**STATE OF ILLINOIS**
**ILLINOIS COMMERCE COMMISSION**

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

# REPLY BRIEF ON EXCEPTIONS OF ILLINOIS-AMERICAN WATER COMPANY


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# I. INTRODUCTION

This Reply Brief on Exceptions of Illinois-American Water Company ("IAWC" or the "Company") responds to the Briefs on Exceptions ("BOEs") of: (1) the Staff ("Staff") of the Illinois Commerce Commission ("Commission"); (2) the People of the State of Illinois, by the Attorney General of the State of Illinois ("AG"); (3) the Illinois Industrial Water Consumers together with the Federal Executive Agencies (collectively, "IIWC/FEA"); (4) the Cities of Champaign and Urbana and the Villages of Savoy, St. Joseph, Sidney and Philo (collectively, the "Cities and Villages"); and (5) the Village of Bolingbrook ("Bolingbrook") related to the Administrative Law Judge's Proposed Order ("ALJPO") issued in this proceeding on July 31, 2012. As set forth below, IAWC opposes each of the substantive exceptions proposed by these parties.

IAWC's Reply Brief on Exceptions is organized by section of the ALJPO. Where a party or parties take exception to a section of the ALJPO, IAWC's reply to that exception is set forth under the respective ALJPO section heading. The sub-headings identify the party and exception number (if provided by the party) to which IAWC's reply is directed.

# II. RATE BASE

## A. ALJPO Section IV.B, "Business Transformation Costs" (ALJPO pp. 8-24)

<u>Response to AG (AG BOE, pp. 5-18) and Cities and Villages Exception 2 (Cities and Villages BOE, p. 5)</u>

The ALJPO finds the record supports the need for the Business Transformation ("BT") program: "The current [information technology] system is outdated and in need of replacement. The processes used to develop the BT program, and the projects that comprise the program, can reasonably be expected to satisfy that need." (ALJPO, p. 22.) The AG apparently agrees. In its Brief on Exceptions, the AG acknowledges the BT systems are "necessary," and it does not take issue with the ALJPO's finding above. (AG BOE, pp. 5, 10-18.) Nevertheless, the AG takes exception to the ALJPO's conclusion approving inclusion of IAWC's BT costs in rate base. (Id., pp. 5-18.) But in taking exception to that conclusion, the AG tenders the same unfounded arguments the ALJPO already thoroughly assessed, but ultimately (and correctly) rejected. The Commission should again reject them.

First, the AG argues, as it did before, that the Service Company Agreement does not authorize inclusion of BT costs in IAWC's rate base. (AG BOE, pp. 5-7.) Initially, the AG misrepresents the ALJPO's findings here. The AG asserts the ALJPO "finds that the Service Company Agreement does not address whether IAWC can include charges from the Service Company in rate base." (AG BOE, p. 6.) That is wrong. In fact, the ALJPO expressly finds "[t]he Agreement does not purport to *dictate* how charges by IAWC, to its ratepayers, are to be assessed." (ALJPO, p. 23 (emphasis added).) That finding accords with the record evidence. As IAWC discussed in briefing, the Service Company Agreement dictates how the American Water Works Service Company ("Service Company") charges IAWC; it does not dictate how IAWC treats those charges for accounting or ratemaking purposes. Nor should it. While the Service Company must charge its regulated affiliates in an identical manner, it is the regulatory and accounting rules of each regulated affiliate's jurisdiction that determines how it treats the charges on its books. (IAWC Init. Br., p. 12; IAWC Ex. 5.00SR (Rev.) (Kerckhove Sur.), p. 12.) The AG appears unwilling or unable to grasp this concept.

The AG's subsequent arguments are not entirely clear. However, the AG appears to be asserting that: (1) the Service Company Agreement does not permit the Service Company to charge IAWC a "lump sum" for the BT facilities; and (2) the Service Company Agreement does not permit IAWC to charge its customers the financing costs for an asset that it paid for via the

Service Company Agreement.[1] (AG BOE, p. 6.)

Regarding the latter conclusion, as explained above and extensively by IAWC in testimony and briefing and aptly acknowledged by the ALJPO, the Service Company simply charges IAWC for the costs incurred without any markup or "profit." As such, there is no "profit" earned by the Service Company, as the ALJPO correctly finds. (ALJPO, p. 23.)

Regarding the former, the AG argues that, rather than be expensed in a "lump sum," the charges should be reflected as part of the overhead included in the Service Company's fees. (AG BOE, pp. 6-7.) These "lump sum" and "overhead" arguments are new, but they are inconsequential nevertheless. The AG continues to miss the point: whether the Service Company charges are invoiced to IAWC as labor, overhead or otherwise, the Service Company does not dictate IAWC's accounting treatment of the charges it incurs, nor should it. IAWC determines how it accounts for them on its books. (IAWC Init. Br., p.12; IAWC Ex. 5.00SR (Rev.), p. 12.)

The AG appears to base its position in part on a concern about IAWC's ratepayers paying a return on IAWC's BT investment. But IAWC's shareholders are *investing* in assets—the BT systems—when they pay the BT charges. IAWC is procuring and developing (with the help of the Service Company) the BT assets (information technology ("IT") systems, licenses, business processes, data, etc.) that are property and assets of IAWC. (See IAWC Ex. 4.00 (Grubb Dir.), p. 3.) IAWC's investors are entitled to a return on their investment, just as they would be if IAWC built a standalone IT system for itself (and abandoned the economies of scale of the Service Company). Moreover, the Service Company Agreement requires that "all costs of service" be charged to IAWC, and permits charges to recover such things as lease payments, utilities and

[1] The AG appears to confuse "profit" or mark-up with carrying or finance costs.

"other costs of leasing . . . equipment" (see AG Cross Ex. 3, Article 2.5 (Service Company Agreement)), as well as items such as interest for working capital (as part of overhead, id., Article 3.1). BT charges are properly included in the wide range of items specified in the Service Company Agreement. Moreover, the AG assumes all BT costs are for computer equipment and software when this is not the case. (See IAWC Ex. 4.00, p. 3.) Labor and overhead costs can be properly capitalized if associated with a capital project. See, e.g., Illinois-American Water Co., Order, Docket 09-0319 (Apr. 13, 2010), pp. 21-22 (including in rate base the unamortized balance of IAWC's portion of the cost of the Service Company's Comprehensive Planning Study).[2] The AG's confusion on this point is no basis to alter the ALJPO's sound reasoning. The AG's argument should be rejected.

Notably, in continuing to advocate that the BT costs be expensed (in whatever form) by IAWC rather than capitalized, the AG also continues to overlook that, as the ALJPO, IAWC and Staff agree, recovering the BT costs as an operating expense would result in a *higher* revenue requirement—by millions of dollars—and thus higher rates in this proceeding, than would rate base treatment. (ALJPO, p. 23; IAWC Ex. 4.01.) As stated, capitalizing those costs will significantly reduce the up-front rate increase for IAWC's customers and will result in a significantly lower revenue requirement when compared to collecting the costs as expenses in rates. (IAWC Ex. 5.00R (2d Rev.) (Kerckhove Reb.), p. 23.) Capitalizing BT costs also will result in proper intergenerational equity by more closely aligning BT cost recovery with the anticipated service life of the assets and their use by customers. (Id.) Thus, the AG's contrary argument is not in the best interests of Illinois ratepayers. It should be dismissed.

Next, the AG argues the allocation of BT costs to IAWC is overstated. (AG BOE, pp. 7-

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

8.) Here, it alternatively recommends, if the Commission allows BT costs in rate base (it should), then it should remove 12.3% of the total costs to reflect (what the AG believes) is a fair allocation of those costs to IAWC's unregulated affiliates (it should not). (Id.) The AG claims "there is no obvious reason that American Water's unregulated operations would not use American's most recent technology for their corporate level needs." (Id.)[3] But there *is* an obvious reason: no evidence in this case even *suggests* the AG's proposition, as the ALJPO aptly acknowledges. (ALJPO, p. 24.) Instead, the record makes plain that American Water's non-regulated affiliates operate *separate* finance, accounting, management of asset lifecycle, customer service, customer billing and strategic planning systems, which in large part satisfy the market-based operations' needs in these areas. (IAWC Ex. 9.00R (Rev.) (Twadelle Reb.), p. 8 (referencing IAWC's response to ICC Staff data request DLH-10.01).) Thus, the functionality associated with the BT systems was not designed for IAWC's market-based operations, and IAWC's market-based affiliates will continue to use different systems to support their core business activities. (Id.; IAWC Ex. 5.00R (2d Rev.), pp. 16-17.)[4] The AG simply continues to

[3] Here, the AG cites the Final Audit Report in Docket 10-0366 in support of IAWC's unregulated affiliates' alleged historical use of IT services provided by the Service Company. The AG does not reference the report by exhibit number because it has none. IAWC notes, as it did in its Reply Brief (pp. 10-12), the AG's motion "for Entry of Evidence" filed jointly with Staff just prior to the start of the evidentiary proceeding was granted "*subject to normal procedural rules in Section 200.670 and other sections in the Rules of Practice*." (Notice of ALJ Ruling, p. 2 (May 15, 2012) (emphasis added).) Commission Rule 200.670 requires "*[a]ll* exhibits *shall* be marked numerically and/or alphabetically with a party or staff designation . . . [and] an original and two copies *shall* be offered at the hearing and a copy provided to the Hearing Examiner, and to each party and staff witness." 83. Ill. Adm. Code 200.670(a)-(b) (emphasis added). Despite that specific direction, the AG and Staff failed to comply with the requirements of Rule 200.670 with respect to the Final Audit Report. The Audit Report is not marked as an exhibit—in fact, it cannot be found on e-Docket in this case or anywhere else in the record of this proceeding. It was not even mentioned at the hearing. As such, it is not properly part of the evidentiary record in this proceeding and so cannot be relied on by the Commission in reaching a decision. See Business & Prof'l People for the Pub. Interest v. Ill. Commerce Comm'n, 137 Ill. 2d 192, 227 (1989) (Commission findings must be based exclusively on the record evidence). The AG's references to the Audit Report should be accorded no weight. To the extent the Audit Report nevertheless is accorded weight, IAWC notes the AG relies on the Audit Report selectively, and ignores the fact that the Audit Report in fact *endorsed* BT, as explained in IAWC's Reply Brief (p. 12, n.4).

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

refuse to believe, or chooses to ignore, the BT program and IT systems have been specifically designed to accommodate the needs of American Water's regulated utility companies. (IAWC Ex. 9.00R (Rev.), p. 8.)[5]

In advocating this position, the AG also ignores the ALJPO approved the reporting requirements proposed by Staff in this proceeding which will track any reductions in actual costs incurred and allocated to IAWC for current or future affiliates' use of the BT systems. (ALJPO, p. 24.) Updates to these reports will be included in the next rate case filing. (Staff Cross Ex. 2.0 (DLH-IAWC 30.03).)

The AG also takes issue with the 1% increase in the percentage of BT costs allocated to IAWC from 2010 to the October 27, 2011 filing of this rate case (related to the sale of New Mexico American Water and Arizona American Water, which caused a change in the required customer count allocation percentages under the Service Company Agreement). (AG BOE, p. 8.) The AG claims, because the increase was not due to the growth of IAWC's operations, it allegedly improperly "burdens Illinois consumers." (AG BOE, p. 8.) Again, there is no record basis for the AG's position here. The AG's argument is based on outdated 2010 allocation percentages referenced in the Docket 10-0366 Final Audit Report. The AG appears to assume, without record support, that the total level of BT costs in this case has not been impacted by the divestiture of those subsidiaries. This is incorrect: when IAWC filed its petition in October 2011, the amount and percentage allocation of BT costs it included in its filing accurately reflected the divesture of the Arizona and New Mexico subsidiaries, and complied with the terms of the Service Company Agreement.

Finally, the AG continues to urge the Commission to "follow the lead of California" and

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[5] Further, the record reflects, to the extent American Water's non-regulated business subsidiaries do use the BT systems, they will be charged accordingly. (IAWC Exs. 9.00R (Rev.) pp. 7-8; 5.00R (2d Rev.), pp. 16-17.)

offset IAWC's BT costs with what the AG contends are anticipated dollar savings. (AG BOE, pp. 8-9.) The Cities and Villages agree with and adopt the AG's position here, but present no new argument of their own.[6] (Cities and Villages BOE, p. 5.) Respectfully, this Commission is under no obligation to adopt the practices of other individual state commissions. See North Shore Gas Co./Peoples Gas Light & Coke Co., Order, Docket 07-0241 (Feb. 5, 2008), p. 152. In fact, the ALJPO rightly declined to adopt the adjustment imposed in California for myriad reasons. Most notable, the decision in that case (relying on an earlier and different evidentiary record with different rate case protocols) authorized a revenue requirement for the years 2011-2014; that period extends well beyond IAWC's test year here. See California-American Water Co., Order, Nos. 10-07-007 & 11-09-016 (June 14, 2012), p. 2, available at http://docs.cpuc.ca.gov/word_pdf/final_decision/168807.pdf. As the ALJPO correctly finds, here, "the cost-savings estimate recommended by Staff and IAWC is the more accurate estimate of the amount of savings in the test year . . . ." (ALJPO, p. 23.) Moreover, the AG offers nothing that establishes that the regulatory environment in California is comparable to Illinois such that consideration of the California decision on BT would be appropriate. Thus, although the AG faults the ALJPO for "not provid[ing] the Commission with sufficient information to assess the California PUC's decision" (AG BOE, p. 8), the ALJPO rightfully declined to do so given the California case is not comparable to the one at bar.

Moreover, in championing this position, the AG again ignores the record evidence. The record reflects IAWC anticipates potential benefits from BT, in the form of mitigation of operations and maintenance expense increases, will begin once the new systems are fully deployed and employees are fully trained on those systems, beginning in 2014. (IAWC Ex.

[6] In fact, the Cities and Villages submitted no evidence in this proceeding.

5.00R (2d Rev.), p. 21.) IAWC cannot begin to achieve benefits from the new BT systems until they are implemented and the Company's employees have become acclimated to them. (Id.) As such, they will be reflected in the revenue requirement of future cases. The ALJPO acknowledged that (ALJPO, p. 23), but the AG simply overlooks that the ALJPO does not preclude consideration of BT benefits in future cases.

Staff and IAWC agreed in all respects regarding the appropriate ratemaking treatment to be afforded IAWC's investment in BT and the ALJPO properly adopts their approach. Only the AG and the Cities and Villages (who simply adopt the AG's position) take a contrary approach. The ALJPO correctly rejected the AG's arguments now reiterated in its Brief on Exceptions. The AG and the Cities and Villages' exceptions regarding BT cost recovery should be rejected.

### B. ALJPO Section IV.C.1, "Cash Working Capital—Prepayments to Service Company" (ALJPO pp. 25-27)

Response to AG (AG BOE, pp. 18-22)

The ALJPO, Staff and IAWC agree the Service Company Agreement between IAWC and the Service Company plainly provides for prepayments by IAWC of amounts due the Service Company. (ALJPO, p. 27; ICC Staff Ex. 9.0-C (Kahle Reb.), p. 9; Staff Init. Br., p. 18; IAWC Reply Br., pp. 22-24.) As the ALJPO correctly finds, "[t]he amounts that are 'due' from IAWC [under the Agreement] clearly include payments for upcoming services to be provided over the remainder of the 'current' month." (ALJPO, p. 27.) Only the AG interprets the Service Company Agreement differently and takes exception to this conclusion. (AG BOE, p. 18-21.) But the AG's exception is based on a misinterpretation of the Service Company Agreement, a disregard of the record evidence and a failure to acknowledge Commission precedent on this issue.[7] As such, the AG's exception should be dismissed. The ALJPO's conclusions regarding Service Company prepayments should be approved.

In its Brief on Exceptions, the very provision the AG relies on plainly mandates that IAWC prepay the Service Company for its services: "As soon as practicable after the last day of each month, Service Company *shall* render a bill to Water Company for all amounts due from Water Company for services and expenses for such month *plus an amount equal to the estimated cost of such services and expenses for the current month*." (AG Cross Ex. 3 (Service Company Agreement, ¶ 4.1) (emphasis added).)[8] Further: "All amounts so billed shall reflect the credit for payments made on the *estimated portion* of the prior bill . . . ." (Id.) As IAWC explained in briefing, that language requires that the bill from the Service Company include two amounts: (i) amounts due and (ii) an amount equal to the estimated cost of such services and expenses for the current month. (IAWC Reply Br., p. 22.) Thus, as the ALJPO finds, the Service Company Agreement clearly requires advance payment of an estimated amount. (ALJPO, p. 27.)

Despite that plain language, the AG asserts the requirements that the Service Company issue its bills "[a]s soon as practicable" after the last day of the month and that IAWC remit payment "within a reasonable time" after receipt of the same somehow make prepayment discretionary. (AG BOE, p. 20 (quoting AG Cross Ex. 3 (Service Company Agreement, ¶ 4.1).) But the AG does not, and cannot, explain how use of those standard contract terms relating to the

[7] The AG also contends the ALJPO "ignores the argument and analysis of the People." (AG BOE, p. 19.) Clearly, that is not the case. The ALJPO recites at length the AG's position on this issue. (ALJPO, pp. 24-25.) Notably, despite the AG's contention in this regard, it suggests no revisions to the ALJPO's recitation of its position.

[8] The AG accuses the Service Company of having "nebulous billing practices" because some Service Company charges are prepaid while others are postpaid. (AG BOE, p. 20.) The AG contends IAWC's cash working capital analysis does not distinguish between those charges and, on this, the AG concludes IAWC's cash working capital calculation somehow is unsupported. (Id.) The AG does not explain why the distinction between pre- and post-payments to the Service Company matters in that calculation. It does not. The AG's assertion here is insignificant.

time of billing and payment negates the requirement that the substance of the Service Company's bills "shall" included estimated fees for the current month. The ALJPO correctly rejects this conclusion.

The AG also asserts (without evidentiary support) that prepayment of Service Company fees is "inherently unfair to customers." (AG BOE, p. 19.) Here, the AG conveniently ignores the record evidence. The record reflects prepayment eliminates a Service Company overhead cost (for cash working capital) that IAWC otherwise would be required to pay its share of. (IAWC Ex. 6.00R (Rungren Reb.), p. 34; IAWC Init. Br., p. 31.) This has been sanctioned by the Commission: "[b]ecause the Service Company Agreement allows the Service Company to pass its costs directly on to IAWC, Illinois-American could not actually avoid the cost and ratepayers would ultimately be responsible for the costs. As a result, the Commission sees no benefit to ratepayers from modifying the cash working capital requirement . . . ." Order, Docket 09-0319 (Apr. 13, 2010), p. 18. Thus, the record reflects the prepayment term in the Service Company Agreement is cost effective and reasonable.

The AG next argues IAWC "presented no evidence" to support that excluding prepayment costs from its cash working capital calculation could increase Service Company fees. (AG BOE, p. 19.) This misses the point. The record shows IAWC still would be required to prepay the Service Company under the terms of the Service Company Agreement; therefore, such an adjustment would (improperly) bar IAWC from recovering its prudently incurred Service Company costs. (Tr. 356; IAWC Exs. 6.00R, p. 37; 6.00SR (Rungren Sur.), p. 19.) The record here demonstrates, because IAWC must adhere to the terms of the Service Company Agreement, including the prepayment term, it would be required to prepay Service Company fees even if the AG's adjustment were adopted. (IAWC Ex. 6.00R, p. 37.) But IAWC would no longer recover the cost associated with the prepayment, effectively penalizing IAWC for compliance with that Agreement.

Finally, the AG's position disregards not only that the Commission twice has approved the Service Company Agreement, including the prepayment provision, as reasonable and in the public interest, see Order, Docket 88-0303 (July 19, 1989); Order, Docket 04-0595 (Oct. 19, 2005), but also that it has *rejected* the same adjustment proposed by the AG here, see Order, Docket 09-0319 (Apr. 13, 2010), p. 18. Instead, the AG continues to urge the Commission to abandon this precedent and adopt the approaches taken in Pennsylvania and West Virginia, the only jurisdictions in which American Water subsidiaries operate to have required such an adjustment. (AG BOE, pp. 20-21.) But (as it has done throughout this proceeding) the AG fails to demonstrate why the approach used in those states is appropriate for Illinois (it is not) and it fails to address whether those jurisdictions feature comparable test years, conditions of service, accounting rules or ratemaking practices. Thus, there is no basis for the AG's proposed importation of those states' practices to Illinois. See Antioch Milling Co. v. Pub. Serv. Co. of N. Ill., 4 Ill. 2d 200, 210 (1954) (excluding evidence of differing rates where the party failed to demonstrate that the utilities being compared were sufficiently similar to warrant comparison); North Shore Gas Co./Peoples Gas Light & Coke Co., Order, Docket 07-0241 (Feb. 5, 2008), p. 152.

Moreover, as IAWC explained in briefing, the Pennsylvania case *is* in fact distinguishable because that commission's rationale for adopting the adjustment was the utility's failure to quantify any benefit to customers. (See AG Ex. 2.3, p. 47 (Pennsylvania American Water Co., Order, No. R-922428 (June 7, 1993), p. 23); IAWC Init. Br., pp. 34-35; IAWC Reply Br., p. 23.) The ALJPO was correct in declining to give weight to those states' practices.

(Indeed, one could just as easily argue those commissions should revise *their* practice and follow the Illinois Commission's clear guidance.)

## III. OPERATING REVENUES AND EXPENSES

### A. ALJPO Section V.A, "Test Year Sales Volumes and Revenues" (ALJPO pp. 39-47)

Response to IIWC/FEA Exception 1 (IIWC/FEA BOE, pp. 2-5)

The ALJPO correctly recognizes (and neither Staff nor the AG dispute[9]) "the record supports . . . that residential sales volume, on a per customer basis, has been declining and can reasonably be expected to continue to decline in the short term." (ALJPO, pp. 45.) (As expressed in its Brief on Exceptions, IAWC disagrees "the short term" is the next 45 days, which the ALJPO effectively concludes in adopting projected sales for the year ending September 30, 2012 as the test year level of usage. (IAWC BOE, pp. 17-21.)) Nevertheless, IIWC/FEA continue to advocate a test year sales volume—and, related, a methodology of forecasting the same—which simply ignores the reality of declining usage. That is, IIWC/FEA would establish base (non-weather sensitive) usage for the year ending September 30, 2013 on actual base usage from three years prior—2010. (IIWC/FEA BOE, p. 2; IIWC/FEA Init. Br., pp. 5-6.) For this reason, IIWC/FEA take exception to the ALJPO's adoption of the year ending September 30, 2012 usage and, consequently, its rejection of IIWC/FEA's forecast sales volume. (IIWC/FEA BOE, pp. 2-3.) IIWC/FEA's exception should be dismissed.

The ALJPO notes IIWC/FEA's position on the issue of declining usage is not clear, but recognizes their forecast methodology "suggests IIWC/FEA does not believe residential usage will continue to decline." (ALJPO, p. 45.) IIWC/FEA do not take exception to that language.

[9] In fact, the AG affirmatively agrees "there appears to be a currently declining *long-term* consumption trend . . . ." (AG Init. Br., p. 50 (emphasis added).)

(IIWC/FEA BOE, p. 3.) But IIWC/FEA's position on this issue remains unclear. In their Brief on Exceptions, IIWC/FEA continue to champion a position which ignores declining usage. (Id., pp. 2-5.) This implies IIWC/FEA do *not* accept declining usage. However, IIWC/FEA alternatively suggest, if the Commission does not accept their recommended test year usage level (and the Commission should not), then the AG's position should be adopted. (Id.) The AG's recommended test year usage is IAWC's forecast for the year ending September 30, 2012, which reflects IAWC's declining usage methodology through that period. (ALJPO, pp. 46-47.) IIWC/FEA also suggest that using 2010 base usage as test year base usage "reflects the decline in residential usage in recent years." (IIWC/FEA BOE, p. 4.) These statements, then, imply IIWC/FEA *do* accept declining usage. Because they take inconsistent approaches in their Brief on Exceptions, it remains unclear whether IIWC/FEA dispute the reality of declining usage.

As the ALJPO correctly acknowledges, because IIWC/FEA's approach relies on historical usage data, it is less reliable than the other approaches in the record "[i]n the face of declining residential sales volumes, on a per customer basis . . . ." (ALJPO, p. 46.) IIWC/FEA are forecasting consumption based on only *one* season of base usage data—2010—rather than the *nine* seasons of base usage data available, which were relied on by IAWC. (IAWC Exs. 8.00R (Rev.) (Naumick Reb.), p. 6; 5.00SUPP (Kerckhove Supp. Dir.), p. 6.) Yet, IIWC/FEA continue to claim their approach "produce[s] a more conservative and reasonable result" and is "more realistic" than IAWC's forecast test year sales level. (IIWC/FEA BOE, pp. 2, 3.) That is not the case. As the ALJPO notes, "it is not clear how [IIWC/FEA] reached that conclusion." (ALJPO, p. 45.) And it remains unclear. IIWC/FEA have not explained how establishing test year consumption based on 2010 consumption is "more realistic" when it ignores reality—that IAWC has experienced a 1.90% annual decline in residential usage since 2010. (See IAWC Ex.

8.00R (Rev.), p. 20.) IIWC/FEA suggest (for the first time in their Brief on Exceptions) that using 2010 base usage as test year base usage (somehow) "reflects the decline in residential usage in recent years." (IIWC/FEA BOE, p. 4.) But IIWC/FEA do not explain how using 2010 data, when the record reflects usage has declined since 2010 (and will continue to decline) "reflects the decline in residential usage" at all, let alone "in recent years." Simply put, it does not.

IIWC/FEA's exception to the ALJPO's conclusions regarding test years sales volume should be rejected. For the reasons stated in IAWC's Brief on Exceptions, the Commission should adopt IAWC's exceptions language related to the ALJPO's conclusions in this regard. (IAWC BOE, pp. 17-21, Appx. A, pp. 6-8.)

### B. ALJPO Section V.C.2, "Rate Case Expense—Consultant's Hourly Rate" (ALJPO pp. 50-51)

<u>Response to Staff (Staff BOE, pp. 3-5)</u>

The ALJPO acknowledges the tax issues addressed by IAWC witness Mr. Warren in this case "are very complex," and it notes that Mr. Warren, "an expert in this area," "exercised [his] expertise in an efficient manner—including under examination at the hearing . . ." went largely unchallenged. (ALJPO, p. 51.) The ALJPO further notes that Mr. Warren's hourly rate in this case "is at or below those charged by others with similar expertise" is another fact that went largely unchallenged. (<u>Id.</u>) As such, the ALJPO finds it inappropriate to simply supplant, as Staff suggests, Mr. Warren's hourly rate with the lower hourly rate charged IAWC by one of the certified public accountants ("CPA") hired to review its projected financial statements in this case. (<u>Id.</u>) Staff, however, takes exception to the ALJPO's adoption of an average hourly rate, claiming such rate "could appear to be arbitrary, since the merits of an average rate were never debated on the record." (Staff BOE, p. 3.) But it is Staff's simply substituting the CPA's hourly rate for Mr. Warren's that produces the more arbitrary result.

There is no record evidence that the CPA whose rate Staff uses could perform the services Mr. Warren provided or that, if he could, he would do so in the same amount of time or at the same rate he charged IAWC to review its financials. (IAWC Init. Br., p. 57.) Further, there is no record evidence the CPA's education, expertise, credentials, experience, years of practice or level of skill are comparable to Mr. Warren's. (Id.) They are not. Most notably, unlike the CPA, Mr. Warren is an attorney. (See IAWC Ex. 13.00R (Warren Reb.), pp. 1-3; Tr. 779.) Thus, it is *Staff's* substituted hourly rate that is arbitrary. It should not be heard to take issue with the ALJPO's hourly rate. Staff's exception should be rejected.

In exceptions, Staff asserts the only other hourly rate pertinent to this issue is that of the AG's witness, Mr. Smith, and that Mr. Warren's rate should be considered just in the context of Mr. Smith's. (Staff BOE, p. 4.) But Staff itself pointed to the hourly rates of IAWC's attorneys and its other experts in this case in testimony and in arguing this issue in briefing.[10] (ICC Staff Ex. 16.0 Supp. (Rev.) (Ostrander Reb.), p. 4; Staff Init. Br., p. 25.) IAWC notes, unlike those other attorneys and experts, Mr. Warren has a Master of Laws (LL.M.) in taxation from New York University School of Law and his career has focused specifically on tax issues affecting the utility industry. (IAWC Ex. 13.00R, pp. 1-3.) IAWC also pointed out Mr. Warren's rate should be considered in light of the (higher) rates for other senior lawyers in his practice area. (IAWC Init. Br., p. 58; IAWC Ex. 7.03SR, pp. 700-01 (JMO-10.02).) Finally, Staff's assertion here

[10] The rates for other attorneys and consultants are not a valid basis for assessing whether amounts expended to compensate Mr. Warren are just and reasonable because (1) he provides a different service than the other attorneys and technical experts retained by the Company, none of whom are capable of providing the same specialized service, (2) the attorney and other expert rates may be discounted rates negotiated by IAWC and those service providers in light of the market conditions that existed at the time the rates were negotiated, and (3) with respect to the external attorneys' hourly rates, those rates reflect the substantial volume of attorney time necessary to litigate the rate case. (See IAWC Ex. 7.03SR, pp. 700-01 (JMO-10.02).)

ignores that IAWC carries the burden of proof in this case and it is often far more expensive to defend than to allege. Staff also contends its arbitrarily selected CPA hourly rate "is a more appropriate proxy" than the ALJPO's averaged hourly rate for Mr. Warren, "comparing the spread" between Mr. Smith and Mr. Warren's hourly rates. (Staff BOE, p. 4.) The hourly rate used in the ALJPO's, however, actually more closely approximates the midpoint of that range than does Staff's CPA rate. Staff's exception here should therefore be rejected.

### C. ALJPO Section V.C.5, "Rate Case Expense—Service Company Labor" (ALJPO pp. 53-54)

Response to AG (AG BOE, pp. 22-25)

The AG takes exception to the ALJPO's rejection of its adjustment to remove Service Company labor costs from IAWC's rate case expense because (the AG summarily asserts) "the underlying job duties performed by Service Company employees in preparing a rate case are normal functions and can be expected to replace the time devoted by those employees to IAWC services." (AG BOE, p. 22.) But the Service Company labor charges included in rate case expense are *not* for normal job duties; as the record shows, they are for labor separate from and incremental to IAWC's test year labor expense. As such, as the ALJPO aptly finds, "there is not a duplication or double-counting" related to those services. (ALJPO, p. 54.) The AG's exception should be rejected.

The AG does not provide a single citation to the record evidence supporting the premise on which the AG's position is based: that the rate case expense Service Company charges are for "normal job duties" and "double-count[]" test year labor. (AG BOE, p. 23.) This is because the record makes clear that those charges are for the services of certain Service Company and temporary personnel in preparing and litigating the rate case. (IAWC Ex. 7.00 (Bernsen Dir.), p. 14. See also IAWC Ex. 7.03SR (including invoices from temp agencies reflecting the time of temporary personnel employed to assist on the rate case).) As such, they are direct charges IAWC would not incur but for the filing of this rate case. (IAWC Ex 7.00R (Bernsen Reb.), p. 9.) Simply because the AG contends Service Company personnel's normal job duties "should" include rate case activities, it does not mean that they *do*. (AG BOE, p. 23.)

Despite that record evidence, the AG asserts:

> IAWC already has an allowance for Service Company charges in its last rate case, and *the same internal employees who manage the utility have submitted testimony*. There are only so many hours in a day, and it is unreasonable to believe that these employees provided the full compliment of services in the prior years (which were included in rates) and then another set of services for the rate case.

(AG BOE, p. 23 (emphasis added).) Clearly, the AG is confused. As IAWC witness Mr. Bernsen testified in response to questioning by the AG's counsel at hearing, when a Service Company employee's "normal job duties" include assisting in IAWC's rate cases, the charge for their services *is* included in test year Service Company labor charges and is *not* included in rate case expense. (Tr. 271-73 (Mr. Bernsen testifying neither his time, nor that of IAWC witnesses Mr. Kerckhove or Mr. Rungren, who testified in this case and in IAWC's last, are included in rate case expense).) The services provided by those employees are distinguishable from the services provided to IAWC in this case by Service Company employees (and temporary personnel) whose "normal job duties" are *not* to assist on IAWC rate cases. As such, charges for the latter *are* properly included in rate case expense.

To assist the AG in grasping this distinction, in briefing, IAWC offered as an example the services of IAWC witness Ms. Cooper. (IAWC Init. Br., p. 60.) Ms. Cooper is a Service Company employee who serves as Manager, Business Services for the Service Company's Customer Service Center ("CSC"). (IAWC Ex. 15.00R (Cooper Reb.), p. 1.) Thus, her job responsibilities do not include assisting in the preparation and litigation of IAWC's rate cases. (Id.) Nevertheless, Ms. Cooper's participation as a witness in this case was necessitated by certain allegations raised by Staff related to the CSC.

The AG appears to accept that Ms. Cooper's services in this case are incremental and not duplicative of test year labor. (AG BOE, p. 23.) But the AG is not satisfied: "Beyond the testimony of Ms. Cooper, IAWC presented *no* evidence or argument to explain the role of *other* Service Company personnel in the rate case and why their respective involvement in the rate case extended beyond the scope of normal job duties." (AG BOE, pp. 23-24 (emphasis added).) But that assertion is wrong. As stated, IAWC provided ample evidence in the form of written testimony, live testimony and invoices supporting the incremental Service Company labor charges included in rate case expense. (See IAWC Exs. 7.00, p. 14; 7.00R, p. 9; 7.03SR; Tr. 271-73. See also IAWC Init. Br., pp. 59-60; IAWC Reply Br., p. 40.) As discussed above, IAWC provided evidence at hearing that the cost of certain Service Company personnel whose job duties *are* to assist with the rate case were not included in rate case expense. Moreover, a cursory review of the qualifications of several of IAWC's witnesses in this case who are employed by the Service Company makes evident it is not part of their "normal job duties" to assist IAWC with its rate cases. (See, e.g., IAWC Ex. 8.00 (Naumick Dir.), p. 1.)

Like the ALJPO, Staff recognizes the record evidence "support[s] that the Service Company services and associated labor costs related to the rate case were incremental to the normal job duties performed for the Company and would otherwise not have been incurred if there was no rate case." (Staff Init. Br., p. 26.) The AG's apparent confusion on this issue is no reason to alter the ALJPO's sound, record-based conclusion that IAWC's Service Company labor costs included in rate case expense are separate from and incremental to its test year Service Company labor expense. The AG's exception should be rejected.

## IV. OTHER INCOME TAX ISSUES

### A. ALJPO Section VI.A, "DPAD—Section 199" (ALJPO pp. 61-63)

Response to AG (AG BOE, pp. 25-27)

The AG takes exception to the ALJPO's conclusion regarding the Domestic Production Activities tax deduction ("DPAD"). (AG BOE, pp. 25-27.) The AG's exception, however, is based on the erroneous premise that "IAWC's standalone tax return reflects taxable income in the test year." As the ALJPO correctly found, "if [IAWC] were to file its taxes on a standalone basis for the test year, there would be no DPAD deduction because operating losses in other years would entirely offset taxable income in the test year." (ALJPO, p. 63.)

Consistent with longstanding Commission practice, IAWC calculates an amount of federal tax expense in the test year for ratemaking purposes. As IAWC witness Mr. Warren explained, however, reviewing IAWC's actual and projected taxable income for the period 2006 through 2013 indicates that IAWC will have a net tax loss for the entire period. (IAWC Ex. 13.00R (Warren Reb.), pp. 39-40.) Thus, IAWC has no positive taxable income during the period. (This means there would, on a stand-alone basis, be no DPAD. (Id.)) The AG seems to think this is a problem. But as IAWC explained in its Initial Brief (pp. 140-41), differences between tax expense calculated for ratemaking and per books tax payments are nothing new in Illinois. See Union Electric Co., Order, Docket 58738, 1974 Ill. PUC LEXIS 4 (Oct. 23, 1974). Because there are such differences routinely, Illinois computes ADIT to reflect the deferral of tax payments, and deducts the ADIT amount from rate base in recognition of the fact that the deferred payments are non-investor supplied funds. See Citizens Utils. Co. of Ill., Order, 1981 Ill. PUC LEXIS 23, *22-29 (May 27, 1981); Central Ill. Light Co., Order, Docket 60044, 1976 Ill. PUC LEXIS 22, *15-18 (July 14, 1976). The AG suggests, nevertheless, if there is no taxable income in the test year, there is "no reason to include any tax expense in rates." (AG

BOE, p. 26.) This assertion ignores how taxes are treated for ratemaking purposes in Illinois. In fact, the AG would appear to offhandedly advocate a wholesale change in the regulatory treatment of taxes in Illinois, without consideration of potential serious implications to its suggestion, such as whether this would violate tax normalization rules. (See IAWC Init. Br., p. 138.) The AG's unfounded suggestion should be rejection.

Moreover, the DPAD is unavailable for the consolidated American Water tax group. Under the applicable tax requirements of Section 199, where there is a consolidated tax group, there must be a "group" DPAD for any member to have one. (IAWC Ex. 13.00R, p. 36.) And, because the American Water group has no taxable income, regardless of how much eligible activity income any member produces, there is, under the statute, no DPAD. (Id.)

The AG also argues that the Commission "should" follow an order of the California commission on this issue. (AG BOE, pp. 26-27.) As discussed in response to the AG's Exception regarding BT (see Section II.A supra), the AG has provided no basis for following the California Commission's decision on this issue, not least because the necessary comparability between California American and the California regulatory environment and IAWC and the Illinois regulatory environment has not been established. Therefore, this suggestion should be rejected.[11]

The ALJPO also is correct that there is no DPAD calculation in the record. The AG suggests "the Commission regularly requests utilities to provide information and rate impacts based upon the conclusions of a rate case." (AG BOE, p. 27.) But "such information and rate

[11] The AG suggests in several parts of its BOE that the Commission should follow the California commission's orders (and those of various other jurisdictions). Taken to its logical conclusion, this argument suggests that the Commission also should adopt a 9.99% return on equity and a 53% equity ratio in the capital structure as the California Commission did for California American. See Application of California Water Service Co., Order, Decision 12-07-009; Application 11-05-001; Application 11-05-002; Application 11-05-003; Application 11-05-004, 2012 Cal. PUC LEXIS 297, *1 (Cal. PUC July 12, 2012).

impacts" typically reflect application of revised revenue requirements to rate designs that are *in the record*. The AG is proposing that IAWC be ordered to make a calculation, the methodology and components of which are nowhere to be found in the record, and whose inputs are anyway uncertain. (For example, as the AG acknowledges (AG BOE, p. 25), many service areas purchase rather than produce water, so the extent of the deduction's applicability is unclear (Tr. 744).)

**B. ALJPO Section VI.B, "Bonus Depreciation" (ALJPO pp. 63-68) and ALJPO Section VI.C, "Consolidated Tax Returns" (ALJPO pp. 68-69)**

<u>Response to AG (AG BOE pp. 28-33)</u>

The AG takes exception to the ALJPO's conclusion rejecting AG witness Mr. Smith's vague recommendation that "that the Commission find IAWC's (and American Water Works') decision for IAWC to not utilize 2011 bonus tax depreciation to be imprudent from the ratepayers' perspective" and that "appropriate recompense should be made to IAWC ratepayers through some means." (ALJPO, p. 68; AG BOE, pp. 28-31.) The AG argues that the ALJPO is incorrect in stating "there do not appear to be adverse consequences to IAWC as a result of AWWC's decision." (AG BOE, p. 28.) However, the record shows that the ALJPO correctly found there are not any adverse consequences of IAWC's position (and in fact IAWC benefits from participation in the consolidated tax structure (<u>see</u> IAWC Init. Br., pp. 133-38)). As IAWC explained in its Initial Brief (pp. 137-38), bonus depreciation deductions would merely increase IAWC's net operating loss carryforward, and so they would have no current effect on the Company's cash flow or on its ADIT. (IAWC Ex. 13.00R (Warren Reb.), p. 33.) ADIT represents the extra cash that is produced by deferring tax that would, absent a specified deduction, otherwise be payable. (<u>Id.</u>) If the extra deduction merely increases a net operating loss carryforward, then there is no additional tax deferred. (<u>Id.</u>) In the current year, the same amount of tax, zero, is paid with or without the extra deduction. The deduction only produces a cash benefit when the carryforward is used to reduce a future tax liability. However, in the year in which the deduction is claimed, there is no cash benefit and, consequently, there should be no incremental ADIT.

For IAWC, net operating losses in 2008, 2009, 2010 and 2012 (which total $104,123,796) will entirely offset its taxable income in all of the other years 2006-2013 (which totals $73,752,349), even without bonus depreciation. (Id., p. 34.) In short, it will pay no tax for the period. Had the Company claimed bonus depreciation with respect to its 2011 additions, it would not have paid any less tax. (Id.) It simply would have produced a larger CNOL carryforward. Thus, there would be no tax deferral and, critically, no incremental ADIT. (Id.) Thus, there are no adverse consequences of the ALJPO's determination.

The AG nevertheless continues to argue that failure to claim bonus depreciation is a basis for imposing a consolidated tax adjustment. As IAWC explained in briefing, this recommendation should be rejected. (IAWC Init. Br., pp. 133-39; IAWC Reply Br., pp. 103-04; 106-12.) The AG cites to a handful of jurisdictions that have adopted a consolidated tax savings adjustment. But in so doing, the AG ignores the forty-seven jurisdictions[12] (including Illinois) that do not apply, or have affirmatively rejected, adjustments for tax savings which result from subsidiary utilities' participation in the consolidated income tax returns filed by their parents. (Tr. 826 (Mr. Warren testifying "the vast preponderance of regulatory jurisdictions do exactly what Illinois does and has always done.").) (See also IAWC Reply Br., pp. 106-11.) In particular, the reasons the majority of jurisdictions reject a consolidated tax adjustment relate to the risk that the consolidated tax adjustment, which purports to pass through to ratepayers tax

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

benefits attributable to the losses of affiliates, including non-regulated affiliates, will erode the separation between regulated and non-regulated affiliates. IAWC submits the majority view (including Illinois', see Citizens Utils. Co. of Ill., Order, Docket 80-0468, 1981 Ill. PUC LEXIS 23, *22-29 (May 27, 1981)) is far more persuasive.

Further, the AG's basis for its position is in part based on a misstatement of IAWC witness Mr. Warren's testimony. The AG asserts that Mr. Warren said it was not controversial for a state commission to "'determine that there are consolidated tax savings to begin with that are subject to shift.'" (AG BOE, p. 29 (quoting Tr. 798).) The AG's quoted text reflects an error in the hearing transcript for which IAWC has, in accordance with the Commission's rules, made the following correction (which correction is unopposed):

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

(Tr. 798, lines 10-16; IAWC's Suggested Corrections to the May 15-17, 2012 Hearing Transcript (June 19, 2012).)

The AG continues to suggest that an adjustment adopted 20 years ago in Indiana can be utilized here, because the "record contains the methodology." (AG BOE, p. 30.) But the record does not support making any such adjustment. No witness has calculated or quantified the AG's proposed consolidated tax savings adjustment, or explained how it would be determined. (IAWC Init. Br., p. 140.) No witness in this proceeding testified as to why the Indiana approach would be appropriate in Illinois or what the appropriate inputs would be should the Indiana approach be adopted here. The AG's own Brief on Exceptions illustrates the uncertainties surrounding its proposal. The AG states: "It is reasonable to *expect* that applying Indiana's approach . . . *could* significantly benefit Illinois consumers." (AG BOE, p. 29 (emphasis added).) But this is just speculation of counsel—no witness testified that in fact applying the Indiana adjustment would provide significant benefits. And numerous jurisdictions have concluded that consolidated tax adjustments do not provide benefits. (See IAWC Init. Br., pp. 106-11.) With no basis on which to determine the AG's Indiana adjustment, the ALJPO properly rejected it.

Moreover, the AG fails to mention in its Brief on Exceptions (or elsewhere) that the Indiana Commission, in continuing to apply a decades old adjustment, required by a decades old Indiana court order and related to parent company interest expense, *declined* to adopt an expanded "tax savings" adjustment proposed by Mr. Smith in that case because, similar to the majority of jurisdictions cited above, it was concerned about the allocation to Indiana ratepayers of the tax burdens and savings of out-of-state affiliates. Indiana American Water Co., Order, No. 44022, 2012 Ind. PUC LEXIS 178, *272-74 (Ind. URC June 6, 2012).

Finally, the AG argues, for the first time in its Brief on Exceptions, that the Commission should initiate a rulemaking to consider consolidated tax saving adjustments. (AG BOE, p. 31.) No witness proposed such a rulemaking or testified that one was necessary or appropriate. The AG does not set forth any appropriate legal basis for a rulemaking. In short, the record does not support the AG's proposal. It should be rejected.

## V. COST OF CAPITAL AND RATE OF RETURN

### A. ALJPO Section VII.B, "Capital Structure" (ALJPO, pp. 69-77)

Response to Staff (Staff BOE, pp. 5-15)

Throughout this proceeding, Staff has complained that IAWC's forecasted balance of common equity is too high. The ALJPO recommends a capital structure comprised of less common equity than Staff itself recommended in the alternative proposal floated in its Initial

Brief. For Staff to now complain that "the PO's proposed capital structure contains a higher proportion of common equity than the record supports" is simply baffling. (Staff BOE, p. 5.)

The table below compares the ALJPO recommended capital structure and Staff's alternative recommendation:

| | ALJPO | Staff |
|---|---|---|
| Short-term debt | 1.30% | 1.34% |
| Long-term debt | 50.60% | 50.23% |
| Common equity | 48.10% | 48.44% |

Staff, of course, makes no mention of the fact that the ALJPO more or less adopts the same result (albeit for different reasons) that Staff recommended. Instead, Staff continues to tilt at windmills by arguing that IAWC has an "incentive" to use a capital structure with "an excessive amount of common equity, which would then allow AWW a greater return on its capital." (Staff BOE, pp. 5-6.) Charging that this incentive exists, and actually producing evidence that it has been acted on, are very different things. Staff's continuous insinuations that IAWC manipulating its capital structure in order to benefit AWW are unsupported and wrong.

According to Staff, "[t]he threshold question is whether IAWC's risk or cost was increased due to IAWC's affiliation with its parent, [AWW]." (Staff BOE, p. 5.) That's a good question. The problem for Staff is that it has provided no evidence that AWW has manipulated IAWC's capital structure; no explanation of how much equity in IAWC's capital structure would be "excessive"; and no quantification of the extent to which use of IAWC's capital structure would allegedly "inflate" its rate of return. Staff has simply failed to provide any of the evidence the Commission would need to make an adjustment under Section 9-230 of the Public Utilities Act, 220 ILCS 5/9-230.

The only thing Staff has managed to show is that AWW has a riskier capital structure than IAWC:

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

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

Staff also agrees that IAWC's affiliation with AWW produces tangible benefits to ratepayers. For example, by virtue of ownership by AWW, IAWC has the ability to obtain financing through American Water Capital Corporation ("AWCC"). (Tr. 631.) Staff also agrees that "Illinois-American's affiliation with the parent company is a benefit insofar as it mitigates the effect of financial risk that Illinois-American would have as a stand-alone entity." (Tr. 632, lines 8-12.) Setting rates with a capital structure that disregards IAWC's lower financial risk, relative to its parent company, would be in direct conflict with the legislature's directive that IAWC's cost of capital exclude any "incremental risk" or "increased cost of capital" resulting directly or indirectly from its affiliation with AWW.

Staff's Brief on Exceptions is otherwise more of the same: arguments and theory, but no evidence. Staff's capital structure exceptions should be disregarded.

## VI. COST OF SERVICE STUDY

### A. ALJPO Section VIII.B, "LOWU Contracts" (ALJPO pp. 111-16)

Response to IIWC/FEA Exception 2 (IIWC/FEA BOE, pp. 5-9)

IIWC/FEA do not take exception to the ALJPO's ultimate conclusion that any recommendation to bring Large Other Water Users ("LOWU") rates to full cost of service is unreasonable and should be rejected. (IIWC/FEA BOE, p. 8-9.) IIWC/FEA only contest the ALJPO's finding that IAWC's rebuttal cost of service analysis, which removed the allocation of contract customer costs for the combined Zone 1 and Chicago Metro service area and reflected the revenues of LOWU customers as "other water revenue," should be "given consideration." (IAWC Init . Br., pp. 96-97.) IIWC/FEA's exception in this regard should be rejected. The ALJPO gave balanced consideration to both IAWC's direct and rebuttal cost of service studies, and requires IAWC to submit a cost of service study using the same method as it does in direct, if it submits a cost of service study using the method IAWC used in rebuttal. (ALJPO, pp. 105-06.) As IAWC explained in briefing (IAWC Init. Br., pp. 96-97; IAWC Reply Br., pp. 68-69) the rebuttal approach more accurately reflects the benefits of contract customers and appropriately allocates the benefit of having contract customers in IAWC's system. (IAWC Ex. 11.00SR (Herbert Sur.), p. 12.) Moreover, showing the full cost to serve contract customers in the COSS is less helpful as contract rates are less than full-tariff rates. (Id., p. 13.) Thus, IIWC/FEA's exception should be rejected in favor of the ALJPO's more balanced approach.

## VII. RATE DESIGN

### A. ALJPO Section IX.A, "Customer Charges" (ALJPO pp. 117-25)

Response to Staff (Staff BOE, pp. 15-22), AG (AG BOE pp. 33-40) and Cities and Villages Exception 1 (Cities and Villages BOE, pp. 1-5)

In taking exception to the ALJPO's proposed customer charge, Staff disputes the level of customer costs associated with 5/8 inch meters reflected in the ALJPO. Staff incorrectly states that IAWC's proposed Customer Charge revenues from 5/8 inch meters is more than $55 million. (Staff BOE, pp. 15-16.) In fact, the ALJPO is correct that the revenues are less (see AG Ex. 3.03). The ALJPO does, moreover, correctly find that the most accurate estimate of the monthly customer cost for a 5/8 inch meter in Zone 1 with Chicago Metro is $17.25. (ALJPO, p. 123; IAWC Ex. 11.01SR (Herbert Sur.).) That this is the most accurate estimate does not appear to be disputed. Thus, if the customer cost for a 5/8 inch meter is $17.25, IAWC's proposed customer charges for Chicago Metro ($17.00) and/or Zone 1 ($18.00) are reasonable.

The AG and the Cities and Villages also propose a lower customer charge, based on a similar argument to Staff's—that IAWC's proposed customer charges over-recover customer costs. (AG BOE, pp. 34-35; Cities and Villages BOE, p. 4.) As explained by IAWC witness Mr. Herbert, IAWC set the proposed 5/8 inch meter customer charge "to recover the *customer costs for the 5/8 inch meter size*." (IAWC Ex. 11.00R (Herbert Reb.), p. 4, lines 81-82 (emphasis added).) It is vital for the 5/8 inch meter customer charge to recover the 5/8 inch meter customer costs because 92% of residential customers have 5/8 inch meters. (Id., p. 5.) Each customer should, therefore, "pay the appropriate level of customer costs so that intra-class subsidies are avoided." (Id., pp. 5-6.) Moreover, all the arguments about "over-recovery" of customer costs ignore the fact that IAWC has fixed costs over and above its customer costs; so, to the extent that IAWC is recovering fixed costs (whether customer costs or otherwise) through the fixed customer charge, there is no concern about "price signals." Given that a significant portion of IAWC's costs are fixed, recovery through the customer charge of costs above those defined as customer costs, but which are still fixed costs, is appropriate.

As the ALJPO correctly recognizes, "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." (ALJPO, p. 125.) To the extent the Company's customer charges recover fixed costs, even if the fixed costs are over and above fixed customer costs, such a result is consistent with the Commission's policy consistently supporting the recovery of a greater portion of a utility's fixed costs through the customer charge across all types of utility service. See Commonwealth Edison Co., Order, Docket 10-0467 (May 24, 2011), p. 232; see also Nicor Gas Co., Order, Docket 08-0363 (Mar. 25, 2009), pp. 90-91; Central Ill. Public Serv. Co., et al., Order, Docket 07-0585/0590, p. 238 (Sept. 24, 2008). In Commonwealth Edison Co., the Commission explained that it "recognized the importance of recovering fixed costs predominantly through fixed charges . . . ." Order, Docket 10-0467, p. 232. Similarly in Nicor Gas Co., the Commission noted, "the combination of increasing the fixed customer charge and decreasing the volumetric charges for fixed cost recovery is essentially a revenue neutral exercise." Order, Docket 08-0363, p. 90 (relying on Order, Docket 07-0585/0590). Likewise, in IAWC's previous rate cases, the Commission has requested IAWC to "consider proposing rates whereby a greater portion of its fixed costs will be recovered through the customer charge for each rate class." Illinois-American Water Co., Order, Docket 07-0507 (July 30, 2008), p. 122. "From a rate design perspective, all other things being equal, the Commission believes it is preferable for fixed costs to be recovered through fixed charges, and for variable costs to be recovered through variable charges, such as usage charges." Illinois-American Water Co., Order, Docket 09-0319 (Apr. 13, 2010), p. 170. Thus, IAWC's customer charges are appropriate as long as they recover fixed charges, and the record supports that they are.

The AG and the Cities and Villages further suggest, for the first time in their Briefs on Exceptions, that IAWC's customer charges should be reduced proportionately to match IAWC's authorized revenue requirement. (AG BOE, pp. 35-36; Cities and Village BOE, p. 3.) No witness proposed this adjustment or testified that such an approach is reasonable. This approach was not utilized in IAWC's previous rate case, Docket 09-0319.

Staff and the AG also take exception to the ALJPO's use of the Company's rate design for meters larger than 5/8 inch, proposing use of the AWWA meter factor approach instead. (Staff BOE, pp. 16-17; AG BOE, p. 34.) However, the ALJPO correctly adopts the Company's position. IAWC increased the customer charges for meters larger than 5/8 inches using the same methodology as in IAWC's last rate case. (IAWC Ex. 11.00SR, p. 7.) As shown in IAWC Exhibit 11.01R, the Company "chose to increase the customer charges by a uniform percentage rounded to the nearest $0.10." (IAWC Ex. 11.01R, p. 1.) IAWC determined that this method "would produce reasonable customer charges that were consistent with the AWWA factors and also the customer charges previously approved by the Commission." (Id.) Indeed, the ratios used by the Company are *lower* than the AWWA meter factors. (Id.) For example, the ratio used by IAWC to increase its 1 inch meter customer charge was 2.17 versus the AWWA factor of 2.5. (Id.) The Commission should adhere to its precedent in IAWC rate cases and utilize the lower ratios to increase customer charges for meters larger than 5/8 inches.

Staff also takes exception to the ALJPO's adoption of three different 5/8 inch meter customer charges for the consolidated Zone 1 and Chicago Metro district. (Staff BOE, p. 17.) Staff contends that because the costs IAWC incurs to serve these consolidated customers (meter reading, customer accounting and billing, administrative and general, customer service) are the same regardless of the location of the customer, the reasonable approach is to develop a single set of rates that apply to all similar customers. (Id.) In support of this contention, Staff points to the Commission's continued support of a movement to single tariff pricing. (Staff BOE, p. 18.) IAWC agrees that the Commission supports moving towards single tariff pricing. But the Commission has approved varying customer charges for a consolidated area en route to that goal, an example being South Beloit in Docket 09-0319. Further, as IAWC explained in its Reply Brief, Staff's proposed uniform customer charge also fails to recover the costs for all 5/8 inch meter customers. (IAWC Reply Br., p. 65.) Contrary to Staff, IAWC's proposed charges use as a starting point "the existing Zone 1 customer charges, which reflect a more gradual increase." (IAWC Ex. 11.00SR, p. 7.) This is particularly true for South Beloit. The Company also explained that it would support consolidating customer charges in the next rate case. (IAWC Ex. 11.00R (Herbert Reb.), p. 5.) Therefore, Staff's exception should be rejected.

The AG concludes its exception by arguing that the ALJPO's proposed customer charges would place a disproportionate burden on smaller users and discourage customer conservation. (AG BOE, p.36.) The Cities and Villages make the same argument. (Cities and Villages BOE, p. 1.) This argument is unsupported by the record and should be rejected—no witness testified as to these concerns with the proposed customer charges.[13] In fact, the record shows that increasing recovery of fixed costs through fixed charges does send a proper price signal. (IAWC Exs. 14.00R (Rev.) (Heid Reb.), pp. 21-22; 14.00SR (Rev.) (Heid Sur.), pp. 15-16.) Moreover, this argument ignores the fact that decoupling fixed cost recovery from usage can encourage the utility to embrace conservation measures, since revenues are not as directly linked to sales volume. (IAWC Ex. 14.00R (Rev.), pp. 22-23.)

[13] IAWC notes 82 Ill. Adm. Code 200.830(e) provides: "Statements of fact in briefs on exception and replies to briefs on exception should be supported by citation to the record."

### B. ALJPO Section IX.B, "Usage Charges" (ALJPO pp. 125-30)

Response to IIWC/FEA Exception 3 (IIWC/FEA BOE, pp. 9-11)

IIWC/FEA take exception to the ALJPO's adoption of IAWC's proposed usage charges, proposing instead an "across the board" (uniform percentage) approach. IIWC/FEA's position appears to primarily be driven by their conclusion that IAWC's rebuttal cost of service study (COSS) is flawed. But, as discussed above, this conclusion is wrong. Further, IAWC varied the increases in the commodity charges by rate block to generally move each customer class to its allocated cost of service. (IAWC Ex. 11.00R (Herbert Reb.), p. 19.) In lieu of the varied increases, IIWC/FEA propose adjusting the rate elements by a uniform percentage to coincide with the increased revenues granted by the Commission in this case. (IIWC/FEA Ex. 2.0 (Collins Dir.), p. 24.) A uniform percentage adjustment, however, would not move revenues more in-line with the allocated cost of service. (IAWC Ex. 11.00SR (Herbert Sur.), p. 14.)

Response to Staff (Staff BOE, pp. 22-25)

Staff takes exception to the ALJPO's usage charges primarily on the grounds that (Staff believes) they result from customer charges that are too high, and so reflect the wrong price signals. (Staff BOE, p. 22.) As explained above, Staff's position on the customer charge should be rejected. As IAWC explained in its Initial Brief, Staff and IAWC primarily dispute the shifting of cost recovery from customer charges to usage charges. (IAWC Init. Br., p. 102; Staff Init. Br., p. 62.) Staff's methodology recommends a higher usage charge due to understating the 5/8 inch meter customer charge. (IAWC Ex. 11.00SR, p. 7.) By shifting more customer costs in volumetric rates, customers that consume more, such as large families, would pay more for customer-related costs than small users. (Id., p. 6.) Staff's methodology violates the rate principle of gradualism and fails to produce the Company's requested cost of service. (IAWC Init. Br., pp. 102-03.) The Commission should again reject Staff's proposed usage charges. The

ALJPO correctly approved the Company's more reasonable rate structure, which moves revenues toward cost of service. (Id., p. 7.)

### C. ALJPO Section IX.C, "Fire Protection Charges" (ALJPO pp. 130-33)

Response to Staff (Staff BOE, pp. 25-27)

Staff takes the position that, for the Fire Protection charge in Chicago Metro, a charge that recovers 101.5% of the cost of the service, does not comply with Section 9-223(a) of the Public Utilities Act, 220 ILCS 5/9-223(a). (Staff BOE, p. 25.) Staff's argument appears to be that Section 9-223(a) requires the fire protection charge to recover the cost of service *exactly.* But Section 9-223(a) does not say that the charges have to match costs exactly. Section 9-223(a) provides: "[a]ny fire protection charge imposed shall *reflect the costs* associated with providing fire protection service for each municipality or fire protection district." 220 ILCS 5/9-223(a) (emphasis added). The requirement that the charges just "reflect" the costs suggests that some minor variation between cost of service and the actual charge is acceptable. And, as Staff admits, (Staff BOE, p. 25), the percentage variation here is small.

On the Lincoln Fire Protection charge, however, Staff's proposed alternative increase (Staff BOE, p. 26) creates a fire protection charge that is too low. Staff's proposed charge varies too much from the cost of service, and so simply does not "reflect the costs" as Section 9-223(a) requires. (See IAWC Init. Br., p. 105.) Therefore, Staff's exception on the fire protection charges for Chicago Metro and Lincoln should be rejected.

### D. ALJPO Section IX.D, "Consolidated of Volumetric Charges" (ALJPO pp. 133-35)

Response to IIWC/FEA Exception 4 (IIWC/FEA BOE, pp. 12-13)

IIWC/FEA propose exceptions on this issue that purport to "direct" that the issue be considered in IAWC's next rate case. (IIWC/FEA BOE, p. 13.) IAWC, however, sees little substantive distinction between the ALJPO, which states, "As a result, the Commission rejects IIWC/FEA's proposal without prejudice so that it may [be] addressed, if necessary, in a later proceeding," and IIWC/FEA's proposed revision, which states, "As a result, the Commission rejects IIWC/FEA's proposal without prejudice so that the consolidated billing issue may be addressed in the Company's next rate case proceeding." (ALJPO, p. 135; IIWC/FEA BOE, p. 13.) IIWC/FEA's proposed language that the issue "may" be addressed does not appear to require that it "must" be addressed. Nevertheless, to the extent IIWC/FEA seek to require that the issue be addressed in the next case, this recommendation should be rejected as presupposing that the issue must be resolved in a rate case, and thus potentially mandating that time and expense unnecessarily be expended to do so.

## VIII. CONSOLIDATION OF ZONE 1 AND CHICAGO METRO

### A. ALJPO Section X, "Consolidation of Zone 1 and Chicago Metro Rate Areas" (ALJPO pp. 136-46)

<u>Response to IIWC/FEA Exception 5 (IIWC/FEA BOE, pp. 13-18)</u>

IIWC/FEA take exception to the ALJPO's approval of IAWC's proposal to consolidate the non-production related costs of the Chicago Metro and Zone 1 districts. (IIWC/FEA BOE, pp. 13-18.) Specifically, they dispute the ALJPO's characterization of their opposition to consolidation as premised only on "general, conceptual principles" rather than record evidence. (<u>Id.</u>, p. 13; ALJPO, p. 146.) Yet, in so arguing, IIWC/FEA (again) present just that—theoretical arguments, rather an actual evidentiary basis for their position. The ALJPO properly dismissed IIWC/FEA's unsupported position; the Commission should do so once more.

IIWC/FEA initially contend their recommendation is "based on actual, sound, fundamental principles that apply to utility costs." (IIWC/FEA BOE, p. 13.) But they then present the *exact same* conceptual arguments they presented in testimony and in briefing. First, they claim consolidation ignores the distinctiveness and geographic characteristics of each service territory, differences in rate base and non-production costs, and cross-subsidies created by the consolidation. (IIWC/FEA BOE, pp. 13-14; IIWC/FEA Init. Br., pp. 25-27.) IIWC/FEA claim they gave "specific examples of how the different customer compositions and different zonal class structures affect the actual costs of customers." (IIWC/FEA BOE, p. 14.) However, as the record demonstrates, that is inconsequential—the actual differences in customer composition between Chicago Metro and Zone 1 are minor and would not affect the consolidated pricing. (IAWC Ex. 11.00SR (Herbert Sur.), p. 9.) Further, IAWC's rate design satisfactorily addresses any differences in load characteristics between the two zones. (Id.) IIWC/FEA's theoretical concern regarding different base and capacity costs between districts is also a non-issue, because those costs are largely comprised of production costs, which are maintained separately in the rate design. (Id., p. 10.) Notably, in continuing to advocate their position, IIWC/FEA simply ignore the myriad *similarities* between Chicago Metro and Zone 1; these similarities support consolidation. (See IAWC Ex. 11.00R (Herbert Reb.), p. 16.)

IIWC/FEA also argue the creation of price subsidies will erode system efficiency by "eras[ing] economic incentive for customers in higher cost districts to be more efficient in placing demands on the water system because the prices they pay will not accurately reflect the cost of delivering the water service." (IIWC/FEA, BOE, p. 15; IIWC/FEA Init. Br., p. 27.) But, as IAWC explained in testimony and briefing and as aptly acknowledged by the ALJPO, IIWC/FEA's "parade of horribles" is not supported by any evidence. (IAWC Exs. 11.00R, p. 17; 11.00SR, p. 10; ALJPO, pp. 145-46.) That is, despite contending their position is "based on actual, sound, fundamental principles" (IIWC/FEA BOE, p. 13), IIWC/FEA fail to offer any analysis to show that inefficiencies exist or price signals would be distorted under the consolidated pricing (id.).

The only "proof" IIWC/FEA can point to is, in fact, anything but. IIWC/FEA contend IAWC's rebuttal COSS indicates the Large Industrial rate class in Zone 1 will see an increase of 22.5% "*as a result of the consolidation*." (IIWC/FEA BOE, pp. 14-15 (citing IAWC Ex. 11.03R, Sch. A-Z-1 w/CMW) (emphasis added).) IIWC/FEA further claim, absent consolidation, that class will receive only a 15.1% increase. (Id., p. 14.) This, they contend, supports that consolidation will harm ratepayers. (Id., p. 15.) IIWC/FEA's contention is misplaced. As the ALJPO aptly recognizes, the proper comparison of consolidation to stand alone cost of service studies for the Large Industrial rate class is in IAWC's direct COSS, IAWC Ex. 11.01, which shows that rate class will receive the same rate increase with or without consolidation. (ALJPO, p. 145 (citing Schedules A-Z-1 w/CMW and A-Z-1).) IIWC/FEA disregard that IAWC's rebuttal COSS on which they rely, IAWC Ex. 11.03R, was for the combined Zone 1 and Chicago Metro only. (IAWC Exs. 11.00R, p. 20.) That revised COSS shows the rate increase for the Large Industrial rate class as 22.5% with consolidation, but it does not include schedules for Zone 1 and Chicago Metro on a stand alone basis. Given the revisions to the original (direct) COSS in the revised (rebuttal) study (see id., pp. 20-21), the rate increase for the large Large Industrial rate class would be the same with and without consolidation in the revised COSS. For this reason, the ALJPO correctly concludes IAWC's rebuttal COSS does not support IIWC/FEA's assertion the Large Industrial rate class would see a larger increase as a result of consolidation. (ALJPO, p. 145.)

The record supports the myriad benefits of consolidation and, as such, the ALJPO correctly found it in the public interest and approved it. (ALJPO, p. 146.) IIWC/FEA's exception should be rejected and the ALJPO's reasoned conclusion regarding consolidation approved.

Response to Bolingbrook (Bolingbrook BOE, pp. 1-12)

Bolingbrook also takes exception to the proposed consolidation of Zone 1 and Chicago Metro. In so doing, Bolingbrook advocates against a rate decrease for all but its lowest volume customers—a rate decrease of as much as 6 - 8% for larger volume users. (See Verified Response (by letter) to ALJ's Post Record Data Request, Bill Comparison, p. 5 (Aug. 14, 2012).) Bolingbrook's basis for opposing a rate decrease for its residents is a purported lack of evidence on the impacts of the consolidation. But Bolingbrook's alleged lack of evidence is really a product of Bolingbrook's unfamiliarity with the record, rather than any actual lack of sufficiency. As IAWC explained in its Reply Brief (pp. 58-59), IAWC witness Mr. Herbert provided the basis for the consolidation, described how the consolidation included only non-production costs, defined non-production costs, explained the methodology by which non-production costs were determined and provided a detailed calculation in support. (IAWC Exs. 11.00 (Rev.) (Herbert Dir.), pp. 15-16; 11.02; see also Tr. 230-31.) IAWC presented evidence that the consolidation is in the best interests of ratepayers, including extensive cost of service studies and rate design information reflecting both Chicago Metro and Zone 1 consolidated and stand alone, for comparison purposes. (See IAWC Exs. 11.00 (Rev.); 11.01; 11.03R.) Staff and IAWC witnesses analyzed IAWC's proposal and testified to its consequences. (See IAWC Exs. 11.00 (Rev.), pp. 12-18; 11.00R (Herbert Reb.), pp. 15-17; 11.00SR (Herbert Sur.), pp. 9-10; ICC Staff Exs. 4.0 (Boggs Dir.), pp. 5-11; 12.0 (Boggs Reb.), pp. 17-20.) Staff witness Mr. Boggs performed an extensive analysis of the impacts of consolidation and determined that consolidation was beneficial. (ICC Staff Ex. 4.0, p. 10.) Mr. Boggs found that the Company's proposed consolidation of the Zone 1 and Chicago Metro Water divisions would lower monthly bills for Chicago Lake Water and Chicago Moreland typical use residential customers. (Id., pp.

6-7, Tbls. 4.1, 4.2.) As Mr. Herbert explained, for Chicago Metro on a stand alone basis, the proposed customer charges are equal to the Zone 1 present rates, but with higher consumption rates to recover the cost of service on a stand alone basis. (IAWC Ex. 11.00 (Rev.), p. 17.)

Contrary to Bolingbrook's assertions in its Brief on Exceptions that this evidence does not examine the long-term impacts of consolidation (and putting aside the fact that no witness testified that the analysis performed of the consolidation was in any way insufficient), the record shows that consolidating the districts will spread capital improvement costs over a larger customer base, lower rate case expense and lower administrative fees. (ICC Staff Ex. 4.0, p. 10.) Further, IAWC designed rates in the consolidated district to ensure Chicago Metro ratepayers would not pay for water treatment costs in Zone 1, established separate production costs for each district and equalized the rate for nonproduction costs. (Tr. 230-31.) In short, the consolidation is for costs, such as customer service, customer billing and administrative and general costs, that are essentially the same for all service areas. (ICC Staff Ex. 12.0 (Boggs Reb.), pp. 19-20; Staff Reply Br., pp. 23-24.)

In its Brief on Exceptions, Bolingbrook suggests that Chicago Metro could end up paying for capital improvements in Zone 1 that were already paid for in Chicago Metro (and the corollary implication that Chicago Metro would pay for investment in Zone 1 but not in Chicago). (Bolingbrook BOE, p. 7.) But the record shows that this argument is unfounded. To begin with, as discussed above, the consolidation is only for non-production costs, so that Chicago Metro is not paying for water production and treatment investment in the rest of Zone 1. Second, the record makes clear that IAWC is projecting substantial investment in Chicago Metro through the test year that is unique to that district, including but not limited to projects such as the Bolingbrook Lily Cache Lane Water Utility Relocation Phase II (cost, $400,000), Chicago

Waste Water – Marina Water Reclamation Facility Replacement (cost, $3.4 million), Arbury Lake Water Connection (cost, $1 million) and Rollins Fire Flow Improvements (cost, $1 million). (IAWC Ex. 3.00 (2d Rev.) (Kaiser Dir.), pp. 28, 34, 37-38.) Further, contrary to Bolingbrook's assertions, IAWC has provided detailed evidence on its capital investment plans and projects in both Chicago Metro and Zone 1. (See id., pp. 3-45.)

Bolingbrook also alleges the consolidation is contrary to statue, and in particular, to Section 9-241 of the Public Utilities Act, 220 ILCS 5/9-241, which provides that, *inter alia*, "No public utility shall establish or maintain any unreasonable difference as to rates or other charges, services, facilities, or in any other respect, either as between localities or as between classes of service." 220 ILCS 5/9-241. This line of argument is somewhat ironic, since the proposed consolidation will actually narrow or eliminate "difference as to rates or other charges." Id. Further, it ignores the fact that, to the extent there are differences between Zone 1 and Chicago Metro (e.g., Metro is served primarily by purchased water), these differences have been accounted for by consolidating only non-production costs—precisely to address differences between facilities and localities.

Finally, Bolingbrook argues that the Commission required in Docket 00-0476, as a condition of the merger of Citizens Utility into IAWC, that IAWC "maintain in effect the various rates, rules, regulations, terms and conditions of service to the public heretofore approved by the Commission for each of its service areas, including the area previously served by CUCI." (Bolingbrook BOE, p. 9.) But this argument is easily dismissed, as it omits what the actual requirements of the Docket 00-0476 Order were. That Order states, "From and after the effective date of the Acquisition and *until such time as a change(s) is (are) approved by the Commission*, Illinois-American will maintain in effect the various rates, rules, regulations, terms and conditions of service to the public heretofore approved by the Commission and currently in effect for each of the service areas of Illinois-American, including the area previously served by Citizens." Order, Docket 00-0476 (May 15, 2001), p. 48 (emphasis added). Clearly, the rates, rules, regulations, and terms and conditions of service of the former Citizens territories have been changed by the Commission since 2001 (e.g., in rate case Dockets 02-0690, 07-0507 and 09-0319). In fact, IAWC's rules, regulations and conditions of service have been consolidated into one standard set for the entire state. (See IAWC Rules, Regulations and Conditions of Water Service, ILL.C.C. No. 23, Sheet Nos. 1-45 (filed June 9, 2009).) Clearly, the Docket 00-0476 order places no restriction on the Commission making further changes to the rates, rules, regulations, and terms and conditions of service of the former Citizens territories.

## IX. AFFILIATED INTEREST ISSUES

### A. ALJPO Section XII, "Affiliated Interest Issues" (ALJPO pp. 163-77)

Response to Staff (Staff BOE, pp. 28-47)

In the affiliated-issues section of its Brief on Exceptions, Staff states that it "does not take exception to the Joint Facilities Adjustment ordered in the PO" or "to the PO's conclusion not to order a Phone Charge Adjustment." (Staff BOE, p. 28.) But Staff challenges the "conclusion that opening a new investigation into violations of the Act would be inefficient or unwarranted at this time." (Id.) Staff provides no basis for revisiting this conclusion.

#### 1. The ALJPO Correctly Concluded that the Audit Performed in Docket 10-0366 Does Not Support the Initiation of Another Investigation.

One of the reasons given in the ALJPO for rejecting Staff's recommended investigation was "that a lengthy and detailed management audit of the fees assessed by the Service Company under the same Service Company agreement was recently completed" and is pending in Docket 10-0366. (ALJPO, p. 177.) In rejoinder, Staff asserts that its proposed investigation is "separate and distinct from the management audit." (Staff BOE, p. 29.) Staff concedes, however, that the Docket 10-0366 audit covers "similar" matters as in this case. (Id., p. 31.)

First, Staff misapprehends the significance of the Docket 10-0366 audit to this case. No one has argued that the audit covered precisely the same issues as Staff witness Mr. Sackett's investigation, and the ALJPO did not state as much. The audit was simply one of many factors weighing against Staff's recommended, additional investigation. The most critical factor, in the Company's view, was that Staff's investigation in this case turned up next to nothing. The numerous audits and reviews of Service Company costs—in every rate case since the Service Company Agreement was approved, in the Service Company cost study performed in IAWC's last rate case, and in the recent and ongoing management audit—only confirmed that yet another investigation was not warranted.

Nevertheless, Staff is incorrect that the scope of the Docket 10-0366 audit does not overlap with its proposed investigation. The audit examined the cost of services charged by the Service Company to IAWC, see, e.g., Order Initiating Management Audit, Docket 10-0366 (June 2, 2010), p. 2, essentially the same inquiry that Staff proposes to revisit here. Staff claims that the audit "did not consider allocation information regarding services to AWR" (Staff BOE, p. 31), but this is wrong, too. The Final Audit Report makes clear that the auditor considered the allocation of affiliate charges to IAWC in its review. (See, e.g., Final Audit, Report, Docket 10-0366 (Jan. 1, 2012), p. I-11 (audit includes "an analysis of AWWSC charges including the allocation methods used to direct costs to IAWC"); id., pp. IX-1–IX-12 (reviewing "customer service functions provided by AWWSC, including the costs charged from AWWSC to IAWC," including "functions . . . performed" from "CSC[] located in Alton").)

This only confirms the decision of the ALJPO. Ordering an extensive, perhaps extra-jurisdictional investigation, with (at best) *de minimis* evidence in support, and with numerous similar reviews in the immediate background, would not be a prudent use of Commission resources, but speculative overkill. This is common sense, and Staff offers no reason to doubt it.

### 2. Any Affiliated-Interest Issues Presented in this Docket Were Fully Remedied in this Docket.

In attempting to justify a superfluous investigation, Staff offers some curious arguments. For example, it asserts that "[t]he Commission cannot, in Docket No. 10-0366, remedy the violations of the AIA presented in this docket." (Id. at 31.) As an initial matter, as previously discussed, there have been no violations of the Service Company Agreement. Even if there had been, Staff provides no legal basis or other argument supporting this alleged restriction on Docket 10-0366. As the ALJPO (p. 177) correctly finds, opening a *new* proceeding would be not be "efficient or otherwise warranted while the proceeding in Docket 10-0366 is pending." More to the point, Staff's argument about redressability in another docket simply ignores this docket. To the extent the ALJPO found that errors had occurred, it remedied them. The ALJPO found that a $3,422 joint-facilities cost misallocation occurred, and it remedied that error by requiring a $3,422 adjustment. With respect to the call referral issue, the ALJPO also required the Service Company to provide certain information to inquiring callers, which IAWC has accepted. So both issues were fully remedied, and Staff has not opposed the rejection of their other adjustments. (Staff BOE, p. 28.) As the only "errors" found in this docket were fully remedied in this docket, redressability in Docket 10-0366 is irrelevant.

### 3. Staff Proved No Instances where IAWC Did Not Follow Its Affiliated-Interest Agreement.

Staff also asserts that "instances where IAWC has not been following its AIA" justify additional investigation. (Staff BOE, p. 32.) Staff appears to have two instances in mind. One is the fully remedied $3,422 joint-facilities allocation. Staff calls this a "violation" of the agreement, but no violation of the Service Company Agreement was in fact shown. A charging error by itself does not necessarily reflect a violation. Staff, in characterizing a $3,422 misallocation as a "violation" warranting a full-blown investigation, seems to lack a certain sense of proportion—particularly, again, when the allocation has been fully remedied.

The second "violation" is the "phone charge adjustment" that was rejected by the ALJPO, see ALJPO, p. 176—a rejection, again, that Staff does *not* challenge. (Staff BOE, pp. 33, 28.) This is another unusual argument. A *rejected* adjustment *supports* the order of an investigation that would likely consume hundreds of hours and hundreds of thousands of dollars? If the law and the record do not warrant *any* phone-charge adjustment—not a single cent—then, *a fortiori*, they do not support the exponentially greater step of a large-scale, highly expensive and time-consuming investigation.

**(a) Given that Staff does not challenge the rejection of the phone-charge adjustment, its arguments regarding phone charges are unnecessary—and they remain problematic.**

Nevertheless, despite not challenging the rejection of the phone-charge adjustment, Staff spends five-and-a-half pages discussing it. (See Staff BOE, pp. 33–38.) But it seems pointless to reargue this issue when Staff has not contested the rejection of the adjustment.

To the extent Staff continues to press this point, IAWC would simply point out that none of the fatal problems with Staff's phone-charge adjustment have gone away. The due process, fairness problems remain: Staff withheld this theory until after the hearing concluded, so IAWC had no opportunity before the hearing to consider the theory, put on its own responsive evidence, and cross-examine the sponsoring witnesses. (IAWC Reply Br., pp. 87–89.) It would be inappropriate to order an extensive, expensive and potentially extra-jurisdictional investigation based on allegations and speculations raised by Staff for the first time in the briefing stage of these proceedings and unsupported by record evidence.

If anything, the record support problems have gotten worse, as Staff, in its BOE, continues to make assertions that lack citation to the record. As was the case in its Initial Brief, Staff's Brief on Exceptions is essentially another exercise in offering testimony after the hearing has closed. As such, Staff makes the problem with raising issues for the first time in briefing clear: it now must use its Brief on Exceptions as an opportunity to provide rebuttal testimony. Again, multiplying, unsupported allegations made in the briefing stage should not justify initiation of expensive and unnecessary litigation. The Commission must make its decisions based on record evidence. Atchison, T. & S. F. R. Co. v. Ill. Commerce Comm'n, 335 Ill. 624, 638–39 (1929). Staff's unsupported assertions are not evidence, and they provide no basis for reconsidering any issue in the ALJPO.

**(b) Staff mischaracterizes IAWC's arguments regarding the phone charge.**

Staff spends two pages arguing against the following position allegedly taken by IAWC, namely, that "AWR should only pay incremental costs." (Staff BOE, p. 36.) First, it is unclear why Staff engages in this purported rebuttal at all—whatever point the Company made, it was in response to the phone-charge adjustment, which was rejected and is no longer being pursued.

In any event, Staff mischaracterizes IAWC's argument. As even the excerpt quoted by Staff should make clear, IAWC did not argue that AWR does or should pay only incremental costs. The Company merely pointed out that it was unreasonable to assume that "every second of activity by a single employee actually incurs [the equivalent share of the call center's total] cost" (IAWC Reply Br., p. 92), which was an assumption built into Staff's phone-charge adjustment. Because Staff rebuts a position that IAWC did not take, there is little point in responding to its rebuttal.

Staff's concern ultimately seems to be about the methodology of the allocation between the Service Company and AWR of certain charges. But Staff does not assert that *no* costs were charged to AWR, just that Staff would have charged them differently. Staff's Brief on Exceptions suggests that Staff would track each second of each individual's activity every day, and allocate costs that way regardless of feasibility or cost. Leaving that aside, the point here is that Staff's belief that some other allocation method should be used does not even suggest a violation of the APA, and the specific allocation issues which do appear in this record have been dealt with accordingly in the ALJPO.

Again, there is little reason to follow Staff into the weeds on this issue, given that it was not raised until the hearing had ended, the ALJPO rejected it, and the rejection was not even challenged by Staff. The ALJPO correctly resolved these issues.

**(c) Staff's addition to the ALJPO of language regarding the phone-charge adjustment should be rejected.**

Staff has not challenged the rejection of the phone-charge adjustment, but it proposes adding language to the order stating that "the record does support a finding that AWWSC did not charge AWR properly" and that "[t]he method utilized was not adequate and undercharged AWR and shifted cost inappropriately to IAWC." (Staff BOE, p. 44.) The adjustment was improper and rightly rejected, and this language should be, too, for reasons already given above and in the Company's Reply Brief.

**4. The ALJPO Correctly Rejected Staff's Allegations that IAWC Did Not Share Information.**

As the ALJPO notes, "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." (ALJPO, p. 177.) But these arguments were belied by the fact "that no motions to produce or compel formal discovery were filed by Staff." (Id.) In apparent response, 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 [sic] the AIA." (Staff BOE, p. 39.)

IAWC is not sure what to make of this statement, which seems something like a backhanded concession. The Company would reiterate, as explained in its Reply Brief, that it was cooperative with Staff, providing thousands of pages of documentation in response to hundreds of discovery requests and accommodating on site call center visits and interviews. (IAWC Reply Br., pp. 85-87.) Although the Company did file legitimate objections to certain discovery requests, the ALJPO correctly reasoned that Staff should not be heard to allege a lack of cooperation when it failed to avail itself of the proper remedies, and Staff does not appear to challenge that determination.

Nevertheless, Staff does accuse the ALJPO of failing to "accurate[ly] characteriz[e]" Staff's arguments. (Staff BOE, p. 38.) It asserts that the "central basis for Staff's recommended investigation" was *not* "IAWC's refusal to provide relevant information" but "the evidence of violations to the AIA." (Id., p. 39.) Staff quotes the following section of its Initial Brief in support, but this is another odd selection as it plainly *refutes* Staff:

> [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.

(Id., p. 38 (emphases added).) As this quotation clearly shows, the only reason given in support of an investigation is "IAWC's failure to provide information." (Id.) And that section plainly does not allege that violations of the "AIA" (Service Company Agreement) occurred, but simply recommends determining "whether" or "if" they occurred. (Id.) In short, the only one mischaracterizing Staff's arguments is Staff.

#### 5. Staff Has Offered No Reason to Revisit the Ruling on Referrals and Transfers.

Staff also "takes exception to the PO's conclusion regarding transfers and referrals" because it "would allow transfers to occur, which may not ultimately be in the best interest of the customer." (Staff BOE, p. 39.) Staff does not offer any new argument here. IAWC will certainly offer the disclaimers required by the ALJPO, and it still fails to see how rejecting a transfer specifically requested by the customer is in that customer's best interests. IAWC explained this point in greater detail in its Reply Brief. (IAWC Reply Br., p. 98.)

Staff also asserts that the ordered disclaimer "should be extended to include any affiliate marketing any product other than IAWC services." (Staff BOE, p. 39.) If it is not too late to raise a new substantive recommendation in a brief on exceptions, it is never too late. This issue should be considered waived. It is also impossible to fairly review this recommendation. There is no evidence in the record concerning additional affiliate marketing of any particular product, so there is no way to evaluate whether such an order would be appropriate. And as IAWC has already explained numerous times, the Commission cannot rule on an issue like this without a record. Staff is simply inviting the Commission to take a shot in the dark.

#### 6. Staff Offers No Reason to Prohibit IAWC from Determining Whether a Leak Is the Company's Responsibility or the Customer's.

Staff concludes by asserting that the ALJPO did not rule on the emergency-service-orders issue or its recommendation that the Service Company and IAWC be prohibited "from making determinations for *any* affiliate regarding leak repair responsibility." (Staff BOE, pp. 39-40.) IAWC has already explained in detail why this is a non-issue: IAWC must investigate leaks, it must determine who is responsible for the leak (utility or customer), and it has no interaction with AWR in this regard. (See IAWC Init. Br., pp. 120, 129; IAWC Reply Br., pp. 99-100). Staff raises no new issues here, and the Commission should simply make clear that it has rejected this recommendation for the reasons given by IAWC.

In short, Staff's Brief on Exceptions fails to note any weakness in the ALJPO's resolution of the affiliated-interest issues. Much less does it identify any problem that needs revisiting. On these points, the ALJPO should stand.

## X. CONCLUSION

For the reasons discussed above, IAWC submits that the Exceptions addressed above should be rejected. For the reasons stated in IAWC's Brief on Exceptions, the Company requests the Commission adopt the Exceptions set forth in Appendix A to IAWC's Brief on Exceptions.

Dated: August 20, 2012

Respectfully submitted,

Illinois-American Water Company

By: */s/ Albert D. Sturtevant*

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**CERTIFICATE OF SERVICE**

I, Albert D. Sturtevant, certify that on August 20, 2012, I caused a copy of the foregoing *Reply Brief on Exceptions of Illinois-American Water Company* to be served by electronic mail to the individuals on the Commission's Service List for Docket No. 11-0767.

*/s/ Albert D. Sturtevant*
Attorney for Illinois-American Water Company