

**STATE OF ILLINOIS  
ILLINOIS COMMERCE COMMISSION**

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Illinois-American Water Company	)	
	)	
	)	
Proposed General Increase in Water	)	Docket No. 11-0767
and Sewer Rates.(tariffs filed October	)	
27, 2011)	)	

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**PUBLIC  
BRIEF ON EXCEPTIONS OF THE STAFF  
OF THE ILLINOIS COMMERCE COMMISSION**

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Now comes the Staff of the Illinois Commerce Commission ("Staff"), by and through its undersigned attorneys, and pursuant to Section 200.830 of the Commission's Rules of Practice, 83 Ill. Adm. Code Section 200.830, respectfully submits this Brief on Exceptions to the Proposed Order issued by the Administrative Law Judge ("ALJ") on July 31, 2012 ("Proposed Order" or "PO").

**I. INTRODUCTION AND PROCEDURAL BACKGROUND**

In this proceeding, the Commission is investigating the October 27, 2011, request for a proposed general increase in water and sewer rates pursuant to Article IX of the Illinois Public Utilities Act (the "Act" or "PUA"), 220 ILCS 5/9, filed by Illinois-American Water Company (the "Company" or "IAWC"). In general, the PO reviews the issues presented in this proceeding in a clear and concise manner, is well written, and reflects the positions taken by Staff, the Companies, and the numerous intervening parties. Although Staff supports many of the PO's conclusions, there are items to which

Staff takes exception as set forth below. Staff addresses issues to which it replies in the order in which they appear in the PO.

Initial Briefs (“IB”) were filed on June 15, 2012 by the People of the State of Illinois *ex rel.* Lisa Madigan, Attorney General of the State of Illinois (the “AG”); United States Steel Corporation-Granite City Works (“U.S. Steel”), the University of Illinois, Air Products and Chemical Company (“Air Products”), participated in this proceeding as the Illinois Industrial Water Consumers (“IIWC”), together with the Federal Executive Agencies (“FEA”), referred to collectively as (“IIWC/FEA”); the Cities of Champaign and Urbana, and the Villages of Savoy, St. Joseph, Sidney and Philo ( the “Cities”); the Village of Bolingbrook (“Bolingbrook”); Staff; and IAWC. Reply Briefs (“RB”) were filed by the respective parties on June 29, 2012.

**II. NATURE OF IAWC’S OPERATIONS**

**III. TEST YEAR; PROPOSED REVENUE INCREASES**

**IV. RATE BASE**

**A. PENSION ASSET**

**B. BUSINESS TRANSFORMATION COSTS**

**C. CASH WORKING CAPITAL**

**1. Prepayments to Service Company**

The AG’s position and IAWC’s and Staff’s position have been transposed in the Commission’s conclusion (page 27 of the PO). The following corrections to the second paragraph of the Commission’s conclusion are necessary to accurately reflect the parties’ positions:

Recommended Language:

Whether the Service Company Agreement requires IAWC to make prepayments is in dispute. The IAWC and Staff AG argues that prepayments are required, while ~~IAWC and Staff~~ the AG contends that they are not.

- D. ADIT – Repairs Deduction – FIN 48**
  - E. Unamortized Management Audit Costs**
  - F. Forecasted Additions to Utility Plant in Service**
  - G. Approved Rate Base**
- V. OPERATING REVENUES AND EXPENSES**
- A. TEST YEAR SALES VOLUMES AND REVENUES**
  - B. STAFF ADJUSTMENTS TO OPERATING EXPENSES**
  - C. RATE CASE EXPENSE**
    - 1. Disallowance of SFIO Consultant Costs**
    - 2. Consultant’s Hourly Rate**

Staff takes exception to the PO’s conclusion regarding consultant James Warren’s hourly rate. The PO states that relying solely on the CPA rate used by Staff would not be an accurate proxy for a reasonable hourly rate, and finds that averaging that CPA rate with Mr. Warren’s actual rate would provide a reasonable result. (PO, p. 51) Staff is concerned that the use of an average hourly rate of \$487 instead of the consultant’s contracted hourly rate of BEGIN CONF\*\*\*\$XXXXXX\*\*\* END CONF could appear to be arbitrary, since the merits of an average rate were never debated in the record. Therefore, Staff maintains its recommendation that an hourly rate of BEGIN CONF\*\*\*\$XXX\*\*\*END CONF should be used, which is the highest rate charged by the CPAs working for the accounting firm Kerber, Eck and Braeckel, that reviewed IAWC’s

projected financial statements for the instant proceeding. (Staff Ex. 16.0 Supp. (Rev.), p. 4) The only other hourly rate pertinent to this issue is BEGIN CONF\*\*\*\$XXX\*\*\*END CONF, which is the rate charged by the AG witness Ralph Smith.

IAWC claims to have hired Mr. Warren to rebut Mr. Smith because of his education, expertise as an attorney and CPA, and his years of experience. (IAWC IB, p. 57) Similarly, the AG hired their expert Mr. Smith because of his education, expertise as an attorney and CPA and his years of experience at an hourly rate nearly four times less than Mr. Warren's discounted hourly rate. (Staff RB, p. 10) Comparing the spread between the two consultant's hourly rates, BEGIN CONF\*\*\*\$XXX to \$XXXXXX\*\*\*END CONF, Staff's recommended hourly rate of BEGIN CONF\*\*\*\$XXX\*\*\*END CONF is a more appropriate proxy for a reasonable hourly rate than the PO's use of an average hourly rate of \$487.

Staff therefore recommends the language of the PO on page 51 be amended as follows:

Recommended Language:

**c. Conclusion**

First of all, the Commission disagrees with the Company's assertion that Section 9-229 does not contemplate or even permit the scrutiny of the hourly rates charged as part of the Commission's assessment of rate case expense. After all, Section 9-229 requires the Commission to "specifically assess the reasonableness of the justness and reasonableness of any amount expended by a public utility to compensate attorneys or technical experts to prepare and litigate a general rate case filing." In the Commission's opinion, evaluating the hourly rate can be a logical and appropriate element to consider in the performance of such an assessment.

In the instant situation, Staff contends Mr. Warren's rate is too high. Staff believes the tax issues addressed by Mr. Warren are ones for which "a practicing CPA would and should have such knowledge."

A review of the record indicates that the tax issues raised by the AG witness, to which Mr. Warren responded, are very complex. Mr. Warren is an expert in this area. IAWC's assertions that Mr. Warren exercised that expertise in an efficient manner -- including under examination at the hearing -- and that the rate charged is at or below those charged by others with similar expertise, are largely unchallenged.

~~Under the circumstances, relying solely on the CPA rate used Staff would not be an accurate proxy, since it appropriately considers the range of hourly rates between Mr. Warren and Mr. Smith, and provides for a reasonable midpoint between the two rates. However, when comparing the hourly rates of Mr. Warren and the AG witness, whose hourly rate is four times less than that of Mr. Warren's, the hourly rate proposed by Staff The Commission finds that averaging that CPA rate with Mr. Warren's actual rate would provide a reasonable result~~

## **VI. OTHER INCOME TAX ISSUES**

## **VII. CAPITAL STRUCTURE AND RATE OF RETURN**

### **A. OVERVIEW**

### **B. CAPITAL STRUCTURE**

The threshold question is whether IAWC's risk or cost was increased due to IAWC's affiliation with its parent, American Water Works ("AWW"). The PO, however, never addresses this issue and in doing so, fails to apply Section 9-230 of the Act. As Staff testified, IAWC's proposed capital structure is needlessly expensive due to an excessive amount of common equity. Although the PO does not adopt the capital structure proposed by IAWC, the PO's proposed capital structure contains a higher proportion of common equity than the record supports. Because equity is a more expensive form of capital than debt, a greater percentage of equity in a utility's capital structure requires a higher rate of return to cover the cost of capital. (See *Illinois Bell*

*Tel. Co. v. Illinois Commerce Commission*, 283 Ill. App.3d 188, 205 (2<sup>nd</sup> Dist. 1996)) (“IBT”) IAWC has a clear incentive to use a capital structure with an excessive amount of equity, which would then allow AWW a greater return on its capital, while leaving ratepayers to shoulder the increased costs of capital for IAWC.

The PO states that:

The Commission notes that Staff's discussion of how capital structure affects the overall cost of capital is very informative. (Staff Ex. 6.0 at 3-4) Also of interest to the Commission is the parties' discussion of the potential incentives IAWC and/or its parent may or may not have to manipulate IAWC's capital structure as well as the discussion of Section 9-230 of the Act.

(PO, at 76)

Staff appreciates the recognition of its arguments and analysis described above. However, the PO then entirely ignores Section 9-230. Instead, the PO looks at the last IAWC rate case capital structure and applies a “reasonable” standard where it found it “appropriate” in setting the Company’s capital structure. (PO, at 76-77)

Of course, the “just and reasonable” standard is still applicable, but to be just and reasonable, the rates must exclude any incremental risk or increased cost of capital. (*IBT*, 283 Ill. App.3d 188, 207-08) (“[A]ll reasonable rates exclude any incremental risk or increased cost of capital due to affiliation; however, the simple exclusion of such risk or cost does not a fortiori, make rates reasonable.”) Staff’s point is that rates need to be just and reasonable, but to be so; the Commission *must* first exclude any amounts of

incremental risk or increased cost of capital. Section 9-230 provides in relevant part that:

In determining a reasonable rate of return upon investment for any public utility in any proceeding to establish rates or charges, the Commission *shall not* include *any* (i) incremental risk, [or] (ii) increased cost of capital ... which is the direct or indirect result of the public utility's affiliation with unregulated or nonutility companies.

220 ILCS 5/9-230 (emphasis added).

The phrase “*shall not include any*” does not mean that the Commission *may* include a *reasonable amount* of increased cost of capital where it finds it *appropriate*. This language means exactly what it says -- none, zero. In fact, the General Assembly has removed any discretion from the Commission regarding Section 9-230 that it would otherwise enjoy. (*IBT*, 283 Ill. App.3d 188, at 206-07) (“It is impermissible for the Commission to substitute its reasonableness standard for the legislature's absolute standard.”)

Illinois courts have concluded that the mandatory directive in Section 9-230 means that the Commission is not allowed “to consider what portion of a utility's increased risk or cost of capital caused by affiliation is ‘reasonable’ and therefore should be born by the utility's ratepayers.” (*Id.*) Moreover, Section 9-230 mandates that the Commission not allow “one iota” of increased risk or “one dollar more for capital because of its affiliation with an unregulated company.” (*Id.*)

The Illinois Appellate Court explained that:

Section 9-230 *does not allow* the Commission to consider what portion of a utility's increased risk or cost of capital caused by affiliation is “reasonable” and therefore should be born by the utility's ratepayers; the legislature has determined that any increase whatsoever must be

excluded from the ROR determination. *It is impermissible* for the Commission to *substitute its reasonableness standard* for the legislature's *absolute standard*. The Commission may not define a portion of the Act in a way that conflicts with a specific directive contained in the Act. We hold that if a utility's exposure to risk is one iota greater, or it pays *one dollar more* for capital because of its affiliation with an unregulated or nonutility company, the Commission must take steps to ensure that such increases do not enter in its ROR calculation.

(*IBT*, 283 Ill. App. 3d at 207) (emphasis added; citation omitted).

Two things are apparent from this holding. First, the Commission cannot consider the reasonableness of a proposed capital structure until it makes a threshold determination that the capital structure in question satisfies the requirements of Section 9-230. Second, Section 9-230 absolutely bars, as a matter of law, the adoption of a capital structure which, as a result of affiliation, results in increased risk or increased cost of capital. Section 9-230 is designed to preclude parent companies from realizing greater returns from ratepayers by proposing a capital structure with a greater percentage of common equity at the utility level.

The capital structure adopted in the PO fails to address the violation of Section 9-230 of the Act due to the higher proportion of common equity in IAWC relative to its affiliate parent, AWW. Although the PO does not adopt the capital structure proposed by IAWC, it includes a higher proportion of common equity than the record supports.

In determining the appropriate capital structure for setting rates in this proceeding, the PO begins by accepting Staff's 1.30% short-term debt ratio. To determine the proportions of long-term debt and common equity, the PO started with the proportions found to be reasonable for ratemaking purposes in IAWC's last rate proceeding, Docket No. 09-0319. The PO notes that IAWC and Staff were in

agreement on the capital structure in that case and neither party provided a compelling explanation for the significant variation in their capital structure proposals in this proceeding.

In Docket 09-0319, Section 9-230 was not raised as a concern with IAWC's proposed capital structure. However, just because Staff did not look at Section 9-230 in the last rate proceeding does not mean that it cannot be applied here. Since that proceeding, IAWC's equity ratio has diverged further from that of its parent company. The equity ratios of AWW and IAWC from 2006 through 2011 are presented in the table below.<sup>1</sup>

Equity Ratio	2006	2007	2008	2009	2010	2011
IAWC	44.27%	41.61%	45.22%	47.67%	48.33%	50.73%
AWW	48.19%	47.52%	43.59%	42.18%	41.97%	42.36%
difference	-3.92%	-5.91%	1.63%	5.49%	6.36%	8.37%

As can be seen in the table, while the equity ratio of the utility was less than that of the parent in 2006 and 2007, IAWC's equity ratio has exceeded AWW's equity ratio since 2008. On September 30, 2011, IAWC's common equity ratio was more than 8 percentage points higher than that of AWW.

Moreover, as Staff has explained, IAWC has an incentive to use a capital structure with an excessive amount of equity, which would then allow AWW a greater

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<sup>1</sup> Years 2006 – 2010: IAWC Exhibits 10.05 and 10.06, p. 2; 2011: as of September 30, 2011: Staff Ex. 6.0, p. 8.

return on its capital, while leaving ratepayers to shoulder the costs. Since a company with less business risk can carry a lower percentage of equity on its balance sheet than a company with greater business risk, Staff asked that the Company demonstrate that IAWC has higher risk than AWW to justify the higher common equity ratio for the utility. However, the Company failed to quantitatively demonstrate that IAWC has significantly more operating risk than AWW and therefore has not justified the need for the higher common equity ratio for ratemaking at IAWC and failed to meet its burden pursuant to Section 9-230 of the Act.

Consequently, the Commission should reject the PO's capital structure and adopt Staff's in accordance with Section 9-230. Staff therefore recommends the language starting on page 75 of the PO be amended as follows:

Recommended Language:

As discussed above, IAWC's forecasted average capital structure for the test year ending September 30, 2013 is comprised of 0.26% short-term debt, 49.23% long-term debt and 50.51% common equity. Staff proposes an imputed capital structure comprised of 1.30% short-term debt, 56.70% long-term debt and 42.00% common equity. The table below compares the two proposed capital structures in this proceeding.

	IAWC Proposed	Staff Proposed
Short-term debt	0.26%	1.30%
Long-term debt	49.23%	56.70%
Common equity	50.51%	42.00%

As described in more detail above, Staff believes that IAWC's proposed capital structure contains too much common equity and must be adjusted to comply with Section 9-230 of the Act. Conversely, IAWC's view is that Staff's proposed capital structure contains too much long-term debt and that using it would result in a violation of Section 9-230 of the Act.

The Commission notes that Staff's discussion of how capital structure affects the overall cost of capital is very informative. (Staff Ex. 6.0 at 3-4) Also of interest to the Commission is the parties' discussion of the potential incentives IAWC and/or its parent may or may not have to manipulate IAWC's capital structure as well as the discussion of Section 9-230 of the Act.

We agree with Staff that the fundamental flaw in IAWC's proposed capital structure is that its common equity ratio is more than 8 percentage points higher than that of its parent company, AWW. In fact, as of September 30, 2011, the equity ratio of AWW was 42.36%, while that of IAWC was 50.73%. We also agree with the fundamental principle that equity is a more expensive form of capital than debt. Consequently, the more equity in a utility's capital structure, the higher the rate of return must be to recover the cost of capital. IAWC's proposed capital structure is needlessly expensive due to an excessive amount of equity. (Staff IB at 31-32, RB at 14)

IAWC has a clear incentive to use a higher proportion of common equity than its parent, which would then allow AWW a greater return on its capital, while leaving ratepayers to shoulder the costs. Unless 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 IB at 32, RB at 17)

A company with less business risk can carry a lower percentage of equity on its balance sheet than a company with greater business risk. IAWC failed to quantitatively demonstrate that it has significantly more operating risk than AWW and therefore has not justified the need for the higher common equity ratio for ratemaking at IAWC and failed to meet its burden pursuant to Section 9-230 of the Act. (Staff RB at 17)

IAWC's position hinges on its argument that it is less diversified than AWW because of the former's smaller service territory. However, we agree with

Staff that IAWC focuses on only one source of operating risk. IAWC fails to consider other sources, such as construction risk. Second, even if one assumes that IAWC's operating risk is higher than AWW's, IAWC failed to quantify that alleged difference in operating risk, which is necessary for the Commission to assess whether that difference in operating risk justifies keeping IAWC's common equity ratio eight percentage points higher than that of AWW. On the other hand, Staff's proposed imputed capital structure both complies with the mandatory requirements of Section 9-230 of the Act and indicates adequate financial strength, according to Staff's pro-forma ratio analysis. (Staff IB at 32-33)

IAWC claims that its risk profile decreases as its common equity ratio increases, which will then result in lower debt financing for IAWC. However, since American Water Capital Corp ("AWCC") raises the debt financing for IAWC and AWCC's rating reflects the consolidated credit quality of AWW, IAWC is paying the debt costs that reflect the lower equity ratio of AWW. Consequently, we agree with Staff that IAWC does not get the benefit of lower debt costs as a result of its higher equity ratio. (Staff IB at 33)

The Commission, as Staff points out, cannot consider the reasonableness of a proposed capital structure until it makes a threshold determination that the capital structure in question satisfies the requirements of Section 9-230. Section 9-230 absolutely bars, as a matter of law, the adoption of a capital structure which, as a result of affiliation, results in increased risk or increased cost of capital. Section 9-230 is designed to preclude parent companies from realizing greater returns from ratepayers by proposing a capital structure with a greater percentage of common equity at the utility level. (Staff RB at 16-17)

Mindful of the mandatory directives in Section 9-230, we adopt Staff's proposed capital structure for IAWC that imputes the September 30, 2011 equity ratio of parent company American Water Works, 42.00% for IAWC's average 2013 common equity ratio. This includes a short-term debt ratio of 1.30% and a long-term debt ratio of 56.70%.

~~—The Commission also observes that although the issue of capital structure was contested in IAWC's last rate case, IAWC and Staff were in agreement on the issue in that proceeding. The table below shows the~~

~~IAWC/Staff proposed capital structure as well as the capital structure adopted for ratemaking purposes in Docket No. 09-0319.~~

	<del>Docket No. 09-0319</del>	
	<del>IAWC/Staff Proposed</del>	<del>Approved</del>
<del>Short-term debt</del>	<del>0.15%</del>	<del>2.83%</del>
<del>Long-term debt</del>	<del>51.22%</del>	<del>49.84%</del>
<del>Common equity</del>	<del>48.63%</del>	<del>47.33%</del>

~~The Commission is aware that neither IAWC nor the Staff has any obligation to begin with or compare its proposed capital structure to what it proposed or what was adopted in the previous rate case. The Commission nevertheless finds such information useful. The Commission finds it curious that there is such a significant disagreement in this proceeding over an issue on which the same parties were in agreement in the previous case. The Commission does not believe either party provided a compelling explanation why its proposal in this proceeding varies so far from what it proposed in Docket No. 09-0319. Similarly, the Commission believes that the record is devoid of any persuasive reason the capital structure approved in this proceeding should vary significantly from the one approved in Docket No. 09-0319.~~

~~The Commission concludes that for purposes of this proceeding, the proportion of short-term debt in the capital structure should be lower than was approved in Docket No. 09-0319 but higher than what IAWC projects for the test year. For purposes of establishing an authorized rate of return on rate base in this proceeding, the Commission finds the record supports a capital structure that includes 1.30% short-term debt. While the Commission does not necessarily agree with the specific method by which Staff derived this proportion, it does believe the result is reasonable.~~

~~———— To determine the proportion of long-term debt and common equity in the capital structure, the Commission concludes it should begin with the proportions found to be reasonable for ratemaking purposes in Docket No. 09-0319. The Commission finds it appropriate to increase the proportion of each by one half of the proportion by which the short-term debt proportion was decreased. The table below shows the capital structure which the Commission finds appropriate for purposes of establishing an authorized rate of return on rate base.~~

	Approved Proportion
Short-term debt	1.30%
Long-term debt	<del>50.60</del> <u>56.70</u> %
Common equity	<del>48.10</del> <u>42.00</u> %
Total	100.00%

Before leaving this issue, the Commission notes that Staff also offered an alternative capital structure, as described above. As IAWC points out, however, this proposal was not presented by any witness. Rather, it was advanced for the first time in briefing. The proposal is essentially the result of an expert analysis which did appear in the expert witness' testimony. As such, there has been no opportunity to conduct discovery or cross-examination, or to submit responsive evidence. The proposal will not be adopted.

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**Authorized Return on Rate Base**

As discussed previously in this Order, IAWC's cost of short-term debt and long-term debt are not contested. Reflecting these costs of debt, as well as the previous determinations regarding capital structure and cost of common equity, the Commission concludes that for purposes of this proceeding, IAWC should be

authorized to earn a 7.567.39% rate of return on original cost rate base as shown in the table below and reflected in the appendices to this Order.

	Approved Proportion	Cost	Weighted Cost
Short-term debt	1.30%	0.52%	0.01%
Long-term debt	<u>56.70</u> 50.60%	6.04%	<u>3.42</u> 3.06%
Common equity	<u>42.00</u> 48.10%	<u>9.42</u> 9.34%	<u>3.96</u> 4.49%
Total	100.00%		<u><b>7.39</b></u> 7.56%

**C. COST OF COMMON EQUITY**

**VIII. COST OF SERVICE STUDY**

**IX. RATE DESIGN**

**A. Customer Charges**

Staff takes exception to the PO’s conclusion adopting IAWC’s Customer Charge proposal for 5/8-inch meter customers in the consolidated Zone 1 and Chicago Metro district. It appears that the PO conclusion is based on an inaccurate interpretation of the following facts in the record.

First, the record shows that IAWC’s proposed customer charges for residential customers in the consolidated Zone 1 and Chicago Metro district will exceed residential customer costs by \$3.3 million. (IAWC Ex. 11.0R, p. 4) The PO also indicates that customer related costs for 5/8-inch metered customers are slightly more than \$55 million. (PO, p. 124) This is incorrect. The \$55 million customer costs are the costs for

*all* customers (that is, all meter sizes combined) in the consolidated Zone 1 and Chicago Metro district, not exclusively the 5/8-inch meter customers. Second, the PO's reference to IAWC Ex. 11.01SR as the total customer related costs for 5/8" customers is also incorrect. IAWC Ex. 11.01SR is the average cost per month for all customers, which includes all meter sizes combined. The PO's reference to AG Ex. 3.02 identifies the inconsistencies that Staff is referencing. AG Exhibit 3.02 identifies total customer costs (all meter sizes combined) of \$55,385,658, and yet IAWC's proposed Customer Charge revenues for 5/8-inch meters are greater than \$55,385,658. Moreover, Staff referenced a Company response to Staff Data Request CB 1.11 in its direct testimony (Staff Ex. 4.0, p. 25) where the Company indicated that its proposed Customer Charges for all meter sizes combined would produce revenues that would exceed total customer costs by 18.7%. The Company's revised Cost of Service comparison, IAWC Ex. 11.03R, indicates that its proposed Customer Charges for residential customers would over-recover the cost of service by approximately \$2.1 million.

There is little doubt that the Company's rate design will create a cross-subsidization between 5/8-inch meter customers and customers whose meters exceed 5/8-inches when there is a \$2.1 million over-recovery from the residential class. The PO's approval of the Company's Customer Charge proposal requires the residential class to provide significant subsidies for other classes *and* produces overall revenues that exceed customer costs by \$3.3 million. Thus, contrary to the PO's statement, Staff has not mixed the cost of service study and rate design steps but rather used rate design to correct the Company's proposed over-recovery of total customer costs.

Staff also takes exception to the PO's conclusion to adopt IAWC's meter equivalent methodology proposal to determine the Customer Charges for all meters larger than 5/8-inches. The Commission has set a recent precedent for approving the American Water Works Association ("AWWA") meter ratio methodology for determining Customer Charges for meter sizes larger than 5/8-inches. The Commission has deemed this methodology acceptable in Docket Nos. 11-0141, 11-0142, 11-0561, et al. (Cons.) and the Aqua, Illinois rate case, Docket No. 11-0436. Staff's recommendation is consistent with the methodology approved in the other more recent water rate cases and believes this methodology more accurately captures the meter ratio equivalency from customers whose meter sizes exceed 5/8-inches. Staff also notes that the Company's proposed methodology produces revenues that over-recover the Company's documented cost of service where Staff's AWWA meter ratio methodology proposal does not.

Finally, Staff takes exception to the PO's conclusion to approve three different Customer Charges that the Company proposed for residential customers in the newly approved Zone 1-Chicago Metro Water consolidation. In IAWC's prior rate cases, there is considerable precedent that the utility should move toward Single Tariff Pricing ("STP"), which "is the use of a unified rate structure for multiple water (or other) utility systems that are owned and operated by a single utility, but that may or may not be contiguous or physically interconnected." (Order, Docket No. 07-0507, 7/30/2008, p. 94) In Docket No. 07-0507, there was a general consensus among Staff, IAWC, the AG and the Commission that continual movement toward STP and development of a common rate structure for all IAWC districts would be appropriate (*Id.*, pp. 94-97) In that docket,

Staff also noted that in Docket Nos. 00-0340 and 02-0690, the Commission spoke of STP and extending its use in IAWC's service area. (*Id.*, p. 95) Finally, in Docket No. 09-0319, the Commission approved a further step toward achieving STP by adopting Staff's proposed rates that lowered the overall disparities in the Customer Charges of ratepayers in all of its water districts. (Order, Docket No. 09-0319, 4/13/10, p. 171) This rate case provides an opportunity for further movement toward STP by approving identical Customer Charges for all 5/8-inch customers (\$14.75) in the Zone 1-Chicago Metro consolidated water district. Zone 1 5/8-inch customers would experience a \$0.25 increase from its current Customer Charge, Chicago Metro 5/8-inch ratepayers would also experience a small increase of \$1.25 from its current Customer Charge and South Beloit would experience the largest increase of all 5/8-inch ratepayers in the Zone 1-Chicago Metro Water consolidation proposal, of \$4.25. The \$4.25 increase is only \$0.25 higher than the increase that the Company proposes for the South Beloit 5/8-inch customers. Staff maintains that the costs that IAWC incurs to serve its customers for use of the water system, metering, meter reading, customer accounting, billing, customer service and administrative and general expenses are similar regardless of the physical location of customers. (Staff Ex. 12.0, pp. 19-20) These facts warrant the proposal for a single set of Customer Charges for each meter size in the Zone 1-Chicago Metro Water consolidated division.

Staff's uniform Customer Charge proposal will recover 99.9% of all customers' costs, applies the concept of gradualism, conforms to the AWWA ratio recommendations for meter sizes greater than 5/8-inch, and is consistent with the precedent the Commission has set in IAWC's prior rate cases that moves toward STP.

The Commission should adopt Staff's proposal for Customer Charges for the Zone 1-Chicago Metro water consolidation. Staff therefore recommends the language of the PO beginning on page 123, in the Commission Conclusion section, be amended as follows:

Recommended Language:

IAWC argues that because approximately 92% of residential customers have 5/8-inch meters, it is important that each customer pay the appropriate customer costs to avoid intra-class subsidies. IAWC objects to Staff and the AG's proposed customer charges because, IAWC claims, they would cause customer costs for 5/8-inch customers to be recovered through the volumetric charges. IAWC says such proposals would cause customers that consume more to pay more customer-related costs than smaller users, which it believes is inappropriate and unfair.

Both Staff and the AG take issue with IAWC's proposed customer charges, complaining that the customer charge revenue exceeds customer-related costs. Both propose customer charges that are intended to produce revenue that is closer to customer-related costs.

The Commission has reviewed the extensive testimony and briefs regarding the development of customer charges. Turning first to the calculation of customer-related costs, the Commission finds that Staff's rate design adequately balances bill impacts to customers, conformity to the AWWA meter ratio approach, further approaches STP and recovers all customer costs through the proposed customer charges. ~~IAWC Ex. 11.01SR represents a reasonable estimate of these costs, particularly for 5/8-inch meters as shown on page 2 of that exhibit. IAWC's COSS, as well as IAWC Ex. 11.01SR and AG Ex. 3.02, indicates that the total customer-related costs for 5/8-inch metered customers are slightly more than \$55 million.~~

~~It appears that neither Staff nor the AG has estimated customer-related costs as accurately as IAWC did, or proposed modifications that should be made to IAWC's estimated cost of service. IAWC's position that the cost of the larger meters is greater than the cost of service lines or billing services for large meters is more logical than the AG's suggestion that all three components increase at the same rate that the cost of the meter increases.~~

~~It appears that both Staff and the AG have, to some extent, mixed the cost of service study and rate design steps and concepts in an effort to correct the Company's proposed over-recovery of total customer costs. The Commission believes that this rate design method in a manner which the Commission believes should not be utilized for setting the charge for 5/8-inch meters in this proceeding, as discussed below. The record supports a finding that the best estimate of customer-related costs for 5/8-inch metered customers is \$17.25 per month.~~

The table below shows the current as well as proposed monthly customer charges for 5/8-inch meters for the various customers in the consolidated Zone 1 Chicago Metro district.

	<u>Current</u>	<u>IAWC</u>	<u>Staff</u>	<u>AG</u>
Zone 1	14.50	18.00	14.75	15.20
Chicago Metro	13.50	17.00	14.75	15.20
South Beloit	10.50	14.50	14.75	12.85

~~Having found that IAWC's estimate of the customer related costs for 5/8-inch metered customers, \$17.25, is the most accurate, the Commission is concerned convinced that the Staff and AG proposals would produce a customer charge that for most residential customers does not would recover the cost of service for all ratepayers in the consolidated Zone 1-Chicago Metro Water district. It appears to the Commission that IAWC's proposed customer charges for 5/8-inch meters would produce total revenue of approximately \$53 million; the AG's proposed charges would produce approximately \$46 million; and Staff's would produce even less. Given that the customer-related costs for 5/8-inch metered customers are slightly more than \$55 million, IAWC's proposal is the most reflective of cost.~~

It appears to the Commission that the primary factor driving the Staff and AG recommendations of lower proposed customer charges for 5/8-inch meters is the fact that total revenues produced by customer charges – i.e. when considering all customer classes in total -- exceed customer-related costs. ~~However, it appears this excess of revenues over costs is attributable to meters larger than 5/8-inch, not to the 5/8-inch meters.~~ As previously discussed, the Commission believes this led Staff and the AG to ~~mix cost of service determinations with~~ to develop a rate design in a manner that should not be utilized to set the charges for 5/8-inch all meters sizes in this proceeding. That is, the amounts by which customer charge revenues from all customers ~~exceed~~ equal all customer-related costs, although some being attributable to larger meters, would

essentially be used by ~~AG~~ and Staff to reduce customer charges for 5/8-inch meters. ~~even though IAWC's proposed charges for those meters are not being set above costs.~~

As stated above, Staff also advocates a uniform customer charge for 5/8-inch metered customers throughout the consolidated Zone 1 - Chicago Metro district. The Commission notes that the uniform charge offered by Staff is tied to Staff's overall proposed ~~al~~ for setting customer charges for 5/8-inch meters, which is ~~not~~ adopted as indicated above. The Commission also notes that there are three existing customer charges for Zone 1, Chicago Metro, and South Beloit. In the Commission's view, Staff's argument for a uniform charge is ~~not~~ persuasive. All things considered, the Commission concludes that ~~IAWC~~ Staff's proposed customer charges for 5/8-inch meters in the consolidated Zone 1 and Chicago Metro district are reasonable and are adopted for purposes of this proceeding.

With regard to meters larger than 5/8-inches, rather than disagreements about cost of service, it appears this is primarily a disagreement over rate design. Staff recommends the AWWA meter-factor approach. While IAWC does not dispute that the meter-factor approach is a reasonable one, it proposes increasing existing customer charges by a uniform percentage based upon the relationship among meter sizes. It again appears to the Commission that the proposed rate design of both Staff and the AG may have been focusing on the objective of aligning total customer charge revenue for all classes to total customer related costs.

IAWC is not overly concerned that its proposed customer charges, primarily for nonresidential customers, would produce revenue that exceeds the customer-related costs. IAWC says this would cause usage charges to be reduced slightly. IAWC claims that since such a high proportion of its costs are fixed rather than variable, this result is reasonable.

The Commission is not convinced that IAWC has accurately estimated its proportion of fixed and variable costs. As the AG suggests, it appears that in estimating variable costs, IAWC has emphasized those costs that are variable in the short-run and ignore some costs which may be variable in the long-run. The Commission is persuaded, however, that ~~IAWC has fixed costs other than those costs associated with customer-related activities and investments. As a result, it is not clear to the Commission that there is validity to Staff's argument that IAWC's proposed customer charges will recover \$3.3 million of variable costs through fixed charges. IAWC says as much on page 4 of its rebuttal Exhibit 11.00R.~~

The Commission believes that rates should be based, to the extent possible given other rate design objectives, on the cost of service. ~~Given the Commission's belief that IAWC has fixed costs other than customer-related costs,~~ The Commission is not overly concerned if the customer charges for meters larger than 5/8-inches exceed the customer-related costs. The record supports a finding that ~~IAWC~~Staff's proposed customer charge for these larger meters is reasonable. The Commission adopts ~~IAWC~~Staff's proposal to increase these customer charges by ~~a uniform percentage~~the AWWA meter factor approach based on the relationship among meter sizes. Given Staff's customer charge proposal for all meter sizes are uniform, collect all customer related costs and conform to AWWA meter ratio guidelines, the starting point -- that the ~~customer charge for 5/8-inch meters is cost-based~~ -- the Commission finds this proposal to be reasonable.

It appears to the Commission that no party takes issue with the customer charges proposed by IAWC for the other districts. The Commission concludes that the record supports a finding that ~~IAWC~~Staff's proposed customer charges for the remaining districts are reasonable and the Commission adopts them for purposes of this proceeding.

## **B. Usage Charges**

Staff takes exception to the PO's approval of IAWC's Usage Charge proposal. IAWC has confirmed that its proposed residential Customer Charges will over-recover its total residential customer costs by \$3.3 million. This \$3.3 million over-recovery results in lower Usage Charges proposed by IAWC. Staff and IAWC agree that the Usage Charges should be set to recover the non-production related costs for the Zone 1, Chicago Metro Water, Pekin and Lincoln districts. (Staff Ex. 12.0, p. 10) Staff contends the lower Usage Charges approved by the PO will not send proper price signals to the consumers of water in the Zone 1-Chicago Metro Water consolidated district. Rather, Staff's rate design sends proper price signals to the largest users of water, recovers the non-production costs, promotes water conservation and will allow customers to control the increases in their water bills by conserving water usage.

It is incorrect to dismiss Staff's proposed rate design based on IAWC's assertion that it would result in rate shock for users in the third and fourth non-residential usage blocks. The rate shock argument is misleading because the increases cited are based upon IAWC's proposed revenue requirement which is significantly higher than Staff's proposed revenue requirement. Staff maintains that IAWC is proposing a revenue requirement percentage increase that is more than 100% higher than the revenue requirement percentage increase proposed by Staff (i.e., IAWC proposes a total revenue increase of 16.21% in its surrebuttal testimony vs. 7.77% as proposed by Staff in its rebuttal testimony). Staff maintains that if the Commission adopts a revenue requirement closer to Staff's proposal and Staff's proposed rate design, the resulting rate increase for the third and fourth usage blocks would be far less than that projected by IAWC. (Staff IB, p. 64, Staff RB, p. 27)

The Commission should adopt Staff's proposal for Usage Charges for the Zone 1-Chicago Metro water consolidation. Staff therefore recommends the language of the PO beginning on page 128, in the Commission Conclusion section, be amended as follows:

Recommended Language:

IAWC and Staff are in disagreement regarding the third and fourth block usage blocks for nonresidential customers. Under Staff's rate design proposal, Other Water Utility revenue would increase by 44.72% and Industrial revenue by 40.44%. Staff believes these increases are necessary to properly recover the non-production costs. Staff asserts that IAWC has improperly understated non-production costs to be recovered through the Usage Charge by \$3.3 million. Staff contends that while IAWC's rate design proposal results in what appears to be a lower increase for Other Water Utility revenue (18.4%) and Industrial revenue (23.5%) than what Staff proposes, those lower increases are illusory because they reflect recovery of an artificially lower amount of non-production costs recovered through the usage charge.

IAWC says Staff's proposed increases are more than twice the average overall increase of 18.42%. IAWC believes Staff proposed increases are contrary to the rate principle of gradualism and should not be approved. IWC/FEA also opposes Staff's proposed usage charges.

IAWC indicates that it proposes increases to the commodity charges for Non-Residential Metered General Water Service and the University of Illinois. IAWC says it varied the increases in the commodity charges by rate block to generally move each customer class to its allocated cost of service.

Rather than varied increases, IWC/FEA proposes adjusting the rate elements by a uniform percentage to coincide with the increased revenues granted by the Commission in this case. IAWC argues that a uniform percentage adjustment would not move revenues more in line with the allocated cost of service. IAWC claims that IWC/FEA's recommendation is based upon its concerns with IAWC's COSS, which IAWC believes are unfounded.

It appears to the Commission that between the IAWC proposal and the IWC/FEA proposal, IAWC's is more consistent with the principle that rates should reflect cost of service. The Commission is concerned that IWC/FEA's proposal is similar to an "across-the-board" rate increase that is sometimes used when there are serious problems with a cost of service study or to mitigate disproportionately or abnormally high rate impacts. In this proceeding, the Commission does not believe such an approach is warranted and IWC/FEA's approach for developing usage charges is rejected.

While it is not entirely clear, it appears that the primary, and perhaps only, reason for the disagreement between IAWC and Staff regarding usage charges results from their disagreement regarding customer charges. It appears that both recommend the Commission approve usage-block charges that allow IAWC to recover nonproduction costs and the remainder of the revenue requirement not recovered from the customer charge. In part because ~~IAWC~~Staff's proposed usage charges produce the desired revenues, while ~~Staff~~IAWC's do not, the Commission adopts ~~IAWC~~Staff's proposed method for developing proposed usage charges in this proceeding.

It appears that no party takes issues with the usage charges proposed by IAWC for the other districts and the Commission adopts them for purposes of this proceeding.

It also appears that IAWC's proposed rates for the Chicago Metro Sewer district are not contested. IAWC's proposed one-block rate structure for residential customers is reasonable and is hereby approved. Additionally, the Commission finds IAWC's proposed two-block rate structure for nonresidential customers to be reasonable and it is hereby approved.

### **C. Fire Protection Charges**

Staff takes exception to the PO's approval of Public Fire Protection Charges for the Chicago Metro district and its characterization of the alternative that Staff provides for the Commission. Section 9-223(a) of the Act requires that "[a]ny fire protection charge imposed shall reflect the costs associated with providing fire protection service for each municipality or fire protection district."

Staff contends that Public Fire Protection Charges for the Zone 1-Chicago Metro consolidated division should be set at full cost of service to be compliant with Section 9-223(a) of the Act. The PO's conclusion to approve Public Fire Charges for the consolidated Zone 1 and Chicago Metro district would allow IAWC to recover 101.5% of the cost of service. This approval does not comply with Section 9-223(a) of the Act and as such, Staff recommends that the monthly charge be modified so that Public Fire Charges can be recovered at the full cost of service amount. While 1.5% is a relatively small percentage, it is unclear why the Commission would allow recovery of more than the cost of service when it was not shown to be necessary both as a matter of policy and when such a result can be easily avoided. Thus, Staff is not arguing that this charge be set exactly at 100% of cost; rather, Staff is questioning why the Commission has set a charge to recover more than the cost of the service when there is no justification for doing so.

For the Lincoln division, the PO approves a 53.8% increase in the Public Fire Protection Rates. Staff notes that a sudden 53.8% increase in Public Fire Charges is inconsistent with the principle of gradualism although it would comply fully with Section 9-223(a) of the Act. Staff is well aware, and pointed out in testimony, (Staff Ex. 12.0, pp. 13-14) that an increase less than 53.8% would not fully comply with Section 9-223(a). Nonetheless, because it is sensitive to the heightened concern expressed by the Commission on high bill impacts particularly in more recent water rate case orders, (Staff IB at 66, citing Docket Nos. 11-0059/11-0141/11-0142 (Cons.)) its recommendation simply provides an alternative option for the Commission to consider should it be interested in mitigating the bill impacts to Lincoln customers. Staff's alternative Public Fire Protection Charges would cut the cost of service revenue recovery deficit for Public Fire Charges in half at the conclusion of this rate case and would pave the way for full cost recovery considerations in IAWC's next rate case. (Staff IB, p. 66) If the Commission wishes to mitigate bill impacts to Lincoln customers, then Staff recommends the language of the PO beginning on page 132, in the Commission Conclusion section, be amended as follows:

Recommended Language:

IAWC proposes that the Lincoln Public Fire Protection Charge be set to recover the cost of service, which would increase the charge by approximately \$2.35 per month or 53.8%. Staff proposes a more gradual increase in charges for Lincoln, suggesting a limit of 27% in this proceeding. The Commission believes that ~~IAWC~~Staff's proposal for the Lincoln Public Fire Protection Charge is reasonable and it is hereby adopted. The Commission concludes that while gradualism should receive adequate consideration when the proposed percentage increase is somewhat large, although in dollar terms the increase is reasonable. ~~In addition, IAWC~~Staff's proposal will ensure not be in full compliance with Section 9-223(a) of the Act ~~in a timely manner~~. Section 9-223(a) requires that "[a]ny fire protection charge imposed shall reflect the costs associated with

providing fire protection service for each municipality or fire protection district." The Commission concludes that Staff's Public Fire Protection Charge proposal for the Lincoln district adequately balances gradualism and the need to be compliant with Section 9-223(a) of the Act. Staff's proposal maps out a clear and acceptable plan that full compliance with Section 9-223(a) of the Act should be achieved at the conclusion of the Company's next rate case and will mitigate the large percentage increase that IAWC proposes for Lincoln Public Fire Protection customers in this proceeding.

With regard to the other Public Fire Protection Charges, whether IAWC and Staff are in agreement is unclear. For example, Staff suggests that in the event the consolidation of Zone 1 and Chicago Metro is not approved, it agrees with IAWC's proposed charges. (Staff IB at 59) IAWC, however, indicates that in the event consolidation of Zone 1 and Chicago Metro is not approved, it does not agree with Staff's proposed Public Fire Protection Charges. (IAWC Ex. 11.00R at 10) Whether IAWC and Staff agree about Public Fire Protection Charges in the event consolidation is approved is also unclear to the Commission.

In any event, the Commission is approving the consolidation of Zone 1 and Chicago Metro district, as addressed below. The question before the Commission is whether to require IAWC to set Public Fire Protection Charges at a level that recovers 100.00% of the cost of service for the consolidated Zone 1 and Chicago Metro district as suggested by Staff, at least initially, or set those charges such that it recovers 101.05% of the cost of service as proposed by IAWC.

The proposals of IAWC and Staff are very close in terms of cost of service recovery. ~~If Staff is arguing that these charges must be set at exactly 100% of cost of service, its position is not reconciled with its proposed Public Fire Protection Charges for Lincoln.~~ The Commission finds ~~IAWC~~Staff's proposal for the consolidated Public Fire Protection Charges to be lawful and reasonable, and it is hereby approved.

There is no dispute regarding Public Fire Protection Charges in the remaining districts; the Commission concludes that IAWC's proposed Public Fire Protection Charges for those districts are reasonable and they are hereby approved.

**X. CONSOLIDATION OF ZONE 1 AND CHICAGO METRO**

**XI. PROPOSED REVENUE ADJUSTMENT CLAUSE**

**XII. AFFILIATED INTEREST ISSUES**

**A. Staff Position**

**1. Overview**

Staff does not take exception to the Joint Facilities Adjustment ordered in the PO. (PO, at 175-76) Nor does Staff take exception to the PO's conclusion not to order a Phone Charge Adjustment in this case. (PO, at 176) Staff does, however, take exception to the PO conclusion that opening a new investigation into violations of the Act would be inefficient or unwarranted at this time. (PO, at 177) Section 7-101(3) of the Public Utilities Act ("Act") gives the Commission the authority to investigate whether Affiliated Interest Agreements ("AIA"s) are in the public interest before they are approved. (220 ILCS 5/7-101(3)) The Commission should order an investigation in this case because Staff has already offered sufficient evidence to demonstrate that IAWC is in violation of the provisions of its Commission-approved AIA with AWWSC. In addition, Staff has offered evidence that, upon further Commission investigation, may lead to a showing that additional violations of the AIA exist. Certainly, if IAWC and AWWSC are not operating in accordance with their Commission approved AIA, an investigation into (1) whether this agreement is still in the public interest and (2) whether IAWC and its affiliates have violated the Act, is warranted.

The PO declines to approve the investigation for three reasons. First, there is already an investigation into the management charges for AWWSC. Second, it is

inefficient to open multiple investigations. Third, the Staff did not file motions to compel information from IAWC. (PO, at 177)

## **2. Scope of Audit Proceeding – Docket No. 10-0366**

The scope of the investigation sought by Staff, including interactions between AWWSC and AWR, is separate and distinct from the management audit referenced by the PO, which was ordered by the Commission in Docket No. 09-0319 and is currently pending in Docket No. 10-0366.

The Commission's interest and concern regarding charges from AWWSC to IAWC first began in IAWC's 2007 rate case. In the Final Order in Docket No. 07-0507, the Commission questions IAWC's actions and oversight of AWWSC.

The Commission points out that *it does question whether IAWC is doing everything possible to be efficient in controlling its management fees to avoid passing unnecessary costs to ratepayers.* Although the Commission holds that the expense requested is not unreasonable, it does so only in the absence of specific and adequately justified adjustments. The Commission acknowledges that it is possible that CSC expense has increased due to complaints and unhappy customers. If IAWC plans to continue to utilize the Service Company because doing so arguably benefits ratepayers by reducing IAWC's labor and other related costs, then at some point the lower costs must be more evident.  
(Order, Docket No. 07-0507, July 30, 2008, pp. 30-31, emphasis added)

The Commission's concern regarding lack of IAWC oversight is identical to Staff's own concerns in this case. (Staff IB, pp. 96-97) In IAWCs' 2007 rate case, the Commission ordered an investigation into the services provided to IAWC by AWWSC, stating that:

Based on the evidence, the Commission adopts the management expense as recommended by IAWC. The Commission, however, has a continuing obligation to ensure just and reasonable rates. *Because the Commission questions whether IAWC is doing everything possible to ensure low costs for ratepayers,* the Commission directs IAWC to conduct a study comparing the

cost of each service obtained from the Service Company to the costs of such services had they been obtained through competitive bidding on the open market.

(Order, Docket No. 07-0507, July 30, 2008, pp. 30-31, emphasis added)

The investigation ordered by the Commission in the 2007 rate case was two-fold. It was (1) to compare the market value of the services performed by AWWSC with the expenses AWWSC charged to affiliates for those services; and (2) to include an analysis of services and allocations.

As part of the study, IAWC must also provide an analysis of the services provided by the Service Company to all of IAWC's affiliates. *The analysis must provide details on the specific services provided to IAWC and how costs are allocated among affiliates of IAWC.* IAWC shall include the study in its next rate filing.

(Order, Docket No. 07-0507, July 30, 2008, pp. 30-31, emphasis added)

IAWC filed its study and analysis in Docket No. 09-0319 and, after reviewing that filing, the Commission ordered an adjustment that reduced proposed increases in Services Company costs to 5% above the amount from the previous rate case.

Based on its review of the record, the Commission believes that *IAWC has not justified the increase it requests for the Service Company fees.....*

*IAWC did not provide the information as specified above in this rate filing.*

With no basis for comparison of the lower of cost or market for these services, the Commission cannot adequately determine whether the increases in management fees proposed in this case by IAWC are just and reasonable. Thus, the Commission agrees with the AG's position on this issue and concludes that the Service Company Fees should be capped at 5% over the amount approved in the 07-0507 Order.

(Order, Docket No. 09-0319, April 13, 2010, p. 47)

The Order in Docket No. 09-0319 also required IAWC to cooperate with an independent management audit. That audit is now the subject of Docket No. 10-0366; it is limited in scope and does not consider the type of evidence presented in this docket regarding interactions between AWWSC and AWR. "The scope of the Audit shall be to compare the cost of each service currently obtained from the Service Company to the

cost of such services if the services were obtained through competitive bidding on the open market.” (Order Initiating Management Audit, p. 2) IAWC was not required to perform any further analysis of allocations from AWWSC to IAWC.

While IAWC was to provide “affiliate agreements” to the auditor during the RFP process for selecting an auditor<sup>2</sup> (Order Initiating Management Audit, p. 3), IAWC did *not* provide either agreement between AWWSC and AWR to Staff or the audit teams. (Staff Ex. 15.0, Attachment O) Since the auditor did not require this affiliate information to determine if the services provided could have been provided by a third party at a lower cost to IAWC, the scope of the audit case does not overlap with the investigation recommended by Staff in this proceeding. The audit did not consider allocation information regarding services to AWR, and, thus, that information will not be presented to the Commission. What Staff has uncovered and presented in this docket is additional evidence for an investigation of a similar but distinct matter. The Commission cannot, in Docket No. 10-0366, remedy the violations of the AIA presented in this docket, because these violations are not a part of that record.

### **3. Violation of Commission Approved AIA**

It is Staff’s position that AWWSC violated its agreement with IAWC, which was found to be in the public interest and approved by the Commission in Docket No. 88-0303. The Commission should order an investigation into the cost allocations between

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<sup>2</sup> “IAWC shall: i. During the RFP process, compile and have ready for the Auditor, the following items regarding the Service Company for calendar years 2009 and 2010. To the extent possible, the following should be available both in hard copy and electronically. The following is not intended to be a limitation on information that the Auditor may request during the Audit: 1. affiliate agreements,” (Order Initiating Management Audit, p. 3)

AWWSC and all affiliates to determine if AWWSC violated the Act when it violated its AIA and whether the AIA is still in the public interest as a result. The AIA approved by the Commission in Docket No. 88-0303 requires that no costs from unregulated affiliates (other than AWWSC - i.e. AWR) may be charged to IAWC. (Staff Ex. 7.0, Attachment A, Article 5.2, p. 12)

There are several instances in the current proceeding where it is clear that AWWSC did violate the provisions of its Commission-approved agreement with IAWC and in fact, as the following examples illustrate, the PO discusses instances where IAWC has not been following its AIA requirements to prevent all costs from unregulated affiliates from being charged to IAWC.

#### **4. Joint Facilities Expansion Adjustment**

Staff had proposed to make an adjustment to depreciation expenses because AWWSC did not charge AWR *anything* for its portion of the 2007 expansion at the joint facility in Alton, Illinois. Failure to allocate these costs to AWR resulted in the costs being allocated amongst all the regulated utilities.

The PO states that “The Commission finds that one-third of the \$10,268 in depreciation expense related to the facility should be removed from IAWC’s test-year operating expenses to reflect the portion of the expansion costs properly attributable to AWR.” (PO, at 176) The phrase “properly attributable” is apt, because it indicates that AWWSC improperly charged IAWC for the depreciation expense and therefore, violated the Commission-approved AIA. This violation of the AIA is one factor to warrant an investigation.

## **5. Phone Charges Adjustment and Other Phone Issues**

The CCAP/SLAP adjustment proposed by Staff reflected the cost the service center charged to IAWC due to the service company under-charging AWR for the costs of services that AWR was provided. This adjustment was founded on facts in the record, reasonable inferences and conclusions. (Staff IB, pp. 88-90) The sources of all of these facts were IAWC, AWWSC or AWW. As a result, in its Initial Brief, Staff performed simple calculations with reasonable assumptions for its proposed adjustment. Whether or not the Commission orders an adjustment, the arguments set forth in Staff's Initial Brief should present sufficient facts and inferences from those facts to support an order initiating an investigation to address the issue of costs for services to unregulated affiliates being transferred to IAWC and its ratepayers.

Staff disagrees with the PO's conclusion that the "adjustment is not supported by the evidentiary record, and it is not adopted." (PO, at 176) The record does, in fact, support the conclusion underlying Staff's recommended adjustment-- that AWWSC did not charge AWR properly for these costs. The method utilized by the service company undercharged AWR, thereby shifting costs to IAWC. While the PO concluded that the record does not support the amount that Staff proposed for the test year, this historic misallocation appears to be a violation of the AIA by AWWSC and is another factor to warrant an investigation.



AWWSC clearly incurs costs for each script read. Because AWWSC charges for each transfer, cost causation implies that costs are only incurred when a transfer is made. However, IAWC has asserted that the time for a transfer is a split second. Thus, the incremental costs of a transfer are nil. Rather, it is when the script is read that call center costs increase both because of the additional time for phone charges and the labor (with overhead). Staff contends that the method for cost recovery is divorced from the method of incurrence. IAWC has freely admitted that they do not track the number of statements for the entire period. (IAWC response to Staff DR DAS 7.06b – Staff Ex. 15.0, Attachment H, p. 2) In fact they have only tracked the number of transfers since 2008. (IAWC response to Staff DR DAS 7.06c – Staff Ex. 15.0, Attachment H, p. 2)

It is worth noting that AWWSC does not track information required to determine if allocations are adequate to cover costs. AWWSC did not track the number of scripts read. (Staff Ex. 15.0, Attachment H, p. 2) It cannot know if the SLAP charges it levied to AWR were sufficient to cover its costs. Nor does it track duration of calls for each utility or AWR. (Staff Ex. 15.0, Attachment J, p. 2) So AWWSC *cannot* know if IAWC is subsidizing other utilities or AWR. AWWSC *does not even attempt* to allocate its phone charges in a manner consistent with its Commission-approved AIA. In view of these known violations *and* IAWC's disregard of its obligations under the AIA, it is imperative that the Commission investigate and determine if additional violations of the AIA itself have occurred and whether the affiliate agreement is still in the public interest.

IAWC argues in its Reply Brief that Staff's Initial Brief calculations of the Phone Charges adjustment are inflated because AWR should only pay incremental costs. (IAWC RB, p. 92)

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 \$2.49 transfer charge.

However, Staff uses the same costs (down to the penny) that AWWSC used in determining its SLAP charge. AWWSC charges AWR a portion of total call center costs to determine the 2011 SLAP charge. (IAWC response to Staff DR DAS-6.09 – Confidential Attachment 3 – Staff Cross Ex. 3.1, p 1) If AWR was not supposed to pay for non-incremental costs, then AWWSC would have only used incremental costs in its allocation. While Staff has argued that the portion of the costs is too small, AWWSC appears to agree that all call center costs should be included in the allocation. This is logical, because, for the time that those CSRs are in the phone, they are using phones, facilities and training paid for by AWWSC, not AWR.

Charges to AWR under the CCAP/SLAP were based on total costs incurred including overhead. (Staff Ex. 7.0, Attachment B, p. 2-4) While AWWSC divided the correct total costs it failed to allocate to AWR its correct *portion* of the total costs. Under the AWR-AWWSC AIA, charges to AWR should be based on Fully Distributed Costs ("FDC") (*Id.*), not incremental costs. Charges to IAWC are based on FDC (Staff Ex. 7.0, Attachment A, pp. 9-10); charges were to be the same for AWR and regulated affiliates. (*Id.*, p. 12)



The AWW utilities that have SLAP and AWR billing on utility bills should have more costs allocated to them because their policy choices to allow these programs results in more calls, longer calls and hence, higher costs. Once again, AWWSC's failure to track average duration of calls precludes a determination whether IAWC is subsidizing its affiliates in this matter. The cost allocator that has been used by AWWSC is yet another factor that warrants an investigation.

## **6. Non-Cost Issues, Referrals and Other Issues**

The PO also refers to an alleged lack of cooperation by IAWC as Staff's repeated reason to order an investigation. (PO at 177) "In considering this request, the Commission notes that one of the reasons offered repeatedly by Staff in support of initiating an investigation is that Staff was unable to properly assess some of the issues because IAWC refused to provide information requested by Staff." (*Id.*) This is not an accurate characterization of the basis for Staff's recommendation. Rather, Staff's primary reasons for recommending an investigation are what it views as multiple violations of the AIA as listed above. Specifically, the Staff recommended the Commission:

[O]pen a proceeding to investigate whether IAWC violated Section 7-101 of the Act by providing services to AWR, via AWWSC, without authorization from the Commission. Furthermore, Staff recommends that the Commission consider whether imposing penalties on IAWC would be appropriate if it is found to be in violation of Section 7-101 of the Act. Additionally, given IAWC's failure to provide information regarding this matter in this case, which has deprived the Commission of a complete record, Staff recommends that that the Commission direct the investigation to include whether the IAWC-AWWSC AIA is still in the public interest. Last, Staff recommends that the Commission order IAWC to demonstrate that AWR does not enjoy access to ratepayer information. (Staff IB, p. 101)

Staff acknowledges that given more time it might have pressed for a motion to compel given IAWC's refusal to provide relevant information; but discovery disputes aside, the central basis for Staff's recommended investigation was the evidence of violations to the AIA. The PO notes that AWWSC failed to charge AWR at all for its portion of the 2007 expansion. While this adjustment is small, AWWSC improperly failed to charge AWR its 1/3 of \$2.8 million. (Staff IB, pp. 93-94) The Commission cannot ignore such disregard for its approved agreements.

Staff takes exception to the PO's conclusion regarding transfers and referrals. The PO acknowledges the importance of correcting ratepayer misperceptions. (PO, at 177) However, it falls short in correcting the problem. The PO would allow transfers to occur, which may not ultimately be in the best interest of the customer. Therefore, Staff still believes that any referrals provide a service to AWR that the Commission prohibited in Docket No. 02-0517. In the alternative, the PO's direction for a disclaimer about AWR (*Id.*) should be extended to include any affiliate marketing any product other than IAWC services.

The PO's conclusion ignores the Issue of the Emergency Service Orders. Staff Witness Sackett presented evidence in his direct and rebuttal testimonies concerning this issue. Staff's arguments from its IB on this issue (Staff IB, pp. 98-99) were presented in the PO. (PO at 170)

Last, Staff recommended in its Initial Brief that the Commission "prohibit AWWSC and IAWC from making determinations for *any* affiliate regarding leak repair

responsibility.” (Staff IB, p. 106) This recommendation is not addressed by any of the PO’s conclusions.

The restriction on referrals does not preclude any ESO support (determination of repair responsibility), and thus the Commission still must address it, rule on the evidence and determine whether the Commission will continue to allow ESO support by IAWC and AWWSC. While IAWC is adamant that no support occurs, a directive by the Commission that denies IAWC and AWWSC the ability to provide ESO support would clarify the situation.

In accordance with the statements set forth above, Staff recommends the language of the PO beginning on page 163, be amended as follows:

Recommended Language:

IAWC’s current agreement with its affiliated service company, AWWSC, was approved in Docket No. 04-0595. The preceding agreement with AWWSC was approved in Docket 88-0303. These agreements outlined services that AWWSC could provide to IAWC, established the method of cost recovery for AWWSC, and provided certain restrictions on the behavior of AWWSC in its actions with other companies. (Staff IB at 78)

In Docket No. 02-0517, IAWC requested Commission approval of an agreement with another affiliate, American Water Resources. This agreement would have authorized IAWC (and AWWSC) support of AWR through letters, mailings, billing and repair service initiation. In its Order on Reopening, the Commission declined to approve any assistance to AWR and denied approval of the agreement. (Staff IB at 79; Staff Ex. 7.0 at 3-4)

According to Staff, “Despite the Commission’s refusal to approve the proposed agreement above, IAWC has ignored and circumvented this prohibition by allowing its affiliated service company, AWWSC, to interact with AWR on its (i.e. IAWC’s) behalf.” (Staff IB at 79) AWWSC has entered into several agreements that enable AWR to benefit from its indirect association with IAWC. Specifically, AWWSC has set forth

methods of allocating costs to AWR “that do not adequately reflect AWWSC’s own incursion of these costs.” (*Id.*)

As a direct result, Staff argues, IAWC ratepayers are currently paying and will continue to pay for costs that should have been assigned to AWR. In addition, AWWSC and IAWC “provide other services to AWR that have not been approved by the Commission and for which inadequate compensation is received.” (*Id.*, citing Staff Ex. 7.0 at 3, 8-10) In order for the Commission to determine the presence and extent of any misconduct between IAWC, AWWSC and its affiliates, these agreements and their subsequent interactions must be reviewed.

In Staff’s view, the Commission should “open an investigation into whether the IAWC-AWWSC AIA is in the public interest, given AWWSC and IAWC’s failure to abide by their agreement and their joint provision of services both directly and indirectly apart from the AIA.” (Staff IB at 81)

In his rebuttal testimony, Staff witness Mr. Sackett made “three specific recommendations.” They are (1) Open a proceeding to determine whether IAWC is in violation of Section 7-101 of the Public Utilities Act (“Act”) by allowing its affiliate, acting as its agent, to provide services not approved by the Commission and consider whether imposing penalties on IAWC for violating the Act would be appropriate; (2) Order that IAWC prohibit AWWSC employees from referring IAWC’s ratepayers to any affiliate providing non-regulated services; and (3) Reduce test year depreciation expense by \$44,120 [later reduced to \$10,268].”

In Staff’s IB it sets forth two additional recommendations. First, Staff recommends that “Because AWWSC utilized allocation methodology that did not adequately charge AWR for its phone costs, Staff recommends a reduction in operating expenses of \$75,000 for IAWC.” Second, the Commission should “prohibit AWWSC and IAWC from making determinations for any affiliate regarding leak repair responsibility.” (Staff IB at 101)

Section VII.B.1 of Staff’s IB is titled, “IAWC, AWWSC and AWR Affiliated Interest Agreements (‘AIA’).” Staff states, in part, “The IAWC–AWWSC AIA allows AWWSC to provide services to regulated affiliates as long as *the terms of this agreement are equal to or better than those offered to regulated affiliates*. Additionally, the agreement allows AWWSC to provide services to non-regulated affiliates (and non-affiliates) as long as no costs from serving these other parties are passed on the IAWC.” (Staff IB at 81)

VII.B.2 of Staff's initial brief is titled, "AWWSC AIA and MOU." In addition to the aforementioned agreements that require Commission approval, AWWSC entered into other agreements "that do not require Commission approval but, nevertheless, do impact rates to IAWC ratepayers." (Staff IB at 83)

In February of 2007, AWWSC entered into an agreement with AWR ("AWR-AWWSC AIA") in support of the Call Center Awareness Program ("CCAP"). Under the AWR-AWWSC AIA, AWWSC provided Call Center Awareness Program or Service Line Awareness Program ("SLAP") services. These services consisted of reading scripts about AWR products to all callers from certain states and transferring calls to AWR. (*Id.* at 83-84)

In December of 2007, AWWSC entered into an agreement with AWR ("AWR-AWWSC Memorandum of Understanding ("MOU")"). The agreement outlines the allocation and assignment of costs for a facility in Alton, Illinois that is jointly used by AWWSC and AWR but does not provide for services between the two parties.

Section VII.C of Staff's initial brief discusses, "Commission Decisions Regarding Actions of Service Companies." (Staff IB at 84-96) Staff states that in Docket No. 11-0046, "the Commission ordered Nicor Gas to stop soliciting on behalf of its affiliates. The Commission ruled that Nicor Gas ratepayers were subsidizing its affiliate because the value of a service exceeded the cost that was paid by an affiliate." (Staff IB at 84-85)

In the North Shore Gas Company and The Peoples Gas Light and Coke Company rate proceedings, Docket Nos. 11-0280 and 11-0281 (Cons.), "the Commission ordered an adjustment to operating expense for the market value of services provided to a marketing affiliate by an affiliated service company which provided customer service to utility ratepayers." (Staff IB at 85)

In Docket No. 11-0561, et al., the Commission approved an agreed to adjustment for the provision of information to a third party and an investigation into the AIAs between all Illinois Utilities Inc. utilities and their service company.

Staff argues, “Similarly, in this case, an investigation into the AIA is an appropriate outcome in a rate case where there is evidence of suspected or actual impropriety.” (Staff IB at 86)

.....  
(PO 175-177)

In his rebuttal testimony, the Staff witness made “three specific recommendations.” The first was to open an investigation. The second was to “order that IAWC prohibit AWWSC employees from referring IAWC’s ratepayers to any affiliate providing non-regulated services.” The third was to disallow \$10,268 of test year depreciation expense for what was sometimes referred to as “IAWC’s portion of costs related to AWR’s expansion of joint facilities with AWWSC.” In its brief, Staff also proposed a “phone charge adjustment” of \$75,000 “due to AWWSC’s overcharges to IAWC-” and recommended that the Commission expressly prohibit IAWC and AWWSC support of repair responsibility determination.

### **Joint Facilities Adjustment**

Staff recommends that the Commission disallow \$10,268 of test year depreciation expense “for IAWC’s portion of costs related to AWR’s expansion of joint facilities with AWWSC.” American Water Resources, or “AWR,” is an affiliate of IAWC.

IAWC opposes the adjustment. IAWC argues that AWR paid increased rent after the second expansion and only a “small portion” of the total expansion was related to AWR’s facilities, so the disallowance is overstated.

An IAWC witness testified that approximately one-third of the expansion was related to AWR’s operations.

The Commission finds that one-third of the \$10,268 in depreciation expense related to the facility should be removed from IAWC’s test-year operating expenses to reflect the portion of the expansion costs properly attributable to AWR.

### **Phone Charge Adjustment**

In its initial brief, Staff recommends “an adjustment of \$75,000 in total due to AWWSC’s overcharges to IAWC.” The overcharges to IAWC are a result from AWWSC charging AWR for the number of transfers, not the “actual time spent” or even the number of statements read.

As indicated by IAWC, however, the methodology used to calculate the adjustment involves a series of calculations discussed for the first time over a several-page portion of Staff’s initial brief.

As IAWC points out in its reply brief, neither the adjustment itself, nor the multi-step methodology used to calculate it, were proposed anywhere in the evidentiary record.

The adjustment is essentially the result of an expert analysis which did appear in the expert witness’ testimony.

As such, there has been no opportunity to conduct discovery or cross-examination, or to submit responsive evidence.

The Commission finds that adjustment is not supported by the evidentiary record, and it is not adopted. However, the record does support a finding that AWWSC did not charge AWR properly for these costs in 2011. The method utilized was not adequate and undercharged AWR and shifted cost inappropriately to IAWC.

## **Transfers and Referrals**

Staff complains that AWW Service Company representatives “refer IAWC ratepayers that call into the Customer Service Center on IAWC’s toll-free number and ask for information about warranty products to AWR.” In Staff’s view, these referrals lead to a situation in which IAWC ratepayers call IAWC regarding AWR products because IAWC and AWR have failed to clarify that AWR products are not IAWC products. Staff believes “Correcting such a misperception is ultimately in the best interest of the ratepayer.” (Staff IB at 98)

IAWC asserts that transferring an IAWC customer to AWR when the customer specifically asks about the AWR program is a service and convenience to IAWC's own customers, and that the "clarifications" suggested by Staff could lead to customer inconvenience and confusion, and increased costs.

Having reviewed the record, the Commission finds that IAWC customers who call the IAWC toll-free number should not be transferred or otherwise referred<sup>4</sup>~~connected to any affiliate providing non-regulated services AWR without being provided with information clarifying that AWR products are not IAWC products.~~

***Alternative Language:***

Having reviewed the record, the Commission finds that IAWC customers who call the IAWC toll-free number should not be transferred or otherwise referred<sup>5</sup>~~connected to any affiliate providing non-regulated services AWR without being provided with information clarifying that affiliate AWR products are not IAWC products.~~

**Emergency Service Order Support**

Staff recommends that the Commission should "prohibit AWWSC and IAWC from making determinations for any affiliate regarding leak repair responsibility." (Staff IB at 101)

Upon consideration of the record in this case and other findings and considerations in this Order, the Commission finds that utility support of AWR's repair process, while unclear the extent of that support or the exact party performing such service, it is not in keeping with our guidance to not lend its name and assistance to AWR in support of WLPP as outlined in Docket No. no 02-0517 to allow such support. Therefore, AWWSC and IAWC are hereby prohibited from making determinations for any affiliate regarding leak repair responsibility.

**Investigation**

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<sup>4</sup> "Referred" means any method of getting ratepayers connected with AWR – transfer, provision of phone number or web address.

<sup>5</sup> "Referred" means any method of getting ratepayers connected with AWR – transfer, provision of phone number or web address.

Staff recommends that an investigation be opened “to review the [Affiliated Interest Agreement] between AWWSC and IAWC to determine if it is in the still in the public interest.” (Staff IB at 97)

~~In considering this request, the Commission notes that one of the reasons offered repeatedly by Staff in support of initiating an investigation is that Staff was unable to properly assess some of the issues because IAWC refused to provide information requested by Staff. While the Commission encourages the voluntary submission of requested information, there are remedies available when the DR process has not been successful. Here, the Commission observes that no motions to produce or compel formal discovery were filed by Staff.~~

In those instances where the Staff witness did make adjustments or other specific recommendations, the Commission has made determinations as set forth above. However, the Commission has specifically noted that the Joint Facilities Adjustment reflects a violation of the AIA between AWWSC and IAWC. Furthermore, while the Commission did not order an adjustment in the phone charges adjustment recommended by Staff, there is an indication that AWWSC has not sufficiently allocated costs to AWR in accordance with the requirements of the AIA between AWWSC and IAWC.

The Commission also observes that a lengthy and detailed management audit of the fees assessed by the Service Company under the same Service Company agreement was recently completed by NorthStar Consulting Group. That audit was conducted at the direction of the Commission, and is the subject of pending case in Docket 10-0366. The Commission further observes that the scope of this audit is limited to the market value of such services and does not address the allocations of those costs, which are the crux of Staff’s recommendation.

Upon consideration of the record in this case and other findings and considerations in this Order, the Commission ~~does not believe~~ that opening a new investigation at this time “to review the AIA between AWWSC and IAWC to determine if it is in the still in the public interest,” as urged by Staff, is warranted because the scope of such investigation is different from addressed in the audit and it would give an indication into the reason that AWWSC charges are above market~~would be efficient or otherwise warranted while the proceeding in Docket 10-0366 is pending.~~ IAWC is instructed to file for re-approval of its affiliated interest agreement with its Service Company within 90 days of the date of this Order. Further, IAWC shall provide

testimony and such information as can be made available regarding customer information that may be in AWR's possession.

**B. IAWC Position**

**XIII. REVENUE REQUIREMENT**

There is an immaterial error (\$46) on page 2 of Appendix A which should be corrected for presentation purposes. The affect of interest synchronization on State and Federal Income Taxes is not correctly summed from the rate areas. Interest Synchronization should be (\$16,670) and (\$125,731) for State and Federal Income Tax (Column (b) rows 23 and 24) respectively. Accordingly, there are derivative changes on both pages 1 and 2 of Appendix A. This error does not affect the revenue requirement for any rate area.

**XIV. CONCLUSION**

For the reasons set forth in Staff's Initial Brief, Reply Brief, and this Brief on Exceptions, Staff respectfully requests that the Commission's Final Order in this proceeding reflect all of Staff's recommendations.

Respectfully submitted,

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