 2003 Ill. PUC Lexis 685 (August 12, 2003) at *307). The Commission went on to suggest that under such circumstances, movement toward single tariff pricing would be difficult. (*Id*.). There are rate classes which would see significant increases as a result of the consolidation of Zone 1 and the Chicago Metro District. For example, the Large Industrial rate class in Zone 1 would see an increase of 22.5% (Herbert, IAWC Ex. 11.03R, Sch. A-

Z-1 w/cmw) as a result of the consolidation based on the Company's rebuttal COSS study as opposed to 15.1% on a Zone 1 stand-alone basis. (Herbert, IAWC Ex. 11.01, Sch. A-Z-1).

Also, the Staff overlooks or ignores that the Commission has previously rejected proposals for single tariff pricing (consolidation) involving the Chicago Metro Water District and what is now Zone 1,while at the same time authorizing single tariff pricing (consolidation) of other downstate IAWC water districts. (*See, Illinois-American Water Company*, ICC Docket 02-0690, 2003 Ill. PUC Lexis 685 (August 12, 2003) generally).[3] Thus, simply because the Commission has previously authorized consolidation of some IAWC rate districts, does not mean it must or should authorize consolidation of the Chicago Metro District and Zone 1.

Lastly, Staff argues that its bill impact analysis supports consolidation of Zone 1 and the Chicago Metro District. However, Staff focuses only on the bill impact for certain rate classes. Staff ignores, overlooks, or fails to consider impacts for customers in rate classes other than the residential class. The Commission, in evaluating consolidations (single tariff pricing), has been concerned about the impact on all rate classes, not just the residential class. As a result of Staff's failure to consider the impact on all of the Company's rate classes, the Staff's recommendation that Zone 1 and Chicago Metro District be consolidated should be rejected.

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[3] The Company also ignores that the Commission has not always approved proposals for consolidation and single tariff pricing made in IAWC rate cases. The Commission recognizes that consolidation and single tariff pricing are not appropriate in all circumstances. The record here clearly has not shown consolidation to be appropriate for Zone 1 and the Chicago Metro District in this case.

C. RAC Rider

In support of its RAC Rider, IAWC argues that it ". . . must operate its source of supply, treatment and transmission and distribution system to provide water service to its customers whether those customers use no water in a given month or 100,000 gallons of water." (IAWC Init. Br. at 107). While the exaggerated comparison does hold some truth it should not serve as the foundation for a Rider designed to guarantee revenues with no regard as to how much water the Company actually delivers and sells. As stated in its Initial Brief IIWC/FEA continue to urge the rejection of the Rider RAC because it runs counter to accepted ratemaking principles, shifts operating risk to the customers and bears a striking resemblance to single issue ratemaking which has been rejected by Illinois courts.

1. The Rider RAC Shifts Risk from Utility Investors to Utility Customers

Company witness Heid suggested in his rebuttal that the very purpose of regulation should be to deliver a fixed revenue recovery to the utility and adjust the price to the consumer as determined by the Company. (Heid, IAWC Ex. 14.00R Rev. at 32-33). Mr. Heid shifts operating risks to the customers, operating risk that is traditionally borne by the utility and addressed through a traditional ratemaking proceeding.

A policy that permits the Company to adjust its rates for individual cost or revenue items outside of a base rate case shifts regulatory risk from utility investors to customers by providing investors with accelerated recognition of specific cost and revenue adjustments in utility rates. (Collins, IIWC/FEA Ex. 2.0 at 8). To add insult to injury this reduction in the Company's risk would occur without a corresponding reduction to its rate of return to recognize the reduced business risks faced by the Company. (*Id.*).

A utility's allowed return on rate base is established to compensate the utility's investors for the various business risks it incurs, including the risk that regulatory lag will delay the recognition of cost increases or revenue fluctuations in utility rates between rate cases. (*Id.*).

The Company through the RAC rider proposes to shift much of this risk to customers allowing the Company to adjust rates between base rate cases to recover increases in production expenses or to offset the Company's claimed reduction in sales revenues.

When Company risk is transferred to the customer it has the effect of changing the philosophy of the Company. The utility's management no longer has the same strong incentive to control cost escalations. (*Id.* at 9). The Company counters this argument implying that because the RAC rider only impacts revenues Illinois-American remains at risk for fluctuation in fixed costs or unit production costs. (IAWC Init. Br. at 115). Therefore it believes Company management must actively and efficiently manage the cost elements that comprise IAWC's total cost of service. (*Id.*). IIWC/FEA disagrees with the Company; investor risk provides the strong incentive to control cost escalations. This is the case because any cost increase affects the utility's bottom line until the next rate case. (Collins, IIWC/FEA Ex. 2.0 at 9). The existing regulatory framework also gives the Company a strong incentive to control its costs in order to avoid upward pressure on rates, as again, shareholders are at risk for a loss of revenues resulting from a decline in sales levels between rate cases. Shifting the risk of such cost increases and sales revenue reductions to the customer between rate cases severely curtails the motivation of the utility to control costs. (*Id.*).

2. The Rider RAC Violates the Rule Against Single Issue Ratemaking

Rider RAC has the potential to violate the rule against single issue ratemaking. Each of the expense adjustments that occur in the future can be made without regard to other changes that may lower Illinois-American's overall revenue requirement. IAWC is proposing a mechanism which decouples the Company's recovery of fixed costs in providing water utility service to its customers from the volume of water it actually sells. (IAWC Init. Br. at 108). The Company believes Rider RAC "will not have any impact whatsoever on IAWC's overall revenue requirement." (*Id.*). Despite what the Company claims, the proposed Rider adjusts rates on the basis of only selected cost elements, namely metered revenue and production expenses, without taking into consideration other cost factors that would affect the utility's overall profitability. The Rider has the potential to provide additional revenue to Illinois-American without the traditional Commission review to determine the prudence of the cost and revenue elements. (Collins, IIWC/FEA Ex. 2.0 at 6-7).

It is improper to consider changes to components of the revenue requirement in isolation. Often change in one item of the revenue formula is offset by a corresponding change to another component of the formula. (*A. Finkl & Sons Co. v. Illinois Commerce Comm'n*, 250 Ill. App. 3d 317, 325, 620 N.E. 2d 1141, 1147 (1st Dist. 1993)).

3. Illinois Law and Commission Practice and Policies Do Not Support Approval of Rider RAC

The Company argues that Illinois law and Commission practice and policies support approval of Rider RAC. (AG Init. Br. at 55-60). For the reasons stated in the Illinois Attorney General's Initial Brief, IIWC/FEA respectfully disagree. In making its argument, IAWC notes that a "growing number of state commissions - this Illinois Commission included - have approved revenue decoupling mechanisms, such as the RAC or a straight-fixed variable rate design, ..." (IAWC Init. Br. at 110). It cites a number of Illinois Commerce Commission cases in support of this proposition. IIWC/FEA believes it is worth noting that in only one case has the Commission approved a decoupling mechanism similar to RAC. (*North Shore Gas Company, et al.,* ICC Docket 07-0241 and 07-0242 (Cons.) Order, (February 5, 2008)). In the remaining Illinois cases cited by IAWC, the Commission basically rejected the implementation of a rider mechanism (Rider VBA) similar to Rider RAC. Instead the Commission elected to address utility concerns on this issue through appropriate rate design changes to allow the utility to recover more of its fixed costs through fixed charges. IIWC/FEA favor the implementation of such an approach to the extent the Commission believes that some action is warranted to address the concerns of IAWC. (*Nicor Gas Co.,* ICC Docket 08-0363, Order, (March 25, 2009) at 71 and 91 - rejecting Rider VBA and adopting a straight fixed variable rate design; *see, also, Central Illinois Public Service Company, et al.,* ICC Docket 07-0585 and 07-0590 (Cons.), Order, (September 24, 2008) at 237). Given the significant legal issues involving the adoption of Rider RAC, the Commission may be better off to address this issue as a simple rate design problem and allow IAWC to recover more of its fixed costs through its fixed charges. As the Commission has noted, this type of redesign is easier for customers to understand than rider mechanisms, such as Rider RAC. (*Id*.).

D. Large Other Water Utility Class should be brought to Cost of Service

According to the Company, the Large Other Water Utility Service ("Large OWU") class is comprised of customers with contracted rates and as such, the company claims their rates cannot be raised outside of the terms of their respective agreements. (Herbert, IAWC Ex. 11.00R at 17). The Company further states that most Large OWU contracts include provisions for annual increases that were built in to the Company's future test year projection of current revenues. (IAWC Init. Br. at 106). However, based on IAWC's future test year projection contained in its rebuttal CCOS study, it would appear that all Large OWU contracts prevent any kind of increase to the rate. Review of the Company's rebuttal CCOS study reveals there is no increase in the revenues for this class. (Herbert, IAWC Ex. 11.03R, Sch. A-Z-1 and Sch. A-Z-1 w/CMW). This either contradicts the Company testimony or suggests the entire Large OWU class has a provision in their contract preventing any type of rate increase. The Company should provide sufficient proof explaining the exemption of the entire class or whether the class revenues will increase by virtue of the price increase provisions found in the contracts.

The Company has excluded the Large OWU class from the allocation of costs in its rebuttal CCOS study. This exclusion distorts the allocation of total IAWC costs to all remaining classes and skews IAWC's estimate of its cost of service for the remaining customers. (Collins, IIWC/FEA Ex. 4.0 at 6). The Company's rebuttal CCOS study provides no indication as to what the actual cost of service is to serve these customers. Also, the Company's rebuttal CCOS study provides no indication as to whether any cost subsidies are being provided to the Large OWU class. (*Id.*). IIWC/FEA continues to recommend the Large OWU customers should remain included in the Company CCOS study and their rates should be brought to cost of service. (Collins, IIWC/FEA Ex. 2.0 at 21).

E. Adjusting Rate Elements of Declining Block Rate Schedule

The Company proposes increases to the commodity charges for Non-Residential Metered General Water Service by varying the increases in the commodity charges by rate block to generally move each customer class to its allocated cost of service. (IAWC, Init. Br. at 106). The Company rejects the IIWC/FEA recommendation to adjust the rate elements by a uniform percentage to coincide with the increased revenues granted by the Commission in this case. (Collins, IIWC/FEA Ex. 2.0 at 24). The Company claims a uniform percentage adjustment will not move revenues more in-line with the allocated cost of service. (Herbert, IAWC Ex. 11.00SR at 14). However, the Company's rebuttal CCOS study suffers from the distortion of combining the cost of service for Zone 1 and Chicago Metro as well as the removal of the Large OWU class from the allocation of costs in the CCOS study. As explained in Section IV.A. above and IIWC/FEA's Initial Brief (IIWC/FEA Init. Br. at 32-34) these two issues render the Company's rebuttal CCOS critically flawed. Since the Company's rebuttal CCOS is flawed, the Company's argument that a uniform percentage increase would not move revenues more in line with the allocated cost of service is without merit and should be rejected.

Though the Company’s direct CCOS study is far more reasonable than its rebuttal CCOS, the Company’s direct CCOS study still suffers from some errors. For example, the Company failed to allocate any of the requested revenue increase to the Large OWU class, and it misallocated purchased power cost on only base volume rather than a combination of base and extra capacity allocation. Even with these errors, the Company’s direct CCOS study shows that most customer classes should receive a close to system average increase to bring their rates to cost of service. (Herbert, IAWC Ex. 11.01, Sch. A-Z-1). Because of the errors in the direct CCOS study and the general finding that most class rates are generally close to cost of service, IIWC/FEA recommend a uniform percentage increase to the Company’s commodity block structure as a fair and appropriate rate adjustment.

Staff proposes increases to the usage blocks for non-residential customer rates. (Staff Init. Br. at 63-64). Specifically, the Staff recommends a commodity block structure for non-residential customers that includes increases for the third and fourth consumption blocks of over 48.25% and 42.92%, respectively. The Staff's proposal should be rejected. The Staff's proposal is not cost based and results in an unjustified allocation of the rate increase to large users. The Staff's proposed allocation of a large portion of the increase in this case to large users is not supported by the Company's direct CCOS study which shows that large users' rates are fairly close to cost of service. As noted above, IIWC/FEA believes that the Company's direct CCOS study already over allocated cost to large users. Hence Staff's proposed rate design is severely flawed and prejudicial to large users. For example, the Staff's proposal would result in a 41.35% increase for the Industrial class in Zone 1 (Boggs, Staff Ex. 4.0, Sch. 4.1, Zone 1, Page 16 of 247). As shown by the Company in its direct CCOS study (Herbert, IAWC Ex. 11.01, Sch. A-Z-1), it proposes a 28% increase for the Industrial class which results in the collection of revenue in excess of this class' cost of service. The Staff's proposal would only exacerbate the over collection of revenue from this class in excess of its cost of service. Since the Staff's proposal to increase the third and fourth consumption blocks is not based on cost of service, it should be rejected. IIWC/FEA agree with the Company that Staff's proposal results in drastic increases and should be rejected. (IAWC Init. Br. at 102-103).

For the reasons stated above, IIWC recommends a uniform percentage increase to the Company's commodity block structure as a fair and appropriate rate adjustment.

CONCLUSION

For the reasons stated herein and for the reasons stated in the IIWC/FEA Initial Brief, the recommendations and positions to IIWC/FEA should be adopted.

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