STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

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

REPLY BRIEF OF ILLINOIS-AMERICAN WATER COMPANY

PUBLIC

Albert D. Sturtevant
Anne M. Zehr
Rebecca L. Segal
WHITT STURTEVANT LLP
180 N. LaSalle Street, Suite 1822
Chicago, Illinois 60601
Phone: 312-251-3017
sturtevant@whitt-sturtevant.com
zehr@whitt-sturtevant.com
segal@whitt-sturtevant.com

Mark A. Whitt
WHITT STURTEVANT LLP
PNC Plaza, Suite 2020
155 East Broad Street
Columbus, Ohio 43215
Phone: 614.224.3911
whitt@whitt-sturtevant.com

John J. Reichart
Kenneth C. Jones
Illinois-American Water Company
727 Craig Road
St. Louis, MO 63141
314-996-2287
John.Reichart@amwater.com
Kenneth.Jones@amwater.com

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I. INTRODUCTION

Staff and the Interveners in this case propose numerous adjustments in briefing. But many proposals are long on assertions and short on facts. Several are made for the first time in briefing, and are unsupported in the testimony of any witness. The Commission should not entertain any consideration of Staff's and the Intervenors attempts to introduce new, unsupported theories and proposals for the first time in briefing. For example, Staff now proposes a new adjustment for phone charges and alleges an unspecified adjustment is needed with respect to the duration of calls to IAWC's affiliated Service Company call center. The AG proposes for the first time in briefing that this Commission adopt an Indiana consolidated tax savings adjustment related to interest expense, although no witness either testified that this adjustment was appropriate in Illinois or quantified the methodology. And Staff's proposal to impute IAWC's parent's capital structure is unsupported by any evidence that any "increased cost of capital" is the "result of" IAWC's affiliation with American Water, as would be required for Staff to establish a basis for its adjustment under Section 9-230 of the Public Utilities Act. Staff follows this with an alternative capital structure proposal that was not presented in testimony. Other parties simply skipped the facts altogether—the initial brief of the Village of Bolingbrook contains no citations to the evidentiary record.

In rate case proceedings, an extensive discovery and testimony schedule is established to allow the orderly presentation of evidence—and no less importantly, a fair opportunity to respond. By waiting to make substantive proposals in briefing, parties subvert this orderly procedure and (if their untimely recommendations are adopted) deprive IAWC of a fair proceeding. By failing to present their factual theories and specific recommendations in testimony, these parties deprived IAWC of the right to explore the issues through discovery, to present its own evidence and to cross-examine adverse witnesses. Such eleventh hour, unsupported proposals should be rejected.

The Commission, as is its duty, should instead focus on the facts of record. For example, it is undisputed that from the last rate case test year (2010) through the test year in this proceeding (the year ending September 30, 2013), IAWC projects it will invest approximately $190 million in capital projects needed to sustain adequate and reliable service. Such necessary investments include the Peoria water-treatment facility and the Business Transformation project to replace antiquated information technology systems. At the same time, IAWC has held overall operations and maintenance expenses flat since its last rate increase in Docket 09-0319. But while IAWC's duty to serve demands substantial investment, the record shows that 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.

The Commission should embrace these facts and decide the issues in this case accordingly. With respect to capital investment, the Commission should give IAWC the opportunity to obtain necessary capital on reasonable terms. As IAWC explained in its Initial Brief, 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%) 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. This balance has been working well; there is no reason to upset it.

To address the emerging business reality of declining usage over the long term, the

Commission should approve IAWC's test-year forecast of water sales. IAWC also 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 similar to Rider VBA recently approved by the Commission for Peoples/North Shore. The RAC will provide IAWC with a measure of revenue stability despite the declining usage trend that IAWC has experienced and expects to continue to experience. It should be approved by the Commission.

For these reasons, IAWC respectfully requests that the Commission approve its proposed revised tariffed rates, as discussed below.[1]

II. RATE BASE

A. Business Transformation Costs

Staff and IAWC agree in all respects regarding the appropriate ratemaking treatment to be afforded *all* of the Company's investment in Business Transformation ("BT"). (See Staff Init. Br., pp. 11-14.) The Company further agrees with the BT reporting requested by Staff, and with Staff's recommendation that these reporting requirements be memorialized in the findings and ordering paragraphs of the Commission's Order in this case. (Staff Cross Ex. 2.0 (DLH-IAWC 30.01-30.03).)

In contrast, the AG argues that *all* of IAWC's Business Transformation cost should be excluded from IAWC's rate base because somehow the *Service Company* is earning a return on *IAWC's* investment. The AG believes the agreement between IAWC and the Service Company does not permit IAWC to reflect amounts paid to the Service Company as capital costs to be included in IAWC's rate base. (AG Init. Br., pp. 11-14.) In the alternative, the AG argues that,

[1] Issues raised in this proceeding that are now resolved, as reflected in the parties' initial briefs, are set forth in IAWC Reply Brief Appendix A.

if the Commission approves inclusion of BT costs in IAWC's rate base, the Commission should impute both 12.3% of the BT costs to American Water's non-regulated business and a BT "savings" amount in IAWC's rates. (Id., pp. 9-11, 14-18.) The Cities and Villages likewise argue *all* of the BT investment should be excluded from rate base because those parties believe there is no proof of ratepayer benefit resulting from BT. (Cities and Villages Init. Br., pp. 6-7.) The AG and the Cities and Village's arguments are misplaced and inconsistent with the record evidence and the Commission's precedent on capital additions. Their recommendations are not in the best interest of IAWC's customers. They should be rejected.

Including BT Costs in Rate Base Is Consistent with the Terms of the Agreement between IAWC and the Service Company Approved by the Commission.

The BT costs IAWC pays are capital investments that are properly included in utility rate base. As discussed in IAWC's Initial Brief, BT costs are incurred by the Service Company and, consistent with the Service Company Agreement between IAWC and the Service Company, IAWC's share of those costs are charged to IAWC at the Service Company's cost. (IAWC Init. Br., p.12; IAWC Ex. 5.00SR (Rev.) (Kerckhove Sur.), p. 12.) That is, there is no additional cost component (or "profit") 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 pays the costs as shown on the invoice and records the amount as capital investment. The AG argues that, in order for IAWC to capitalize assets procured for it by the Service Company, the agreement between IAWC and the Service Company must expressly provide how IAWC books Service Company costs or how it recovers those costs through the ratemaking process:

> The SC Agreement does not include the authority to include Service Company costs or an allocation of Service Company costs in IAWC's rate base. AG Cross Ex. 3 at ¶3.2. In contravention of the SC Agreement and its representations to the Commission that there is no "profit" associated with Service Company charges, IAWC is asking the Commission to allow it to earn a profit on Service Company

BT costs by adding these costs to rate base.

(AG Init. Br., p.13.) The AG's argument is wrong. The Service Company Agreement sets forth how the Service Company charges IAWC for services, but does not (and need not) determine how IAWC books its charges, or how IAWC recovers its costs in the ratemaking process. Rather, IAWC makes the determination to capitalize the Service Company BT charges based on the ratemaking and accounting considerations most appropriate for the Company as a regulated Illinois public utility. (IAWC Init. Br., p.12; IAWC Ex. 5.00SR (Rev.), p. 12.)[2] IAWC's determination to capitalize BT costs does not require express authorization in the Service Company Agreement and in no way violates the terms of that agreement, as the Commission has previously recognized. See, e.g., Illinois-American Water Co., Order, Docket 09-0319 (Apr. 13, 2010), pp. 21-22 (including in rate base the unamortized balance of IAWC's portion of the cost of the Service Company's Comprehensive Planning Study). Moreover, as discussed below, to treat the BT costs as Service Company charges that are not capitalized, but expensed, would result in a significant increase to IAWC's test year revenue requirement. The AG's position to the contrary is untenable and should be rejected.

BT Costs Are Properly Allocated to IAWC and Its Affiliates.

The AG recommends that the Commission allocate "12.3% of total [BT] costs to American Water's non-regulated operations." (AG Init. Br., p.11.) The AG's recommendation is based on the unsupported and false premise the Service Company will use the new BT systems to support the core business activities of IAWC's market-based affiliates. But there is no evidence in this case that even suggests that the new BT systems will be used to support the core business activities of IAWC's market-based affiliates. The AG instead relies on innuendo and

[2] As noted in IAWC's Initial Brief, capitalizing large-scale IT systems replacements is consistent with past Commission practice. (IAWC Init. Br., p. 10 (citing dockets).).

misinformation.

The AG claims there is a "lack of any apparent reason that functions such as human resources, finance and accounting, purchasing and inventory management, capital planning, cash management and customer services would not be needed by American Water's non-regulated (but still water related) services . . . ." (AG Init. Br., p. 10.) But the record makes plain that American Water's non-regulated affiliates operate these functions *separately*. (IAWC Ex. 9.00R (Rev.) (Twadelle Reb.), p. 8.) IAWC's "unregulated" or market-based businesses own and operate separate finance, accounting, management of asset lifecycle, customer service, customer billing and strategic planning systems, which in large part satisfy the market-based operations' needs in these areas. (Id. (referencing IAWC's response to ICC Staff data request DLH-10.01).) Thus, the functionality associated with the BT systems was not designed for IAWC's market-based operations, and IAWC's market-based affiliates will continue to use different systems to support their core business activities. (Id.; IAWC Ex. 5.00R (2d Rev.) (Kerckhove Reb.), pp. 16-17.)[3] It is clear the AG simply refuses to believe, or chooses to ignore, the BT program and IT systems have been specifically designed to accommodate the needs of American Water's regulated utility companies. (IAWC Ex. 9.00R (Rev.), p. 8.) Staff understands as much. (See ICC Staff Ex. 2.0 (Hathhorn Dir.), p. 10 (acknowledging IAWC's explanation in discovery that its non-regulated affiliates will access only two parts of the BT systems).)

Further, the record reflects, to the extent American Water's non-regulated business subsidiaries do use the BT systems, they will be charged accordingly. IAWC's market-based affiliates will access two limited aspects of the new BT systems: (1) Success Factors and (2) a portion of the SAP CRM (Customer Relationship Management) module. (IAWC Exs. 9.00R

[3] If the BT systems were designed to accommodate American Water's "unregulated" or market-based businesses, the overall cost of the BT program would have been considerably more.

(Rev.) pp. 7-8; 5.00R (2d Rev.), pp. 16-17.) As a result, certain BT implementation costs have been and will be directly charged to the Company's market-based affiliates and, in other circumstances, will be credited to the Company and its regulated utility affiliates through a reduction in BT implementation (capital) costs. (IAWC Ex. 5.00R (2d Rev.), p. 17.) The record also shows certain ongoing subscription and maintenance costs will be charged to market-based affiliates, with a corresponding reduction in Service Company fees. (Id.) The AG's continued refusal to accept this cannot serve as a proper basis for the AG's recommendation here.

Further, IAWC has agreed to reporting requirements, proposed by Staff, that will track any reductions in actual costs incurred and allocated to IAWC for current or future affiliates' use of the BT system. Updates to these reports will be included in the next rate case filing. The AG simply ignores that the Company has agreed:

> to file a report on the ICC's e-Docket system under Docket No. 11-0767, with a copy provided to the Manager of the ICC's Accounting Department, every six months beginning with the date of the Order in Docket No. 11-0767 through and until new rates are effective from the rate proceeding filed after Docket No. 11-0767, of actual costs incurred and allocated to IAWC by ICC account number for its [BT] implementation costs[; and]
>
> to file a report on the ICC's e-Docket system under Docket No. 11-0767, with a copy provided to the Manager of the ICC's Accounting Department, every six months beginning with the date of the Order in Docket No. 11-0767 through and until new rates are effective from the rate proceeding filed after Docket No. 11-0767, of reductions in actual costs incurred and allocated to IAWC for current or future affiliates' use of the BT system, by ICC account number[.]

(Staff Cross Ex. 2.0 (DLH-IAWC 30.01-30.02).) IAWC also has agreed "to file as part of its direct case in its next general rate case proceeding filed after Docket No. 11-0767, updates to the reports" identified above. (Id. (DLH-IAWC 30.03).) Therefore, to the extent that an IAWC market-based affiliate is permitted to access any additional portions of the BT systems, IAWC will report on that amount, and customers will benefit through a reduction in BT development costs and/or a proportionate reduction in the ongoing BT operating and maintenance costs that will be reflected in IAWC's next rate case filing. The AG's contrary assertions are baseless and should be accorded no weight.

The AG also contends for the first time in briefing that the increased percentage allocation of BT costs from 2010 to the test year is "further indication" allocation of BT costs to IAWC is "overstated." (AG Init. Br., p. 10.) The AG asserts IAWC did not explain the increase in IAWC's customer count allocation percentage from 8.9% in 2010 to 9.9%, since IAWC's customer count has not increased. (Id.) The explanation, however, is simple. IAWC's allocation percentage increased because the number of customers in the American Water system decreased with the sale of utilities in New Mexico and Arizona. See In re Acquisition by Epcor Water (USA) Inc. of the Common Stock of New Mexico-American Water Co., Order, No. 11-00085-UT, 2011 N.M. PUC LEXIS 60 (NM PRC Dec. 22, 2011); In re Arizona-American Water Co. for a Waiver under A.A.C. R14-2-806 or, in the Alternative, Notice of Intent to Reorganize under A.A.C. R14-2-803, Order, No. W-01303A-11-0101, 2011 Ariz. PUC LEXIS 298 (Ariz. CC Nov. 17, 2011). Thus, IAWC's percentage of the remaining customers is larger.

The Commission Should Reject the AG's Recommendation to Impute Additional BT "Savings."

The AG recognizes "American Water and IAWC 'are unable to confirm the amount of potential savings that may be realized as a result of BT and are unable to specifically identify how potential savings will be attained.'" (AG Init. Br., p. 14.) Nevertheless, the AG also recommends that the BT costs should be offset by the imputations of estimated cost savings based on estimated BT "related" benefits identified in preliminary documents presented to the American Water Board of Directors and on the opinions in the Final Audit Report prepared by NorthStar Consulting Group in Docket 10-0366 (the "Audit Report"). (Id., pp. 14-17.)

Although IAWC believes that its customers will benefit from the increased information system functionality and the efficiencies that will result from the implementation of the Business Transformation program, the AG's use of very preliminary board materials to determine a specific "savings" offset is premature and unwarranted. As an initial matter, the AG misconstrues American Water's preliminary analysis. The analysis speaks of 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*. (IAWC Init. Br., pp. 17-18.) Even if the estimated benefits were anticipated in the Company's test year (they are not, beyond what IAWC has already reflected in its update), applying these estimated benefits as cost offsets to IAWC's revenue requirement overstates their value and fails to take into account costs and trade-offs necessary to achieve those benefits. It is anticipated that potential benefits from Business Transformation, in the form of mitigation of operations and maintenance expense increases, would begin once the new systems are fully deployed and employees are fully trained on those systems, beginning in 2014. (IAWC Ex. 5.00R (2d Rev.), p. 21.) It should be self-evident that IAWC cannot begin to achieve cost savings from the new BT systems until they are implemented and the Company's employees have become acclimated to them. (Id.) As such, they will be reflected in the revenue requirement of future cases.

Moreover, the projection of potential benefits, made several years ago to determine the feasibility of a project, is insufficient evidence to support the imputation the AG seeks. (See Staff Init. Br., p. 12 (disagreeing with the AG's proposal to impute BT cost "savings," arguing "Staff does not believe that the evidence supports a finding 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.").) It seems highly unlikely, indeed unthinkable, that the Commission would be satisfied with such a modest showing by a utility to support utility rate case cost projections.

Nevertheless, the AG, selectively using but a single slide from a Board presentation, recommends the imputation of multi-million dollars of alleged "BT-related savings." (AG Init. Br., p. 18, n. 10 (citing AG Ex. 2.2, Sch. C-8, referencing p. 23 of AG Ex. 2.6).) But the context provided by the other slides of the April 2011 presentation on which the AG relies underscores the insufficiency of the projections. For example, Page 10 demonstrates design of the BT systems had not yet begun. (AG Ex. 2.6, p. 10.) Page 35 shows that the initial "Blueprint Phase" of the BT program had only just been completed. (Id., p. 35.) Page 20 states: "Confidence in the level of forecasted costs & benefits will increase over the project lifecycle," and indicates confidence levels of only 50% and 25% for costs and benefits, respectively, as of the time of that presentation. (Id., p. 20.) In other words, the projections the AG relies on are at once preliminary and stale.

Moreover, as IAWC has made clear, the ability to realize benefits is a matter of timing. "IAWC should not be reasonably expected to quantify all potential benefits of BT before it has even begun implementation of the program." (IAWC Ex. 5.00R (2d Rev.), p. 19, lines 426-28.) While quantifiable cost benefits may occur once the Business Transformation program is fully implemented (in 2013-2014), they do not occur during the test period of this rate case. (Id., p. 21.) As IAWC witness Mr. Kerckhove, IAWC's Manager of Rate Regulation, explained, "[f]rom a ratemaking perspective, the imputation of any benefits from the BT system must be aligned with the reality that the systems must be in place and fully functioning before any cost savings may logically be realized or imputed. To do otherwise would not be responsible ratemaking." (Id., p. 21, lines 477-80.)

In opposing BT cost recovery, the AG also relies on statements in the Audit Report filed with the Commission on January 11, 2012 in Docket 10-0366. (AG Init. Br., pp. 15-17.) Just prior to the start of the May 15, 2012 evidentiary hearing in this case, the AG and Staff jointly moved for that report's entry into the record. See Jt. Mtn. of ICC Staff and People of the State of Illinois for Entry of Evidence (May 11, 2012). The ALJ granted the Motion "*subject to normal procedural rules in Section 200.670 and other sections in the Rules of Practice*." Notice of ALJ Ruling, p. 2 (May 15, 2012) (emphasis added). Commission Rule 200.670 provides in pertinent part:

> **Exhibits**
>
> a) Marking and size of Exhibits. *All* exhibits *shall* be marked numerically and/or alphabetically with a party or staff designation and shall conform to the requirements of Section 200.110.
>
> b) Copies of Exhibits. When Exhibits are identified for the record, unless the Hearing Examiner directs otherwise, an original and two copies *shall* be offered at the hearing and a copy provided to the Hearing Examiner, and to each party and staff witness.

83. Ill. Adm. Code 200.670(a)-(b). Despite the ALJ's specific direction in the May 15, 2012 Order, the AG and Staff failed to comply with the requirements of Rule 200.670 with respect to the Audit Report. The Audit Report is not marked as an exhibit—in fact, it cannot be found on e-Docket in this case or anywhere else in the record of this proceeding. It was not even mentioned at the hearing. As such, it is not properly part of the evidentiary record in this proceeding and so cannot be relied on by the Commission in reaching a decision. Business & Prof'l People for the Pub. Interest v. Ill. Commerce Comm'n, 137 Ill. 2d 192, 227 (1989) (Commission findings must be based exclusively on the record evidence). Rather than burden the record with further motions practice on this point, however, IAWC submits that, in light of the AG's failure to comply with the ALJ's ruling, the AG's references to the Audit Report

should be accorded no weight.[4]

Also relying on the Audit Report, the AG recommends, for the first time in briefing, "[t]he Commission should require IAWC to implement the controls NorthStar identified as a condition to any recovery of increased AWWSC charges and costs associated with the BT systems." (AG Init. Br., p. 16.) No witness made this recommendation. No witness defined or otherwise explained the "controls" on which the AG (now) believes recovery of BT costs should be conditioned. No witness explained how such "controls" should be implemented, or if they can be. The AG's untimely and unsupported recommendation should be rejected.

The Unrebutted Record Evidence Demonstrates BT Will Benefit Ratepayers.

The record is replete with evidence BT is necessary—IAWC's antiquated IT systems need to be replaced—and will benefit ratepayers and the Company alike. (IAWC Init. Br., pp. 8-9, 11-12; IAWC Ex. 9.00 (Twadelle Dir.), pp. 13-15; AG Ex. 2.6.) The Cities and Villages did

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[4] Although the Audit Report is not part of the evidentiary record and so not properly considered by the Commission, IAWC notes that the AG quotes the Audit Report selectively, and ignores the fact that the Audit Report in fact endorsed BT. Notably, regarding BT, the Audit Report concludes:

- **The need for undertaking the BT program was well documented**.
  - The CPS clearly identified the aging status of AWWSC's ITS infrastructure.
  - NorthStar confirmed the need and inefficiencies caused by the aging IT systems.

- **American Water undertook the BT program in a reasonable manner.**
  - A strong business case for the program was developed showing the need for and the benefits to be received from undertaking the program.
  - The selection of the ITS platform for the program was performed in an appropriate fashion using a competitive bidding and evaluation process.
  - Likewise, the system integrator was selected with a similar bidding and evaluation process.

- **The project is ahead of schedule, and projected costs are still within the budgeted amount and very reasonable given industry norms . . . .**
  - Implementation is expected to start in 2012 and be completed in 2013 compared to the original schedule of a start in 2012 and a completion in 2014.

(Audit Report, IV-6.) As such, the Audit Report fully supports IAWC's proposed ratemaking treatment of its BT costs.

not rebut this evidence.[5] Nevertheless, they argue the BT investment should be removed from IAWC's rate base because they believe "the costs have not been shown to convey any meaningful customer benefits." (Cities & Villages Init. Br., p. 6.) That argument is contrary to the record and should be dismissed on that ground alone. Staff agrees. "Staff does not believe that the evidence supports a finding 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." (Staff Init. Br., p. 12.) "The Company's test year reflects full retirement of the old computer systems that the BT program will replace. (Staff Ex. 10.0, pp. 11-12.) [Disallowing the BT costs] would result in the unreasonable position that the Company should receive no cost recovery for computer systems necessary in providing utility service." (Id., p. 13.)

Moreover, the Cities and Villages' position is not the standard by which plant investments are evaluated in Illinois. As explained in IAWC's Initial Brief, there is no regulatory requirement that quantifiable benefits must be proven and captured in the revenue requirement before the revenue requirement of the expenditure may be collected from ratepayers. (IAWC Init. Br, pp. 14-15.) The Cities and Villages cite none. Rather, they assert: "'The utility has the burden of providing that an *operating* expense for which it seeks reimbursement directly benefits the ratepayers or the service which the utility renders.'" (Cities & Villages Init. Br., p. 7 (quoting Candlewood Lake Utils. Co. v. Ill. Commerce Comm'n, 122 Ill. App. 3d 219, 227 (2d Dist. 1983)) (emphasis added).) The BT costs are not an operating expense; they are capital costs. The legal standard for determining whether they 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

[5] In fact, the Cities and Villages submitted no evidence of their own in this proceeding.

Ex. 10.0, p. 11.) 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. (IAWC Init. Br., pp. 10-13.) Because the Cities and Villages simply ignore the legal standard in Illinois for recovery of plant investment (as well as the record evidence), their recommendation should be accorded no weight.

Finally, to the extent the Cities and Villages argue BT costs should not be recovered unless and until BT cost "savings" are imputed, that argument should be dismissed for the reasons set forth in response to the AG's same argument.

Recovery and Capitalization of BT Costs Are In the Best Interests of IAWC's Customers.

IAWC's BT investment is prudent and reasonable, and the BT assets will be used and useful in providing utility service during the test year. (See Staff Init. Br., pp. 11-14; AG Init. Br., pp. 8-19 (stating (p. 17) "[BT] was developed to make existing processes more efficient," and contesting only the ratemaking treatment of the BT investment); Cities & Villages Init. Br., pp. 6-7 (contesting only the ratemaking treatment of the BT investment).) "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." (Staff Init. Br., p. 13.) Thus, by accepting the AG and the Cities and Villages' argument BT costs should not be included in rate base (the Commission should not), IAWC's only choice would be to recognize all BT costs as expenses. This would increase the test year revenue requirement by millions of dollars. (See IAWC Ex. 4.01.) Capitalizing BT costs will significantly reduce the up-front rate increase for IAWC's customers and will result in a significantly lower revenue requirement when compared to collecting the costs as expenses in rates. (IAWC Ex. 5.00SR (2d Rev.), p. 23.) As explained in IAWC's Initial Brief, because the BT assets will provide service to ratepayers over their useful life (10-12 years), the recovery of BT costs over their useful life is a more responsible ratemaking method than seeking to recover the costs over the shorter period when the costs are incurred. (IAWC Init. Br., p. 13; IAWC Ex. 5.00R (2d Rev.), p. 23.) Capitalizing BT costs also will result in proper intergenerational equity by more closely aligning BT cost recovery with the anticipated service life of the assets and their use by customers. (IAWC Ex. 5.00R (2d Rev.), p. 23.)

In sum, the record makes plain IAWC's BT costs meet the standard for rate base recovery on IAWC's investment in Business Transformation and Staff agrees. All of IAWC's BT costs should be included in rate base.

B. Pension Asset

Staff and the AG's arguments that the $9,575,288[6] representing the difference between the level of IAWC's pension contributions per federal funding requirements and the level of pension expense which it can recover through rates per the Commission's requirements (see IAWC Init. Br., pp. 19-25) should be excluded from rate base are misplaced and should be rejected. Both continue to adhere to the narrow position that, absent a showing IAWC's "pension asset" (as the amount has been dubbed) was shareholder funded, it is not includable in rate base. (Staff Init. Br., pp. 5-6; AG Init. Br., p. 7.) Yet, as explained in IAWC's Initial Brief, the appropriate focus of inquiry is not the source of the funds that created the pension asset, but the proper ratemaking treatment applied to the timing difference from which it results. (IAWC Init. Br., p. 22.) It is not disputed that pension expense amounts established for a given year pursuant to FAS 87 will typically be different than actual pension contributions—so that pension costs reflected in rates are different from actual amounts being contributed to the pension plan.

[6] The AG asserts IAWC's pension asset is $10.521 million. (AG Init. Br., p. 6.) That is wrong. The AG ignores the Company updated its pension asset when it received updated projections for its pension expense accruals under FAS 87 and its pension contribution amounts for 2012 and 2013 from Towers Watson. (IAWC Ex. 6.00SUPP (Rungren Supp. Dir.), p 5; Sch. B-2.22 (First Rev.).)

When pension contributions are less than FAS 87 pension expense, the Commission approves a rate base deduction reflecting the difference. (Id., pp. 19-20 (citing dockets).) Fairness dictates the converse situation be treated symmetrically: when pension contributions exceed FAS 87 pension expense, the Commission should approve a rate base increase. Staff and the AG's narrow position fails to account for such fairness. They have presented no reason to treat symmetrically converse situations asymmetrically.

Nevertheless, Staff asserts prior Commission orders support its position. (Staff Init. Br., pp. 7-10 (citing Northern Ill. Gas Co., Dockets 95-0219 and 04-0779; Peoples Gas Light & Coke Co./North Shore Gas Co. ("Peoples/North Shore"), Dockets 07-0241/0242 (cons.), 09-0166/0167 (cons.) and 11-0280/0281 (cons.)).) Relying on them, Staff contends IAWC "fails to understand" the Commission has rejected proposals similar to the symmetrical ratemaking IAWC advocates here. (Id., p. 6.) Respectfully, it is Staff who "fails to understand" those orders are distinguishable from the present case. In the Northern Illinois Gas Co. dockets, the pension asset at issue resulted from a previous overpayment, or prepayment, of pension expense. The utility conceded that its pension plan was "overfunded," and that it was not required to contribute to its pension plan for a period of years. Order, Docket 04-0779 (Sept. 20, 2005), pp. 20, 23; Order, Docket 95-0219 (Apr. 3, 1996), 1996 Ill. PUC LEXIS 204, at **19-20, 22-23. (Staff Init. Br., p. 7.) IAWC does not contend its FAS 87 pension expense is other than ratepayer funded. Here, IAWC's plan is not "overfunded." (IAWC Ex. 6.00R (Rungren Reb.), p. 38.) In the Peoples/North Shore dockets, the pension asset at issue resulted from a negative, or unrecovered level, of FAS 87 pension expense. See, e.g., Order, Dockets 09-0166/0167 (Jan. 21, 2010), p. 26. Again, the Commission found as a matter of fact ratepayers supplied the missing funds. Id., p. 36; Order, Dockets 07-0241/0242 (Feb. 5, 2008), p. 36; Order, Dockets 11-0280/0281 (Jan. 10, 2012), p. 33. That makes sense considering traditional ratemaking is based on the premise the expenses underlying rates fluctuate such that, while some may go up, others go down and all are collected in rates. See Business & Prof'l People for the Pub. Interest v. Ill. Commerce Comm'n, 146 Ill. 2d 175, 244 (1991). Here, IAWC does not contend it has under-recovered its FAS 87 pension expense.

What makes this case different is that ratepayers *have* supplied the total level of FAS 87 pension expense; however, what IAWC contributes to the pension fund now (and for the past several years and into the near future) *exceeds* the level of FAS 87 pension expense the Commission requires ratepayers to supply via rates. (IAWC Ex. 6.00R, p. 21.) Staff agrees IAWC's pension contributions exceed its FAS 87 expense. (IAWC Cross Ex. 12 (IAWC-ICC 2.08).)

Even accepting Staff's position that a showing of shareholder funding is a prerequisite to recovery on IAWC's pension asset (it is not), unlike the dockets relied on by Staff, there is no basis in the record of this case for a finding IAWC's pension asset was *other than* shareholder funded. The record evidence demonstrates that:

- Staff does not contend IAWC receives compensation from ratepayers for the shortfall resulting from the difference between its pension contributions and what it is permitted to collect in rates per FAS 87 (IAWC Cross Ex. 12 (IAWC-ICC 2.01));

- Staff does not contend ratepayers' payments of their utility bills, or a segregated portion thereof, constitute contributions to IAWC's pension fund (id. (IAWC-ICC 2.03, 2.07));

- Staff does not contend ratepayers incur a separate charge funding its pension asset (id. (IAWC-ICC 2.06)); and

- Staff does not contend IAWC may use or even access amounts it has contributed to the pension plan (id. (IAWC-ICC 2.05)).

If, as Staff apparently acknowledges, ratepayers did not supply the funds representing the difference between IAWC's pension contributions and the FAS 87 pension expense the Company collects in rates, then *who did*? The only logical conclusion is shareholders. Moreover, the last point is important—IAWC cannot access or withdraw amounts contributed to its pension plan. Thus, there can be no analogy to situations where funds supplied are available to the utility for some other purpose. The pension contribution amounts are no longer available to IAWC, and so are appropriately viewed as an asset.

Staff also appears to imply that the Commission has *never* approved a return on a pension asset. That is wrong. Staff ignores Docket 94-0040, wherein the Commission authorized inclusion in rate base of the utility's prepaid pension expense. See Central Ill. Light Co., Order, Docket 94-0040, 1994 Ill. PUC LEXIS 577, at *7 (Dec. 12, 1994). IAWC referenced that docket in testimony and in discovery. (IAWC Ex. 6.00R, pp. 25; 21-22 (citing IAWC's response to DLH-1.10).) Yet, to date, Staff has not discussed this case in setting out its position.

Absent from the AG's opposition to recovery on IAWC's pension asset is any discussion of the crux of IAWC's proposal: the AG does not mention the FAS 87 pension expense/ contribution timing difference or the symmetrical ratemaking IAWC advocates. (See generally AG Init. Br., pp., 6-8.) Instead, the AG contends IAWC is not entitled to a return on "increased pension expenses." (Id., p. 7.) The AG has misunderstood and mischaracterized the issue. IAWC is not seeking a return on increased pension expense; it is seeking a return on amounts that it has contributed above its FAS 87 pension expense amount.

The AG also continues to claim the Company cannot have a pension asset because "IAWC's pension has an unfunded liability of $421 million as of December 31, 2011." (Id., p. 7.) Again, that contention is misplaced. As explained in IAWC's Initial Brief, American Water's pension funding status—whether overfunded or underfunded—is not relevant to the calculation of *IAWC's* pension asset. (IAWC Initial Br., pp. 23-24.) Further, the AG relies on the definition the Commission accorded "pension asset" in Commonwealth Edison Co., Docket 11-0721. However, the Commission has granted rehearing on the pension asset issue in that docket. See Commonwealth Edison Co., Notice of Comm'n Action, Docket 11-0721 (June 22, 2012). For these reasons, the AG's arguments in this regard should be accorded no weight.

The Commission should encourage pension contributions, not penalize utilities and their shareholders for making them. IAWC's pension asset should be fully recognized.

C. Cash Working Capital Issues

1. Pension Expense

In its Initial Brief, Staff maintains its position that FAS 87 pension expense, rather than IAWC's actual contributions to the pension fund, should be used in the cash working capital calculation. (Staff Init. Br., pp. 14-17.) Staff alleges it is contrary to Commission practice to include pension contributions (id., p. 16), however, Staff fails to identify a single Commission rule or statute that would preclude the use of pension contribution amounts in the cash working capital calculation. Thus, Staff's recommendation should be rejected. As IAWC explained in its Initial Brief (p. 25), in this case, IAWC clearly has a pension contribution amount to be paid in the test year. IAWC's cash working capital should be determined based on that actual information.

IAWC does not dispute Staff's point that the cash working calculation includes items that do not use actual cash payments. (IAWC Ex. 6.00SR (Rungren Sur.), p. 4.) That said, if it is possible to easily eliminate an inaccuracy in the cash working capital calculation by, in this case, using the actual pension contribution amount, then such an approach is reasonable and should be accepted by the Commission. In this case, the Company's cash contributions to the pension trust are projected to be significantly larger than the FAS 87 amounts in the test year. Thus, using the operating expense (FAS 87) amount will result in a shortfall in the Company's cash working capital balance. (Id.) Using the actual pension contribution amount, then, is reasonable and practical. Staff's adjustment should be rejected.

Finally, Staff states for the first time in its Initial Brief that if the Commission were to adopt the Company's position, the Commission would have to adopt a similar approach with income taxes—i.e., the Commission should also reduce federal taxes to zero in the cash working capital calculation. (Staff Init. Br., p. 17.) Staff's eleventh hour recommendation should be rejected for three reasons. First, Staff's position was not made in and is not supported by any testimony. Thus, IAWC has had no opportunity to conduct discovery or cross-examination on, or otherwise respond to, this proposal. Second, Staff simply presents its recommendation and provides no quantification of its effect on IAWC's revenue requirement. Thus, the record does not show what the effect would be on cash working capital, or whether the impact would be negative or positive. Third, Staff's position assumes the Company "has no cash outlay" in the test year with respect to federal income taxes, which is contrary to the record. As IAWC explained in its Initial Brief, American Water operating companies forward tax payments to the parent as part of the operation of the consolidated tax group. (IAWC Init. Br., p. 134; IAWC Ex. 13.00R (Warren Reb.), p. 30.) These payments would represent actual cash outlays. Staff assumes, without record support, that such payments are zero. In fact, IAWC projects such payments in the test year. (See AG Cross Ex. 1, p. 1.) For these reasons, Staff's last minute, unsupported and unexplained recommendation should be rejected.

2. Collection Lag

Staff agrees "the evidence in the instant proceeding supports the collection lag days as proposed by the Company." (Staff Init. Br., p. 17.) The AG asserts, however, that IAWC's revenue collection lag is "distorted." (AG Init. Br., p. 23.) But it is the AG's position that ignores the purpose of cash working capital is to compensate the utility's investors for providing the funds for those day-to-day business operations that 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 AG does not calculate an actual collection lag. Rather, the AG simply replaces IAWC's detailed projection of its revenue requirement collection lag days, which is based on actual lags identified in the Company's new lead-lag study, with an arbitrary lag amount based solely on the 21-day lag approved in IAWC's prior rate case. That is improper.

Notably, the AG does not dispute the proposed 21-day lag does not represent an actual lag amount. (AG Ex. 4.0 C (Rev.) (Smith Reb.), p. 18.) Nor does the AG acknowledge in briefing Staff's rejection of that recommendation, or that Commission Rule 280.90(c) only sets a 21-day deadline in which a customer's bill should be paid and does not reflect the actual collection lag. (ICC Staff Ex. 9.0-C (Kahle Reb.), pp. 8-9.) 83 Ill. Adm. Code 280.90(c). In fact, Mr. Smith admitted at hearing that he did not account for the two-day grace period in IAWC's tariff in his 21-day collection lag. (Tr. 723-24.) Thus, late payment charges do not begin to accrue until 23 days after a bill is issued. Instead, the AG argues IAWC's lead-lag study is "distorted" because IAWC did not remove the effect of uncollectibles. (AG Init. Br., p. 23.) That is wrong. As shown on line 4 of Schedule B-8, IAWC removed uncollectibles from its cash working capital calculation. (IAWC Ex. 6.02SR (Sch. B-8 (Rev.))

Rather than rely on the AG's arbitrary 21-day collection lag and for the reasons articulated in IAWC's Initial Brief (pp. 28-30) and recommended by Staff (Staff Init. Br., p. 17), the Commission should utilize IAWC's actual calculated collection lags based on the updated lead-lag study in this case.

3. Service Company Prepayments

Staff recommends the AG's proposal to adjust payment lag to the Service Company be rejected because "the record evidence in the instant proceeding supports the collection lag days as proposed by the Company." (Staff Init. Br., p. 18.) Indeed, as explained in IAWC's Initial Brief, the record makes plain the Commission-approved Service Company Agreement between IAWC and the Service Company requires prepayment of Service Company fees and that these prepayment terms are cost effective and reasonable. (IAWC Init. Br., pp. 31-32.)

Despite this, the AG argues the Service Company Agreement does not require prepayment. (AG Init. Br., pp. 21-22.) That assertion is unfounded; it is contradicted by the express terms of the Service Company Agreement. Under the Service Company Agreement, IAWC is contractually required to prepay the Service Company for services: "'As soon as practicable after the last day of each month, Service Company shall render a bill to Water Company *for all amounts due* from Water Company for services and expenses for such month *plus an amount equal to the estimated cost of such services and expenses for the current month*.'" (IAWC Ex. 6.00R, p. 34 (emphasis added).) The quoted language requires that the bill from the Service Company include two amounts: (i) amounts due; and (ii) an amount equal to the estimated cost of such services and expenses for the current month. Further: "'All amounts so billed shall reflect the credit for payments made on the estimated portion of the prior bill . . . .'" (Id.) This confirms that the Service Company Agreement requires advance payment of an estimated amount. Thus, the Service Company Agreement clearly requires prepayment, and IAWC does in fact pay the current month's estimated Service Company fees in advance.

The AG also argues, based on information from other jurisdictions, adopting the AG's adjustment will not cause IAWC to be charged more by the Service Company. (AG Init. Br., pp. 21-22.) The AG argues, because IAWC cannot demonstrate that its affiliate Pennsylvania-

American Water Company has increased its charges as a result of the prepayment adjustment established by the Pennsylvania commission some twenty years ago, there is no reason to believe that the charges to IAWC will be any different. (AG Init. Br., p. 22.) This misses the point. IAWC would still have to follow the terms of the agreement and prepay the Service Company, so the adjustment simply bars recovery of a prudently incurred cost by the utility. (Tr. 356; IAWC Exs. 6.00R, p. 37; 6.00SR, p. 19.) Furthermore, Mr. Rungren's testimony at hearing was that while he does not believe the Pennsylvania ruling increased the fees the utility was paying to the Service Company, the utility was "taking a hit"—i.e., the utility is no longer able to recover its prudently incurred costs. (Tr. 356.)

Of the jurisdictions in which American Water subsidiaries operate, the AG can only point to two (Pennsylvania and West Virginia) that have adopted a similar adjustment. The AG simply ignores the Pennsylvania commission's rationale for its decision—that the utility failed to quantify any benefit to its customers. The PAWC decision upon which the AG relies is thus distinguishable from IAWC's current case because the Commission has found Illinois ratepayers benefit as a result of an arrangement featuring prepayments to the Service Company by 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. (IAWC Init. Br., pp. 34-35; AG Ex. 2.3 (Rev.), p. 47 (Pennsylvania American Water Co., Order, No. R-922428 (June 7, 1993), p. 23); Illinois-American Water Co., Order, Docket 09-0319 (Apr. 13, 2010), p. 18. The AG also ignores the Tennessee commission recently rejected an adjustment similar to that proposed by Mr. Smith in this case in Tennessee American Water Company's most recent rate case. Tennessee American Water Co., Order, No. 10-00189, 2012 Tenn. PUC LEXIS 76, at **235-38 (Tenn. Reg. Auth. Apr. 27, 2012). Additionally, the AG ignores the Commission rejected the very adjustment the AG proposes here in IAWC's last rate case. Order, Docket 09-0319 (Apr. 13, 2010), p. 18. Given the Commission's clear decision on this issue in Docket 09-0319, one could just as easily argue that Pennsylvania and West Virginia Commissions should revise their practice and follow the guidance of Illinois.

In sum, it is the AG's position that the Commission should ignore its own ratemaking treatment of prepayments to the Service Company and its approval (and re-approval) of the Service Company Agreement. It should not. As recommended by Staff, the Commission should reject the AG's proposal and approve the collection lag days proposed by IAWC.

4. Current and Deferred Income Taxes

As explained in IAWC's Initial Brief, it was not proper for Staff to, on rebuttal, combine current and deferred income taxes in its cash working capital calculation. Staff has not supported its position. (See generally Staff Init. Br.) It should be rejected.

D. ADIT – FIN 48

Ratepayers benefit when IAWC adopts uncertain tax positions because, as IAWC explained in its Initial Brief, if 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. (IAWC Init. Br., pp. 40-42.) See also In the Matter of Union Electric Company, d/b/a AmerenUE's Tariffs to Increase Its Annual Revenues for Electric Service, Order, No. ER-2008-0318, 2009 Mo. PSC Lexis 71, at *89 (Mo. PSC Jan. 27, 2009).[7] This point appears not to be in dispute. But the position taken by Staff and the AG in their Initial Briefs eliminates the incentive for IAWC to take uncertain tax positions. Staff and the AG propose for ratemaking purposes to treat the amounts associated

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

with uncertain tax positions ("FIN 48" amounts) as ADIT that is deducted from rate base. That treatment, however, would encourage IAWC to forego taking any uncertain tax position—in other words, under Staff or the AG's proposals, IAWC would be better off simply not taking the uncertain position, even though it could ultimately benefit ratepayers to do so. (See IAWC Ex. 13.00R (Warren Reb.), pp. 22-23; Tr. 824.) For this reason alone, their positions should be rejected. IAWC (and all utilities) should be encouraged to adopt uncertain tax positions to the benefit of ratepayers. The best way to do this is to treat the Company fairly in the regulatory process: it should not be required to recognize as deferred taxes FIN 48 amounts which it ultimately expects to pay with interest to the IRS.

Staff and the AG's positions are based on the misperception that FIN 48 amounts are comparable to ADIT. (Staff Init. Br., pp. 18; AG Init. Br., pp. 25-26.) They are not. To begin with, the AG argues that FIN 48 amounts are not investor-supplied capital. But, as discussed below, they are not ratepayer-supplied funds either. Rather, they represent a form of government loan, or government-supplied funds. (IAWC Ex. 13.00R, pp. 6-7.) Further, as explained in IAWC's Initial Brief (pp. 42-43), FIN 48 amounts are *not* an interest-free loan from the government. (IAWC Exs. 13.00R, pp. 8-9; 13.00SR (Warren Sur.), p. 3.) Thus, they simply cannot be considered a cost-free source of capital. (Id.) Staff's Initial Brief is inherently inconsistent on this point, arguing on page 18 that FIN 48 amounts "represent an interest free source of funds from the Federal and State government," but stating on the very next page, "the Company does risk *the payment of interest* on the uncertain tax position . . . ." (Staff Init. Br., pp. 18-19 (emphasis added).) The AG's Initial Brief simply ignores the point. (See AG Init. Br., pp. 25-29 (making no mention of the interest and penalties which can accrue on FIN 48 amounts).) Moreover, FIN 48 amounts are, for financial reporting purposes, expressly *not* to be classified as

ADIT. (IAWC Cross Ex. 8, p. 5; Tr. 709-10.) Staff's inconsistency and the AG's misunderstanding[8] the nature of FIN 48 amounts should not serve as the basis to deny IAWC appropriate recognition of its uncertain tax positions, which all parties agree benefit ratepayers.

The AG repeatedly points out in its Initial Brief that FIN 48 amounts are not investor supplied. (AG Init. Br., pp. 26, 27, 29.) IAWC does not dispute this point. (IAWC Ex. 13.00R, p. 6.) What the AG fails to recognize, however, is it is the *government*—and not ratepayers which "suppl[y]" the FIN 48 amounts (with interest). (Id.) Although it appears the AG would have the Commission believe FIN 48 amounts are akin to customer advances, as explained in IAWC's Initial Brief, they are not: the portion of a tax deduction giving rise to a FIN 48 liability is effectively an interest-bearing loan from the government; but for that deduction, the utility would have paid more taxes. (Id.; IAWC Init. Br., pp. 42-43.) IAWC reiterates 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. The AG offers none.

Nevertheless, the AG contends the record demonstrates "IAWC's position is based on the

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[8] The AG's misperception is made plain by the AG's assertion (without citation to the record or authority) that Mr. Warren "invent[ed]" the distinction between ADIT and non-ADIT loans. (AG Init. Br., p. 26.) In fact, Mr. Warren testified to the contrary:

> Q. But FIN 48 doesn't use the term 'Non-ADIT loan,' does it?
>
> A. Back in '09 that is the pronouncement that governs all tax accounting, including the creation of ADIT, it doesn't call ADIT a loan either, but we refer to it commonly as a loan, *referring to the economic significance*.
>
> * * *
>
> Q. You hadn't created the concept to communicate your view of it?
>
> A. Like [Al Gore] created the internet[?] I am not sure I created it. I don't think I created it, but I recognize that *that's the economic effect of it*.

(Tr. 818, lines 3-9, 12-17 (emphasis added).) The AG's inability to perceive the economic significance of FIN 48 amounts clearly has lead the AG to misunderstand the industry's terminology.

erroneous premise that IAWC should be allowed to earn a return on non-investor capital." (AG Init. Br., p. 26.) But in support, the AG cites an incomplete portion of the hearing transcript, leaving out not only the initial question in the exchange (between AG counsel and Mr. Warren), but also part of the answer. (See AG Init. Br., pp. 26-27.) In fact, the complete exchange makes clear not only is IAWC's position appropriate, but also the AG's is too extreme:

> Q. Let me start over. If the IRS rejects the deduction, then the Company has to pay the full amount of the tax liability, number one, right?
>
> A. Absolutely. If the IRS does what everybody, the Company and the auditors, think they are going to do, then you are right; they pay the amount.
>
> Q. And they also pay an interest cost?
>
> A. Yes. If there is interest on the assessment, yes.
>
> Q. Now, if the costs of -- if the interest cost is paid to the Company, then the Company would not have any loss as a result of that transaction, isn't that right?
>
> A. Well, of course it would.
>
> Q. Well, if the Company pays the tax as it is obligated to do?
>
> A. Yes.
>
> Q. And it receives reimbursement for the interest expense?
>
> A. Yes.
>
> Q. Then hasn't the Company been made whole?
>
> A. ***No.***
>
> Q. And why not?
>
> A. Well, because the Company -- assuming that we are dealing with Mr. Smith's proposal, you have reduced rate base by an amount of tax that you posited when you [set] rates was, you know, cost free capital and you have paid it back. And so all of a sudden your rate base, even under Mr. Smith's construction, that rate base offset should have been there. If you knew --
>
> Q. But in the --

A. In hindsight -- let me finish.

[Here is where the AG's Initial Brief starts.] ***If we want to place the Company in the position they would have occupied had they known when rates were set what was known a year or two years from now when they pay the tax, you wouldn't have reduced rate base by that amount***.

Q. Mr. Warren, isn't it correct, though, that during that period of uncertainty . . .

A. Uh-huh.

Q. when you didn't know that you were going to have to pay that tax, the Company had that loan, that money, available to it to fund its operations?

A. It had -- yes.

Q. That was not investor money, correct?

A. And the cost of that, we are talking about an arbitrage between reducing rate base at the weighted overall cost of capital, which is what would happen, and then allowing the Company just to earn the interest. I mean, okay, it is better -- being compensated for the interest is better than nothing. ***But it is still not making the Company whole because the Company is still better off not having taken the deduction***.

Q. So you are saying that the Company should be allowed to earn an investor return on this non-investor supplied capital, isn't that correct?

A. I am saying that in the normal course -- yes, that is what I am saying, exactly. The only non-investor source of capital they don't owe a return on are deferred taxes, ***and these aren't them.***

(Tr. 821, line 20 – 824, line 16 (emphasis added).) In short, the AG fails to grasp that merely recovering interest does not make IAWC whole, if, as the AG and Staff propose, rate base is reduced by the FIN 48 amounts. This is because the rate base deduction could continue even after IAWC has repaid the FIN 48 liability to the IRS as expected. The AG would treat the entire amount of potential tax liability as if IAWC will win on all positions and never have to pay the tax. That is contrary to the record, which make clears that more likely than not, IAWC *will* be required to repay the tax liability associated with the uncertain positions. (IAWC Ex. 13.00R, p. 22; Tr. 828-29.) The result is too extreme: if IAWC loses the uncertain tax positions (as is expected), there would be no deferral of tax and no means by which IAWC could recover the amount of revenue requirement associated with the reduced rate base.

The AG cites a recent order of the West Virginia Public Service Commission in support of its position this Commission should adopt the same ratemaking treatment of FIN 48 amounts sanctioned in that jurisdiction. (AG Init. Br., p. 28-29.) (The AG makes no attempt to show the circumstances of that case are comparable to those here or to explain why this Commission should defer to that one.) Notably, the AG fails to acknowledge that the West Virginia Commission, to guard against the revenue harm perceived by the utility and *to encourage it to continue to adopt uncertain tax positions which ultimately benefit ratepayers*, allowed the utility recovery on a regulatory asset equal to the related negative revenue requirement impact resulting from the disallowed ADIT:

> In its rebuttal testimony, WVAWC raised the concern that if the Commission elected to flow through the benefits of the capital repairs and rejected its FIN 48 reserve proposal, it might be caught in a situation where the benefits of the disallowed adjustment would suddenly be owed to the IRS even though the benefits would have already been flowed through to customers. Ex. MAM-R at 61, 62. As stated above, however, the Commission will normalize the impact of the capital repairs deduction changes. While normalization reduces the potential future revenue harm to WVAWC of an adverse tax ruling on its capital repairs deduction, an adverse tax ruling between rate proceedings could still impose costs on WVAWC if a portion of the ADIT is removed from the Company's books, but the full ADIT remains as a rate case deduction underlying the Company's approved rates. The Commission will allow a more balanced accounting mechanism than that proposed by WVAWC (i) to recognize the unusual nature of the capital repairs deduction accounting change and (ii) *to encourage WVAWC to continue to advocate for tax positions that ultimately benefit ratepayers*. Therefore, if the IRS actually does modify and disallow a portion of the deduction(s) WVAWC has taken and that are reflected as a deferred tax credit offset to rate base in this proceeding, the Commission will allow WVAWC to record a regulatory asset equal to the related negative revenue requirement impact in this case from the disallowed ADIT.

West Virginia-American Water Co., Order, No. 10-0920-W-42T, 2011 W. Va. PUC LEXIS 901, at **77-78 (W.Va. PSC Apr. 18, 2011) (emphasis added). Thus, the West Virginia Commission ordered a ratemaking outcome (albeit a somewhat complex one) that recognized that the utility should retain the incentive to take uncertain tax positions. The AG presents no such proposal here.

Staff, for its part, has attempted to soften the blow of its extreme position: "Since the Company does risk the payment of interest on the uncertain tax position if the IRS disallows the tax deduction, the Commission could allow the Company to recover from ratepayers an interest accrued on FIN 48 funds in its cost of service an interest expense." (Staff Init. Br., p. 19.) However, this is not enough. As explained in IAWC's Initial Brief, Staff's proposal does not mitigate the impact of including FIN 48 in ADIT—a reduction of rate base of $1.529 million—and does nothing but discourage IAWC from ever taking uncertain tax positions. (IAWC Init. Br., p. 40.)

Finally, Staff contends the Commission should take notice of certain FERC guidance on FIN 48 amounts. (Staff Init. Br., p. 18.) FERC guidance is not an authority upon which the Commission should rely in this context. Notably, FERC regulates electric and gas utilities. Therefore, it is unclear how its guidance is relevant to an Illinois water utility. (IAWC Ex. 13.00SR, p. 4.) Further, in its introduction to the guidance portion of the document, the FERC states: "'This guidance is for Commission financial accounting and reporting purposes only and is without prejudice to the ratemaking practice or treatment that should be afforded items addressed herein.'" (Id.) In other words, the FERC explicit states it did not intend to prescribe ratemaking, but only financial reporting. (Id., pp. 4-5.) The document, therefore, simply is not relevant to this Commission's determination here and Staff's request that the Commission take notice of it should be dismissed.

In sum, the arguments presented by Staff and the AG in support of their contention

IAWC's FIN 48 amounts should be included in ADIT (and thus excluded from rate base) are confused and incomplete. They propose ratemaking treatment which would *discourage* IAWC from adopting uncertain tax positions which all parties agree *benefit* ratepayers. Their proposals should be rejected.

E. Utility Plant in Service – Forecast Additions

The AG apparently has abandoned Mr. Smith's proposal to adjust IAWC's proposed additions to Utility Plant-in-Service based on an analysis of actual capital expenditures compared to proposed capital expenditures. (See generally AG Init. Br.) For the reasons set forth in IAWC's Initial Brief, and as recommended by Staff, the Commission should accept the Company's proposed plant additions. (IAWC Init. Br., pp. 43-45; Staff Init. Br., p. 14.)

F. Unamortized Management Audit Costs

Staff and IAWC agree: because management "audit costs are statutorily mandated costs, it is appropriate to include the unamortized balance in rate base to earn a return for shareholders." (Staff Init. Br., pp. 27-28.) The AG does not, and takes the position that the unamortized portion of IAWC's Section 8-102 (220 ILCS 5/8-102) costs for the audit undertaken in Docket 10-0366 should not be included in rate base. But the AG's position disregards Commission precedent and indicates a fundamental misunderstanding of management audit costs. It should be rejected.

The AG's Initial Brief simply ignores that the Commission has routinely authorized amortization of Section 8-102 management audit costs and inclusion in rate base of the unamortized balance. See, e.g., Central Ill. Pub. Svc. Co., Order, Docket 90-0072, 1990 Ill. PUC LEXIS 625, at **38-40 (Nov. 28, 1990) (approving five-year amortization period and including unamortized balance in rate base); Central Ill. Light Co., Order, Docket 90-0127, 1991 Ill. PUC LEXIS 17, at **41-43 (Jan. 16, 1991) (approving three-year amortization period and including unamortized balance in rate base); Peoples Gas Light & Coke Co., Order, Docket 90-0007, 1990

Ill. PUC LEXIS 593, at *54 (Nov. 9, 1990) (approving three-year amortization period); Contel of Ill., Inc., Order, Docket 90-0128, 1991 Ill. PUC LEXIS 18, at **78-79 (Jan. 16, 1991) (approving two-year amortization period); North Shore Gas Co, Order, Docket 91-0010, 1991 Ill. PUC LEXIS 636, at *29 (Nov. 8, 1991) (approving three-year amortization period). (See also ICC Staff Ex. 11.0 (Ostrander Reb.), p. 10 (citing dockets).) On this basis alone, the AG's position fails.

The AG's position also should be rejected because it is based on a fundamental misunderstanding of Section 8-102 management audit costs. Without citation to authority, the AG asserts IAWC's audit costs should be excluded from rate base because they are "rate case related costs." (AG Init. Br., p. 24.) That is wrong. The AG misunderstands the difference between rate case expense and management audit costs. It is simple: rate case expense is the expense incurred by a utility to prepare and present a rate case. Central Ill. Pub. Serv. Co. v. Ill. Commerce Comm'n, 243 Ill. App. 3d, 421, 423 (1st Dist. 1993). Section 8-102 management audit costs are *not* incurred by a utility to prepare and present a rate case; they are incurred in relation to a management audit undertaken pursuant to Section 8-102 of the Act. Thus, they are not rate case expense.

For the first time in briefing, the AG also makes the novel argument that including Service Company-related management audit costs in IAWC's rate base somehow violates the Service Company Agreement provision directing the Service Company to provide its services at cost. (AG Init. Br., pp. 24-25; 33-34.) This position is not set forth in the testimony of any witness. Nevertheless, this argument is based on a fundamental misperception. Consistent with the Service Company Agreement, Service Company labor costs are charged to IAWC at the *Service Company's* cost. (See IAWC Ex. 5.00SR (Rev.) (Kerckhove Sur.), p. 12.) *IAWC* pays these Service Company charges in full, then determines how best to treat the costs based on the ratemaking and accounting considerations most appropriate for IAWC as a regulated Illinois utility. (Id.) Once included in IAWC's rate base, *IAWC*—and not the Service Company—will earn a return on them. (Id.) This is routine. See, e.g., Illinois-American Water Co., Order, Docket 09-0319 (Apr. 13, 2010), pp. 21-22 (including in rate base the unamortized balance of IAWC's portion of the cost of the Service Company's Comprehensive Planning Study). In short, the AG is ignoring the distinction between the Service Company's provision of services at its cost with IAWC's treatment of the costs it pays as investment included in rate base.

Finally, the AG argues that to amortize the Service Company related management audit costs "effectively overloads the future test year with affiliate labor charges." (AG Init. Br., p. 34.) But the Audit is not a daily, monthly or even yearly occurrence in the normal course of business. (IAWC Ex. 7.00SR (Bernsen Sur.), pp. 13-14.) Thus, the services performed by Service Company personnel related to the Audit—attending interviews, responding to discovery, etc.—are not everyday job duties. They are incremental to normal duties and were charged to IAWC accordingly. (Id., p. 14; Staff Init. Br., p. 28; IAWC Cross Ex. 4 (IAWC-ICC 8.02).) The AG's position should be rejected.

G. Proposed Rate Base

The Commission should approve IAWC's total rate base, as shown on IAWC Initial Brief Appendix A.

III. OPERATING REVENUES AND EXPENSES

A. Forecast Sales Volumes – Declining Customer Usage

IIWC/FEA and the AG both recommend that IAWC's test year water sales projections be rejected in favor of their alternative projections. Inexplicably absent from IIWC/FEA and the AG's condemnation of IAWC's test year usage forecast, however, is *any* recognition of the declining usage trend experienced by IAWC or the myriad drivers exerting downward pressure on usage per customer. (See IIWC/FEA Init. Br., pp. 5-6; AG Init. Br., pp. 29-30.) Staff does not dispute the accuracy of the decline in annual usage. (ICC Staff Ex. 13.0 (Harden Reb.), p. 6.) The AG agrees "there appears to be a currently declining long-term consumption trend . . . ." (AG Init. Br., p. 50.) That trend should not be ignored in the test year usage forecast. For this reason, IIWC/FEA and the AG's alternative test year usage projections should be rejected.

Although IIWC/FEA claims its witness "offers a more appropriate and conservative forecast" than IAWC's (IIWC/FEA Init. Br., p. 5), Mr. Collins simply supplants IAWC's test year base usage with 2010 base usage for the Total Company and Zone 1[9] (id., pp. 5-6). By so doing, he ignores the fact that IAWC actually experienced a 1.90% annual decline in usage since 2010 and the effect of water efficient fixtures installed or conservation measures undertaken since that year. (IAWC Ex. 8.00R (Rev.) (Naumick Reb.), p. 20.) IAWC's forecast is based on a detailed projection based on multiple years of data and incorporates IAWC's analysis of declining per customer usage trends. (IAWC Init. Br., pp. 47-48.) IIWC/FEA's forecast lacks this level of detail. While IAWC's usage forecast methodology uses eight seasonal averages, Mr. Collins looks at only *one*. (Id.) This leads him to the erroneous conclusion that IAWC has understated its test year usage. (IIWC/FEA Init. Br., p. 6.) Such a narrow approach cannot be the basis for IAWC's test year level of consumption. It should be rejected.

Unlike Mr. Collins, AG witness Mr. Rubin did not prepare a consumption forecast. (IAWC Ex. 8.01R, pp. 1-3 (IAWC-AG 2.01, 2.01, 2.03).) Instead, he simply adopts IAWC's 2011-2012 forecast and recommends that be used rather than the test year one. (AG Ex. 1.0 (Rubin Dir.), pp. 3-4.) Despite this, the AG mischaracterizes *IAWC's* consumption model as "simplistic." (AG Init. Br., p. 29.) Moreover, despite adopting IAWC's 2011-2012 forecast, the

[9] Mr. Collins does not calculate test year usage for IAWC's remaining service areas.

AG criticizes IAWC's forecast method as "erroneous" and ignoring factors that influence usage such as population, economic conditions, changes in water-use technologies, weather, climate and price. (Id.) That is not the case. IAWC's forecast model considers exactly those factors. It is the AG that ignores a time series analysis recognizes that multiple factors influence usage and do so *over time*. (IAWC Ex. 8.00R (Rev.), pp. 3-4.) That is, rather than selectively including or excluding specific factors, as the AG suggests would be appropriate, IAWC's method quantifies the composite effect of *all* factors on usage over time. (Id.) Time, as the dependent variable, thus functions as a proxy for increased fixture and appliance efficiency, consumer conservation ethic and education, price changes and a host of other factors that influence usage. (Id.) The AG's contrary contention here is just not credible.

The AG also criticizes IAWC's projection because the AG believes the base period it employs excludes the non-weather sensitive months of November and December. (AG Init. Br., pp. 29-30.) This argument ignores the record evidence. As Company witness Mr. Naumick explained, some of IAWC's residential customers whose data was used were billed on a bi-monthly basis. (IAWC Ex. 8.00R (Rev.), p. 5.) For this reason, there is a lag between actual consumption and sales figures such that sales figures from November and December can include usage from September and October. (Id., pp. 5-6.) The AG appears to agree that is potentially weather-sensitive usage because the AG identifies November and December, and not September and October, as non-weather sensitive months: "In Illinois, weather sensitive outdoor water use is limited to summer months, making it appropriate to treat November and December as non-weather sensitive months." (AG Init. Br., p. 29.) Thus, IAWC properly excluded weather-sensitive October and September usage from base period usage. (IAWC Ex. 8.00R (Rev.), p. 5.)

Next, the AG claims—without citation to the record or further explanation—that IAWC's consumption forecast methodology, by averaging the demand for each year, ignores the variability in monthly usage. (AG Init. Br., p. 30.) But seasonal variability is *precisely* what must be removed to study an underlying trend in non-weather sensitive, base usage. (IAWC Ex. 8.00R (Rev.), p. 6.) Averaging accomplishes this. The AG further criticizes IAWC's methodology as using too limited a number of years. (AG Init. Br., p. 30.) Yet the *eight* seasonal averages (2003 – 2011) on which IAWC based its analysis represents the maximum data set available and strikes a reasonable balance between providing sufficient statistical data for analysis and being representative of today's demographics and drivers. (IAWC Ex. 8.00R (Rev.), pp. 6-7.) By contrast, the AG recommends a projection based on only one year. Thus, the AG's criticisms in this regard are baseless.

Despite all the AG's criticisms, two things remain true. First, the AG *adopts* IAWC's usage forecast methodology, but simply for the 2011-2012 period because that forecast "appeared" to Mr. Rubin "to be a less extreme result." (IAWC Ex. 8.02R, p. 1 (IAWC-AG 2.01).) Second, the AG *recognizes* (but apparently does not want to account for) the significant and continuing annual declining usage trend experienced by IAWC. As noted in IAWC's Initial Brief, Mr. Rubin acknowledges "there may be a declining long-term trend in consumption." (AG Ex. 1.0, 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).) Moreover, even in briefing, the AG admits: "Mr. Rubin's recommendation, like the Company's, results in lower total revenues in the test year compared to the year ending Sept. 30, 2010 for all districts except Pekin." (AG Init. Br., p. 30.) Criticizing IAWC's methodology does not make that declining usage trend any less apparent. Indeed, to ignore the trend, as the AG and IIWC/FEA do, would result in an improper and invalid consumption forecast.

Finally, to the extent IIWC/FEA and the AG oppose IAWC's usage forecast, their concurrent condemnation of the RAC—which would eliminate any concern about the revenue impacts resulting from the variance between usage forecasts and actual usage because it prevents harm to either the ratepayer or the utility from usage that deviates from the projected usage on which rates are set—is contradictory. (IAWC Ex. 8.00R (Rev.), p. 20.) On this ground, as well, their positions should be rejected.

B. Current Rate Case Expense

Arguments against Recovery of SFIO's Fee Are Unsupported, Contrary to the Record and Unbalanced.

Initially, it bears noting Staff and the AG do not take issue with the level of IAWC's rate case regulatory consultant's (SFIO's) fee. Instead, they continue to argue that expense should be disallowed in its entirety because SFIO did not submit testimony or work product in this case and, as such, there is no "tangible" evidence of SFIO's value. (Staff Init. Br., p. 24; AG Init. Br., p. 35.) Noticeably absent from Staff and the AG's briefs on this issue, however, is any citation to legal authority. In fact, neither Section 9-229 of the Act, 220 ILCS 5/9-229, nor any other authority deems only "tangible" evidence sufficient to support rate case expense. Their arguments should be rejected on that ground alone. Nonetheless, as explained in IAWC's Initial Brief, the record *is* replete with "tangible evidence"—in the form of testimony and other documentation—of SFIO's value. (IAWC Exs. 7.00R (Bernsen Reb.), pp. 2-3; 7.00SR (Bernsen Sur.), pp. 2-4; 7.03SR, pp. 321-22, 442-50, 516, 518, 580, 582-84, 728.) For this reason, Staff's reliance on the Commission's recent Utilities, Inc. Order, which rejected the cost of SFIO's services as "vaguely documented," is inapposite. See Order, Dockets 11-0561/0566 (May 22, 2012), p. 19. Moreover, in preparing their cases, both Staff and the AG's regulatory consultant relied on the services—particularly, review of testimony—of individuals who have not filed testimony or other work product in this proceeding. (Tr. 603-04, 690-92.) They cannot be heard to claim that what is valuable to them in preparing their cases is valueless to IAWC.

Staff and the AG also argue SFIO's expense should be disallowed because (they believe) SFIO's work is duplicative of Company management and legal counsel's. (Staff Init. Br., p. 24; AG Init. Br., p. 35.) The record supports the opposite conclusion. As explained in testimony and in IAWC's Initial Brief, SFIO's extensive regulatory experience permits it to offer IAWC valuable insight from a global perspective not comparable to that provided by the Company's management or legal counsel. (IAWC Ex. 7.00SR, pp. 2-3; IAWC Init. Br., p. 54.) Again, Staff relies on similar services in preparing its case. (Tr. 596-98.) Wholesale disallowance of SFIO's fee is therefore unbalanced and should be rejected.

Staff Adjustment to Mr. Warren's Fee Is Baseless.

Nothing in PUA Section 9-229 directs the Commission, or its Staff, to evaluate the *hourly rate* of the attorneys and technical experts a utility engages to assist in the preparation and litigation of its rate case. See 220 ILCS 5/9-229. All the statute mandates is that "any amount expended" be just and reasonable. Id. It is not surprising then that Staff's Initial Brief does not cite *any* authority supporting its reduction of IAWC witness Mr. Warren's hourly rate—it cannot. (Staff Init. Br., p. 25.) The only basis for Staff's position is its belief any "practicing CPA" would have "knowledge" of the myriad tax issues Mr. Warren addressed in this case. (Id.) But Staff does not contend—nor could it—that *any* practicing CPA has the level of education, experience and expertise that Mr. Warren has or that *any* practicing CPA could address the instant tax issues with the precision and brevity with which Mr. Warren addressed them. (See IAWC's Init. Br., p. 57-58.) Clearly, hourly rate is not the *only* factor to consider in determining an "amount expended" and Staff agrees. (Tr. 608.) As explained in IAWC's Initial Brief, the "amount expended" for Mr. Warren is unquestionably just and reasonable given the total value of the complex tax-related adjustments he addresses.

Staff's Disallowance of Demand Study Costs Is Unsupported and Narrow.

Staff recommends disallowance of a portion of IAWC's Direct Demand Study cost for which it claims IAWC did not provide supporting invoices. (Staff Init. Br., pp. 25-26.) Again, Staff is inserting into Section 9-229 a requirement that is not there. Invoices are not a prerequisite to a just and reasonable rate case expense. See 220 ILCS 5/9-229. Moreover, Staff's position simply ignores the record evidence supporting the reasonableness of the amount expended for the Direct Demand Study. (IAWC Exs. 7.00 (Bernsen Dir.), pp.17-18; 7.00SUPP (Bernsen Supp. Dir.), p. 4; 7.03SR.)

Binding IAWC to estimates of the individual *elements* of a component of rate case expense (here, elements of the Direct Demand Study component) results in recovery of less than the total estimated level of that expense component and, by default, in denial of recovery of the other, non-disputed elements of that expense component. (IAWC Ex. 7.00SR, p. 6.) That is, allowing IAWC recovery of less than its estimated Direct Demand Study legal fees necessarily results in the Company under-recovering other Direct Demand Study cost components which are not in dispute. Such an approach is unfair and impractical; it is *impossible* for IAWC (or any utility) to project a future expense with the pinpoint precision Staff requires related to rate case expense. Staff seemingly agrees. In testimony, Staff *withdrew* its previously proposed adjustment to remove estimated but un-incurred legal expenses related to the Direct Demand Study as "too narrow in scope" because such an approach "fails to consider the remaining estimates of the other expense components of the Demand Study." (ICC Staff Ex. 16.0 Supp. (Rev.) (Ostrander Reb.), pp. 4-5, lines 85-87.) Inexplicably, however, Staff continues to recommend disallowance of components of the Direct Demand Study cost. This inconsistent position should be rejected.

<u>The AG Does Not Understand the Incremental Nature of the Service Company Labor Expense.</u>

The AG continues to contend the Service Company labor included in rate case expense is a "normal job function" and to include it in rate case expense would "double-count" the test year Service Company labor cost. (AG Init. Br., pp. 34-35.) Yet, the record makes plain the Service Company labor included in rate case expense reflects the cost of services which are *incremental* to normal job duties and are services which would not be performed *but for the filing of this rate case*. (IAWC Ex. 7.00R, p. 9.) For example, the cost would include direct charges for IAWC witness Karen Cooper's time, because her normal job duties as Manager of Business Services for the Service Company's Customer Service Center would not include assisting on IAWC rate cases. (IAWC Init. Br., p. 60; IAWC Ex. 15.00R (Cooper Reb.), p. 1.) By contrast, costs for Service Company employees for whom working on rate cases *is* part of their normal job duties are not included in rate case expense. (Tr. 271-73 (IAWC witness Mr. Bernsen testifying neither his time, nor that of IAWC witnesses Mr. Kerckhove or Mr. Rungren are included in rate case expense).) Staff understands the distinction. (Staff Init. Br., p. 26.) The AG does not. But the AG's confusion is not a valid basis for disallowance of this reasonable cost. The AG's position should be rejected.

C. Management Audit Costs

Staff and IAWC agree: "it is appropriate to include as recoverable operating expenses the incremental costs that were solely incurred to support and facilitate the performance of the management audit." (Staff Init. Br., p. 27.) The AG does not, and proposes that the $722,000 of audit costs over and above the auditor fee be disallowed. But for all of the AG's rhetoric, the AG can provide no support for its untenable position. That position should be rejected.

The AG makes much of the level of IAWC's incremental audit costs relative to the level of the auditor's fee. (AG Init. Br., p. 31-32, 33.) That is not the standard for recovery of audit costs. Section 8-102 of the Act and the Commission's Dockets 09-0319 and 10-0366 Orders direct IAWC to recover the cost of the audit—and not of just the *auditor*—through normal ratemaking procedures. 220 ILCS 5/8-102; Amendatory Order, Docket 09-0319 (May 5, 2010), p. 1; Initiating Order, Docket 10-0366 (June 10, 2010), p. 2. As IAWC explained in its Initial Brief (pp. 63-65), Commission precedent defines the cost of the audit to include incremental expenses incurred—including outside consultant and outside counsel costs. Also as explained in IAWC's Initial Brief (and made plain by the record), the costs IAWC has incurred related to the Audit 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. (IAWC Init. Br., pp. 61-63; IAWC Ex. 4.00 (Grubb Dir.), p. 15; AG Cross Ex. 8.) As such, they are recoverable.

The AG does not, and cannot, point to *any* record evidence suggesting any of those incremental costs are "excessive" despite such claims. (See AG Init. Br., pp. 31-34.) No witness testified the collective audit costs or any individual component thereof was unreasonable. (See generally AG. Exs. 2.0 C (Rev.) (Smith Dir.), pp. 77-78; 4.0 C (Rev.) (Smith Reb.), pp. 35-36.) Simply stating, as the AG does in its Initial Brief, the level of an expense is high does not make it so or make it uncontrolled, as the AG seems to believe. See Citizens Util. Bd., 166 Ill. 2d 111, 126, 133-34 (1995).[10] Further, although the AG claims IAWC has not provided any justification

[10] The AG's reliance on Peoples Gas Light & Coke v. Slattery, 373 Ill. 31 (1940), clearly is misplaced. The AG cites that case for the proposition "[t]he Commission must assess whether large increases to expenses are reasonable." (AG Init. Br., p. 31.) The audit costs are not a regularly occurring operating expense which increased without explanation due to a business reorganization, as was the case in Slattery. (Id., pp. 31-32 (citing Slattery, 373 Ill. at 66).) That case simply does not apply here.

for the Service Company labor and outside audit consultant costs the Company incurred related to the audit, (AG Init. Br., pp. 32-33), the record evidence proves the opposite. IAWC explained the necessity for additional Service Company labor related to the audit, the role of outside counsel and the necessity for the audit consultant. (IAWC Exs. 4.00, pp. 14, 15; 7.00SR (Bernsen Sur.), pp. 13-14; 4.00, p. 15.) And the AG's own cross exhibit further describes the necessity for the audit consultant. (AG Cross Ex. 8, p. 2.)

Finally, the AG takes issue with the increase in IAWC's estimates of its audit costs from February 2011 to October 2011.[11] (AG Init. Br., p. 33.) Again, the AG simply ignores the record. AG Cross Exhibit 8, the February 15, 2011 Affidavit of Edward J Grubb submitted in Docket 10-0366 with IAWC's Notice of Provision of Cost Estimates filed in that proceeding, unequivocally notes the preliminary nature of the audit process. (AG Cross Ex. 8, p. 1.) The Affidavit provides cost estimates but states Staff has only initiated a Request for Proposals process and an independent auditor has not yet been selected. (Id.) The Affidavit sets an estimated cost of $400,000-600,000, excluding the cost of the independent auditor. (Id., pp. 2-3.) It further states that the cost estimates contained therein "represent IAWC's best current estimate of the costs necessary to support the audit process and, if necessary, *will be supplemented with updated estimates or actual costs*." (Id., p. 3 (emphasis added).) When IAWC filed its rate case on October 27, 2011—after an independent auditor *had* been selected and the audit process *was* in full swing—the Company did just that: it updated its estimates to reflect the current case amount of $1.114 million (the $392,000 auditor's fee plus $722,000 in incremental expenses). (IAWC Ex. 4.00, pp. 14-15.) Indeed, AG witness Mr. Smith would agree, "the further out the projections, the more likely that changes will occur." (AG Ex. 4.0 C (Rev.), p. 13.)

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[11] The AG claims IAWC's audit cost estimates increased by 80%. (AG Init. Br., p. 33.) That is far from the case. IAWC's estimates increased about 12%, from $992,000 to $1,114,000. (See AG Cross Ex. 8; IAWC Ex. 4.00, p. 15.)

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

As IAWC explained in its Initial Brief, Staff's proposed reduction to test year depreciation expense related to the Service Company's Alton, Illinois Customer Service Center facility is not appropriate and should be rejected. (IAWC Init. Br., pp. 65-66.) IAWC further responds to Staff's Initial Brief on this point below. (See infra Section VII.A.)

E. Proposed Operating Income and Revenue Requirement

The Commission should approve the annual revenue needed to afford IAWC the opportunity to earn a reasonable rate of return, as shown on IAWC Initial Brief Appendix A.

IV. COST OF CAPITAL AND RATE OF RETURN

A. Capital Structure

1. Overall Capital Structure

Staff Has Provided No Basis for Imputing an Artificial Capital Structure to IAWC.

Staff continues to recommend that the Commission disregard IAWC's actual capital structure and impute to it a structure including substantially more debt and substantially less common equity. (Staff Init. Br., p. 29.) IAWC addressed this point in detail in its Initial Brief (pp. 66–75), so it will only add a pertinent additional point here.

First, Staff has not offered any sound reason for ignoring IAWC's actual capital structure. It asserts that PUA Section 9-230 prohibits use of the actual capital structure, but this argument amounts to little more than an assertion. As pertinent here, that section prohibits the Commission from including "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 (emphasis added).

The statute plainly imposes a causation requirement, but Staff has not even attempted to show that any "increased cost of capital" is the "result of" IAWC's affiliation with American

Water Works Company, Inc. ("AWW"). It asserts that "the Commission cannot adopt a capital structure that reflects a higher cost of capital due to the higher equity ratio of the utility." (Staff Init. Br., p. 31.) That is simply misstating the applicable rule—the statute does not allow (much less require) reductions to equity simply for the sake of a lower equity ratio. The higher cost of capital must be *caused by affiliation*—as the case cited by Staff makes clear: the increased cost of capital must be "*because of* its affiliation with an unregulated or nonutility company." Illinois Bell Tel. Co. v. Ill. Commerce Comm'n, 283 Ill. App. 3d 188, 207 (2nd Dist. 1996) (emphasis added). In other words, the statute does not just allow the Commission to change debt-to-equity ratios whenever it is of the mind to lower rates. Such reductions are only permitted if certain facts have been proved: that the higher costs were *caused by* affiliation. Staff has simply not made that showing.

Staff's Initial Brief states, "[u]nless IAWC's operating risk is sufficiently higher to justify that differential, its 50% common equity ratio would produce a rate of return that violates Section 9-230." (Staff Init. Br., p. 32.) But, as IAWC's Initial Brief explains, at hearing, Staff *admitted* that IAWC faces greater operating risk than AWW. (Tr. 629.) Thus, following Staff's own logic, IAWC's equity ratio does not violate the Act.

Indeed, Staff has it all backwards. It argues that IAWC's "common equity ratio is more than 8 percentage points higher than that of its parent company." (Staff Init. Br., p. 31.) But *less* equity means *more* risk, and Staff acknowledges throughout its brief that the imputed capital structure *adds to* IAWC's risk. (See id. at 39 (noting "the higher financial risk of IAWC that results from imputing the common equity ratio at 42%"); id. at 44 (same).) Thus, Staff would impute the *riskier* capital structure of AWW in the name of a statute prohibiting the inclusion of AWW's "incremental risk." To the extent the statute applies in this case, it prohibits Staff's recommendation, not IAWC's.

That is Staff's only argument for imputing an artificial capital structure to IAWC, and it plainly lacks merit. Of further note is that the only other party to make a substantive cost of capital recommendation, IIWC/FEA, accepts IAWC's proposed capital structure. (IIWC/FEA Ex. 1.0 (Gorman Dir.), pp. 9-10.) Staff's capital structure recommendation must be rejected.

Staff also proposes, as an alternative, a capital structure that subtracts the balance of goodwill from the balance of common equity. (ICC Staff Init. Br., pp. 33-34.) This proposal was advanced for the first time in briefing and is not supported by the testimony of any witness. It is another example of a post-hearing proposal to which IAWC has had no opportunity to respond. It should be rejected for this reason alone.

In addition, Staff's proposal is flawed because external funds that are used to finance Goodwill, defined as the value of assets acquired above that of the book value of those assets, are sourced through the capital components that comprise the Company's capital structure, and in proportion to each capital component's percentage of total capital. Thus, it is not appropriate to attempt to trace the external funding of an acquisition to a specific source of capital, such as long-term debt or common equity, since that acquisition is financed by the mix of capital comprising the Company's overall capital structure. (ICC Staff Group Cross Ex. 2.0 (JF-5.02).) Further, Staff asserts that it is "Commission practice" to subtract goodwill from the common equity balance, but the Commission has approved a common equity balance including goodwill in at least each of IAWC's last two rate cases, Dockets 07-0507 and 09-0319. Staff's flawed position should be rejected.

2. Balance of Short-Term Debt

IAWC continues to oppose Staff's balance of short-term debt for the reasons set forth in its Initial Brief. (IAWC Init. Br., pp. 75-76.)

B. Cost of Debt

There is no material dispute amongst the parties on the cost of debt, as explained in IAWC's Initial Brief. (IAWC Init. Br., pp. 76-77.)

C. Cost of Common Equity

Staff's Adjustment to IAWC's Rate of Return Is Erroneous and Should Be Rejected.

Staff and IIWC/FEA both proposed substantial reductions in the rate of return established by the Commission in IAWC's last rate case. Neither has provided any basis for doing so. Moreover, neither has offered any new or compelling argument that warrants a conclusion other than that set in IAWC's Initial Brief—that IAWC's current return on equity of 10.38% should be retained. IAWC's recommendations should be accepted.

Staff Erred by Depending on a Non-Water-Utility Proxy.

Staff develops its recommended return on equity by using a non-water-utility group to depress the effect of the riskier nature of the water utilities. (Staff Init. Br., pp. 35–36.) IAWC explained why this was inappropriate: Staff essentially (and literally) waters down the risk profile of the proxy group by including electric, combination electric and gas and natural gas utility industries, who do not present the water industry's unique investment risks. (IAWC Init. Br., p. 87.)

Staff Erred in Its Application of the DCF Model.

Staff recommends using a non-constant-growth DCF. But as IAWC explained in its Initial Brief, the single-stage constant growth DCF model is the most widely utilized version of the DCF, because utilities—especially water utilities—are generally in the mature stage of their lifecycles, not transitioning from one growth stage to another, and in a stable, regulated environment. And the Commission has indicated that the type of DCF model used should be determined in each case. (IAWC Init. Br., pp. 83–84.)

Staff also erred in ignoring projected growth rates in performing its DCF calculations. As IAWC noted earlier, Staff cites no empirical evidence from which one could conclude that stable and mature utility companies will grow at the average historical or projected growth rate of the U.S. economy—as IAWC showed, utilities experienced greater than average growth during the past decade. (IAWC Init. Br., pp. 88–90.) Thus, it is reasonable to use growth rate projections made by security analysts in a constant growth, single stage DCF; these take into account historical *and* current information likely to impact the future. And such projections are relied upon in the market. In essence, Staff's rate-of-return analyst would simply ignore how investors behave. (Id.)

Staff Has Not Answered the Flaws in Its CAPM Analysis.

Staff also errs in its execution of the CAPM. As IAWC anticipated in its Initial Brief, Staff uses the historical yield on 30-year U.S. Treasury bond as the risk-free rate. Similar to its error in ignoring growth projections when determining the DCF growth rate, Staff's use of a spot 30-year U.S. Treasury Bond yield ignores the prospective nature of cost-of-capital ratemaking because it merely provides a snapshot of yields at a point in time. Investors—whose behavior the cost-of-capital analysis is attempting to emulate—are more likely to rely on forward-looking information than information on spot yields. (See IAWC Init. Br., p. 90.)

Staff responds that "if investors believe that the forecasts are valuable, that belief would be reflected in current market interest rates." (Staff Init. Br., p. 48.) This essentially *equates* spot prices with forecasts, which is obviously false. Moreover, this response also fails to account for the fact that spot prices *do* change; a forecasted price takes that reality into consideration and uses the best information available to account for it.

Staff then points out that the Commission elected to use a spot price rather than a forecasted price in Docket 09-0319. That is true, but the Commission neither analyzed the issue in detail nor settled it once and for all. It essentially decided the issue on the record in that case and on the basis that Staff's overall result was reasonable. See Order, Docket 09-0319 (Apr. 13, 2010), p. 112 (stating "the Commission does not believe the record in this case requires that corrections be made to the Staff's DCF and CAPM determinations" and noting that Staff's approach to the issue was "generally sound"). Here, Staff's overall approach is not sound, but is founded on the large-scale error of imputing an artificial capital structure to IAWC and would drastically cut IAWC's cost of equity with no substantial justification. Whatever benefit of the doubt Staff received on subsidiary issues in Docket 09-0319, it is not entitled to it here.

Staff also erred by failing to apply the ECAPM. This is necessary to account for the fact that the security market line ("SML") as described by the traditional CAPM is not as steeply sloped as the predicted SML, so the traditional CAPM does not fully capture the greater returns required by increased risk. Id. Staff concedes that corrections must be made to the CAPM and essentially concedes that an ECAPM should be used. (Staff Init. Br., p. 49 ("by using adjusted betas, Ms. Freetly already effectively transformed her Traditional CAPM into an ECAPM").) But Staff is wrong that adjusted betas answer the problem, as the literature makes clear: "adjusted betas are . . . not a solution to the discrepancy between the theoretically predicted and empirically observed relationship between risk and return." (IAWC Ex. 10.00SR (Rev.) (Ahern Sur.), p. 9 (internal quotations omitted).) Moreover, Ms. Ahern explained that "the slope of the SML should not be confused with beta" and that the literature describes this as a "mistake" sometimes made by "[s]tudents." (Id. at 11 (internal quotations omitted).) Staff simply does not address this problem.

Staff Offered No Valid Critique of Ms. Ahern's Use of Historical Data in Her Analysis.

Staff asserts that IAWC's use of "historical data to estimate the current dividend yield in her DCF analysis and the equity risk premium in [its] RPM and CAPM analysis" is "problematic." (Staff Init. Br., p. 50.) According to Staff, this implies that IAWC is saying the past will repeat itself and that the markets "will revert to a mean." (Id.)

Staff misunderstands IAWC's position. Ms. Ahern explained, "Absent empirical evidence to the contrary, it is reasonable to assume that investors utilize the types of historical data in arriving at their expectations and required returns as I have used in my DCF, CAPM and RPM applications." (IAWC Ex. 10.00R (Ahern Reb.), p. 22.) And Ms. Ahern pointed to studies concluding that "long-run capital market return studies can reveal a great deal about the future." (Id. (internal quotations omitted).) She also explained that the use of such data does not suggest eventual reversion to a mean—"studies of long-term historical market returns and equity risk premiums indicate[] both are randomly generated" and that "statistically speaking, the average, specifically the arithmetic mean, is the best estimate of the next expected value of a randomly generated data series—such as historical market returns and equity risk premiums." (Id. at 23.)

Ms. Ahern also explained that Staff misunderstands its only cited source. Burton G. Malkiel's *A Random Walk Down Wall Street* stated that "'*short-run* changes in stock prices cannot be predicted'" (id. at 24 (quoting *Random Walk*, p. 16) (added emphasis sic)), but "[s]hort-run changes in stock prices are *not* what rate of return analysts . . . are attempting to derive in our analyses of the cost of common equity." (Id. (emphasis sic).) The goal is "to emulate investor behavior, using data available . . . to investors, in an attempt to arrive at an expert opinion of *long-run* investor expectations." (Id. (emphasis sic).)

In short, Staff has no viable critique of Ms. Ahern's use of historical data.

Staff Offered No Persuasive Reasons for Rejecting IAWC's Investment-Risk Adjustment.

Staff proposes rejecting Ms. Ahern's upward adjustment to the cost of common equity "to reflect IAWC's combined financial risk and unique business risks relative to her proxy group." (Staff Init. Br., p. 54.) Staff asserts that Ms. Ahern "failed to put forward any analysis to demonstrate the higher relative risk of IAWC relative to her proxy group." (Id.)

But this is not true. Ms. Ahern conceded that "there is no direct way to quantify an adjustment for the combined impact on common equity cost rate of IAWC's somewhat lower financial risk and greater unique business risks." (IAWC Ex. 10.00R, p. 23.) This, of course, is true of numerous elements of cost-of-capital issues, but that does not mean there is no analysis. And despite Staff's assertions, Ms. Ahern did furnish an analysis. She explained that "the magnitude of such an adjustment for IAWC's collective unique business risk can be derived based upon data contained in Chapter 7 entitled 'Firm Size and Return' from *SBBI – 2011*," and she explained her methodology and the conservative assumptions she used. (Id.)

Staff has provided no response to that analysis by pretending it is not there. It has accordingly offered no sound reason for rejecting IAWC's proposed risk adjustment. That adjustment should be adopted.

The Commission Should Adopt IAWC's Proposed Flotation-Cost Adjustment.

Staff asserts that Ms. Ahern's proposed flotation-cost adjustment should be rejected. According to Staff, such costs "are to be allowed only if a utility can verify both that it has incurred the specific amount of flotation costs for which it seeks compensation and that those costs have not been previously recovered through rates." (Staff Init. Br., pp. 54–55.)

Staff overstates the precedent in suggesting that the Commission will not generally consider them: "the Commission is open to considering the impact of flotation costs on the authorized return on equity in certain circumstances." Ameren Illinois Co., Order, Docket 11-0282 (Jan. 10, 2012), p. 126. But IAWC concedes that the Commission has stated that it "believes that it is appropriate to allow a flotation cost adjustment to the extent that the evidence shows the utility has incurred issuance expenses that have not been recovered." Northern Ill. Gas Co., Order, Docket 04-0779, (Sept. 20, 2005), p. 92 (emphasis sic omitted).

IAWC believes that the Commission's approach to flotation costs—essentially applying an operating-expense standard to a cost-of-capital issue—is erroneous. Ms. Ahern explained that flotation costs "are charged to capital accounts and are not expensed on a utility's income statement" and are thus "analogous to capital investments reflected on the balance sheet." (IAWC Ex. 10.00R, pp. 29.) Therefore, "flotation costs should be recovered through an adjustment to common equity cost rate even when there has not been an issuance during the test year, or in the absence of an expected imminent issuance of additional shares of common stock." (Id.) The Commission should reconsider its approach to this issue.

Staff's Adjustment Related to the RAC Should Be Rejected.

For the reasons set forth in IAWC's Initial Brief (pp. 116-17) and addressed below (see infra Section VI.A), Staff's recommendation that IAWC's cost of common equity be adjusted downward upon the Commission approving the Revenue Adjustment Clause (in any form) should be rejected.

IIWC/FEA's Adjustment to IAWC's Rate of Return Is Erroneous and Should Be Rejected.

IIWC/FEA Erred by Using a Gas-Utility Proxy Group.

IIWC/FEA asserts that "the most reasonable estimate of investment risk for Illinois-American" requires use of "a gas utility proxy group." (IIWC/FEA Init. Br., p. 10.) IAWC explained in its Initial Brief why IIWC/FEA's use of a gas utility proxy group is inappropriate. Using such a group ignores the fact that the water utility industry faces unique investment risks relative to other utility industries and thus fails to reflect the unique risks of water utilities in general and IAWC specifically. (IAWC Init. Br., p. 91.)

In support of its gas proxy group, IIWC/FEA relies heavily on the notion that considering gas and water together is "consistent with industry reports published by S&P." (IIWC/FEA Init. Br., p. 10.) But Ms. Ahern described the flaws with this reasoning: S&P's consideration of these two groups together were for a limited purpose; in fact, S&P "recognize[d] differing factors affecting consumption in each industry and greater credit risk for water utilities, as evident by the recent, greater trend in negative outlooks for the water utilities." (IAWC Ex. 10.00SR, p. 13.) She also noted that "S&P's focus is on the risks borne by debt holders, so the bond/credit rating process is not a means by which one can specifically quantify the differential in common equity risk between companies or the gas and water utility industries." (Id.)

IIWC/FEA also states that "the assets, capitalization and operations of gas utilities and water utilities are very similar" and both "are dependent on large main investment and operations, infrastructure replacement and upgrades, and reliability and safety compliance with state, local and federal regulations." (IIWC/FEA Init. Br., p. 11.) But as Ms. Ahern explained, "the nature of [the] commodity is very different," "water . . . [is] subject to additional health and safety regulations than natural gas," and "water utilities serve a production function in addition to the delivery functions served by gas utilities." (IAWC Ex. 10.00SR (Rev.), p. 14.) This latter fact means that water utilities require "significant capital investment in sources of supply and production in addition to transmission and distribution systems, both to meet customer growth and to repair and replace aging systems." (Id.)

For these reasons, using a proxy group of natural gas utilities for an ROE analysis for a water company is inadequate for water utility cost of capital purposes.

IIWC/FEA Erred in Its Application of the DCF Models.

IAWC explained the flaws with each one of IIWC/FEA's DCF models in its Initial Brief. (IAWC Init. Br., pp. 92–94.)

Regarding the constant-growth model, IAWC pointed out that IIWC/FEA's erroneous inclusion of a negative constant growth value for one utility skewed the results downward. Ms. Ahern excluded that utility and recalculated the average and median constant growth DCF results, which resulted in a higher, more accurate growth rate. IAWC also explained why IIWC/FEA was wrong to consider projected GDP as a ceiling for sustainable growth, and pointed out that IIWC/FEA had provided no empirical support that utility or water companies track GDP growth. (Id. at 92–93.)

As for the multi-stage analysis, IAWC explained that using five- to ten-years growth in GDP as a proxy for all years past eleven resulted in a mismatch. (Id. at 93.) Moreover, the same criticisms that IAWC discussed earlier regarding Staff's use of a multi-stage analysis apply here as well.

IIWC/FEA's sustainable growth DCF methodology also is flawed. The sustainable growth methodology was no more than a circular, short-term forecast. IIWC/FEA adduced no empirical evidence that its depiction of "sustainable growth" accurately represents investors' expected growth. And IIWC/FEA's resulting ROE turned out *lower* than the expected average Value Line ROE of 10.57% for the same proxy group. IAWC showed that expert forecasts of growth have been empirically supported, and IIWC/FEA provided no reason to reject those forecasts in favor of sustainable growth or a multi-stage DCF model. (Id. at 93–94.)

For all these reasons, as explained in more detail in IAWC's Initial Brief, IIWC/FEA's DCF modeling is flawed and should be rejected.

IIWC/FEA's Application of the CAPM Was Flawed.

IIWC/FEA also relies on a CAPM study prepared by Mr. Gorman, although it notes that it placed "less weight" on that study than the DCF models. (IIWC/FEA Init. Br., pp. 16–19.) IIWC/FEA is right to put less weight on Mr. Gorman's CAPM model. As explained in detail in IAWC's Initial Brief, IIWC/FEA's application of the CAPM is flawed. His incorrectly derived market equity risk premium is incorrect; his forward-looking equity risk premium is *not* prospective; and he failed to correct the model's inaccuracies by using the ECAPM. (IAWC Init.

Br., pp. 94–96.)

IIWC/FEA Has Not Identified Flaws in IAWC's Analysis.

IIWC/FEA asserts that there are several flaws with Ms. Ahern's methodology. This is incorrect.

IIWC/FEA's first asserted flaw—that Ms. Ahern's DCF model is flawed because it uses a growth rate greater than projected GDP—has already been addressed above. National GDP simply does not impose any ceiling on any particular company.

IIWC/FEA asserts that there are two flaws in Ms. Ahern's risk premium studies. First, it asserts that she should have used "actual observable utility bond yields rather than . . . inflated projected utility bond yield estimate." (IIWC/FEA Init. Br., p. 20.) But IIWC/FEA's argument is wholly circular. That argument boils down to: "projected" yields are greater than "observable"; therefore, the projections are "overstated." (Id. at 21.) But this ignores the issue in dispute: whether projected yields match investor expectations *better than* observed yields. Asserting that one is overstated simply because it is higher is conclusory. Moreover, Ms. Ahern testified that using projected bond yields was more sensible, as both "the determination of the cost of capital and the ratemaking are prospective in nature," so "events that affect the future, impact market activity, volatility and investor expectations and are relevant to the determination of the cost of common equity." (IAWC Ex. 10.00R, p. 44.) IIWC/FEA's first alleged flaw is a non-starter.

IIWC/FEA's second alleged flaw is that Ms. Ahern used an "inflated equity risk premium." (IIWC/FEA Init. Br., p. 20.) According to IIWC/FEA, Ms. Ahern "skewed the equity risk premium estimate by subtracting from the total return on the market only the income return on the corporate bonds," which it asserts "does not reflect the true investment risk differential between investing in stocks relative to a corporate bond." (Id. at 21.) But Ms. Ahern explained that using the yield, and not the total return, presumes that the bond will be held to maturity and thus its yield over the life of the bond *is* the total return; she also explained that the academic literature uses a bond yield, and not the total bond return. (IAWC Ex. 10.00R, p. 46.) IIWC/FEA has not shown error in Ms. Ahern's risk premium calculations.

IIWC/FEA also asserts that the "ECAPM study should be rejected because it relied on adjusted utility betas," which it says leads to double-counting. (IIWC/FEA Init. Br., p. 22.) But as Ms. Ahern explained, "The ECAPM is a return adjustment which accounts for this reality," and "not an adjustment to beta which is an x-axis adjustment accounting for regression bias." (IAWC Ex. 10.00R, p. 47.) "[T]he use of adjusted betas is not equivalent to the ECAPM" (id.), so contrary to IIWC/FEA's argument, using both does not double-count anything.

IIWC/FEA also asserts that Ms. Ahern developed a "comparable earnings analysis using a group of nonregulated companies as a proxy group." (IIWC/FEA Init. Br., p. 22.) It asserts that while "the companies may have comparable betas, she has not shown they have comparable business and operating risk to a low-risk regulated utility company." (Id. at 23.)

First, despite IIWC/FEA's apparent attempt to fit Ms. Ahern's analysis into the ban of a certain line of Commission cases (see id.), Ms. Ahern never used the words "Comparable Earnings Model." (IAWC Ex. 10.00R, p. 48.) She did analyze the earnings of companies with similar measures of total risk as IAWC, which is both appropriate and "consistent with the *Hope* doctrine that the return to the equity investor should be commensurate with returns on investments in other firms having corresponding risks." (Id. at 49.)

And contrary to Mr. Gorman's assertion, Ms. Ahern did show that the nonregulated companies manifested comparable risk. She explained that "the selection criteria for the proxy group of non-price regulated companies [were] based upon measures of total risk, i.e., systematic (non-diversifiable) risk as measured by betas and non-systematic (diversifiable) risk as measured by the standard errors of the regression giving rise to the betas." (IAWC Ex. 10.00R, p. 49.) And she supported her conclusions in detail in her direct testimony—IIWC/FEA provides no reasoned response to her analysis. (See IAWC Ex. 10.00 (Ahern Dir.), pp. 64–67.)

Because these companies were "comparable in total risk," their calculated returns "are relevant to the returns on book values of price regulated companies and hence appropriate for setting an authorized return rate on common equity in the current proceeding." (IAWC Ex. 10.00R, p. 49.)

In sum, both Staff and IIWC/FEA's cost-of-capital recommendations lack merit and should be rejected. Numerous errors afflict them both, and their proposed end result is unreasonable. As IAWC explained before, while the evidence supports adopting IAWC's proposed return on equity, the Commission could strike a reasonable balance and leave it unchanged. Whatever the Commission does, it has no basis for drastically reducing IAWC's return on equity.

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%

V. COST OF SERVICE AND RATE DESIGN

A. Cost-of-Service Study

In its Initial Brief, IAWC addressed IIWC/FEA's concerns with the Company's revised Cost of Service Study. (IAWC Init. Br., pp. 96-98.) IIWC/FEA combined this issue with the revenue allocation for Large Other Water Utility customers in its Initial Brief. (IIWC/FEA Init. Br., p. 32-34.) IAWC, therefore, has combined its response to both issues. (See infra Section V.H.)

B. Consolidation of Zone 1 and Chicago Metro Rate Areas

The Commission Should Approve Consolidation of Chicago Metro and Zone 1.

Response to Village of Bolingbrook

The Village of Bolingbrook ("Bolingbrook") argues against the consolidation of Chicago Metro and Zone 1 based on misguided legal arguments and an alleged lack of evidence that the consolidation is in the best interests of ratepayers. (Bolingbrook Init. Br., p. 6.) But it is Bolingbrook that fails to present testimony or record evidence to support its own conclusions.[12] In fact, Bolingbrook does not provide a single cite to testimony or the transcript to support its position in its entire Initial Brief. It simply makes conclusory assertions to be accepted by the Commission. As a party participating in this proceeding, Bolingbrook is required to support its proposals with record evidence. See, e.g., In re Ill. Commerce Comm'n on Its Own Motion v. Ill. Consol. Tel. Co., Docket 94-0042, 1995 Ill. PUC LEXIS 828, at *103 (Dec. 6, 1995) ("[E]ach party proposing a result should bear the burden of adducing evidence in support of that

[12] This is Bolingbrook's apparent *modus operandi*. It simply relied on the other parties to make its case: "The Village of Bolingbrook objects to the Company's latest biennial attempt to increase rates, which is also being opposed in certain respects by the Office of the Attorney General, ICC staff, and other municipalities, and joins in those objections in general." (Bolingbrook Init. Br., p. 1.) Bolingbrook not only fails to support its opposition with record evidence, but also it fails to recognize that Staff and Intervenors' positions in this proceeding in large part conflict. It is therefore unclear what position Bolingbrook "joins." The Commission should dismiss of Bolingbrook's generic objection.

proposal.”).

Bolingbrook asserts that, with respect to consolidation, “non-production related costs” were not defined, “nor was any sufficient testimony or evidence presented to the Commission in this proceeding that the proposed consolidation is in the best interests of Illinois ratepayers.” This is simply incorrect. IAWC witness Mr. Herbert defined non-production costs, explained the methodology by which non-production costs were determined and provided a detailed calculation in support. (IAWC Exs. 11.00 (Rev.) (Herbert Dir.), pp. 15-16; 11.02; see also Tr. 230-31.) IAWC presented evidence that the consolidation is in the best interests of ratepayers, including extensive cost of service studies and rate design information reflecting both Chicago Metro and Zone 1 consolidated and stand alone, for comparison purposes. (See IAWC Exs. 11.00 (Rev.); 11.01; 11.03R.) Staff and IAWC witnesses analyzed IAWC’s proposal and testified to its consequences. (See IAWC Exs. 11.00 (Rev.), pp. 12-18; 11.00R (Herbert Reb.), pp. 15-17; 11.00SR (Herbert Sur.), pp. 9-10; Staff Exs. 4.0 (Boggs Dir.), pp. 5-11; 12.0 (Boggs Reb.), pp. 17-20.) Staff witness Mr. Boggs performed an extensive analysis of the impacts of consolidation and determined that consolidation was beneficial. (ICC Staff Ex. 4.0, p. 10.) Mr. Boggs found that the Company’s proposed consolidation of the Zone 1 and Chicago Metro Water divisions would lower monthly bills for Chicago Lake Water and Chicago Moreland typical use residential customers. (Id.) Typical Chicago Lake Water customers, for example, would see only a 2.66% bill increase with consolidation, but an 11.63% increase on a standalone basis. (Id., pp. 6-7, Tbls. 4.1, 4.2.) *Indeed, notwithstanding Bolingbrook’s posture, this consolidation will actually be in Bolingbrook customers’ interest, with their rates increasing slightly at most, or potentially decreasing.* (See Sch. E-7, p. 43.) If the consolidation is not approved, however, Chicago Metro rates will increase more significantly. As Mr. Herbert explained, for Chicago Metro on a stand alone basis, the proposed customer charges are equal to the Zone 1 present rates but with higher consumption rates to recover the cost of service on a stand alone basis. (IAWC Ex. 11.00 (Rev.), p. 17.) Beyond that, consolidating the districts will spread capital improvement costs over a larger customer base, lower rate case expense, and lower administrative fees. (ICC Staff Ex. 4.0, p. 10.) Further, IAWC designed rates in the consolidated district to ensure Chicago Metro ratepayers would not pay for water treatment costs in Zone 1, established separate production costs for each district, and equalized the rate for nonproduction costs. (Tr. 230-31.)

Moreover, Bolingbrook's legal arguments are severely flawed. Bolingbrook claims that the Public Utilities Act's provisions "militate *against* consolidation of service areas, in general." (Bolingbrook Init. Br., p. 7 (emphasis sic).) But the authorities it cites stand only for the general proposition that costs should be allocated to cost causers and rates should not be unreasonably different. (See id.) As IAWC explained in its Initial Brief (pp. 98-99), the Commission has routinely, over a series of prior IAWC rate cases, approved consolidation of IAWC's rate areas. (See also Staff Ex. 12.0, p. 19, lines 368-72 ("The Commission has approved consolidation of rate divisions and movement toward Single Tariff Pricing for IAWC in several dockets including Docket Nos. 92-0116, 95-0076, 97-0102, 00-0340 and most recently in Docket Nos. 09-0507 and 09-0319.").)

Similarly, Bolingbrook's legal conclusion that "the ICC regulations themselves indicate that separate service areas should be maintained," is also a fallacy. (Bolingbrook Init. Br., p. 7.) Bolingbrook reaches this conclusion by citing the Commission's regulation requiring a public utility to provide "separate rate base schedules for 'each applicable service and for each service area for which separate tariffs exist (e.g., district, division, etc.) where a requested change in rates is being proposed.'" (Id. (citing 83 Ill. Adm. Code 285.2000(b)).) That regulation says nothing about whether those service areas can be consolidated. Instead, the Commission's regulations expressly contemplate consolidation: requiring utilities requesting common rates "for a service area for which separate tariffs currently exist" to present schedules for "each service area requesting common rates and the combined service areas requesting common rates." 83 Ill. Adm. Code 285.3000(b).

Finally, Bolingbrook recommends that the Commission should open a separate proceeding to analyze the consolidation since "[a] rate case proceeding is clearly not the proper venue in which to decide this issue." (Id., p. 9.) This ignores Commission precedent. The Commission has approved consolidations of service territories in rate cases. See, e.g., Illinois-American Water Co., Order, Docket 09-0319 (Apr. 13, 2010), p. 154 (approving the consolidation of Sterling and Champaign into Zone 1).) The evidence supports ordering consolidation in this case. (See IAWC Init. Br., p. 98-99.)

Response to IIWC/FEA

IIWC/FEA also recommends rejecting consolidation for several reasons. IAWC will respond to each in turn. First, it claims that IAWC ignores the distinctiveness and geographic characteristics of each service territory, differences in rate base and non-production costs, and cross-subsidies created by the consolidation. (IIWC/FEA Init. Br., p. 25 (citing IIWC/FEA Ex. 2.0 (Collins Dir.), p. 4).) The differences in customer composition between Chicago Metro and Zone 1, however, are minor and would not affect the consolidated pricing. (IAWC Ex. 11.00SR, p. 9.) Further, any differences in load characteristics between the two zones is addressed in IAWC's rate design. (Id.) IIWC/FEA's concern regarding different base and capacity costs between districts is also a non-issue, because "production costs, which comprise a large portion of base and extra capacity costs, are maintained separately in the rate design." (Id., p. 10, lines

218-20.) Though IIWC/FEA "glosses over" the similarities between Chicago Metro and Zone 1, these similarities support consolidation. (See IAWC Ex. 11.00R, p. 16.)

IIWC/FEA next argues that the creation of price subsidies will erode system efficiency by "eras[ing] economic incentive for customers in higher cost districts to be more efficient in placing demands on the water system because the prices they pay will not accurately reflect the cost of delivering the water service." (IIWC/FEA Init. Br., p. 27 (citing IIWC/FEA Ex. 2.0, p. 4).) But as pointed out in the rebuttal and surrebuttal testimony of Mr. Herbert, IIWC/FEA's parade of horribles is not supported by any evidence. (IAWC Exs. 11.00R, p. 17; 11.00SR, p. 10.) IIWC/FEA fails to offer any analysis to show that inefficiencies exist or price signals would be distorted under the consolidated pricing. (Id.) On the contrary, as noted by IIWC/FEA, the Commission previously found the consolidation of the Champaign and Sterling districts into Zone 1 to be reasonable "based on the record in prior cases." (IIWC/FEA Init. Br., p. 28 (citing Illinois-American Water Company, Order, Docket 09-0319 (Apr. 13, 2010), p. 154).) IIWC/FEA simply asks the Commission to accept its assertions without offering any proof that harm will occur.

Finally, IIWC/FEA acknowledges the Commission's precedent of approving consolidations, but explains that the Company still has the burden to demonstrate the appropriateness and reasonableness of the proposed consolidation. (IIWC/FEA Init. Br., pp. 28-29.) As explained above, IAWC has met that burden. As IAWC explained in its Initial Brief, consolidating Chicago Metro and Zone 1 will move IAWC's rates towards single tariff pricing, a policy explicitly endorsed in the Commission's Docket 07-507 Order and consistent with IAWC's consolidation of the Champaign and Sterling into Zone 1 in Docket 09-0319. (IAWC Init. Br., p. 98 (citing IAWC Ex. 5.00 (Rev.) (Kerckhove Dir.), p. 21).) Similar to the

Champaign and Sterling consolidation, the Chicago Metro consolidation moves IAWC towards the Commission's policy of single tariff pricing. (IAWC Exs. 11.00R, p. 15; 11.00SR, p. 9.) For the reasons stated above and in IAWC's Initial Brief, the Commission should approve the consolidation of the Chicago Metro and Zone 1 districts.

C. Proposed Customer Charges

The Commission Should Approve IAWC's Proposed Customer Charges.

IAWC's Proposed Customer Charge Methodology Should Be Adopted.

The AG recommends rejecting IAWC's proposed customer charge methodology, claiming that IAWC's proposed rates "recover non-customer related costs through unnecessarily high customer charges" and "by using multiple customer class ratios." (AG Init. Br., pp. 63-64.) The AG recommends that the Commission should instead use the AWWA meter ratios to set customer charges, which it claims "is consistent with past Commission practice." (Id, p. 64.)

"Past Commission practice" supports using the meter capacity ratios applied by IAWC for meters larger than ⅝ inches. Historically, IAWC's meter capacity ratios for larger meters have been determined as a multiple of the ⅝-inch meter. (IAWC Ex. 11.00SR, p. 4.) To illustrate, the ⅝-inch meter capacity is 20 gallons per minute (gpm), while the ¾-inch meter capacity is 30 gpm. (Id.) Therefore, the meter capacity ratio for the ¾-inch meter is 1.5 (i.e., 30 gpm / 20 gpm). (Id.) Similarly, the 4-inch meter capacity is 500 gpm, thus its meter capacity ratio is 25 (i.e., 500 gpm / 20 gpm). (Id.) This uniform increase methodology of calculating meter ratios is what IAWC has consistently used in prior rate cases. (Id., p. 7.) The AG fails to present any evidence supporting deviation from this prior precedent, and the AWWA meter capacity ratios have *not* been used by IAWC in its rate cases.

The AG can only claim IAWC would over collect costs by *understating* them. (Id., p. 2.) The AG incorrectly calculated the customer costs associated with each meter class by applying the meter capacity ratios to *all* customer costs (meter, service, and billing and collection costs). (AG Ex. 3.0 (Rubin Reb.), p. 11.) Instead, as explained in IAWC's Initial Brief, the AG should have applied the meter capacity ratios or "meter equivalents" only to the *meter costs*, and it should have applied the service equivalents to the *service costs* and no ratios to the billing and collection costs (because these are the same for all meters). (See IAWC Init. Br., p. 101; see also IAWC Exs. 11.00SR, pp. 2-5; 11.01SR.) Meter capacity ratios should *only* apply to meter costs since "[t]he costs to install service lines vary *much less* than the cost of the meter" and "the cost to bill a 4-inch customer is the same as a ⅝-inch customer, not 25 times more." (IAWC Ex. 11.00SR, p. 4, lines 86-88 (emphasis added).) Because the AG failed to apply the correct ratios to the appropriate costs, the AG's costs are understated. Therefore, the Commission should reject the AG's criticisms and proposed customer charges based on the AG's flawed methodology, and adopt the Company's proposed customer charges.

Staff also claims that the Company's proposed customer charges would over-recover customer costs due to IAWC setting the customer charge for ⅝-inch meter customers "without regard to the revenues that Customer Charges for meter sizes larger than ⅝" would generate." (Staff Init. Br., pp. 59-60.) Staff proposes alternative rates using revenue collected from meters larger than ⅝-inches to reduce the ⅝-inch meter customer charge. (IAWC Ex. 11.00SR, p. 6.)

Staff's proposal creates a cross-subsidy. As explained by IAWC, any over-recovery produced by the Company's proposed customer charges is due to "the use of meter capacity ratios for the larger meter sizes." (IAWC Ex. 11.00SR, p. 6, lines 121-23. See also Staff Init. Br., pp. 60-61.) Meters larger than ⅝-inches over-recover costs "because meter capacity ratios are higher than what actual cost of service ratios would produce." (IAWC Ex. 11.00R, p. 5, lines 90-92.) Therefore, because the customer charges for meters larger than ⅝-inches collect more revenue than costs, Staff advocates transferring this over collected amount to the ⅝-inch meter customers.

Staff's methodology is inherently flawed by cross-subsidizing the ⅝-inch meter customers with revenue from meters larger than ⅝ inches. As explained by Mr. Herbert, IAWC set the proposed ⅝-inch meter customer charge "to recover the *customer costs for the ⅝-inch meter size*." (Id., p. 4, lines 81-82 (emphasis added).) It is vital for the ⅝-inch meter customer charge to recover the ⅝-inch meter customer costs because 92% of residential customers have ⅝-inch meters. (IAWC Ex. 11.00SR, p. 5.) Each customer should, therefore, "pay the appropriate level of customer costs so that intra-class subsidies are avoided." (Id., pp. 5-6.) Otherwise, under Staff's proposal, rates are *not* cost-based by class meter size. Instead, Staff would have ⅝-inch meter customers under-recovering their customer costs. The Commission should not endorse such subsidies and should reject Staff's proposal.

The Commission Should Approve IAWC's Proposed Customer Charges for Meters Larger than ⅝-Inches.

Staff proposes that the Commission reject the Company's use of a uniform percentage to set customer charges for meters larger than ⅝ inches and instead use adopt the AWWA meter factor approach. (Staff Init. Br., p. 60.)

The Company increased the customer charges for meters larger than ⅝ inches using the same methodology as in IAWC's last rate case. (IAWC Ex. 11.00SR, p. 7.) As shown in IAWC Exhibit 11.01R, the Company "chose to increase the customer charges by a uniform percentage rounded to the nearest $0.10." (IAWC Ex. 11.01R, p. 1.) The Company determined that this method "would produce reasonable customer charges that were consistent with the AWWA factors and also the customer charges previously approved by the Commission." (Id.) Indeed, the ratios used by the Company are *lower* than the AWWA meter factors. (Id.) For example, the ratio used by IAWC to increase its 1-inch meter customer charge was 2.17 versus the AWWA factor of 2.5. (Id.) Though the Company's ratio to increase customer charges is *lower*, Staff claims its approach is preferable since it approved customer charges using meter ratios in other water companies' rate cases. But it has not offered persuasive reasons for changing course here. The Commission should adhere to its precedent in IAWC rate cases and utilize the lower ratios to increase customer charges for meters larger than ⅝ inches.

Staff also recommends that the Commission should reject the Company's proposed customer charge for South Beloit customers because it would result in three different ⅝-inch meter customer charges for the consolidated Zone 1 and Chicago Metro district. (Staff Init. Br., p. 61.) Staff contends that because these consolidated customers "face the same set of costs, the reasonable approach is to develop a single set of rates that apply to all similar customers within the consolidated territory rather than charging them different rates." (Id.)

Staff cites no testimony supporting the benefits of its proposed charge, and its rationale of a "single set of rates" for the consolidated district is flawed. Its proposed customer charge fails to recover the costs for all ⅝-inch meter customers and thus will require an inappropriate cross-subsidy, as explained above. Contrary to Staff, IAWC's proposed charge uses "the existing Zone 1 customer charges which reflect a more gradual increase and should be adopted." (IAWC Ex. 11.00SR, p. 7, lines 147-49.) The Company also explained that it would support consolidating customer charges in the next rate case. (IAWC Ex. 11.00R, p. 5.) The Commission should use the Company's proposal and adopt a more reasonable customer charge for the South Beloit Customers.

D. Proposed Usage Charges

<u>The Commission Should Approve IAWC's Proposed Usage Charges.</u>

<u>IAWC Already Has Responded to Staff's Arguments Regarding the Usage Charge Calculation.</u>

Staff believes IAWC's usage charges should be rejected since they result in higher customer charges. Staff asserts that its proposed usage charges "send appropriate price signals to users of the largest volume of water, promote water conservation and allow [] greater control of water bills to customers who strive to conserve." (Staff Init. Br., p. 63.)

As IAWC explained in its Initial Brief, Staff and IAWC primarily dispute the shifting of cost recovery from customer charges to usage charges. (IAWC Init. Br., p. 102; Staff Init. Br., p. 62.) Staff's methodology recommends a higher usage charge due to understating the ⅝-inch meter customer charge. (IAWC Ex. 11.00SR, p. 7.) By shifting more customer costs in volumetric rates, customers that consume more, such as large families, would pay more for customer-related costs than small users. (IAWC Ex. 11.00SR, p. 6.) Staff's methodology violates the rate principle of gradualism and fails to produce the Company's requested cost of service. (IAWC Init. Br., pp. 102-03.) The Commission should reject Staff's proposed usage charges and approve the Company's more reasonable rate structures, which moves revenues toward cost of service. (IAWC Ex. 11.00SR, p. 7.)

<u>Staff's Proposal to Increase the Third and Fourth Blocks for Non-Residential Customers Would Result in Rate Shock.</u>

Staff argues that the Company should increase its third and fourth block rates for non-residential customers. (Staff Init. Br., p. 63.) Staff contends the increases are necessary to recover non-production costs that have been understated by the Company, due to IAWC "artificially lower[ing]" its non-production costs recovered by its customer charge. (<u>Id.</u>, p. 64.)

Staff does not dispute that its proposed increases to Other Water Utility and Industrial revenue would be 44.72% and 40.44%, respectively. (Id., pp. 63-64.) Further, as the Company explains above, the Company has not understated its non-production costs, but has appropriately and properly set its customer charges to recover their fixed costs. It is Staff that has *understated* the costs to be recovered by the ⅝-inch meter customer charge, which results in large increases to its customer charges. (IAWC Ex. 11.00SR, p. 7.) As the Company explained, Staff's proposed increases would result in rate shock, so the Commission should approve the Company's "more reasonable rate structure that moves revenues toward cost of service and avoids the drastic increases proposed by Mr. Boggs." (Id., p. 7, lines 155-57.)

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

In its Initial Brief, the Company addressed the contested issue of Staff's proposed public fire protection charges for the consolidated Zone 1 and Chicago Metro service area. (IAWC Init. Br., pp. 103-04.) Staff did not address this issue in its Initial Brief; thus, the Company is not addressing this issue in its Reply Brief.

F. Public Fire Protection Charges for Chicago Metro

The Company fully addressed in its Initial Brief Staff's issues related to public fire protection charges for the Chicago Metro service territory if the Zone 1 and Chicago Metro consolidation is not approved. (IAWC Init. Br., p. 104.)

G. Public Fire Protection Charges for Lincoln

The Company fully addressed in its Initial Brief Staff's issues related to public fire protection charges for the Lincoln service territory. (IAWC Init. Br., pp. 104-05.)

H. Revenue Allocation: Large Other Water Utility Service Class

IIWC/FEA's Criticisms of IAWC's Revenue Allocation and Cost of Service Study Lack Merit.

IIWC/FEA claims that "based on IAWC's future test year projection contained in its [Cost of Service Study] for the Large OWU class it would seem that all the Large OWU contracts prevent any kind of increase to the rate." (IIWC/FEA Init. Br., p. 33.) IIWC/FEA thus concludes, after looking at the Company's revised Cost of Service Study ("COSS"), that the Company "has assumed no increase in the revenues for this class." (Id.) IIWC/FEA claims that this "would seem to contradict Mr. Herbert's testimony or suggest that the entire Large OWU Class has a provision in their contracts preventing any type of rate increase." (Id.) Finally, IIWC/FEA claims that the Company has not "sufficiently provided proof on whether the entire class should be exempt from the increase." (Id.)

IIWC/FEA misunderstands Mr. Herbert's testimony and the revised COSS. Mr. Herbert explained that "to the extent Large OWU contracts include provisions for annual increases, the most recent annual increases are built into IAWC's future test year projection of *current rate revenues*." (IAWC Ex. 11.00SR, p. 11, lines 237-40 (emphasis added).) Thus, the Large OWU revenue in the "Revenues, Present Rates" column shown in the COSS, whether separately in IAWC Exhibit 11.01 or redistributed in IAWC Exhibit 11.03R, has the most recent annual increases built into this number. IIWC/FEA has not provided any evidence to show that this amount was not properly reflected.

Further, IIWC/FEA's criticism of the Company's revised COSS misses the forest for the trees. The Company restated its COSS because "Commission-approved Large OWU contracts dictate the terms of any price increase" (IAWC Ex. 11.00SR, p. 11, lines 233-34) and rates cannot be raised "beyond limits on rate increases authorized in the contracts" (id., p. 11, lines

245-47). Allocating costs to this class by assuming an artificial increase "not contemplated in the Large OWU contract for purposes of designing rates creates an inaccurate and unreliable rate design." (Id., p. 11, lines 235-37.) Further, even though the full cost to serve these customers was included in the original COSS (IAWC Ex. 11.01), this "has *little value* since we know that the contract rates are less than the full-tariff rates—this is why contract rates exist." (Id., p. 13, lines 274-276.)

The Commission should, therefore, adopt the Company's revised COSS that "more accurately reflects the costs of service incurred by IAWC" and "provides a clearer indication of the cost of full-tariff customers and properly reflects the benefit of contract revenues to all classes." (Id., p. 14, lines 296-99.)

I. Adjusting Rate Elements of Declining Block Rate Schedule

In its Initial Brief, the Company addressed IIWC/FEA's proposed adjustment to the rate elements. (IAWC Init. Br., p. 106.) IIWC/FEA did not address this issue in its Initial Brief.

J. IIWC/FEA Have Not Shown that Air Products is Entitled to Consolidated Billing.

IIWC/FEA recommends consolidating Air Products' total volume load to "fairly compensate IAWC for the single distribution main costs incurred to serve Air Products." (IIWC/FEA Init. Br., p. 35.) IIWC/FEA proposes that the volumetric charges for the Air Products' two meters should be consolidated since they are served by the same distribution main (Id., p. 34-35.) IIWC/FEA concludes that rates "should not be conditioned on how the customer installs plumbing behind IAWC's meters"; it claims that Air Products will otherwise pay twice for IAWC's distribution costs. (Id., p. 35.)

As explained by IAWC witness Mr. Kerckhove, IAWC's rules and regulations state, "When more than one meter setting is installed on a Customer's Premises, each meter setting shall be treated separately (i.e., as if it belonged to a separate Customer). The registrations of such meters will not be combined unless such meters measure water being received by a *common distribution system*." (IAWC Ex. 5.00R (2d Rev.) (Kerckhove Reb.), pp. 27-28 (citing ILL.C.C. No. 23, Original Sheet No. 10) (emphasis added).) According to IAWC's records, Air Products' 2-inch meter is located in a meter vault, while its 4-inch meter is located within the facility. (Id., p. 28.) This justifies separate billing.

IIWC/FEA provided no evidence that its meters serve a common distribution system in accordance with IAWC's tariff provision. To consolidate its billing, Air Products must have a common distribution system *behind* the meters. (Id.) This has not been shown. (IIWC/FEA Ex. 4.0, p. 9.) As such, it cannot be confirmed that the tariff applies.

VI. TARIFF TERMS AND CONDITIONS

A. Revenue Adjustment Clause

Staff and Intervenors assert myriad arguments in opposition to IAWC's proposed Revenue Adjustment Clause (the "RAC"). But, for all of their rhetoric, several facts remain unchallenged: (1) the RAC is a symmetrical decoupling mechanism which would enable IAWC to recover its *Commission-authorized* level of *revenue*—no more and no less; and (2) IAWC is experiencing a decline in annual usage per customer. Keeping these premises in mind, *all* of Staff and Intervenors' arguments against the RAC are inapposite. The RAC should be approved.

<u>The RAC Is Legally Sound.</u>

The legal arguments in opposition to the RAC are all generally based on cases that address the legal validity of riders that recover certain utility expenses outside the context of a traditional rate case. As such, almost all of the legal arguments set forth in opposition to the RAC are inapposite because the RAC is not an expense rider, and in fact is not really a rider at all. The RAC does not recover an expense within IAWC's revenue requirement. Instead, once the revenue requirement is set, the RAC simply allows the Company to recover the revenues established by the Commission.

The AG argues the RAC violates the Commission's test year "matching principle." (AG Init. Br., pp. 52-53.) It does not, as the revenues set to be recovered by the RAC are set based on costs and expenses in a test year in a rate case. The Commission dismissed the same argument in Dockets 07-0241/0242 when it approved Rider VBA, which, like the RAC, permits recovery of the revenues established by the Commission—no more, no less. There, the Commission:

> consider[ed] it clear that there are no test year prescriptions that are violated by Rider VBA. To be sure, the rates we establish arise out of nothing less than a traditional general rate case proceeding where the costs and expenses have been submitted in compliance with the Commission's test year rules. As such, the base rates that are approved in this case and which are the basis for the margin revenues to be recovered under Rider VBA have been evaluated in accordance with the appropriate test year prescriptions. Under the authority of CUB v. ICC, and the soundness of its analysis, we reasonably conclude that there is no test year rule violation with respect to Rider VBA.

North Shore Gas Co., et al., Order, Dockets 07-0241/0242 (Feb. 5, 2008), p. 146. For the same reasons, the AG's contention the RAC violates test year principles is erroneous.

The AG, along with IIWC/FEA and the Cities and Villages, also argues the RAC violates the rule against single-issue ratemaking. (AG Init. Br., pp. 55-60; IIWC/FEA Init. Br., p. 30; Cities & Villages Init. Br., pp. 3-4.) In making this argument, Intervenors ignore the RAC simply permits recovery of IAWC's Commission-authorized revenue requirement. The Commission has made clear the prohibition on single-issue ratemaking:

> is not applicable to a rider that merely facilitates direct recovery of a particular cost without upsetting a utility's revenue requirement.
>
> Consistent with the pronouncements in CUB v. ICC, City III, and Archer-Daniels, the margin revenues which are recovered under Rider VBA do not involve single issue ratemaking *because they do not have any impact whatsoever on the Utilities' overall revenue requirements*. See City III, 281 Ill. App. 3d at 629. *Simply put, margin revenues will have been determined as part of the overall revenue*

> *requirement in the instant proceeding and the adjustments that occur under Rider VBA will do nothing to change the Utilities' approved revenue requirement*. As such, and under the law, Rider VBA does not violate the rule against single issue ratemaking and we reject the arguments of Staff and GCI to the contrary.

North Shore Gas Co., et al., Order, Dockets 07-0241/242 (Feb. 5, 2008), p. 145 (emphasis added). For the same reasons, the RAC does not violate the rule against single-issue ratemaking.

The Second District's recent pronouncement in Commonwealth Edison Co. v. Ill. Commerce Comm'n, 405 Ill. App. 3d 389 (2d Dist. 2010) ("ComEd"), on which the AG heavily (albeit misguidedly) relies, confirms this. There, the Court reviewed ComEd's Rider SMP, which permitted ComEd to recoup the costs of modernizing its delivery system toward a "smart grid." ComEd, 405 Ill. App. 3d at 409, 410. The Court evaluated that rider in light of opposing parties' contention it constituted single-issue ratemaking. It noted:

> The rule against single-issue ratemaking makes it improper to consider in isolation changes in *particular portions* of a utility's revenue requirement. . . . The rule ensures that the utility's *revenue requirement* is based on the utility's aggregate costs and the demand on the utility, rather than on certain specific costs related to a component of its operation.
>
> * * *
>
> Single-issue ratemaking is prohibited because it considers changes in isolation, thereby ignoring potentially offsetting considerations and risking *understatement or overstatement* of the *overall revenue requirement*.

Id. at 401-11 (emphasis added) (internal citations omitted). The Court then undertook a review of Illinois law governing riders which "'facilitate[] direct recovery of a *particular cost*,'" id. at 411 (quoting Citizens Util. Bd., 166 Ill. 2d at 138) (emphasis added), noting such that type of riders must "be closely scrutinized to *prevent understatement or overstatement of the overall revenue requirement*," id. (emphasis added). Based on that review, the Court concluded:

> the Commission has discretion to approve a utility's proposed rider mechanism *to recover a particular cost* if (1) the cost is imposed upon the utility by an external circumstance over which the utility has no control and (2) *the cost does not affect*

the utility's revenue requirement.

Id. at 414 (emphasis added). Turning to Rider SMP, the Court held it did not meet that test. Id. at 414-15.

Unlike Rider SMP, the RAC is not set "to recover a particular cost." It does not impact IAWCs revenue requirement, nor does it consider portions of the revenue requirement in isolation. In fact, the RAC *reflects* the revenue requirement. Its function is to permit recovery of IAWC's Commission-approved revenues—no more, no less. As such, also unlike Rider SMP, the RAC has no bearing on the overall revenue requirement authorized by the Commission. For these reasons, the AG's reliance on ComEd is misplaced and its attempt to compare the RAC to Rider SMP is erroneous.

The AG's attempt to equate the RAC to the rider found unlawful in A. Finkl & Sons Co. v. Ill. Commerce Comm'n, 250 Ill. App. 3d 317 (1993) ("Finkl"), likewise is misdirected. (AG Init. Br., pp. 59-60.) (The Cities and Villages make the same erroneous comparison. (Cities & Villages Init. Br., p. 5-6.)) Notably, the rider at issue in Finkl was approved by the Commission outside a traditional rate case proceeding and after the Commission had recently established the utility's revenue requirement in a rate case. Finkl, 250 Ill. App. 3d at 331-32. More importantly, the rider in Finkl was set to recover *profit* loss, and not Commission-authorized revenues. Id. at 321. As such, comparisons between that rider and the RAC are misdirected. The Commission distinguished Rider VBA from the rider in Finkl on the same grounds. See North Shore Gas Co., et al., Order, Dockets 07-0241/242 (Feb. 5, 2008), pp. 148-49.

Absent from the extensive review of Illinois rider law undertaken by the Second District in ComEd is any reference to Bluefield Waterworks Improvement Co. v. Pub. Serv. Comm'n of West Virginia, 262 U.S. 679 (1923) ("Bluefield") or Federal Power Comm'n v. Hope Natural

Gas Co., 320 U.S. 591 (1941) ("Hope"), on which the AG places extensive (again, misguided) reliance for its contention IAWC is not entitled to recover its Commission-authorized level of revenues. (AG Init. Br., pp. 54-55.) Those cases are inapplicable. Neither proscribe a decoupling mechanism or the recovery of Commission-approved revenues through one. Rather, they address the parameters of utilities' rights respecting "return" and "earnings." In Bluefield, the Court spoke to "a utility's rate of return" and permitting the utility to "earn a return on the value of the [utility] property" and "right to profits." Bluefield, 262 U.S. at 692. Similarly, Hope speaks to "return to the equity owner." Hope, 320 U.S. at 603. Bluefield and Hope do not suggest, as the AG urges, that a utility ought not to be able to recover its revenues through operation of a decoupling mechanism. Rather, it is clear those cases concern the establishment of overall utility earnings. The AG's exaggerated and misplaced reliance on them should be accorded no weight.

In sum, applicable Illinois law and Commission precedent *confirm* the RAC is legally sound. It is the sort of decoupling mechanism—one which has no impact whatsoever on the utility's Commission-authorized level of revenues—that this Commission and the Illinois courts have sanctioned. The Commission should approve it.

Staff and Intervenors' Concerns Are Misplaced.

Unlike Intervenors, Staff appears to accept the RAC for what it is—a symmetrical decoupling mechanism which permits IAWC to recover its Commission-approved revenues, no more and no less. As such, Staff does not argue the RAC is unlawful. (See Staff Init. Br., pp. 72-74.) Instead, Staff continues to assert several concerns (some shared by Intervenors) about the RAC. As explained in IAWC's Initial Brief, and reiterated below Staff and Intervenors' concerns are misplaced.

Changing Business Realities Warrant the RAC.

First, Staff contends the changing business realities experienced by IAWC, including continued annual declining usage, are not compelling reasons to adopt the RAC because IAWC previously has been "able to function" without it. (Staff Init. Br., p. 72.) The AG and the Cities and Villages raise similar arguments. (AG Init. Br., pp. 57-58; Cities & Villages Init. Br., pp. 3-4.) In fact, the AG would like to see evidence of "sustained financial hardship." (AG Init. Br., p. 50.) But there is absolutely no legal authority or other requirement prohibiting the Commission from adopting now a rate mechanism which it has not before considered. (IAWC Init. Br., p. 114.) Nor is there any legal authority or other requirement—and the AG cites none—requiring IAWC to suffer "sustained financial hardship" before the Commission can approve a mechanism which would allow the Company to actually recover its Commission-approved level of revenues. All other things being equal, in the second year the rates established in this proceeding are in effect, IAWC will not be able to recover its revenue requirement authorized in this case. As it did in Dockets 07-0241/0242, that reality warrants a remedy—here, the RAC.

Notably, the AG concedes: "*there appears to be a currently declining long-term consumption trend* . . . ." (AG Init. Br., p. 50). (Indeed, the *entire water industry* is experiencing one. (IAWC Ex. 8.00R (Rev.) (Naumick Reb.), p. 15.)) Nevertheless, the AG claims IAWC's own declining usage data does not justify the RAC. (AG Init. Br., pp. 46, 50-51.) To the extent the AG takes issue with IAWC's test year usage forecast, the AG's concerns are misplaced. (See supra Section III.A.)

The RAC Does Not Subject Ratepayers to Higher Rates.

Staff also argues the RAC potentially subjects ratepayers to higher rates. (Staff Init. Br., p. 72.) The AG and IIWC/FEA present similar arguments. (AG Init. Br., pp. 45-46; IIWC/FEA

Init. Br., p. 30 (contending the RAC "adjusts rates").) That is wrong. The RAC does not change the final rates that will be established by the Commission in its Order in this rate case. The annual RAC adjustments do not modify the reasonable rates set by the Commission or somehow render those rates excessive or insufficient. Instead, the RAC simply is a means of lending more assurance that the level of revenues the Commission sets are not over or under-recovered. (IAWC Ex. 14.00R (Rev.) (Heid Reb.), pp. 31-32.) Moreover, this argument fails to recognize that the RAC is symmetrical—customers also are entitled to a *credit* if actual sales exceed projected levels. (Id., p. 30.)

Moreover, the Commission rejected the same idea in approving Rider VBA:

> Rider VBA does not disturb either this order or any of the Commission's prior orders. Nor does it disallow charges or benefits previously ordered. The adjustments and true-ups under Rider VBA do nothing to alter or de-stabilize the revenue requirement established here. The rates are what they are. Nor does Rider VBA disturb any of the underling revenue formula components and decisions thereon arrived at through the traditional rate- making process in this proceeding. Nor does Rider VBA suggest that the rates are in any way excessive or insufficient. This order establishes the rate that the Utilities are required to charge and pursuant to Rider VBA the Utilities would only receive the margin revenues that the Commission intends to be recovered. It is not the rates, but the computation of these rates that varies.

North Shore Gas Co., et al., Order, Dockets 07-0241/242 (Feb. 5, 2008), p. 145. It likewise should reject that argument here.

The RAC Does Not "Shift" Risk to Ratepayers.

The RAC will not entail any shift of risk to customers because it does not guarantee any specific financial performance—it does not guarantee that IAWC will achieve the financial performance approved by the Commission. (IAWC Ex. 14.00SR (Rev.) (Heid Sur.), p. 14.) Rather, its purpose is to lend a measure of assurance to IAWC's ability to recover its Commission-approved level of revenues. For this reason, the AG and IIWC/FEA's arguments to the contrary are meritless. (AG Init. Br., p. 45; IIWC/FEA Init. Br., p. 30.)

In this regard, IIWC/FEA also asserts the RAC "has the potential to provide *additional* revenue" to IAWC. (IIWC/FEA Init. Br., p. 30 (emphasis added).) That is plain wrong. In fact, the RAC would *prevent* IAWC from recovering more than its Commission-authorized revenues. Notably, IIWC/FEA contends, if the RAC is adopted, a corresponding reduction to IAWC's return on equity should be adopted because the RAC would reduce IAWC's business risk. (IIWC/FEA Init. Br., 32.) IIWC/FEA makes this assertion just three sentences after conceding the RAC also would eliminate any "profit rewards" of increased sales. (Id., p. 31.) IIWC/FEA's position is not only meritless, but also inconsistent.

Related to the misperception that the RAC somehow guarantees *financial* performance (it does not), Staff continues to advocate a reduction of 9 basis points and 23 basis points to Staff's cost of common equity recommendation should the Commission adopt the RAC as proposed on direct or rebuttal, respectively. (Staff Init. Br., pp. 44-46.) For the reasons set forth in its Initial Brief, that position is untenable and should be rejected. (IAWC Init. Br., pp. 116-17.)

The RAC Does Not Undermine IAWC's Incentive to Control Costs.

Staff, IIWC/FEA and the Cities and Villages contend the RAC will undermine IAWC's incentive to control costs. (Staff Init. Br., pp. 72-73; IIWC/FEA Init. Br, pp. 30-31; Cities & Villages Init. Br., pp. 3, 5-6.) As discussed in IAWC's Initial Brief, that position is contrary to the record evidence. The design of the RAC, which recovers revenues net of production costs, is such that Company management must still actively control costs and the price signals to customers are *more* aligned with the reality of the cost of providing water service to them. (IAWC Init. Br., p. 115.) Staff and Intervenors' contentions in this regard should be accorded no weight.

The RAC Does Not Undermine Customers' Incentive to Conserve Water.

Staff, IIWC/FEA and the Cities and Villages also contend the RAC will undermine customers' incentive to conserve because they may not see decreased bills as a result of decreased usage. (Staff Init. Br., pp. 72-73; IIWC/FEA Init. Br, pp. 30-31; Cities & Villages Init. Br., pp. 3, 5-6.) But in so arguing they ignore the question of the incentive to conserve water of a utility whose revenues are driven by sales volume. In fact, decoupling may encourage the utility to conserve, because revenue is no longer linked to sales volume. The further problem with Staff and Intervenors' positions here is their misperception that reductions in sales reduce IAWC's costs, nearly all of which are fixed. (IAWC Ex. 14.00SR (Rev.), pp. 15-16.)[13] Staff and Intervenors' arguments in this regard also ignore there are benefits apart from simple dollar savings to conserving natural resources. For example, there are significant environmental benefits of conservation that accrue to customers. (IAWC Ex. 8.00 (Naumick Dir.), p. 11.) Reduced usage helps maintain water source supplies and reduction in power consumption, chemical usage and waste disposal reduce carbon footprints and waste streams. (Id.) Such benefits do not equate to dollars saved, but nevertheless encourage water conservation.

The AG wants to distinguish the RAC from Rider VBA and the revenue adjustment mechanisms approved for water utilities in California and New York on the basis those mechanisms were adopted to encourage conservation measures by the utilities. (AG Init. Br., pp. 60-32.) The AG's position here ignores IAWC *is* presently subject to state and federal conservation mandates and has initiated its own measures, as explained in IAWC's Initial Brief. (IAWC Ex. 8.00, pp. 4-6, 10; IAWC Init. Br., p. 116.) Finally, related to Rider VBA, the AG's

[13] This argument also ignores the Commission's recent call for straight-fixed variable rate designs in recognition that such mechanisms have identifiable benefits for both ratepayers and utilities. (See IAWC Init. Br., p. 110 (citing dockets).)

position simply disregards the Commission approval of that mechanism on a permanent basis was *not* solely tied to the utilities' conservation measures. North Shore Gas Co., et al., Order, Dockets 07-0241/242 (Feb. 5, 2008), pp. 163-64.

In support of its position, the AG contends the Indiana Utility Regulatory Commission rejected an "identical issue" in Indiana-American Water Company's recent rate case. (AG Init. Br., p. 51.) That is not the case. Indiana-American did not propose a revenue adjustment clause in that case, as the AG implies. Moreover, the AG has not shown that the conditions related to usage in IAWC's service areas—customer demographics, geography, climate, etc.—are comparable to that of Indiana-American Water Company's. And, in any event, the Indiana commission expressly found the evidence in that case demonstrated Indiana-American *was* experiencing a general downward trend in residential customer usage. Indiana American Water Co., Opinion, No. 44022, 2012 Ind. PUC LEXIS 178, at *182 (Ind. URC June 6, 2012).

The RAC Functions Appropriately.

The AG next argues the RAC ignores differences in production among IAWC's service areas. (AG Init. Br., pp. 47-49.) In support of this contention, the AG offers the analysis of AG witness Mr. Rubin, which the AG claims demonstrates variations in the level of sales among districts, rather than reduced overall usage, drives the RAC. (Id., p. 48.) But Mr. Rubin's analysis misses the point. In fact, it illustrates the precise problem the RAC was designed to resolve. The AG's example illustrates a real revenue shortfall to IAWC, despite the variation in sales volumes between districts. It is therefore appropriate that IAWC recover that shortfall from customers because the fixed costs, which have not been avoided, are nevertheless incurred in providing reliable service to those customers. (IAWC Ex. 14.00R (Rev.), p. 33.) In fact, the Commission recently has called for straight-fixed variable rate designs in recognition that such mechanisms have identifiable benefits for both ratepayers and utilities. (See IAWC Init. Br., p. 110 (citing dockets).) In any event, the AG only presents one side of the picture here: if IAWC has revenues which exceed the level set by the Commission in this proceeding, IAWC would be required to refund customers via the RAC. Nevertheless, in testimony, IAWC stated that, if the Commission finds separate RACs should be applied to each Rate Area, the Company would not object. (IAWC Ex. 14.00R (Rev.), p. 34.)

The Commission Should Adopt the RAC Proposed on Rebuttal.

IAWC asks that the Commission adopt the RAC as proposed on rebuttal and set forth in IAWC Ex. 14.02R. Staff, however, asks that, if the Commission adopts the RAC (it should), then it should adopt it with three modifications. (Staff Init. Br., pp. 73-78.) Each such modification is unwarranted.

First, Staff asks that annual surcharge or credit amounts in excess of the 5% cap be absorbed by IAWC and not deferred and applied to future surcharge or credit amounts, as the case may be, which do not hit the 5% limit. (Id., p. 74-75.) Staff reasons such deferral somehow subjects ratepayers to higher rates. (Id., p. 73.) That is not the case. For the reasons set forth above, the RAC—including the surcharge/credit deferral component—does nothing to alter the reasonable rates as set by the Commission in this proceeding.

Related to this, Staff takes issue with IAWC's proposal to apply the AFUDC rate to deferred surcharge and credit amounts, and advocates the lower customer deposit rate instead. (Staff Init. Br., pp. 77-78.) The problem here is that the customer deposit rates do not reflect the cost of capital to IAWC from funding the excess over 5% of surcharges, which represent shortfalls in its authorized revenues. (IAWC Ex. 14.00SR (Rev.), pp. 12-13.) In contrast, the AFUDC rate appropriately reflects that, when IAWC experiences a revenue shortfall, it must obtain capital from a combination of sources of capital (debt, equity and internally generated funds) to continue to fund operations. (Id., p. 13.) It should be noted that the rate of interest applied to deferred amounts is—in keeping with the nature of the RAC—symmetrical. Therefore, if IAWC experiences a revenue overage, customers would receive the benefit of interest at the same rate as the Company. (Id.)

Third, Staff argues IAWC should be subject to an annual internal audit of the RAC, and it sets forth on page 75 of its Initial Brief intended objectives of such an audit. (Staff Init. Br., pp. 75-77.) IAWC believes all of those objectives could and should be accomplished within the framework of the annual filing and accompanying due diligence. (IAWC Ex. 14.00R (Rev.), p. 36.) Although Staff takes issue with that belief, (see Staff Init. Br., p. 75), Staff has not (and cannot) identified or explained which of the internal audit objectives it proposes would not already be accomplished with the annual filing and due diligence (id.). Instead, Staff claims, because the Commission has required annual internal audits related to other rate mechanisms which it has approved, one should be required for the RAC. (Id., pp. 75-76.) However, the Commission should not require IAWC to undertake such an audit, which would add to the Company's operations and maintenance expenses, absent an explanation of why it would not be duplicative. Since Staff has offered none, Staff's recommended annual internal audit requirement, like Staff's other proposed RAC revisions, should be rejected.

IIWC/FEA also asks that the Commission revise the RAC, should it adopt it (it should). Specifically, IIWC/FEA recommends that IAWC not be permitted to reset base production levels between rate cases. (IIWC/FEA Init. Br., p. 32.) That recommendation is ambiguous. It is not clear whether IIWC/FEA is recommending that the unit costs of production expenses or the total cost of production be maintained between rate cases. IIWC/FEA's recommendation also represents a fundamental misunderstanding of the function of the RAC. Because, under the RAC the unit production expense would be multiplied by sales volumes to determine the total production expense that would be deducted from the total revenues to be recovered, if actual unit production costs increased between rate cases, IAWC would be at risk for those increases. (IAWC Ex. 14.00R (Rev.), p. 27.) Accordingly, IIWC/FEA's recommendation in this regard is misplaced and should be dismissed.

Changing realities call for a change to traditional processes. Current ratemaking does not account for what IAWC is experiencing in the present: declining customer usage despite nearly entirely fixed costs. The RAC is an appropriate remedy. The Commission has sanctioned decoupling when the circumstances called for it as they do now. The RAC should be approved.

VII. OTHER ISSUES

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

IAWC no sooner refutes an affiliate-interest theory raised by Staff when two more spring up in its place. When Staff first raised affiliate-interest issues in this case, there were only two, covering about seven pages of testimony: one related to phone transfers and the other to customer service line-leak reporting. (See Staff Ex. 7.0 (Sackett Dir.), pp. 9–16.) In "rebuttal," Staff's testimony expanded to 40 pages and introduced two new issues. (See Staff Ex. 15.0 (Sackett Reb.).) Now, in its Initial Brief, with the threat of cross-examination past, Staff raises yet two more new issues, replete with assertions made without benefit of citation to the record, and these receive top billing. One must read nearly twenty pages before Staff discusses an issue originally raised in Mr. Sackett's direct testimony, to which only two pages are devoted. (See Staff Init. Br., pp. 97–99.) This leads to an unusual, inverse correlation—issues altogether unmentioned in testimony get the most attention on brief, while the issues that started the whole affair receive virtually none. These constantly changing theories reflect the simple fact that IAWC has complied with the law and has committed no violation of the affiliate interest provisions of the Public Utilities Act.

IAWC will respond to the arguments in Staff's Initial Brief, but it is first necessary to correct two global errors: first, Staff's misapprehension of the burden of proof concerning these issues; and second, Staff's repeated, misleading assertions that IAWC "refused" to provide numerous items of information.

Despite Staff's Attempts to Evade It, Staff Bears the Burden of Proof Concerning Its Recommendations.

At numerous points in this section of its Initial Brief, Staff plainly misapprehends the applicable burdens of proof. Staff seems to think it need only accuse IAWC of some impropriety—in some cases for the first time after hearing—and the burden shifts to IAWC to disprove the accusation. For example, Staff states that a certain "adjustment is necessary because *IAWC* has not provided any proof that these costs do not include [improper] expenses." (Staff Init. Br., p. 93 (emphasis added).) As to another issue, Staff did not provide evidence making it "possible to calculate" whether an agreement not involving IAWC had any "effect on proposed rates," but in its view, the *lack of evidence* justified further investigation. (Id.) Again, Staff asserts that IAWC must "demonstrate that it has *not* violated the Commission decision to disallow [the sharing of customer information]." (Id., p. 100 (emphasis added).) These examples are merely illustrative.

While IAWC obviously bears the general burden of supporting its petition, this does not translate into a burden to negate or disprove every recommendation or issue raised by other parties. On the contrary, Staff must support its own recommendations. "[E]ach party proposing a result should bear the burden of adducing evidence in support of that proposal." In re Illinois

Commerce Comm'n on Its Own Motion v. Ill. Consol. Tel. Co., Docket 94-0042, 1995 Ill. PUC LEXIS 828, at *103 (Dec. 6, 1995). "Where a party asks a court to believe a proposition and to base a finding thereon in his favor, the law casts the burden on him of furnishing the evidence upon which such finding can legally rest." Bell v. School Dist., 407 Ill. 406, 416 (1950); Chicago v. Ill. Commerce Comm'n, 133 Ill. App. 3d 435, 442–43 (1st Dist. 1985) (dismissing "the erroneous assumption that a utility has the burden of going forward on any and all issues which are conceivably relevant to the reasonableness of its proposed rates" and noting that once a utility establishes its rates are necessary to provide service, "the burden then shifts to others to show that the costs incurred by the utility are unreasonable because of inefficiency or bad faith"); City of Pekin, Order, Docket 02-0352, 2004 Ill. PUC LEXIS 21, at *11 (Jan. 22, 2004) (the "party seeking affirmative relief bears the burden of proof"); Commonwealth Edison Co., Order, Docket 05-0597, 2006 Ill. PUC LEXIS 38, at *31 (May 4, 2006) ("the Commission finds that Staff and Intervenors have not identified insufficiencies in or refuted [the utility's] proof . . . . [T]hese parties have repeatedly depended on arbitrary and inconsistent theories and artificial mathematical exercises divorced from . . . the actual relevant facts").

These cases reflect the practical reality that disproving certain propositions or proving negatives can be extremely impractical and expensive—or outright impossible. See, e.g., Antioch Milling Co. v. Pub. Serv. Co., 4 Ill. 2d 200, 209 (1954) ("Certainly as a practical matter a utility should not . . . be required to embark upon a full dress justification of its rate structure every time an individual customer files a complaint"); see also, e.g., Ethyl Corp. v. EPA, 51 F.3d 1053, 1064 (D.C. Cir. 1995) (upholding agency decision rejecting interpretation of "burden of proof [that] would be virtually impossible for an applicant to meet, as it requires the proof of a negative proposition").

The notion that opposing parties do not bear the burden to disprove every allegation raised by other parties takes on added force given the circumstances of this case. As IAWC will discuss, Staff now gives top billing to theories proposed for the first time after the hearing ended and the record closed. This leaves IAWC in the position of having to affirmatively disprove these new recommendations in briefing. But, IAWC could not possibly have put on evidence responding to Staff's untimely theories. As the cases above show, it is not IAWC's burden to disprove unsupported allegations. Otherwise, to put the burden of proof on the Company, and hold any silence in the record against it, would be the height (or depth) of unfairness. Further, Staff makes other allegations that appear to require IAWC to prove a negative (for example, Staff alleges IAWC has failed to show it did not improperly share customer information, without identifying any actual instance of concern regarding provision of customer information). This is also an improper attempt to shift the burden to IAWC. It is Staff that bears the burden to support its recommendations, which, as discussed below, it has not done.

Staff Misleadingly Asserts that IAWC "Refused" to Provide Information, when in Fact IAWC Simply Did Not Have It.

There is another problem afflicting Staff's presentation. Staff repeatedly asserts that IAWC "refused" to provide information in discovery. For example, Staff states that "verification [of the costs allocated in certain agreements not involving IAWC] has not been not possible because IAWC has refused to provide some of these agreements." (Staff Init. Br., p. 86.) Elsewhere it states that it "asked IAWC to provide information from AWRs [sic] training, practices and procedures manuals," but that "IAWC refused to provide this information because it believes the information was not relevant to the proceeding." (Id., p. 100; see also id., pp. 93, 95.)

These are half-truths, at best, and very misleading. It is simply not true that IAWC "refused" to turn information over to Staff. IAWC provided everything Staff asked for that it had in its possession or could appropriately request from AWWSC. The only information it did not share was information outside of its possession and control (such as AWR agreements, manuals, and cost or financial information wholly unrelated to call center activities involving IAWC). IAWC simply did not have that information at its disposal. That is to be expected, since, as will be discussed below, IAWC was not supposed to, and did not, share information with AWR or provide services to it. The discovery requests cited by Staff to support its assertions that the Company "refused" production make clear that IAWC did not have the requested information. (See Staff Ex. 15.0, Attachs. A, B, J, and L; see also Staff Init. Br. pp. 86–87, 93, 100 (citing same).)

Staff's Initial Brief, unfortunately, does not make this clear. More than once, Staff asserts that IAWC "refused to provide . . . information because it believe[d] the information was not relevant to the proceeding." (Staff Init. Br., p. 100; see also id., pp. 86–87 ("IAWC has refused to provide documentation about [AWR and AWWSC's] costs and the basis, again stating that such costs are not relevant to this case").) Staff leaves out that IAWC *also* explained that it did not have the requested information. By stating that IAWC "refused" production and mentioning *only* the relevance objection, Staff paints the misleading picture that IAWC was uncooperative and must have had something to hide. While the image of an uncooperative, shifty utility might support Staff's theory that a Commission-ordered investigation is needed, it is a fabrication. This is not just inaccurate, it is improper.

It is also ironic for Staff to imply that IAWC should serve as a one-stop shop for affiliate information. Staff's entire argument is built on the (unproved) notion that IAWC and AWR are too close. Indeed, one of Staff's recommendations is for IAWC to specifically prove it does *not* share information with its affiliates. (See Staff Init. Br., p. 100.) Yet Staff would fault IAWC, and impute facts against it, because it did not obtain information from the same affiliate, and does not serve as custodian of AWWSC's and AWR's agreements and cost information. Adding to the irony, Staff plainly did *not* hand over information in discovery related to its investigation of these issues that *was* in its possession, as discussed in IAWC's Initial Brief. (See IAWC Init. Br., pp. 132–33.)

In summary, Staff's allegations that IAWC refused to provide information must be rejected.

The Commission Need Not Consider the Cost-Shifting Arguments on which Staff Now Primarily Focuses.

As alluded to above, Staff's Initial Brief now primarily focuses on "cost-shifting" issues raised for the first time after the hearing. IAWC will do its best to address these new theories below, despite the considerable handicap of having had no opportunity to take discovery, present its own evidence, or cross-examine Mr. Sackett on the issues. But it should not be necessary to reach the merits of these newly raised theories. Due to the manner in which they were raised, these new issues have been waived, and the Commission should reject them out of hand.

In numerous cases, the Commission has made clear that it will "not consider" issues "raise[d] for the first time after trial" where the party was "afforded the opportunity to present evidence" but did not. Illinois Bell Tel. Co., Order, Docket 01-0120, 2002 Ill. PUC LEXIS 684, at *19–20 (July 10, 2002); see also, e.g., Central Ill. Pub. Serv. Co. v. Wayne-White Counties Elec. Coop., Inc., Order, Docket 92-0463, 1994 Ill. PUC LEXIS 283, at *16 (July 7, 1994) ("it is reasonable to reject [an] argument on procedural grounds" where "had [the] issue been raised" when other issues were raised, it "could have been addressed in the stipulation or in evidentiary hearings"); Interstate Power & Light Co., Order, Docket 07-0246, 2007 Ill. PUC LEXIS 160, at *41 (Nov. 28, 2007) (holding that where Staff's argument was "factually unsupported" and it "fail[ed] to cite the record" that "Staff has waived Commission consideration of this argument"); Citizens Util. Bd., Order, Docket 03-0592, 2004 Ill. PUC LEXIS 408, at **87–88 (July 21, 2004) ("The Commission notes PESCO did not present evidence concerning [a certain contention]. Therefore, PESCO has waived its right to have the Commission consider its contention . . . .").

This rule is not just a hoop for jumping through; it is at the heart of fairness and due process. By failing to present its factual theory and specific recommendations in its testimony, Staff deprived IAWC of the right to explore the issue through discovery, to present its own evidence, and to cross-examine adverse witnesses. See, e.g., Illinois Commerce Comm'n on Its Own Motion v. N. Ill. Gas Co., Order, Docket 02-0170, 2003 Ill. PUC LEXIS 682, at *36 (Aug. 6, 2003) ("Consideration of this evidence at this point in time, without allowing Staff the opportunity to cross-examine [the witness sponsoring untimely evidence], contravenes due process"); WPS Energy Services, Inc., Order, Docket 00-0199, 2001 Ill. PUC LEXIS 597, at **70-71 (May 9, 2001) ("With regard to due process concerns, the Commission notes that WPS received, among other things, . . . an opportunity to present evidence and to cross-examine the Staff witness"); cf. Alton & S. R. Co. v. Ill. Commerce Comm'n, 316 Ill. 625, 630 (1925) ("the statute requires that carriers shall be notified of the complaint which they are required to answer, and though no particular form is prescribed there must be a statement of the thing which is claimed to be wrong, sufficiently plain to put the carrier upon its defense"). The due process requirements of administrative proceedings include "the opportunity to be heard, [and] the right to cross-examine adverse witnesses." Gigger v. Bd. of Fire & Police Comm'rs of City of East

St. Louis, 23 Ill. App. 2d 433, 439 (4th Dist 1960); see also Abrahamson v. Ill. Dep't of Prof'l Reg., 153 Ill. 2d 76, 95 (1992); Balmoral Racing Club, Inc. v. Ill. Racing Bd., 151 Ill. 2d 367, 400-01 (1992) ("cross-examination is required in order to ensure that due process requirements are met").

Two of Staff's affiliate interest issues—the proposed "phone charge adjustment" and the so-called "other phone charge issue" (Staff Init. Br., pp. 88–93)—were raised for the first time in Staff's Initial Brief. These issues were not set out in the testimony of any witness. They rely in large part on unsupported assumptions and conclusions, as discussed below, and much of the discussion in "support" of the issues is merely the argument of counsel, which is not evidence and cannot form the basis for decision. Johnson v. Lynch, 66 Ill. 2d 242, 246 (1977); see 5 ILCS 100/10-35(e); 220 ILCS 5/10-103. Because they were raised for the first time in briefs, IAWC has no opportunity to test these assumptions or conclusions through discovery or cross-examination. IAWC cannot provide responsive testimony. Thus, by withholding these issues until essential procedural steps had passed, Staff has waived the opportunity to raise these issues. Were the Commission to rule against IAWC on this record, it would deny the Company due process of law. Thus, the Commission should simply disregard these new issues.

Staff's Cost-Shifting Recommendations Fail on the Merits.

Staff raises three cost-shifting issues, two raised after hearing, one for the first time in rebuttal. IAWC will address them in the order raised.

Staff's $[redacted] Phone-Charge Adjustment Lacks Record Support and Is Otherwise Meritless.

Staff's first new recommendation is "an adjustment of $[redacted] in total due to AWWSC's overcharges to IAWC." (Staff Init. Br., p. 88.)

Getting to Staff's $[redacted] figure requires an ambitious series of inferences. Staff starts by noting that AWWSC call-center employees read a script on behalf of AWR to ratepayers in several states *not* including Illinois. Staff then points out that two of those states had roughly 1.3 million customers, and that a *different* utility (IAWC) experienced call rates of 1.2 per customer. Staff assumes that IAWC's call rate applies to every affiliated utility, and multiplies that rate by the total of number of customers to arrive at 1.5 million calls. Next, Staff asserts that the AWR script took 15 seconds to read on the stand. It then takes the call center's *total* cost per minute ($[redacted] and divides it by four, leaving [redacted] On that basis, Staff concludes that "each [reading of the script] added $[redacted] to the cost of the call center," meaning that 1.5 million readings added over $[redacted] in costs, which is about $[redacted] less than AWR actually paid for the [redacted] transfers of IAWC callers in 2011. Allocate 9.9 percent of that to IAWC, and—*voila*—$[redacted]. (See Staff Init. Br., pp. 89–90.)

There are numerous, fatal problems with this recommendation.

The "Adjustment" Reflects Costs Outside of the Test Year.

The program under which AWWSC call handlers read scripts to non-Illinois customers, known as the CCAP program, was terminated in February 2012. (IAWC Ex. 15.00R (Cooper Reb.), pp. 5-6.) Any costs related to the program or its script reading, including the costs "calculated" by Staff for 2011, cannot occur in the test year, because the program terminated before the test year begins in October 2012. Staff's proposed adjustment to IAWC's test year expenses is therefore improper.

Numerous Essential Steps in Staff's Recommendation Lack Any Record Support.

One fatal problem with Staff's recommendation—not the only one—is that it is blatant guesswork. The recommendation itself, and numerous elements, lack any support in the record.

First, no witness testified to this issue *per se* in any way at the hearing. This issue was never heard nor was this recommendation ever made on the record. And numerous, essential factual points lack any supporting citation to the record.[14] For example, Staff does not know what the call-per-customer rates in the other states are. It does not know how much time the call center actually spent reading AWR statements. It does not know what it actually cost the call center to read AWR scripts. It does not know how many statements were actually read. And so on. Thus, Staff's conclusion that "AWWSC (and AWR) shifted costs from AWR to IAWC" (id., p. 90) falls somewhere between guessing and wishful thinking. Indeed, this confusion of random statistics, dubious inferences, and outright guesses is what happens when a party waits until a hearing ends to put a theory together.

The lack of record support for Staff's recommendation—both as a whole and as to many points—means it cannot be adopted. The Commission "must make findings in support of its decision, and support for the findings must exist in the record." People ex rel. Madigan v. Ill. Commerce Comm'n, 964 N.E.2d 510, 524 (Ill. Ct. App. 1st Dist. 2011) (internal quotations omitted); Atchison, T. & S. F. R. Co. v. Ill. Commerce Comm'n, 335 Ill. 624, 638–39 (1929) (the Commission's "findings must be based on evidence presented in the case, with an opportunity to all parties to know of the evidence to be submitted or considered, to cross-examine witnesses, to inspect documents and to offer evidence in explanation or rebuttal, and nothing can be treated as evidence which is not introduced as such"). Indeed, in language that could have been composed for this case, the Commission has warned Staff not to depend on "artificial mathematical exercises divorced from . . . the actual relevant facts." Commonwealth

[14] 83 Ill. Adm. Code 200.800(a) provides: "Statements of fact in briefs and reply briefs should be supported by citation to the record."

Edison Co., Order, Docket 05-0597, 2006 Ill. PUC LEXIS 38, at *31 (May 4, 2006). Staff's recommendation lacks record support, is speculative, and must be rejected.

Staff's Recommendation Is Unreasonable.

Even taking it on its own terms, Staff's recommendation raises glaring problems. For example, it defies reality to assert that "each statement [when read] added $[redacted] to the call center." (Id.) Dividing the call center's *total cost* by the number of call minutes yields a certain figure, but this does not mean that every second of activity by *a single employee* actually incurs that amount of cost. Staff ignores the fact that the 15-second reading of a statement would add (if anything) only *incremental* costs, which would drastically reduce the allegedly shifted cost, perhaps to nothing. It is conceivable that the call center's costs would have remained unchanged had no script ever been read. If any costs were incurred, they likely would have been *de minimis* and covered (perhaps over-recovered) by the $[redacted] transfer charge.

Again, Staff deprived IAWC of any opportunity to respond to or challenge this point at the hearing. The issue is waived and cannot be fairly considered on the merits, as IAWC can only respond under a handicap. But even had this reduction been timely proposed, it lacks merit and must be rejected.

The "Other Phone Charge Issue" Is Base Speculation.

Staff's calls its second "cost shifting" issue the "Other Phone Charge Issue." This "issue" is that AWWSC "charges costs to its affiliates . . . based on the average cost-per-call times the number of calls." (Staff Init. Br., p. 92.) In Staff's view, this means that "those affiliates that have shorter calls than average are subsidizing those affiliates that have longer calls." (Id.) But Staff proposes no adjustment, asserting that "IAWC refused to provide" the figures necessary to calculate one. (Id. p. 93.)

Many of the same objections appear here as before. Again, this issue was raised for the first time in Staff's post-hearing brief, so the issue is waived and threatens due process. Again, IAWC did not refuse to provide the requested information—IAWC did not have it. Again, Staff is merely speculating as to any overcharges.

Staff's position essentially boils down to the overbroad argument that because phone costs were allocated, they *might* have been misallocated, so there must be a full investigation and IAWC called on to prove that no misallocations occurred. But "might" is not good enough, as such a standard would open the door for investigations of anything and everything, for any reason or none. Staff investigated this issue but points to no signs that suggest any improper allocation occurred. The issues must be decided on the record, and the record provides no support for Staff's theory. The "Other Phone Charge Issue" is a non-issue.

Staff Has Not Justified Any Reduction Premised on the Joint Facilities Expansion Agreement.

Unlike the previous two cost-shifting issues, Staff actually mentioned in testimony its recommendation for a $10,268 adjustment based on alleged cost-shifting related to the joint facilities expansion agreement. But while this issue is not waived, it plainly lacks merit.

This is one of the issues in which Staff, lacking evidence of any impropriety, attempts to foist the burden of proof on the Company. Staff states that an "adjustment is necessary because IAWC has not provided any proof that [the facility expansion] costs do not include AWR expenses." (Staff Init. Br., p. 93.) But as IAWC explained above, that is procedurally improper and practically impossible. The reduction is Staff's proposal: if there is no evidence that IAWC is being charged AWR's costs, the reduction must be rejected.

Indeed, Staff not only lacks evidence in support of its adjustment, but also ignores the evidence against it. As the Company explained in its Initial Brief, there was no misallocation.

AWR paid increased rent after the second expansion, and only a small portion of the total expansion was related to AWR's facilities. (IAWC Init. Br., p. 65–66.) Staff tries to dismiss this evidence with the curious assertion that one-time costs cannot be recovered through increased rent: "While IAWC claims that AWR pays for its portion of the second expansion with an increase in rent, this does not address the one-time costs needed to expand the facility." (Staff Init. Br., p. 95 (citations omitted).) This *does* address it—there is no rule that "one-time costs" cannot be spread out over a series of smaller payments; it is actually a fairly common practice known as "financing," which is all the more common in situations where the benefit received (e.g., larger facilities) is paid over a period in which the benefit is enjoyed. (IAWC Init. Br., pp. 65–66.) This is another non-issue.

Staff Has Provided No Reason for Launching a Massive Investigation.

None of Staff's individual cost-shifting recommendations hold water, and it has otherwise provided no support for its recommendation for a comprehensive investigation of AWWSC and every company with which it does business. Staff recommends that "the terms of *any other agreements to which AWWSC is a party* must be made available for Staff/Commission review," and that "*all costs* allocated or assigned according to those various agreements must be verified to know that the terms are being followed." (Staff Init. Br., p. 86 (emphases added).)

This is an extremely broad request. The Commission is being asked to review *all the Service Company's* agreements, with affiliates *and* non-affiliates, and without regard to whether those agreements bear any relationship with charges or services provided to IAWC. Not only that, but it is being asked to "verify" *every* cost relevant to those agreements, whether they have any relationship to IAWC or not, and regardless of *whose* cost information must be verified. This would cover AWWSC's contracts for such things as janitorial services and office supplies, and it would require investigation of such non-regulated, non-affiliated companies in order to carry it out. This would be an enormous, expensive job. Staff is essentially asking the Commission to subpoena and investigate the records and information of unregulated persons with no tie to an Illinois utility whatsoever. While the Commission possesses investigatory authority, this request would seem likely to transgress appropriate limits.

But that point need not be addressed, because Staff's request comes with no support. First, despite calling for an unprecedented scope of investigation, Staff provided no citation to legal authority whatsoever in support of its recommendation, which (among other problems) makes it difficult to properly analyze the basis for its request. The *only* factual support Staff provides is the generic allegation that IAWC "refused to provide some of these agreements" and certain cost information. (Id.) But Staff does not explain with any specificity what agreements or information were not provided, whether they were relevant to any issue in this case, or even whether they should have been provided. Moreover, if one examines the four unexplained citations to attachments to Mr. Sackett's rebuttal testimony—it is clear that IAWC did provide agreements where requested, and voluminous other information besides. (See Staff Ex. 15.0, Attachs. B, C, D and L.)

In short, Staff has asked for a maximal (and perhaps more than maximal) investigation with less than minimal support. It has not adduced evidence of utility-affiliate problems that would justify such a massive and expensive effort. The Commission cases cited by Staff are all distinguishable (IAWC discusses them below) but they do stand for an important point: the current review model works. If utilities are subsidizing affiliates, or affiliates are shifting costs to utilities, that will show up either in the utility's books or practices or in the affiliate agreements themselves. Mr. Sackett's investigations have turned up nothing. He points to no charges from AWWSC that are either above-market or other than least-cost. The worst he has found (if it can be called that) are two practices, not even involving IAWC, in which AWWSC acts for the benefit of IAWC customers.

Moreover, costs that are allocated to IAWC as well as direct charged have been reviewed in every rate case since the Service Company Agreement was approved, and presumably will continue to be reviewed in subsequent cases. These costs and the activities of the Service Company generally were exhaustively reviewed in the Service Company cost study performed in IAWC's last rate case, as well as the recent management audit. The multiple rate case reviews and prior studies and audits provide sufficient assurance that IAWC and AWWSC abide by the terms of the Service Company Agreement. Mr. Sackett's investigations in this case do not support a different conclusion, much less the need for further investigation.

This lack of evidence leads to only one conclusion: IAWC is complying with Commission rules and past orders. This record provides no basis for ordering (yet another) massive investigation.

Staff Did Not Rebut the Evidence that IAWC Carefully Scrutinized AWWSC's Budget and Its Charges.

Moving on from cost-shifting issues, Staff's next recommendation is that the Commission "open a proceeding within sixty days of the Order . . . to review the AIA between AWWSC and IAWC to determine if it is in the still in [sic] the public interest." (Staff Init. Br., p. 97.) IAWC responded to this point in full in its Initial Brief. It will only highlight here that Staff has adduced *no* evidence in support of this investigation in its Initial Brief.

Staff's request for a full-scale investigation of IAWC's affiliate-interest agreement is premised on the notion that "the entire [AWWSC] budget should have been reviewed and questions should have been raised regarding the charges and allocations to IAWC and other affiliates under these agreements." (Id. at 96.) But the evidence does not show any lack of review.

For support, Staff depends solely on the cross-examination of IAWC's president Karla Teasley. Ms. Teasley explained on cross that she *personally* reviewed the portion of the AWWSC budget that was allocated to IAWC, but did not *personally* review the entire budget. (See Tr. 65–66.) But Ms. Teasley's direct testimony explained in detail the substantial, multi-layered scrutiny which AWWSC receives from IAWC. Among other things, she explained that "IAWC personnel" scrutinized not just AWWSC's budget, but its "monthly budget/actual variance report for all of its operations." (IAWC Ex. 1.0 (Rev.) (Teasley Dir.), pp. 31–32.) Staff asked no questions about this, however; its cross-examination explored very little of her testimony, covering only 12 pages of the transcript. (See Tr. 59–71.) Her testimony stands unrebutted.

As for Staff's suggestion that Ms. Teasley's testimony on cross "contradicts" her direct testimony, this is demonstrably false. On direct, Ms. Teasley testified that she had "additional review and approval *capability* over the Service Company budget." (IAWC Ex. 1.0 (Rev.), p. 32 (emphasis added).) In this context, to say that one has "capability" to review something is to describe one's *authority*. It is not to say (as Staff suggests) that one personally reviews it, and it should go without saying that the president of a company serving hundreds of thousands customers and employing hundreds cannot do everything herself. And as already noted, Ms. Teasley did explain how other personnel gave careful scrutiny to Service Company charges. Again, Staff chose to ask no questions about that and, for unknown reasons, limited its questioning and discovery to her personal actions.

In short, Staff has no record support in favor of its proposal to order an additional investigation of IAWC.

IAWC Has Already Disposed of Staff's "Non-Cost Issues" in Its Initial Brief.

IAWC addressed the so-called "non-cost" issues in detail in its Initial Brief, and it is not necessary to reproduce that discussion here. (See IAWC Init. Br., pp. 118–33.) It will only respond briefly to a few errors in Staff's presentation.

Staff Has Shown No Impropriety in AWWSC's Transfer of Requesting Customers.

Staff points out that those "ratepayers that call . . . and ask for information about warranty products" are asked if they would like to be transferred to AWR. (Staff Init. Br., pp. 97–98.) It asserts that transferring the call of a customer who asked about warranty products and wanted the call transferred "is not in [the customer's] best interest." (Id., p. 98.)

This is the only alleged misdeed. It is altogether unclear how doing something specifically requested and desired by the customer is *against* that customer's best interests. Nor is it clear how that customer's interests would be furthered by being either subjected to a tutorial on business-association theory and corporate structure or told that "Illinois-American does not offer any service line protection plans, and . . . that [the call center is] not allowed to provide that information." (Tr. 477.) The proposed solutions all seem worse than the alleged "problem."

Nevertheless, at the end of the day, despite the inconvenience and confusion it could cause to IAWC's own customers, and the potential increased costs that could be allocated to IAWC, the Commission could simply require IAWC to prevent any transfer of calls involving IAWC customers, regardless of whether the customer requests a transfer. The fact remains that no "investigation" is necessary or warranted to determine whether IAWC should adopt such a practice.

Staff Has Shown No Impropriety Concerning Leak Investigations.

Mr. Sackett's investigation allegedly also turned up another "possible" issue: AWWSC *may* be saving IAWC's customers a phone call by alerting AWR if a covered line is damaged. (Staff Init. Br., p. 99.) Staff also recognizes that this "'customer convenience' could theoretically apply to another warranty provider" besides AWR. (Id.) But it rules out that IAWC could have any reason of its own to investigate any problems on its customers' service lines: "[t]he only conclusion . . . is that [AWWSC] send[s] the utility technician out to determine if the repair is AWR's responsibility." (Id.) Staff's view, apparently, is that the customer should be required to call AWR so AWR sends its own technician. (Id.)

Again, as IAWC explained in its Initial Brief, it is more than doubtful that Mr. Sackett has uncovered any wrongdoing. As the record shows, it is not a question of utility field service representatives determining whether a leak is "AWR's responsibility." Rather, it is a requirement that the utility determine if the leak is the utility's or the customer's responsibility. (IAWC Ex. 2.00R (Suits Reb.), p. 2.) Prudent utility operation and Commission service regulations require IAWC technicians to respond to emergency service orders, and this is the case regardless of how the customer may ultimately go about fixing a customer-side leak, and regardless of whether the customer has a warranty protection program from AWR or any other entity. (Id.) Staff again glosses over an important point: IAWC technicians do not talk to AWR about the results of water line investigations. (Id., p. 4.) To the extent such communications occur, they are strictly between AWWSC and AWR, and the approved Service Company Agreement (not to mention the AWWSC-AWR agreements to which IAWC is not a party) contemplates that communications like this may occur. Also left unanswered by Staff is how any interactions between AWWSC and AWR affect costs to IAWC ratepayers, since IAWC has an affirmative obligation to investigate service line leaks, regardless of whether the customer has a warranty product. It is evident that Staff's apparent solutions seem only to add needless time and cost; another proverbial remedy in search of a problem.

Staff Has Demonstrated No Improper Sharing of Customer Information.

Finally, having uncovered no evidence that IAWC has inappropriately shared information with its affiliates, Staff asks the Commission to "order IAWC to demonstrate that it has not violated the Commission decision to disallow this assistance." (Staff Init. Br., p. 100.)

As IAWC has discussed throughout, Staff misapprehends the burden of proof. Staff alleges that IAWC is sharing information; it falls to it to provide at least *some* evidence suggesting that this is occurring. Having failed to turn up any evidence, Staff cannot then turn and require IAWC to disprove the allegation.

But this is not to say that there is no evidence on this point. Staff tries to suggest that "[t]he record is unclear whether ratepayer information is passed directly or indirectly from IAWC or AWWSC to AWR," but that is not true. The record is clear, and it all points to the same conclusion: IAWC did *not* share customer information with its affiliates. As IAWC noted in its Initial Brief, Ms. Teasley testified that IAWC does not provide customer information to AWR (IAWC Ex. 1.00SR-Part 2 (Teasley Sur.), p. 12), and Ms. Cooper, that AWWSC does not provide IAWC customer information to AWR, either (IAWC Ex. 15.00R, p. 7). No evidence points the opposite direction.

The Cases Relied upon by Staff Are Distinguishable.

Finally, Staff cites three cases in its argument section, although it does not provide any real argument that these cases control here. And they plainly do not.

In Dockets 11-0280/0281, there Was Hard Evidence of Violated Cost-Allocation Provisions in a Utility-Affiliate Agreement.

In the North Shore/Peoples case, Dockets 11-0280/0281 (cons.), the regulated utilities' "agreement with [the service company] provide[d] that [it] charge the Companies for expenses less revenues provided to IBS by other parties." Order, Dockets 11-0280/0281 (Jan. 10, 2012), p. 88-89. And the evidence showed that another agreement between the service company and unregulated affiliate required the service company to bill the unregulated affiliate at fully distributed cost. Id., p. 89. But contrary to the agreement, the evidence showed that the unregulated affiliate was not charged at all from 2008 until sometime in 2011. Id., pp. 90-92. This meant that not only was the agreement between the service company and the unregulated affiliate violated, but also was the agreement with the utilities.

In short, the *evidence* in that case clearly showed that the parties to those agreements were not observing their cost and allocation provisions: "The evidence supports the conclusion that IBS failed to charge PEHS for services . . . and failed to credit the Companies for those revenues," and this "*in fact*, [had] the end result of IBS over charging the Companies." Id., p. 93. Staff obviously has adduced no such evidence here.

In Docket 11-0046, Utility Employees Solicited on Behalf of Unregulated Affiliates.

In Docket 11-0046 (the Nicor case), Nicor Gas, its affiliated service company and its unregulated affiliate sought re-approval of an affiliated interest agreement, thus the case fell directly within the statutory authorization governing utility agreements with affiliates. See 220 ILCS 5/7-101(3). And the facts were plainly distinguishable. The utility in that case had its *own* call center, staffed by utility employees, who after handling the regulated business would try to sell a gas line protection program offered by its affiliate (and thereby earn a commission from the service company). Order, Docket 11-0046 (Dec. 7, 2011), p. 40.

This case is distinguishable at every point. IAWC does not operate its own call center, and its employees do not handle customer service calls. AWWSC's employees do not solicit every caller with a sales pitch for AWR. They respond to inquiries about AWR by transferring the caller to AWR or providing AWR's phone number or email. It is also notable that in the Nicor case the Commission still *approved* a modified version of the agreement but merely required the utility to quit soliciting on behalf of its affiliate. Id., p. 76. Such a condition would be superfluous in this case.

In Docket 11-0561, the Affiliated-Interest Issue Was Not Resolved on the Merits and Involved a Straightforward Sale of Customer Information.

Finally, Staff cites the Utilities, Inc. rate case in Docket 11-0561 in support of its position. In that case, unlike this one, when the service company enrolled new customers, it would sell the customers' account information to a warranty line protection provider. As discussed above, the unrebutted evidence in this case is that IAWC, AWWSC, and AWR do not share customer information.

Even had that case been on all fours with this one, it is of little import here. The Commission resolved the issues raised by Staff based on "the Companies' concessions to reduce its revenue requirements" and to participate in an additional proceeding. Order, Docket 11-0561 (May 22, 2010), p. 29. The Commission otherwise declined "to approve Staff's proposal to make a finding in this proceeding that the Companies have violated the Public Utilities Act." Id. This case does not support Staff.

In conclusion, Mr. Sackett, on behalf of Staff, devoted considerable attention to affiliate issues in this case. That investigation showed only that IAWC has been doing as it should. Staff's recommendations to the contrary must be rejected.

B. Other Tax Issues

1. Bonus Tax Depreciation

In briefing, the AG appears to have abandoned its recommendation that "appropriate recompense" be made for American Water's prudent decision not to take accelerated or "bonus" depreciation for federal income tax purposes. (AG Init. Br., p. 38 (recognizing the Commission is bound by normalization rules[15] and "American Water's decision to forego bonus depreciation cannot be undone by IAWC or by the Commission . . . .").) Instead, the AG now advocates a consolidated tax adjustment be applied to share tax savings purportedly realized by the American Water consolidated tax group. The AG contends that this is appropriate because IAWC allegedly has lost tax advantages—offering 2011 bonus depreciation as an example—due to its participation in American Water's consolidated tax group. (Id., pp. 37-43.) As discussed below (see infra Section VII.B.3), the AG's adjustment is an adjustment the overwhelming majority of jurisdictions have dismissed. The AG has not quantified the adjustment in any event. (AG Init. Br., pp. 37-43.) Accordingly, as explained below, the AG's consolidated tax savings adjustment should be rejected.

To the extent the AG alleges as a basis for adopting a consolidated tax adjustment the decision to not take 2011 bonus depreciation, IAWC explained in its Initial Brief why the AG's position was flawed. (See IAWC Init. Br., pp. 133-39.) In particular, net operating losses for IAWC 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. (IAWC Ex. 13.00R (Warren Reb.), 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

[15] The calculation of federal income tax for ratemaking purposes is not based upon actual taxes paid; rather, it is normalized for ratemaking purposes. (IAWC Ex. 13.00R (Warren Reb.), pp. 34-35.)

any less tax. (Id.) It simply would have produced a larger NOL carryforward. Thus, there would be no tax deferral and, critically, no incremental ADIT. (Id.) Moreover, the AG misinterprets AG Cross Exhibit 25, suggesting it shows American Water's tax liability with and without bonus depreciation. In fact, AG Cross Exhibit 25 showed what would happen if American Water took bonus depreciation at certain growth sensitivity levels, not if it did or did not take bonus depreciation.

Despite the AG's abandonment of its bonus depreciation adjustment, the Cities and Villages adopt AG witness Mr. Smith's initial position and advocate such an adjustment (for the first time) in their Initial Brief. (Cities & Villages Init. Br., pp. 7-8.) Like Mr. Smith, the Cities and Villages do not quantify the adjustment and provide no explanation as to how it should be implemented. (Id.) Thus, it must be rejected. Moreover, as discussed in IAWC's Initial Brief, the record reflects it was incontrovertibly prudent for American Water management to decide not take bonus depreciation in order to promote the best tax outcome for the water-consolidated group as a whole. (IAWC Init. Br., p. 137; IAWC Ex. 13.00R, p. 29.) The Cities and Villages presented no testimony rebutting that evidence.[16] In any event, bonus depreciation deductions would merely increase IAWC's net operating loss carryforward, and thus have no current effect on the Company's cash flow or on its ADIT. (IAWC Init. Br., pp. 136-37; IAWC Ex. 13.00R, p. 33.) This moots the Cities and Villages' unsupported adjustment. It should be rejected. Staff agrees: "Staff recommends that the Commission not find the Company imprudent in its election not to take bonus depreciation" because, based on the record evidence, "there could be no benefit from electing to take bonus depreciation." (Staff Init. Br., p. 19.)

[16] In fact, as stated, the Cities and Villages submitted no testimony in this proceeding.

2. Domestic Production Activities Deduction

The AG asks the Commission to order IAWC to impute a DPAD tax deduction in calculating its income tax expense. (AG Init. Br., p. 37.) But conspicuously absent from the record (and the AG's Initial Brief) is any quantification of such a deduction, how it would be calculated, or even to what IAWC production activities it would be applied. (AG Ex. 4.0 C (Rev.) (Smith Reb.), p. 45; Tr. 712, 744; AG Init. Br., pp. 35-37.) In other words, the AG proposes a theoretical adjustment, but asks the Commission to do the work.[17] The AG's proposal should be rejected on this ground alone.

The AG seems to accept IAWC cannot take the DPAD deduction as a member of the American Water consolidated tax group. (See IAWC Ex. 13.00R, pp. 35-38.) Instead, the AG continues to claim that IAWC could take the deduction on a standalone basis because IAWC, considered alone, has a positive test year taxable income of $19.02 million. (AG Init. Br., p. 35.) But the AG fails to take into account IAWC had net operating losses in 2008, 2009, 2010 and 2012, which would entirely offset its taxable income in the test year if it were to file its taxes on a standalone basis for the test year. (IAWC Ex. 13.00R, pp. 34, 38-39.) Therefore, there could be no DPAD. (Id.) In other words, the AG's argument about whether IAWC can "take" the deduction miss the point: there is no deduction to take. The AG fails to recognize (or at least accept) this. The AG's position should be rejected.

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[17] The AG relies on a recent order of the California Public Utilities Commission to support its decision. (AG Init. Br., pp. 36-37.) The excerpt relied upon by the AG relates only to the tax treatment of California American Water Company's Water Revenue Adjustment Mechanism balances (a decoupling mechanism similar to the Revenue Adjustment Mechanism proposed by IAWC in this case (see supra Section VI.A)). California-American Water Co., Order, Nos. 10-07-007 & 11-09-016 (June 14, 2012), p. 43 (*available at* http://docs.cpuc.ca.gov/word_pdf/final_decision/168807.pdf (last accessed June 26, 2012)). The AG fails to demonstrate why the circumstances of the California case are comparable to those at bar. Nevertheless, there is one noticeable difference: in the California case, an actual, not theoretical DPAD calculation and methodology was offered by the party proposing imputation of the same. (Id. at 44.)

3. Consolidated Tax Savings Adjustment

The AG recommends that the Commission adopt a consolidated tax adjustment, utilized in Indiana, to share tax savings purportedly realized by the American Water consolidated tax group with IAWC ratepayers. The AG has not even alleged in briefing that there are in fact consolidated tax savings that exist in the test year for IAWC's customers, much less explained how those tax savings might arise, if they might arise in the test year, or what they might result from. In short, the AG simply has assumed the foundational premise of its argument, without any basis, that consolidated tax savings exist which would apply to IAWC in the test year. Moreover, adopting the AG's position would potentially establish a policy of general applicability for all Illinois utilities without an opportunity for other utilities to weigh in. IAWC points out that the Indiana Muncie Remand Order which the AG cites was the product of years of litigation involving many parties. See In re Muncie Water Works Co., Order, No. 34571, 1981 Ind. PUC LEXIS 246, at **1-10 (Sept. 16, 1981) (setting forth procedural history); Muncie v. Public Service Com., 177 Ind. App. 155, 156 (Ind. Ct. App. 1978).

Forty-seven jurisdictions[18] (including Illinois) do not apply, or have affirmatively rejected, adjustments for tax savings which result from subsidiary utilities' participation in the consolidated income tax returns filed by their parents. (Tr. 826 (Mr. Warren testifying "the vast preponderance of regulatory jurisdictions do exactly what Illinois does and has always done.").) The AG hangs its hat on the contrary practice of the remaining five. Without a showing of comparability between Illinois' regulatory environment and that of those five jurisdictions, or of the facts and circumstances of this case to those which the AG cites, the AG argues this Illinois

[18] This includes the District of Columbia and the Federal Energy Regulatory Commission. (Tr. 826.) In 12 of the jurisdictions in which American Water subsidiaries operate, consolidated tax savings adjustments are not imposed. (Tr. 793.)

Commission should adopt the minority view and impose an adjustment for consolidated tax savings—and adjustment which, notably, the AG has not quantified.

The majority of jurisdictions reject consolidated tax adjustments. In particular, their reasons for doing so relate to the risk that the consolidated tax adjustment, which purports to pass through to ratepayers tax benefits attributable to the losses of affiliates, including non-regulated affiliates, will erode the separation between regulated and non-regulated affiliates. IAWC submits the majority view (including Illinois', see Citizens Utils. Co. of Ill., Order, Docket 80-0468, 1981 Ill. PUC LEXIS 23, at *22-29 (May 27, 1981)) is far more persuasive. The well-reasoned analyses supporting rejection of consolidated tax savings adjustments are abundant. For example, the Kentucky Public Service Commission addressed the same adjustment proposed by the same witness (Mr. Smith) in Kentucky-American Water Company's recent rate case. In rejecting Mr. Smith's adjustment in that case, the Kentucky commission explained:

> Except for Case No. 2004-00103, which involves unique circumstances, the Commission has consistently rejected proposals to apply a consolidated tax adjustment and treated utilities on a stand-alone basis. We have found that use of such an adjustment would result in the subsidization of ratepayers by the utility's non-regulated operations. Moreover, many utility regulatory commissions appear to disfavor the use of consolidated tax adjustments. In light of the RWE divestiture and the absence of any compelling argument to jettison the 'stand-alone' rate-making principle, we find that the AG's proposed income tax consolidation adjustment should be denied.

Kentucky-American Water Co., Order, No. 2010-00036, 2010 Ky. PUC LEXIS 1479, at *92 (Ky PSC Dec. 14, 2010) (citing orders from Nebraska, Maryland, Washington, Minnesota and Ohio rejecting consolidated tax savings adjustments) (footnotes omitted). The Washington Utilities and Transportation Commission likewise rejected a consolidated tax savings adjustment:

> The Internal Revenue Service permits an affiliated group of companies (e.g., Puget Holdings, Puget Energy, Inc., [Puget Sound Energy, Inc. ("PSE")], and various other subsidiaries and affiliates) to file a consolidated federal income tax return. A key benefit of filing such a return is that losses associated with any affiliate can be used to offset taxable income of the other affiliates in the group.

> [Industrial Customers of Northwest Utilities] argues PSE's revenue requirement should be reduced by $ 8.8 million on the electric side and $ 3 million on the natural gas side to account for ratepayers' fair share of the value of PSE's taxable income that is used to lower PSE's parent company's (i.e., Puget Holdings) overall federal income taxes.
>
> * * *
>
> [PSE witness] Mr. Marcelia testifies extensively in opposition to ICNU's proposed consolidated tax adjustment, arguing among other things that it: violates the tax code, violates the test year concept, disregards the changed structure of parent and affiliated companies at PSE over the past ten years, disregards PSE's tax loss in 2009 and 2010, n249 and fails to reflect actual tax. Most significantly, PSE argues, ICNU's adjustment erodes the ring-fencing provisions that shield PSE's customers from risks at the parent company level.
>
> * * *
>
> The Commission has repeatedly rejected proposed consolidated tax adjustments, double leverage arguments, and cross-subsidization methodologies. . . . The Commission similarly rejected a proposal by Public Counsel and ICNU to impose a consolidated tax adjustment that would reduce Avista's federal income tax rate from 35 percent to its 'effective tax rate' of 31 percent because it undermined the ring fencing principles put in place to protect utility customers: 'Finally, under either circumstance, the CTA [consolidated tax adjustment] violates the principle, if not the letter, of our recent decisions establishing 'ring-fences' that protect ratepayers from non-regulated activities by declining to pull benefits or burdens from activities 'outside the ring-fence' into the regulated business. Not only are we provided no reason to act contrary to our recent precedent in this regard, doing so here could jeopardize the integrity of the rationale for 'ring-fencing' and undermine its defensibility if it were attacked.'
>
> Accordingly, we reject ICNU's proposal in this case. Although ICNU characterizes its adjustment as a 'loan' or 'tax shield' rather than an imputation to PSE of parent company debt or the tax deduction associated with the debt, the effect is the same. We find ICNU's consolidated tax proposal unacceptable for the same reasons we have rejected other, similar proposals in prior cases.

<u>Puget Sound Energy, Inc.</u>, Order, Nos. UE-111048 and UG-111049, 2012 Wash. UTC LEXIS 423, at **140-41, 142-43, 145-48 (Wash. UTC May 7, 2012) (<u>quoting</u> <u>WUTC v. Avista Corp.</u>, Order, Dockets UE-080416, <u>et al.</u>, 08 P 151 (Dec. 9, 2008)) (footnotes omitted). The Maryland Public Service Commission recently stated:

> The Commission previously addressed the issue of a consolidated tax adjustment

> in a proceeding involving Washington Gas Light Company ('WGL'). The Commission noted that the basic theory for filing a consolidated tax return is that members of the corporate system pay taxes on their consolidated taxable income which permits the net operating income of some members to be used to offset the net operating losses of other companies. Consequently, without taxable income, the tax losses cannot be translated into system-wide tax savings.
>
> The Commission stated that it 'is a rule of general application that the rates charged for a regulated utility should only reflect the costs associated with providing the utility service and should not reflect costs associated with other businesses . . . .' Therefore, the Commission concluded that it must examine the relationship between the regulated entity, whose costs are included in its rates, and the enterprise generating the tax savings in order to determine whether to reflect the tax savings. Furthermore, the Commission noted that it is also relevant to consider whether the tax savings are sufficiently recurring before reflecting them in test year ratemaking.
>
> In order to adopt the Staff's recommended CTA, we would have to depart substantially from prior Commission decisions on this issue and join a very small minority of commissions. Staff's claim that twenty other jurisdictions apply CTAs did not survive cross-examination by the Company and questioning by the Commission - nearly all of the cases Staff cited in its testimony had been overruled or the policy allowing CTAs otherwise superseded. In our view, the important question is whether the parent's tax policies treat the regulated utility unfairly.
>
> * * *
>
> [W]e find that Delmarva is treated fairly for tax purposes in the overall taxation structure of the corporate family, and that Delmarva's ratepayers are not subsidizing the parent or its unregulated affiliates. Accordingly, we find that the Staff's proposed consolidated tax adjustment is not necessary to ensure fairness, and we decline to apply it.

<u>In re Delmarva Power & Light Co.</u>, Order, No. 9192, 2009 Md. PSC LEXIS 61, at **36-38 (Md. PSC Dec. 30, 2009) (footnotes omitted). The Florida Commission also described it well:

> We believe that Consolidating Tax Adjustments (CTAs) are inappropriate in the ratemaking process. Consequently, no CTA adjustments shall be made for the 1992 current test year and for the 1993 projected test year.
>
> The term 'consolidated tax adjustment' (CTA) refers to the controversial ratemaking procedure whereby utility regulators pass through to ratepayers tax benefits attributable to the losses of non-regulated corporate affiliates. A CTA can be made either by (1) adjusting the ratemaking tax expense (and, ultimately, cost of service) of the utility for a portion of the tax benefits arising from the loss

> affiliates; or (2) treating as no-cost capital or, alternatively, excluding from rate base, an amount representing the utility's share of the federal income tax benefits attributable to the filing of a consolidated tax return.
>
> The Commission has a long-standing policy of not considering CTAs in the cost of service of Florida utilities:
>
> A basic premise of regulation is that utility operations should not subsidize other operations nor should they be subsidized by other operations. This is true whether the operations are those of an affiliate joining in the filing of a consolidated federal tax return or the utility. Regulators remove the assets, capital, revenue and expenses associated with these activities from rate base, cost of service and capital structure. Most of these adjustments would have a tax effect. However, the tax effect is coincidental to the adjustment. That is, the adjustment to taxes is not made in an effort to alter the tax expense. It is a result of allowing the tax effect of the regulatory changes to follow the related revenue or expense item.

In re Florida Power Corp., Order, No. 910890-EI, 1992 Fla. PUC LEXIS 1546, at **129-31 (Fla. PSC, Oct. 22, 1992). See also In re Potomac Elec. Power Co., Order, No. 1076, 2010 D.C. PUC LEXIS 68, at *244 (D.C. PSC Mar. 2, 2010) (rejecting consolidated tax savings adjustment and "decid[ing] to adhere to our traditional stand-alone approach regarding federal and district tax expense, which is widely followed by the majority of Commissions throughout the country. ") (footnotes omitted); In re PacifiCorp, Order, No. 20000-ER-03-198, 2004 Wyo. PUC LEXIS 72, at *85 (Wyo. PSC Feb. 28, 2004) (rejecting proposed consolidated tax savings adjustment because "[i]t is contrary to our past treatment of the issue; and it would begin breaking down the separation of the utility from its affiliates which we have carefully maintained in the past."); In re Delmarva Power & Light Co., Order, No. 91-20, 1992 Del. PSC LEXIS 15, at **53-56 (Del. PSC Mar. 31, 1992) (rejecting [Office of the Public Advocate's] recommended consolidated tax adjustment as "'short-sighted'" and adopting Hearing Examiner's view "that it violated the 'fundamental' ratemaking principle that a utility's costs and revenues should be kept separate from those of its non-regulated subsidiaries. As a matter of policy, the Hearing Examiner opined that 'breaching the wall between regulated and unregulated activities is fraught with a potential for mischief which once released may do more harm to ratepayers in the long-term than any short-term benefit that they may otherwise receive.'") (internal citations omitted). If this Commission looks to other state commissions for guidance on this issue—and it need not, see North Shore Gas Co./Peoples Gas Light & Coke, Order, Docket 07-0241 (Feb. 5, 2008), p. 152 ("The Commission is under no obligation to consider the ratemaking practices employed in other jurisdictions.")—IAWC submits that it should be guided by the well-reasoned and compelling analyses of the majority of jurisdictions who have rejected consolidated tax savings adjustments such as that proposed by the AG here.

As noted in IAWC's Initial Brief, Mr. Smith has not calculated or quantified the AG's proposed consolidated tax savings adjustment nor explained how it would be determined. (IAWC Init. Br., p. 140.) Rather, as far as the AG gets in this regard is pointing to Mr. Warren's explanation of a judicially mandated adjustment applied in Indiana. (AG Init. Br., pp. 40-41.) Apparently, based on this alone, the AG asks that the Commission adopt a "procedure and analysis" to impute consolidated tax savings. (Id., p. 43.) But no witness in this proceeding testified as to why the Indiana approach would be appropriate in Illinois or what the appropriate inputs would be should the Indiana approach be adopted here. With no basis on which to determine the AG's phantom adjustment, the Commission should reject it.

Moreover, the AG fails to mention in its Initial Brief that the Indiana Commission, in continuing to apply a decades old adjustment, required by a decades old Indiana court order and related to parent company interest expense, *declined* to adopt an expanded "tax savings" adjustment proposed by Mr. Smith in that case because, similar to the majority of jurisdictions cited above, it was concerned about the allocation to Indiana ratepayers of the tax burdens and savings of out-of-state affiliates. Indiana American Water Co., Order, No. 44022, 2012 Ind.

PUC LEXIS 178, at **272-74 (Ind. URC June 6, 2012). The AG presents only half the picture in advocating its unquantifed adjustment.[19]

Finally, the AG's proposal must be rejected as contrary to the record evidence. The AG contends IAWC's customers derive no benefit from the Company's participation in American Water's consolidated tax group. (AG Init. Br., p. 39.) However, as described in IAWC's Initial Brief, there is ample record evidence of the benefits of IAWC's participation in American Water's consolidated group. (IAWC Init. Br., pp. 134-35.) There is simply no reason to depart from long-standing Commission practice (or the majority view) and adopt the uncalculated consolidated tax savings adjustment the AG champions. It should be rejected.

VIII. 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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[19] The AG's quote of IAWC witness Mr. Warren in support of its position is incorrect. The AG states "Mr. Warren pointed out [the five states imputing consolidated tax savings] 'determine that there are consolidated tax savings to begin with that are subject to shift, *which is not a proposition that actually has controversy*.'" (AG Init. Br., p. 40 (<u>quoting</u> Tr. 798) (emphasis sic).) The AG's quoted text reflects an error in the hearing transcript for which IAWC has suggested the following correction:

> Q. So then these states have determined that it is not impossible to share consolidated tax savings with consumers, is that right?
>
> A. Well, these cases determine that there are consolidated tax savings to begin with that are subject to **<u>sharing</u>** which is not a proposition that **<u>is without</u>** controversy.

(Tr. 798, lines 10-16.) <u>See</u> IAWC's Suggested Corrections to the May 15-17, 2012 Hearing Transcript (filed June 19, 2012).

Dated: June 29, 2012

Respectfully submitted,

Illinois-American Water Company

By: */s/ Anne M. Zehr*

One of their attorneys

Albert D. Sturtevant
Anne M. Zehr
Rebecca L. Segal
WHITT STURTEVANT LLP
180 N. LaSalle Street, Suite 1822
Chicago, Illinois 60601
Phone: 312.251.3017
sturtevant@whitt-sturtevant.com
zehr@whitt-sturtevant.com
segal@whitt-sturtevant.com

Mark A. Whitt
WHITT STURTEVANT LLP
PNC Plaza, Suite 2020
155 East Broad Street
Columbus, Ohio 43215
Phone: 614.224.3911
whitt@whitt-sturtevant.com

John J. Reichart
Kenneth C. Jones
Illinois-American Water Company
727 Craig Road
St. Louis, MO 63141
314-996-2287
John.Reichart@amwater.com
Kenneth.Jones@amwater.com

CERTIFICATE OF SERVICE

I, Anne M. Zehr, certify that on June 29, 2012, I caused a copy of the foregoing *Reply 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.

/s/ Anne M. Zehr
Attorney for Illinois-American Water Company