STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois-American Water Company	)	
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Proposed General Increase in Water and Sewer Rates.(tariffs filed October 27, 2011)	)	Docket No. 11-0767
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REPLY BRIEF ON EXCEPTIONS OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION

James V. Olivero
Michael J. Lannon
Nicole T. Luckey
Office of General Counsel
Illinois Commerce Commission
160 N. LaSalle St., Suite C-800
Chicago, IL 60601
Phone: (312) 793-2877
Fax: (312) 793-1556
jolivero@icc.illinois.gov
mlannon@icc.illinois.gov
nluckey@icc.illinois.gov

Counsel for 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 Rules of Practice of the Illinois Commerce Commission (“Commission”), 83 Ill. Adm. Code Section 200.830, respectfully submits this Reply Brief on Exceptions to the briefs on exceptions (“BOEs”) filed by Illinois American Water Company (““IAWC” or the “Company” BOE”); the People Of The State Of Illinois (“AG BOE”); the Illinois Industrial Water Consumers (“IIWC”), together with the Federal Executive Agencies (“FEA”), referred to collectively as (“IIWC/FEA BOE”); the Cities of Champaign and Urbana, and the Villages of Savoy, St. Joseph, Sidney and Philo (the “Cities BOE”); the Village of Bolingbrook (“Bolingbrook BOE”) which were filed on or before August 13, 2012 in response to the Proposed Order issued by the Administrative Law Judge (“ALJ”) on July 31, 2012 ("Proposed Order" or “PO”).

I. INTRODUCTION AND PROCEDURAL BACKGROUND

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 Commission should not accept the Attorney General's ("AG") proposal to increase expense lead days for service company charges. (AG BOE, p. 18) The Company has testified that if Service Company charges were not prepaid, the Service Company would have to finance its own working capital. (IAWC Ex. 6.00R, pp. 34-35) The Service Company would then increase its charges to pay for the financing. (*Id*., p. 35) While the Company would realize savings by making payments later, it would see increased charges from the Service Company. Whether the net affect for the Company would be an increase, decrease or total offset has not been determined. Staff suggests that this issue could be considered the next time the Company petitions the Commission for re-approval of the Service Company agreement.

D. ADIT – Repairs Deduction – FIN 48

The Commission should not heed the Company's arguments that FIN 48 should not be included as a rate base deduction. (IAWC BOE, 26) FIN 48 represents a source of cost free capital that should be reflected as a rate base deduction. Deferred taxes are a free source of funds from the Federal and State government. Under the

Company's proposal, the Company would reap all benefit from the deferred tax credits until the first rate case after tax returns are no longer subject to IRS review and adjustment. (Staff Ex. 9.0-C, p. 11) Ratepayers should not be required to provide the Company with a return on funds that are not supplied by investors.

As the Attorney General points out in its initial brief, the Company's interpretation of FIN 48 is not valid. (AG IB, p. 9) FIN 48 allow recognition of an uncertain tax position when it is more likely than not, based on the technical merits, that the position will be sustained upon examination. (*Id*.)

V. OPERATING REVENUES AND EXPENSES

A. TEST YEAR SALES VOLUMES AND REVENUES

B. STAFF ADJUSTMENTS TO OPERATING EXPENSES

C. RATE CASE EXPENSE

VI. OTHER INCOME TAX ISSUES

A. DPAD – Section 199

B. Bonus Depreciation

Staff recommends that the Commission reject the AG's proposal for the Commission to initiate a rulemaking to develop a methodology to address the effect of consolidated tax returns on Illinois consumers and to adopt a method to share the consolidated tax savings with consumers. (AG BOE, p. 31) The first time this suggestion was presented was in the AG's BOE, it was not presented in the evidentiary record, and further, the scope of the AG's suggested proceeding has not been defined. The proposal has been made too late in the proceeding to be properly considered and thoroughly discussed by the parties. Staff urges the Commission to deny this rulemaking request as its merits have not been adequately established.

In addition, the AG proposed changes to the Order state a different purpose for the proposed rulemaking as the development of a methodology to address the sharing of benefits when a utility's actual tax liability is determined in a consolidated tax return. (AG BOE, p. 33) The Commission should not leap to a hasty initiation of a rulemaking for a subject that has not been defined in the record of this case.

VII. CAPITAL STRUCTURE AND RATE OF RETURN

A. OVERVIEW

B. CAPITAL STRUCTURE

IAWC takes exception to the capital structure adopted in the PO and maintains that its forecasted capital structure proposal should be adopted. Staff has argued repeatedly that IAWC's forecasted capital structure violates Section 9-230 of the Act. The Company failed to justify why its common equity ratio is more than 8 percentage points higher than that of its parent. (Staff BOE, pp. 5-15) The PO correctly disregarded IAWC's capital structure but failed to apply Section 9-230 of the Act. As Staff argued in its BOE, the Commission should reject the PO's capital structure and adopt Staff's proposed capital structure in accordance with 9-230 of the Act.

C. COST OF COMMON EQUITY

IAWC also takes exception to the cost of common equity authorized in the PO. The Company suggests that there is record support for leaving the return on equity ("ROE") at the current authorized level of 10.38%. IAWC considers this suggestion a possible avenue of compromise among the differing recommendations of the parties. IAWC then attempts to support the 10.38% ROE by referencing the allowed ROEs for its subsidiaries in other states. As Staff has already explained, since the Commission issued its Order on April 30, 2010, in Docket No. 09-0319, which authorized the 10.38% ROE, market capital costs have declined. (Staff RB, pp. 20-21) Hence, the evidence presented in this proceeding does not support a 10.38% ROE.

IAWC claims that the PO disregards the Company's evidence since the Company's analysis is not taken into account in the final recommendation. IAWC argues that it was arbitrary and unreasonable to disregard the constant growth DCF analyses presented by the Company and IIWC/FEA. (IAWC BOE, p. 9) However, the PO did not "disregard" the Company's analysis; in fact, it specifically addresses the issue by finding that it is appropriate to rely on the non-constant DCF model in estimating IAWC's cost of common equity because "the record supports a conclusion that short-term analysts' forecasts of growth are not sustainable." (PO, p. 105)

IAWC continues to argue that the ROE recommendation should not consider the results of non-water proxy groups because no demonstration has been made that the companies included in the non-water proxy group bear financial risk comparable to IAWC. (IAWC BOE, p. 9) Staff, however, agrees with the PO, which states, "the record suggests that IIWC/FEA and Staff have done rigorous analyses in an effort to identify firms in the electric and gas industries that are similar in risk to IAWC." (PO, p. 104) The Companies in Staff's Utility sample were chosen through a principal components analysis using twelve financial and operating ratios to select a sample that reflects both the operating and financial characteristics of IAWC. (Staff IB, pp. 35-36) In addition, Ms. Freetly compared the pro-forma ratios for IAWC and the three-year average ratios for the Water and Utility samples to Moody's key credit metrics for global regulated water utilities to ensure that the samples reflected the financial risk of IAWC. (*Id.*, pp. 40-44)

IAWC alleges that the recommended ROE is not comparable to returns authorized for similar utilities facing similar risk. (IAWC BOE, pp. 11-13) However, IAWC failed to provide a risk comparison of IAWC to the other utilities to support its position that IAWC's ROE should be similar to that authorized for other utilities. Hence, there is no record support for IAWC's position and it should be ignored.

IAWC claims that the record supports a ROE in the range of 9.84 – 10.38%. IAWC asks that the DCF and CAPM results for the non-water sample groups be excluded and that Ms. Ahern's CAPM be included. (PO, pp. 13-14) As stated earlier, the PO correctly includes the non-water sample results because Staff demonstrated that the Utility sample was comparable to IAWC in terms of financial and operating risk. The PO concluded that IAWC's CAPM is not sufficiently reliable because historical data is heavily relied upon and the market risk premium relies on an unsustainable growth rate. (PO, p. 106) Consequently, there is no record support for IAWC's proposal of an ROE in that range.

VIII. COST OF SERVICE STUDY

IX. RATE DESIGN

A. Customer Charges

B. Usage Charges

The IIWC and the FEA exception to the Usage Charges approved by the PO should be rejected. Staff has provided its arguments in support of its Usage Charge proposal in testimony, Briefs and Brief on Exceptions and will not revisit those arguments here. Referring to Staff Ex. 12.0, Schedule 12.1, pages 16 and 29, Staff's rate design produces revenues that are at least equal to the revenue requirement proposed by IAWC in its rebuttal testimony. Thus, Staff's proposed usage charges would, in fact, produce the desired revenues. Staff maintains its recommendation that the Commission adopt the language modification for Usage Charges that Staff provided in its Brief on Exceptions.

X. CONSOLIDATION OF ZONE 1 AND CHICAGO METRO

The Village of Bolingbrook's and the IIWC/FEA's exceptions to the PO's conclusions on the Consolidation of Zone 1 and Chicago Metro should be rejected. The Village of Bolingbrook contends that the Commission should reject the consolidation of Zone 1 and Chicago Metro. The Village of Bolingbrook's argument is misguided because the evidence demonstrates that consolidation is in the best interests of Illinois ratepayers. Staff's analysis shows that the Company's proposed consolidation of Zone-1 and Chicago Metro Water divisions would lower monthly bills for Chicago Lake Water and Chicago Moreland typical use residential customers. The typical use residential customers that would see a slight increase from the consolidation of the two water divisions are those in Zone-1, who would experience a 1.78% increase, and Chicago Well customers, who would experience a 4.48% increase in their monthly bills. In addition, Staff's analysis shows that consolidation would reduce bills for Zone-1 residential customers by an average of 1.3% and raise Chicago Metro bills by an average of 3.8%. (Staff Ex. 4.0, p. 10)

Staff contends that consolidation is also beneficial because it allows the utility to spread out future capital improvement costs over a larger customer base thereby mitigating potential rate shock when large improvement projects need to be made. For example, Chicago Metro Water has approximately 44,490 customers. Consolidating with Zone 1 would produce approximately 256,145 customers. (IAWC Section 285.1015, Schedule A-3, pp. 2-3) When capital improvements inevitably will need to be made, having five times as many customers over which to spread costs will be less burdensome on all ratepayers.

Furthermore, rate case expenses can be lowered by reducing the number of divisions for which a future rate case would be prepared and litigated from five to three. This reduces potential legal and administrative expenses, accounting expenses, expert witness expenses and other miscellaneous costs involved in filing a rate case. (Staff Ex. 4.0, pp. 10-11)

The Commission should also reject IIWC/FEA's exceptions to the PO's approval of Staff's proposed consolidation. (IIWC/FEA BOE, pp. 13-16) IIWC/FEA argues that Staff's consolidation proposal "failed to identify any evidence in this proceeding that identifies or discusses in any way the 'rewards' that are allegedly afforded to all customers from such consolidation." (*Id.,* p. 15) This is inaccurate. As discussed above, the consolidation is beneficial to ratepayers. Staff's proposal is also consistent with the Commission's Orders in previous IAWC rate cases that have favored consolidation of rate divisions. As IAWC witness Mr. Kerckhove observed:

> The Commission has expressed a general policy of favoring cost–based rates and movement towards single tariff pricing and rate uniformity. The Docket 07-0507 Order (see pages 94-98) discussed various approaches to STP (Single Tariff Pricing). As discussed by the Commission, one approach is to combine individual rate areas with other rate areas and develop common rates for customers in the combined group based on the group revenue requirements. (IAWC Ex. 5.0, p. 20)

It is Staff's opinion that the benefits identified above outweigh the slight increases that a typical Zone-1 and Chicago Well residential customer would experience in his or her monthly bill upon consolidation compared to the alternative of no consolidation. Therefore, Staff recommends the Commission approve the consolidation of the Zone 1 and Chicago Metro Water divisions as set forth in the PO.

XI. PROPOSED REVENUE ADJUSTMENT CLAUSE

XII. AFFILIATED INTEREST ISSUES

XIII. REVENUE REQUIREMENT

XIV. RESPONSE TO IAWC REQUEST FOR ORAL ARGUMENT

Staff has no objection to the Company's request, pursuant to Section 9-201(c) of the Public Utilities Act, 220 ILCS 5/9-201(c) and Section 200.850(a) of the Commission's Rules of Practice, 83 Ill. Adm. Code 200.850(a), for oral argument in this proceeding. (IAWC BOE, p. 38) In addition to the subject of rate of return, Staff recommends that the Commission also consider the following subjects: (1) applicability of Section 9-230 to the proposed capital structure; and (2) initiating an investigation into those affiliated interest issues articulated in Staff testimony and briefs.

XV. CONCLUSION

For the reasons set forth in Staff's Initial Brief, Reply Brief, Brief on Exceptions, and this Reply 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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James V. Olivero
Michael J. Lannon
Nicole T. Luckey
Office of General Counsel
Illinois Commerce Commission
160 N. LaSalle St., Suite C-800
Chicago, IL 60601
Phone: (312) 793-2877
Fax: (312) 793-1556
jolivero@icc.illinois.gov
mlannon@icc.illinois.gov
nluckey@icc.illinois.gov

Counsel for Staff of the
Illinois Commerce Commission

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