STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

ILLINOIS-AMERICAN WATER COMPANY	)	
	)	Docket No. 16-0093
Proposed general increase in water and sewer rates.	)	
	)	

INITIAL BRIEF OF ILLINOIS-AMERICAN WATER COMPANY

Dated: August 31, 2016

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I. INTRODUCTION

One issue in this case dwarfs all others—the appropriate cost of equity. The difference in revenue requirement between the Staff position on cost of equity and Illinois-American Water Company's (IAWC) is approximately $20 million. And the outcome will have a significant effect on IAWC, which must compete for capital, not only with other enterprises, but with other American Water affiliates.

The Company proposes a return on equity of 10.75%. Staff, by contrast, proposes an unprecedented low of 8.04%. Staff's proposal, however, is based on unsupportable Discounted Cash Flow (DCF) results and is too low to be given consideration. And there are very serious consequences of even entertaining a return on equity as low as Staff's. IAWC already has the lowest authorized ROE of any utility in the American Water system. The subsidiaries with competitive rates of return are much more likely to attract the capital necessary to address aging water infrastructure in a more pro-active, accelerated fashion. Less competitive subsidiaries (like IAWC) will have to settle for what is needed to address these issues reactively. Adopting Staff's proposals would simply make this situation untenable.

American Water's customers in Illinois have been provided with exceptional service. The Company is proud of its achievements since the last rate case in the areas of service quality and reliability, and is committed to carrying these successes forward into the future. And this achievement has been reached efficiently: in the five years since the Company's last case, IAWC has *reduced* O&M expenses below the amount authorized by the Commission in the last rate case. If the Company is to continue to provide such exceptional service and efficient operations it must be provided with the continued means to do so. Although this Commission has recognized that efficient operations are the norm and do not entitle the utility to premium returns, this does not mean that a utility company should not be rewarded for truly excellent and

exemplary results. The excellent service and productivity gains achieved by the Company warrant providing IAWC a rate of return on equity at the highest end of the range of reasonableness. In sum, Mr. Moul's recommendation of 10.75% is the most reasonable presented and should be adopted.

II. CAPITAL STRUCTURE AND RATE OF RETURN

A. Contested Issues

1. Cost of Common Equity

a. Summary of Recommendations

The differences in the recommended rates of return on equity (ROE) sponsored by the parties in this case are considerable and significant:

PARTY	RECOMMENDATION
Company	10.75%
IIWC/FEA/CUB	9.0%
Staff	8.04%

Although the Illinois Industrial Water Consumers, the Federal Executive Agencies and Citizens Utility Board (IIWC/FEA/CUB) IIWC/FEA/CUB recommendation is low, Staff's recommendation is literally unprecedented. Staff is recommending that the Commission authorize the lowest ROE it has ever authorized since 1968, according to the Rate Case History Report[1] published on the Commission's web site. (IAWC Ex. 10.00R at 2-3; IAWC Ex. 10.04R.) Company witness Paul Moul, consequently observed that "The investment community would be alarmed if the Commission were to adopt Staff's proposal." (IAWC Ex. 10.00R at 6:95-96.)

[1] *Available at* www.icc.illinois.gov/reports/report.aspx (published Aug. 24, 2016) (last accessed Aug. 31, 2016). In Docket No. 95-SF, the Commission authorized a 5.63% return on equity for Nordic Park Water. However, the overall rate of return of 9.71% exceeded the cost of equity. Since rate orders issued prior to the year 2000 are not available online, it cannot be determined if the return on equity represented on the report is correct.

We will demonstrate, *infra,* that because it is based on insupportably low Discounted Cash Flow (DCF) results the Staff recommendation is simply too low to be given consideration. It is below all reasonable recommendations: far more than 150 basis points below rates of return on equity allowed by all regulators in the country, more than 150 basis points below the returns allowed in the water industry, more than 150 basis points below returns allowed for IAWC's sister companies and far below any return authorized by this Commission. We will further show the infirmities, particularly related to the DCF, that affect both Staff's and, to a lesser extent, IIWC/FEA/CUB's recommendation. We will further detail why the FERC has taken a different approach to the DCF that is more reflective of reality. We will then explain the very serious consequences of even entertaining a rate of return on equity as low as Staff and IIWC/FEA/CUB. And, finally, we will show why the excellent service and productivity gains achieved by the Company warrant providing IAWC a rate of return on equity at the highest end of the range of reasonableness. In sum, Mr. Moul's recommendation of 10.75% is the most reasonable presented and should be adopted.

b. Framework for Deciding the Company's Cost of Equity

Although rates of return on equity provided to utilities around the country are certainly not dispositive on this Commission, they do provide a valuable framework with which the issue of the Company's cost of equity can be evaluated and decided. As shown below, by any measure, the recommendations of the Staff and IIWC/FEA/CUB in this case are well below the norm.

Those rates of return on equity for example are well below the return granted by other state regulatory commissions as reported by Regulatory Research Associates (RRA). According to the RRA publication dated April 15, 2016, the average authorized equity returns for electric utilities were:

YEAR	EQUITY RETURN
2011	10.29%
2012	10.17%
2013	10.03%
2014	9.91%
2015	9.85%
2016	10.26%

(IAWC Ex. 10.00R at 3.)

Additionally, all the witnesses on this subject used a proxy group to determine their equity cost recommendations. It is telling that the ROEs for the Water Group companies as determined by their regulators, according to the AUS Monthly Utility Reports dated April 2016 that was provided as part of Mr. Gorman's workpapers, are:

COMPANY	ALLOWED ROE
American States Water Co.	9.43%
American Water Works Co., Inc.	9.75%
Aqua America, Inc.	9.79%
Artesian Resources Corp.	10.00%
California Water Service Group	9.43%
Connecticut Water Service, Inc.	9.63%
Middlesex Water Company	9.75%
SJW Corporation	9.43%
York Water Company	NM
Average	9.65%

(IAWC Ex. 10.00R at 4.)

Finally, the authorized ROEs of the Company's affiliates, as determined by their regulators are:

AMERICAN WATER SUBSIDIARY	ALLOWED ROE
Pennsylvania-American Water Co.	10.25%
Hawaii-American Water Co.	10.20%
Maryland-American Water Co.	10.00%
Tennessee-American Water Co.	10.00%
California-American Water Co.	9.99%
Indiana-American Water Co.	9.75%
New Jersey-American Water Co.	9.75%
Virginia-American Water Co.	9.75%
West Virginia-American Water Co.	9.75%

Missouri-American Water Co.	9.5%-9.75%
Kentucky-American Water Co.	9.70%
New York American Water Co.	9.65%
Iowa-American Water Co.	9.41%
Illinois-American Water Co.	9.34%

(IAWC Ex. 10.00R at 5.) Notably, the return for IAWC under Staff's proposal would be 157 basis points below the next higher return.

Utility ROEs are estimated using financial models that seek to explain investor expectations, including the DCF and CAPM models. In this case, predictions of investor expectations, as expressed in the Staff and IIWC/FEA/CUB DCF methods for estimating ROE, clearly do not line up with recent observations of investors. When averaged with the CAPM indications of ROE, the DCF points to unreasonably low Staff's and IIWC/FEA/CUB's recommendations. The record shows this in numerous ways.

First, the most striking indication of the tendency of the DCF to understate the true cost of equity is the simple fact that applying the DCF model to comparable companies yields results that are far lower than these companies' current authorized ROEs. The companies in Staff's Water Group, for example, have authorized returns of up to 10%, the average being 9.65%. (IAWC Ex. 10.00R at 4.) Yet, when Staff prepared a DCF analysis to explain the investor required ROE for these companies, the results congregate in the high six percent to low seven percent range. (ICC Staff Ex. 5.0, Sch. 5.05.) Staff's DCF approach, therefore, is not only inconsistent with investor requirements, it is also egregiously out of synch with the findings of regulators across the nation.

Second, the DCF results presented in this case are consistently below the witnesses' respective CAPM results, as well as the results of other methods employed as a "reasonableness" check on the DCF and CAPM. (ICC Staff Ex. 5.0, Sch. 5.05; IIWC/FEA/CUB Ex. 1.0 Appx. B at 36; IAWC Ex. 10.00 (Rev.) at 32, 42.) This is true for all of the witnesses.

The consistently low DCF returns are not a sign of consensus that IAWC's cost of equity has decreased from the 9.34% currently authorized. The uniformity of these results merely serves as confirmation that the DCF understates investors' true return requirements when mechanically applied in turbulent, anomalous market conditions. DCF results simply begin to break down when the variables for the DCF model are culled from the type of market that exists today—a market where historically low interest rates coupled with historically high stock prices and unusual global volatility (economic and otherwise) has turned a conventional approach into a dysfunctional one. (*See* IAWC Ex. 10.00R at 8 (noting the DCF model rests on assumptions about cash flows that take place too far in the future to permit precision in forecasting).) Indeed, Staff's DCF results lie in the range of 7.24% to 7.51%. (ICC Staff Ex. 5.0 at 14.) This is such a shockingly low equity cost recommendation—the high end of the range is more than 200 basis points *below* the average returns being determined across the country—as to raise serious questions as to whether the DCF is reliable, at all, in the current environment. And, certainly, it dispels the notion that Staff's DCF construct has any real world value.

Other parties may argue that lower ROEs are to be expected in a low interest rate environment: since banks pay savers less interest, equity investors should be willing to accept lower returns. This theory, however, is wrong. Investors do *not* expect lower interest rates to translate to lower equity returns. It is for this very reason, as we show, *infra,* that FERC recently adopted a new ROE policy that abandons the long-standing practice of making post-hearing adjustments to ROEs based on U.S. Treasury yields. The "mounting evidence that U.S. Treasury bond yields are not necessarily a reliable one-for-one indicator of changes in investor-required returns" led FERC to conclude that its policy could no longer be justified. *Mass. Att'y Gen. v. Bangor Hydro-Electric Co*., 147 FERC 61,234 at ¶ 11 (June 19, 2014) (hereinafter, *Order 531*).

Furthermore, it is clear from recent Federal Reserve policy pronouncements that the direction of interest rates will be up, not down. (IAWC Ex. 10.00R at 12.)

For all of these reasons, the technical discussion of the Company's cost of equity must also be informed by the real world reality of determinations made by other regulators and by the market generally. These real world discussions counsel that an arid mechanical exercise that produces costs of equity that lie more than 150 basis points below authorized rates of return, or which are based on DCF results in the 6% to 7% range, are simply at war with reality and cannot be seriously considered. In fact, the results produced by Staff's analysis show figures which cannot realistically represent a fair rate of return on common equity. This becomes particularly apparent in Ms. Kight-Garlisch's DCF analysis, where four of her Water Sample DCF results are below 7%. (ICC Staff Ex. 5.0, Sch. 5.05.) The yield on public utility debt is 3.96% for A-rated and 4.70% for Baa-rated bonds. (IAWC Ex. 10.00R at 14.) The cost of equity exceeds this spread by a meaningful margin based on the relationship of debt and equity historically. (*Id.*)

c. Overview of Recommendations.

The Commission has historically given substantial weight to DCF and CAPM results. For this reason, knowledge of the mathematical expression of these models is assumed and only a brief description of each is provided.

The underlying theory of the DCF is that an investment in a utility's stock is worth the present value of future dividends, discounted at a rate commensurate with the risk of the investment. (ICC Staff Ex. 5.0 at 5-6.) The inputs of the DCF model are current stock price, expected dividend, and expected growth rate. (IAWC Ex. 10.00 (Rev.) at 17-18; *see also* IIWC/FEA/CUB Ex. 1.0 Appx. B at 22-23.) The stock price and expected dividend are observable and fairly non-controversial. The expected growth rate, however, is subject to considerable judgment, and greatly influences the calculation of the investors' required return.

All other inputs being the same, DCF results of investors' required return will increase as the growth rate used in the calculation increases. (IAWC Ex. 10.00 (Rev.) at 19-20.)

There are several variants of the DCF. The so-called "single stage" or "constant growth" DCF uses one expected growth rate to calculate the future dividend stream. (ICC Staff Ex. 5.0 at 7.) The "non-constant" growth DCF assumes dividend growth for an initial period (usually five years) often followed by a lower growth rate for the remaining measurement period. (IAWC Ex. 10.00 (Rev.) at 21-32; IIWC/FEA/CUB Ex. 1.0 Appx. B at 23-27.) IIWC/FEA/CUB witness Gorman used non-constant DCF models, and Staff witness Kight-Garlisch used a used non-constant, multi-stage DCF. (IIWC/FEA/CUB Ex. 1.0 Appx. B at 29-35; ICC Staff Ex. 5.0 at 7-14.) Mr. Moul used a constant model only. (IAWC Ex. 10.00 at 21-32.) Mr. Moul explained that the non-constant DCF model is not widely used in regulatory proceedings. (IAWC Ex. 10.00R at 8.) "Rather than providing a direct expression of the DCF result, i.e., $D_1 / P_0 + g$, the non-constant DCF model is solved by estimating specific future cash flows and then solving for the result by iteration…the basic fallacy of the non-constant DCF model rests with a set of problematic assumptions of specifying cash flows that are too far out into the future to permit a reasonable and reliable result. That is to say, cash flows extending many years into the future become less precise as the estimates are extended." (IAWC Ex. 10.00R at 7-8.)

All of the witnesses also used the CAPM. (IAWC Ex. 10.00 at 37-42; ICC Staff Ex. 5.0 at 15-26; IIWC/FEA/CUB Ex. 1.0 Appx. B at 36-44.) The theory behind the CAPM approach is that an investor's return equals a risk free rate, plus an associated risk premium. (ICC Staff Ex. 5.0 at 15-16.) The required inputs for this model are an estimate of the 30-year Treasury risk-free rate, beta (a measurement of the systemic risk associated with a stock), and a market risk

premium. (*Id.*; *see also* IAWC Ex. 10.00 (Rev.) at 37.) Like the DCF, the CAPM model is sensitive to the variables used, especially the risk-free rate and market risk premium.

The essential flaw inherent in Staff's CAPM analysis is that the Staff witness's Treasury bond yield, which is a spot yield on April 7, 2016, does not reflect the expected increase in interest rates. (IAWC Ex. 10.00R at 13-14.) The Federal Open Market Committee policy is in the process of moving from an extremely accommodative to more normal monetary policy. (IAWC Ex. 10.00R at 12-13.) All recognized forecasts indicate a future rise in interest rates. (*Id.*) To gain a consensus view of future interest rates, Mr. Moul tabulated the forecasts of yields on 10-year Treasury notes published by a variety of well recognized and investor-influencing sources. He chose the 10-year Treasury note because it is available on a consistent basis across all sources. The comparisons are:

	2016	**2017**	**2018**	**2019**	**2020**	**2021**	**Change in Basis Points**
Blue Chip	2.03%	2.57%	3.30%	3.70%	3.90%	4.10%	207
Value Line	2.10%	2.60%	3.00%	3.50%	3.70%	NA	160
EIA	2.57%	2.72%	3.27%	3.85%	3.83%	3.73%	120
IHS Global Insight	2.60%	2.85%	3.36%	3.72%	3.72%	3.72%	112
CBO- The Budget and Economic Outlook	2.80%	3.50%	3.80%	4.00%	4.10%	4.10%	130

(*Id*. at 13.) All of these interest rate forecasts indicate a significant rise in interest rates, on the order of 112 to 207 basis points, showing that Staff's CAPM result is understated.

The DCF and CAPM formulas are applied to a group of comparable companies with operating characteristics and risk profiles similar to the utility under review. In this case, each witness applied one or more variants of the DCF and CAPM to comparable companies; IAWC's comparable companies consisted of water companies only, (IAWC Ex. 10.02, Sch. 3 at 2), while Staff and IIWC/FEA/CUB used two groups, once each for gas/public utilities and water. (ICC Staff Ex. 5.0 at 3-5; IIWC/FEA/CUB Ex. 1.2 Appx. B.) Here are the range of results:

Party	DCF	CAPM	Overall
IAWC[2]	9.89%	10.93%	10.75%
IIWC/FEA/CUB[3]	6.82 – 9.48%	9.20%	9.00%
Staff[4]	7.24 – 7.51%	8.8 – 8.9%	8.04%

Staff's ROE, based on the DCF figures, is striking. The Commission has not imposed an ROE this low in the 40+ year history it has been keeping track of ROEs and publishing them. (IAWC Ex. 10.00R at 2-3.) Similarly, the low end of IIWC/FEA/CUB's DCF range is equally indefensible—indeed, lower even than Staff's DCF low. Obviously, a DCF that is so indefensibly low should not be used to drag down the cost of equity into such unchartered depths. Such DCF results, which are at war with financial reality, are just not rational.

d. Staff's and IIWC/FEA/CUB's DCF results are anomalous and unrepresentative of investor expectations.

The Staff DCF returns for utilities in the Water Group congregate in the high six percent range. (ICC Staff Ex. 5.0, Sch. 5.05.) These results, when considered in context with other financial and economic indicators, are untenable:

IAWC current authorized return	9.34%[5]
Average Water Group authorized return	9.65%[6]
Average American Water authorized return	9.75%[7]
Aqua Illinois authorized return	9.81%[8]
Average electric utility authorized return	10.26%[9]
S&P500 expected return	12.03%[10]

Moreover, the Commission found not even two years ago, that investors in Aqua required a return of 9.81%. *See Aqua Ill. Co.*, Docket 14-0419, Order at 49 (March 25, 2015). Yet,

[2] (IAWC Exs. 10.00 at 4, 10.00R at 29-30.)_
[3] (IIWC/FEA/CUB Ex. 1.0 Appx. B at 36, 44-45.)
[4] (ICC Staff Ex. 5.0 at 14, 26, 31.)
[5] (IAWC Ex. 10.00 at 3.)
[6] (IAWC Ex. 10.00R at 4.)
[7] (IAWC Ex. 10.00R at 5.)
[8] (IAWC Ex. 1.00R at 2.)
[9] (IAWC Ex. 10.00R at 3.)
[10] (ICC Staff Ex. 5.0 at 20.)

according to Staff, investors in a company offering the same services in the same state expect to earn nearly 180 basis points less? One must question why a person would invest in IAWC when much greater returns are available by investing in Aqua. An ROE discrepancy of this magnitude would place IAWC at a considerable competitive disadvantage relative to Aqua. Like Aqua, IAWC pursues a "win-win" growth strategy by expanding its business through the acquisition of small, troubled systems. (IAWC Ex. 1.00R at 7.) Investment capital would necessarily favor Aqua's 9.81% return over the returns recommended for IAWC here. (*Id*.)

The fact that ROE estimates by means other than the DCF *consistently* produce greater returns is another reason for concern that the DCF generally understates the indicated return for all witnesses, and this is especially so for Staff. Staff's Water Group DCF is 7.24%, while the CAPM is 8.80% for Staff's Water Group. (ICC Staff Ex. 5.0 at 14, 26.) Certainly the DCF and CAPM should not be expected to predict the exact same cost of equity, but a difference of 156 basis points should raise serious questions. These questions are answered when considered in the context of the figures cited above. Ignoring this disparity by simply averaging the results produces a figure that is *less* likely to represent investor expectations rather than more. Calculating an average with a below-average figure necessarily yields a below-average "average."

IIWC/FEA/CUB's CAPM results (8.50% to 9.80%) are also greater than its DCF (7.71% to 8.75%), though not to the same degree as Staff's, depending on which version of IIWC/FEA/CUB's DCF is examined. (IIWC/FEA/CUB Ex. 1.0 Appx. B at 36, 44.) Similarly, Mr. Moul performed a risk premium analysis that produced an 11.25% return, well above his DCF. (IAWC Ex. 1.0 at 4.) An alternative risk premium calculation based on information relied on by Mr. Gorman shows a return of 10.14%, which is also greater than any DCF

recommendation. (IAWC Ex. 10.00R at 26-27.) There is no question that the DCF results are uniformly lower than other methods.

Thus, the record establishes that the Staff DCF results presented to the Commission plainly do not reflect investor requirements. Worse, the DCF results artificially depress the parties' recommendations when averaged with the results of the CAPM and other methods.

Some of IIWC/FEA/CUB's DCF results are equally suspect. In fact, a meaningful portion of the DCF results presented by Mr. Gorman are unreasonable on their face. As indicated below, several of Mr. Gorman's DCF results fall into that category:

COMPANY	DCF
Middlesex Water	5.38%
American States Water	6.08%
York Water	7.17%
Connecticut Water	7.61%

(IAWC Ex. 10.00R at 23.)

Yet, as Mr. Moul explained, each of the companies listed above have DCF returns calculated by Mr. Gorman that fail to provide a sufficient spread over the average yield of 4.09% on A-rated public utility bonds and 5.03% on Baa-rated public utility bonds. (IAWC Ex. 10.00R at 23; *see also* IIWC/FEA/CUB Ex. 1.0 Appx. B, Sch. 1.9 at 1.)

These demonstrated anomalies have led the FERC to re-evaluate its approach to establishing DCF-based equity returns for entities under its jurisdiction. *See Order 531*, 147 FERC 61,234. As an institution of considerable technical skill and prestige, FERC's conclusions deserve attention. Indeed, IIWC/FEA/CUB used the two-stage FERC model in estimating a return on the market to derive a CAPM market risk premium. (IIWC/FEA/CUB Ex. 1.0 Appx. B at 43-44.) If the FERC approach was reliable for this purpose, it is equally reliable for others.

Order 531 arose from a complaint challenging a group of transmission owners' rates. "The Complainants argued that the bubble in the U.S. housing market, the subsequent financial

crisis and economic recession, and the fiscal and monetary policies of the U.S. government have caused a 'flight to quality' in the capital markets. The Complainants contended that these market conditions have lowered bond yields and, as a result, capital costs for utilities." *Order 531*, 147 FERC 16,234 at ¶ 3.

FERC disagreed. FERC concluded that "the capital market conditions since the 2008 market collapse and the record in this proceeding have shown that there is not a direct correlation between changes in U.S. Treasury bond yields and changes in ROE." *Id*. at ¶ 158. This finding led FERC to not only change its DCF methodology, but to also abandon its long-standing policy of post-hearing adjustments to ROE for changes in U.S. Treasury yields. *Id*. at ¶ 160. "[A]djusting ROEs based on changes in U.S. Treasury bond yields may not produce a rational result, as both the magnitude and direction of the correlation may be inaccurate." *Id*. at ¶ 159.

FERC emphasized that ROE serves both a compensatory and capital attraction function. While a "mechanical application" of the DCF produced a midpoint of 9.38% based on the record in *Order 531*, a reduction to that level (from 11.4%) "could undermine the ability of the [utilities] to attract capital for new investment" and impose a "competitive disadvantage" relative to other utilities. *Id*. at ¶ 150.

The FERC DCF relies on publicly available sources for both stages of the growth rate. The initial five-year stage is based on analysts' five year forecasts. "[E]arnings forecasts made by investment analysts are considered to be the best available estimates of short-term dividend growth because they are likely relied on by investors when making their investment decisions." *Id.* at ¶ 17. Staff and IIWC/FEA/CUB performed their multistage DCF calculations with growth rates from the same sources. The long-term growth rate component of the FERC calculation is based on forecasted GDP growth. *Id*. at ¶ 20. Staff and IIWC/FEA/CUB use GDP as a proxy

for their long term growth rate as well. (ICC Staff Ex. 5 at 9-11; IIWC/FEA/CUB Ex. 1.0 Appx. B at 26.)

FERC, however, does not give these growth rates equal weight. "The short-term forecast receives a two-thirds weighting and the long-term forecast receives a one-third weighting in calculating the growth rate in the DCF model." *Id*. at ¶ 17. The weighting scheme recognizes that "long-term projections are inherently more difficult to make, and thus less reliable, than short-term projections." *Id*. at ¶ 21 *quoting In re Transcon. Gas Pipeline Corp.*, 84 FERC 61,084 at 61,423-24 (July 29, 1998). *See also Canadian Assoc. Petroleum Producers v. FERC*, 254 F.3d 289, 297 (D.C. Cir. 2001) (affirming weighting scheme for growth rates).

If Staff's variables for growth rates are plugged into the FERC two-stage DCF model, the implied investor required return is 10.51%, based on the midpoint of the upper half of a range of 8.02% to 12.99%.[11] The calculation is the result of simple mathematics, using the established DCF formula, and variables for this formula that are also part of the record. And 10.51% fits comfortably within the range of results indicated by Mr. Moul. The Commission is therefore entitled to give this information the weight it believes it deserves. "Just as each case needs to be judged on its own merits, the decision regarding which version of the DCF model is most suitable depends on the facts and circumstances at the time of the particular analysis." (ICC Staff Ex. 13.00 at 11.)

FERC recognized that the DCF midpoint results fell below state authorized ROEs for electric distribution utilities. "Although we are not using state commission-approved ROEs to establish the [utilities'] ROE in this proceeding, the discrepancy between state ROEs . . . serves

[11] Staff's DCF model is described in Exhibit 5.0, Schedule 5.01. The sample companies and growth rates are shown in Schedule 5.02. When the growth rates in Schedule 5.02 are replaced with analysts' short-term growth rates and Staff's projected growth in GDP (weighted 2/3 and 1/3, respectively), the range of returns shown on Staff's Schedule 5.05 would change to the range indicated.

as an indicator that an upward adjustment to the midpoint here is necessary to satisfy *Hope* and *Bluefield*." *Id*. at ¶ 148.

Here, as in *Order 531*, the DCF-implied results are consistently lower than other models. "[T]he risk premium analysis, the CAPM, and expected earnings analyses . . . each produces a midpoint (or median) ROE higher than the midpoint of our DCF analysis here." *Id*. at ¶ 146. Here, as in *Order 531*, the DCF-implied results are far below any benchmark the Commission might use—the Company's current ROE, the average ROE of its affiliates, the ROE authorized for Aqua Illinois; it does not matter. The implied DCF result are lower than all available benchmarks. And here, as in *Order 531*, the record of anomalous capital markets abound, including well-informed judgment that future interest rates have only one direction to move—up. "[T]he nationally renowned bond investor Bill Gross commented that global bond yields were the lowest 'in 500 years of record history' and warned that the large number of negative-yielding bonds in the world will eventually lead to 'a supernova that will explode one day.'" (IAWC Ex. 10.00R at 13-14.)

Rather than simply take the DCF-implied returns at face value, the Commission should take into account the evidence regarding low interest rates, how those interest rates depressed the ROE midpoint, and how interest rates will rise in the near-term. *See Order 531* at ¶ 130. Moreover, because the DCF analysis is meant to reflect the rate of return needed to attract investors going forward, data showing increasing interest rates and cost of capital are particularly relevant. *Id*.

e. Mr. Moul's DCF results are more reliable than Staff's or IIWC/FEA/CUB's.

Although the Staff and FERC application of the DCF are both multi-stage models (with FERC using two growth stages and Staff using three), the disparity in results is explainable by

the assumed rates of growth and their weighting. Like the FERC model, Staff uses analysts' five-year forecasts for initial stage growth and GDP for final stage growth. (ICC Staff Exhibit 5.0 at 7-9.) But Staff adds an intermediate growth stage represented by the average of the first and third stage growth rates, and gives each of the three stages equal weighting. (*Id.* at 9.) The intermediate growth stage is a mathematical calculation untied to any evidence that investors rely on growth rates calculated this way when making investment decisions. (*See* IAWC Ex. 10.00R at 25.) And as FERC observed, long-term growth rates are by nature more difficult to predict. *Order 531*, 147 FERC 16,234 at ¶ 21. FERC's approach of weighting short-term projections more heavily than long term projections is consistent with the growth rate evidence produced here. As Mr. Moul explained, earnings growth for the comparable companies historically ranged from 6.36% to 8%, and in the future is projected at 6%. (IAWC Ex. 10.00 (Rev.) at 22-23.) Staff's second-stage growth rate of 4.2% is demonstrably too low.[12]

Mr. Moul's DCF estimates the cost of equity at 9.89%, based on single-stage growth of 6.25% and inclusive of a "leverage" adjustment. (IAWC Ex. 10.00 (Rev.) at 31-32.) Although Mr. Moul's approach is different than FERC's, the similarity of results confirms that both approaches represent different methods of arriving at similar results for the investor-required ROE.

With regard to growth rates, Mr. Moul generally disfavors a multi-stage DCF model because, as FERC recognized, there is no recognized source for analysts' long-term growth

[12] "Staff used the forecasted GDP growth of the United States economy as a proxy for the long-term growth in dividends per share paid to the investors of the sample groups….accepting that long-term GDP growth will be 4.2% merely establishes that *the economy as a whole* will, on average, grow 4.2% annually. That does not mean that stock prices will grow at that rate. Stock market prices do not play a key role directly in the measurement of the GDP. Some companies and industries will grow faster than the average, some slower." (IAWC Ex. 10.00R at 7-9.)

expectations. (IAWC Ex. 10.00R at 8.) Mr. Moul approaches this limitation by employing a single-stage DCF. (IAWC Ex. 10.00 (Rev.) at 21.) The FERC two-stage model approaches this limitation by giving analysts' short-term growth rate projections more weight than long-term projections. *Order 531*, 147 FERC 16,234 at ¶ 17. Both methods address the same limitation presented by speculating about investors' long-term growth projections.

A leverage adjustment to the DCF is necessary to make an apples-to-apples comparison of the returns calculated for the comparable companies to the investor-required return of IAWC. The DCF model pre-supposes that the indicated return is the cost of equity for a firm with its market value, weighted cost of capital. (*See* IAWC Ex. 10.00 (Rev.) at 28-29.) The average capital structure of the Water Group consists of 31.71% debt and 68.22% equity (*id*. at 26), while the ratio for IAWC is closer to 50/50. (*See* IAWC Ex. 6.01SR.) The introduction of additional debt in the capital structure increases risk. (IAWC Ex. 10.00 (Rev.) at 28.) The leverage adjustment is needed to account for the fact that IAWC has more debt in its capital structure than the comparable companies, and is therefore subject to more risk. (IAWC Ex. 10.00 (Rev.) at 27-29.)

The FERC two-stage DCF does not contain an express leverage component, but the FERC approach in general focuses on the goal of capital attraction in light of investor requirements. *Order 531*, 147 FERC 16,234 at ¶ 50. "The only perspective that is important to investors is the return they can realize on the market value of their investment." (IAWC Ex. 10.00 (Rev.) at 27.) An adjustment to account for the difference in book value to market value is entirely consistent with the notion that the DCF ought to be applied in a manner that best explains investor expectations.

Staff will criticize any leverage adjustment, but not for reasons having anything to do with investor requirements. Indeed, investors are an afterthought to Staff's recommendation. Staff's analysis attempts to predict the Water Group's required returns, without bothering to look at their current, authorized returns. (IAWC-Staff Stip. Cross Ex. 1.0 at 5.) Staff did not compare its recommendation to that of any other state regulatory commission. (*Id*. at 8.) Indeed, according to Staff, any recommendations by this or any other commission in the past 24 months are not relevant. (*Id*. at 9, 10.) Asked how investors would be expected to react to Staff's recommendation, Staff has "no opinion." (*Id.* at 6.) This indifference to investor requirements is telling.

Mr. Moul's are the only DCF results remotely in the range of the 10.51% indicated by the FERC two-stage DCF model. The average of Mr. Moul's DCF and CAPM results is 10.41%—remarkably close to what the ROE would be if the issue were in front of FERC. Mr. Moul's 10.75% recommendation is also validated by his risk premium analysis showing a required return of 11.25% and a comparable earnings analysis suggesting a return as high as 13.05%. (*See* IAWC Ex. 10.00 at 32, 46.) Neither Staff nor IIWC/FEA/CUB can point to any extrinsic evidence supporting the reasonableness of their proposals.

f. A Rider VBA reduction would be asymmetrical and unwarranted.

Staff's claim that approval of Rider VBA should be accompanied by a reduction in ROE should be rejected. (*See* ICC Staff Ex. 13.0 at 3.) Staff has never proposed an upward adjustment to account for the likelihood of a utility not earning its authorized return. A mechanism that serves only to allow a utility to earn the ROE the ratemaking process assumes (often erroneously) the utility will earn is not grounds for a downward ROE adjustment of any amount.

Staff claims that Rider VBA would reduce volatility in IAWC's cash flows and improve its credit rating, thereby decreasing risk and lowering investors' required ROE. (ICC Staff Ex. 5.0 at 35, 37.) This argument ignores the fact that the Company's cost of equity is being determined with reference to a proxy group of similar utilities. Mr. Moul explained that the recommended ROE should not be reduced downward to account for the impact of Rider VBA on the Company's business risks because the market-derived ROE for the Company is estimated from market information on the cost of common equity for other comparable water utilities. (IAWC Ex. 10.00R at 19.) Because it has become increasingly common for utility companies in the water, electric, and natural gas industries to employ alternative rate design and ratemaking mechanisms, the approval of trackers, riders and adjustment clauses, forecast test years, and other mechanisms, by regulatory commissions is widespread in the utility business and is already largely embedded in financial data, such as bond ratings, stock prices, and business risk scores. (*Id.*) To the extent that the market-derived cost of common equity for other utility companies already incorporates the impacts of these or similar mechanisms, no further adjustment is appropriate or reasonable in determining the cost of common equity for the Company. To do so would constitute double-counting.[13] (*Id.*)

In fact, five of the nine companies in the Water Group utilize alternative ratemaking mechanisms. (*Id.* at 20; *see also* IAWC Ex. 10.02, Sch. 3 at 2.) Thus, the existence, approval, and impact of these alternative ratemaking mechanisms is embedded in the data the parties used to develop their ROE analyses, including the stock prices, bond ratings, and business risk scores.

[13] Staff drew this conclusion by considering Rider VBA in isolation, without considering the overall impact of Staff's proposal to reduce IAWC's authorized ROE to an unprecedentedly low level. (ICC Staff Ex. 13.00 at 26; IAWC Ex. 10.00R at 18.) As Mr. Moul explained, Staff's proposal would result in the lowest ROE the Commission has authorized since it started keeping public records on the subject, the lowest authorized ROE in the RRA data, and the lowest ROE authorized for any American Water utility. (IAWC Ex. 10.00R at 19-20.) Such a large and unprecedented reduction in authorized ROE would certainly not lead to a credit upgrade, *even if* Rider VBA reduced volatility in the Company's cash flows.

(IAWC Ex. 10.00R at 21.) As a result, the existence, approval, and impact of the alternative ratemaking mechanisms is embedded in the results of those analyses. Mr. Moul's position is well-supported by empirical studies. The Brattle Group published a study in March 2011 entitled "The Impact of Decoupling on the Cost of Capital: An Empirical Investigation." (*See id*. at 21-22.) The study concluded that any impact from decoupling on the cost of capital "must be minimal because it is not detectable statistically." (IAWC Ex. 10.07R.) The Brattle Group released a similar study on March 20, 2014 entitled "The Impact of Revenue Decoupling on the Cost of Capital for Electric Utilities: An Empirical Investigation." (IAWC Ex. 10.00R at 21-22.) The findings of this study were similar to those of their 2011 study, concluding that "there is no statistically significant evidence of a decrease in the cost of capital following adoption of decoupling." (IAWC Ex. 10.00R at 21-22.)

There are simply no grounds for Staff's Rider VBA deduction.

g. A just and reasonable ROE is necessary to support investment, attract capital, and position IAWC to meet the challenges of the future

In the oft-cited *Hope* decision, the United States Supreme Court stated:

> From the investor or company point of view, it is important that there be enough revenue not only for operating expenses, but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard, the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

Fed. Power Comm'n v. Hope Nat. Gas Co., 320 U.S. 591, 603 (1944) (citations omitted). This important statement is a recognition that capital cannot be conscripted and that it will flow to where it obtains the best return for commensurate risk.

The Company's President, Mr. Hauk, explained how IAWC must compete for capital, not only with other enterprises, but with other American Water affiliates. The collective needs of the American Water utilities exceed available capital. (IAWC Ex. 1.00R at 4.) Capital needs for maintaining service quality and reliability in accordance with laws and regulations always get top priority. (*Id*. at 5.) The shareholder is committed to investing in projects necessary to maintain safe and adequate service. (*See id*. at 5.) But the shareholder has the opportunity to invest in many discretionary projects, and available returns influence the shareholder's decision of where to invest discretionary funds. (*Id*. at 5-6.) It does not make sense for the shareholder to invest discretionary capital in Illinois if greater returns are available in other states. (*Id*. at 5.)

IAWC currently has the lowest authorized ROE of any utility in the American Water system. This does not mean the water and sewer system in Illinois is facing a critical risk of falling apart. It does mean, however, that IAWC is at the bottom of the pecking order for discretionary capital. This is not a sustainable situation in the long term if the Commission expects IAWC to continue to deliver exceptional service, as we detail below.

The need for discretionary capital is real. The Company explained the confluence of factors contributing to the need to address aging water infrastructure in a more pro-active, accelerated fashion. (IAWC Ex. 1.00R at 7; *see also* IAWC Ex. 3.00R at 2-10.) This need exists throughout the United States. The subsidiaries with competitive rates of return are much more likely to attract the capital necessary to address these needs proactively. (IAWC Ex. 1.00R at 7-8.) Less competitive subsidiaries (like IAWC) will have to settle for what is needed to address these issues reactively. (*Id*. at 8.)

American Water's customers in Illinois have been provided with exceptional service. If the Company is to continue to provide such exceptional service and efficient operations, it must

be provided with the continued means to do so. Mr. Hauk's description of the struggle to obtain discretionary capital is real and has real implications for IAWC's customers. The Commission should provide Mr. Hauk and his team with the tools to obtain the levels of funding necessary to allow them to continue doing the exemplary job they've been doing.

h. The authorized ROE should reflect the Company's exceptional performance and its dedicated commitment to providing its Illinois customers with exceptional service at high levels of operational efficiency.

It is a long-established element of regulation that the cost of equity falls within a range of reasonableness and that this Commission has discretion to determine, where, within that range, a given utility's authorized rate of return on equity should fall. It is an equally long-established truism of regulation that more efficient utilities should be rewarded with higher earnings while less efficient and imprudent utilities should see reduced earnings. Although this Commission has recognized that efficient operations are the norm and do not entitle the utility to premium returns,[14] this does not mean that a utility company should not be rewarded for truly excellent and exemplary results with a rate of return on equity in the higher end of the zone of reasonableness. IAWC believes that the record establishes that this is a case where a return at the higher end of the zone of reasonableness is more than warranted.

The Company is proud of its achievements since the last rate case in the areas of service quality and reliability, and is committed to carrying these successes forward into the future. First, this is the Company's first rate case in the last five years. This is an impressive record of rate stability and a testimonial to the efficiency of the Company's operations. In fact, in the five

[14]"[E]fficient service is the objective of all utilities and a legal requirement under Section 8-401 of the Act, and no special reward needs to be offered." *Ill. Commerce Comm'n on Its Own Motion v. N. Ill. Gas Co.*, Docket 87-0032, 1988 WL 1533285 (Jan. 20, 1988).

years since the Company's last case, IAWC has *reduced* O&M expenses below the amount authorized by the Commission in the last rate case. (IAWC Ex. 1.00 (Rev.) at 11.) That is virtually unheard of for a regulated utility.

Moreover, and notwithstanding that the Company has reduced its expenses, service has not suffered as a result. Indeed, IAWC has achieved quite the opposite: a recent J.D. Power survey gave IAWC top honors for customer satisfaction:

(*See* IAWC Ex. 1.00R at 8.)

Not only has the Company excelled in containing and reducing costs and in providing the highest levels of service but IAWC is also a leader in promoting a diverse workforce. (IAWC Ex. 1.00 (Rev.) at 19-21.) Just under 70 percent of the people IAWC hired in 2015 are diverse,

and the Company tripled its spend with diversified suppliers in 2015 versus 2014. (IAWC Ex. 1.00R at 8.)[15] Over 85% of the requested rate increase is driven by plant investment (IAWC Ex. 1.00 (Rev.) at 10), yet no rate base disallowances have been proposed in this case. No affiliate transaction issues have been raised. In short, not only does IAWC not deserve the punitive ROE that Staff and IIWC/FEA/CUB recommend in this case but a rate of return in the upper end of the zone of reasonableness is fully warranted for the achievements that the Company has produced.

A 10.75% ROE is just, reasonable and appropriate.

B. Resolved Issues

1. Capital Structure

The parties agree that the following average test year capital structure is reasonable for setting rates in this proceeding:

CAPITAL COMPONENT	BALANCE	WEIGHT
Short-term Debt	$17,060,924	1.90%
Long-term Debt	$433,176,118	48.30%
Common Equity	$446,559,694	49.80%
Total	$896,796,736	100.00%

(ICC Staff Ex. 12.0 at 2, Sch. 12.01; IAWC Exs. 6.00SR at 2 (accepting, to narrow the issues in this proceeding, Staff's proposed common equity ratio), 6.01SR; IAWC-IIWC/FEA/CUB Stip. Cross Ex. 1.00 at 4; AG Exs. 3.0 at 3, 3.1 at Sch. A-3 (relying on Staff's proposed capital ratios).) In light of the parties' agreement, the Commission should approve this capital structure.

[15] The Company is a founding member of the Illinois Utilities Business Diversity Council (IUBDC), formed by the members of the Illinois Energy Association. The IUBDC is a forum for best practice sharing and information exchange among Illinois' utilities, with a focus on advancing the growth and utilization of diverse businesses in the state of Illinois. IAWC hosts and participates in diversity events in Illinois. IAWC supports the National Minority Supplier Development Council (NMSC), the Women's Business Enterprise National Council (WBENC), the Women in Energy Chicago Chapter, the Black Business Alliance (WPNV 106.3 FM Radio Peoria), and the Illinois Black Chamber of Commerce. IAWC also participates in American Water's investment diversity initiatives. (IAWC Exhibit 1.00 (Rev.) at 21.)

2. Cost of Debt

The parties agree that 0.74% and 5.34% are reasonable average costs of short-term debt and long-term debt, respectively, for IAWC in the test year. (IAWC Exs. 6.00R at 3-6, 7-8, 6.01R; ICC Staff Ex. 12.0 at 3-4, Sch. 12.01; IAWC-IIWC/FEA/CUB Stip. Cross Ex. 1.00 at 4; AG Ex. 3.1 at Sch. A-3.) In light of the parties' agreement, the Commission should approve these costs of short-term and long-term debt.

C. Recommended Capital Structure and Rate of Return

For the reasons explained, IAWC proposes the following average capital structure, costs of debt and equity, and overall weighted cost of capital for setting rates in this proceeding:

CAPITAL COMPONENT	WEIGHT	COST	WEIGHTED COST
Short-term Debt	1.90%	0.74%	0.01%
Long-term Debt	48.30%	5.34%	2.58%
Common Equity	49.80%	10.75%	5.35%
Total	100.00%		**7.94%**

(IAWC Exs. 6.00SR at 1, 6.01SR.)

III. RATE BASE

A. Contested Issues

1. Accumulated Deferred Income Taxes Balance / FIN 48

FASB[16] Interpretation Number 48, or FIN 48, now codified as part of Accounting Standards Codification 740, is FASB's financial accounting guidance related to uncertain tax positions. FIN 48 prescribes the way in which companies must analyze, quantify, and disclose the most probable outcome that will result from taking a tax position that is uncertain. (IAWC Ex. 13.00R at 7.)

[16] Financial Accounting Standards Board

IAWC has concluded that some of the tax positions that are part of its method of accounting for repairs are uncertain, and it quantified FIN 48 balances accordingly. (*Id*. at 8.) AG witness Effron argued that IAWC has realized tax savings from taking the repairs deduction on its tax returns. (AG Ex. 1.0 at 9.) Until these deferred tax liabilities are actually paid to the relevant taxing authorities, he contended, they represent non-investor supplied funds that are available to the Company. He proposed the ADIT debit balances related to FIN 48 should be eliminated from the balance of ADIT deducted from plant in service, increasing ADIT and thus reducing rate base. (*Id*. at 10.)

IAWC is willing to eliminate an adjusted FIN 48 balance from rate base. However, Mr. Effron's adjustment must be revised in two ways. First, the ADIT balance in rate base related to FIN 48 is $3,432,525, not $18,343,822, as Mr. Effron proposed. $3,432,525 is the net FIN 48 amount after considering offsets by available net operating losses. This net number is what is included in ADIT. (IAWC Ex. 13.00SR (Rev.) at 2.)

Second, changes in IAWC's proposed 2015 tax filings will cause a portion of the uncertain tax positions to be realized. Therefore, with respect to a 2017 test year, a portion of the deferred tax liability associated with uncertain tax positions will have been eliminated when IAWC files its 2015 tax return. (IAWC Ex. 13.00R at 8-9.) The adjustment to prior repair deductions has been computed, and the change results in IAWC realizing $909,707 of its FIN 48 obligation, reducing the amount of the ADIT impact on rate base from $3,432,525 to $2,485,188. (IAWC Ex. 13.00SR (Rev.) at 2.)

Mr. Effron also proposed that IAWC provide a method for the Commission to verify that the revised FIN 48 amounts are consistent with the filed 2015 tax return. (AG Ex. 3.0 at 5.) This is not necessary: all ADIT activity estimated by the Company through the 2017 test year has not

as yet been reflected on a filed tax return. That fact is inherent in using projections and basing rates on a forecasted test year. And IAWC should not be required to document tax positions that IAWC plans to take with respect to repairs in its 2015 tax return in a manner different than it documents any other tax projection. If the Commission desires, however, IAWC is willing to provide a confidential disclosure of IRS Form 3115 (Application for Change in Accounting Method) or a copy of IAWC's federal pro forma 2015 tax return as a compliance filing in this docket. (IAWC Ex. 13.00SR (Rev.) at 3-4.)

2. Debt Return on Pension Asset

The Company has agreed to reflect in rate base a $1,898,284 accrued liability for other (non-pension) post-employment benefits (OPEBs), which represents the cumulative excess of accrued OPEB costs over actual cash disbursements for OPEB. (IAWC 4.00R at 15; AG Ex. 1.0 at 7.) This has the effect of reducing rate base.

However, IAWC also has a pension asset in the amount of $6,760,144, which reflects the difference between accrued pension expense and projected cash pension contributions. (*See* Schedule B-9.1, Schedule G-5 at 10.) When the accrual for pension expense collected from ratepayers exceeds the contribution amounts, the Commission consistently approves a reduction in rate base reflecting the difference. *See, e.g., Ill.-Am. Water Co*., Docket 09-0319, Order, Appx. A at 2 (Apr. 13, 2010); *Ill.-Am. Water Co*., Docket 07-0507, Order, Appx. A at 3 (July 30, 2008); *Ill.-Am. Water Co.*, Docket 92-0116, Order, Appx. A (Feb. 9, 1993). *See also Aqua Ill., Inc.*, Order, Docket 04-0442, Order, Appx. at 5 (Apr. 20, 2005); *Consumers Ill. Water Co.*, Docket 03-0403, Order, Appx. A, Sch. 3 (Apr. 13, 2004); *Cent. Ill. Light Co.*, Dockets 01-0465/0530/0637 (cons.), Order, Appx. A, Sch. 3 (Mar. 28, 2002); *Consumers Ill. Water Co.*, Dockets 00-0337/0338/0339 (cons.), Order, Appx. B-K (Jan. 31, 2001).

IAWC recognizes that the reverse is not true—when pension contributions exceed the pension expense amount IAWC collects through rates, as is projected to occur in this case, the Commission has not approved an increase to rate base. *Ill.-Am. Water Co.*, Docket 11-0767, Order at 8 (Sept. 19, 2012). However, it remains IAWC's position that including only pension and OPEB balance sheet liabilities, but not the assets, in rate base is inconsistent. (IAWC 4.00R at 15-16.) IAWC therefore proposes a middle ground approach, under which IAWC receives a debt return for its pension asset. This is not an unprecedented proposal: the Commission has previously approved a debt return on certain pension contributions for Commonwealth Edison. *Commonwealth Edison Co.*, Docket 05-0597, Order on Reh'g at 28 (Dec. 20, 2006). And the Illinois formula rate law also allows a debt return on all pension assets. 220 ILCS 5/16-108.5(c)(4)(D). IAWC therefore considers a debt return on its pension asset a reasonable way to balance the deduction of the OPEB liability from rate base. As shown on IAWC Exhibit 4.07SR, such a return would increase the revenue requirement by approximately $175,000.

3. Cash Working Capital for Deferred Income Tax

Cash working capital is the amount of funds necessary to finance the day-to-day operations of a utility. (IAWC Ex. 12.00 at 2.) The necessary level of cash working capital is determined using a lead-lag study, which determines the timing of cash inflows and outflows. (IAWC Ex. 12.00 at 3.)

The two primary components of a lead-lag study are revenue lags and expense leads. (*Id.* at 3.) The revenue lag represents the period of elapsed time between when a company delivers its product to its customers, and when it receives payment from them. (*Id.*) The expense lead represents the period of elapsed time between when a good or service is provided to the company, and when the company pays its supplier for that good or service. (*Id.*) The revenue

lag is compared against the expense lead, and the net difference is the company's cash working capital requirement. (*Id.*)

A dispute arose in this case regarding the cash working capital requirement associated with deferred income taxes. Deferred income taxes are generally deducted from rate base because they are considered a cost-free source of funds. (IAWC Ex. 12.00 at 13; IIWC/FEA/CUB Ex. 2.0 (Rev.) at 36.) In this case, the Company deducted deferred income tax amounts from rate base. (IAWC Ex. 12.00 at 13.) The Company also assigned a zero-day expense lead to deferred income taxes in the lead-lag study to reflect the fact that there is no current expense associated with the deferred tax amounts. (IAWC Ex. 12.00SR at 2.)

The Company, however, applied the same revenue lag it applies to all other revenues to the deferred tax amounts. (IAWC Ex. 12.00 at 13.) Application of the revenue lag reflects the reality that IAWC collects the dollars associated with its deferred tax liability in the same way that it collects *all other revenues*—by billing and collecting from its customers. (IAWC Ex. 12.00SR at 2-3.) All IAWC's revenues are subject to a 49.3-day revenue lag, on average. (IAWC Ex. 12.00R at 5.)

Staff did not dispute IAWC's method of calculating cash working capital associated with deferred income taxes. (ICC Staff Ex. 10.0 at 3.) However, IIWC/FEA/CUB witness Gorman proposed to eliminate the revenue lag applied to deferred tax amounts—in other words, apply a zero-day revenue lag. (IIWC/FEA/CUB Ex. 1.0 at 16-17.) Mr. Gorman made three arguments in support of his proposal, but none of these arguments withstands scrutiny, and his proposal should be rejected.

First, Mr. Gorman argued that a zero-day revenue lag was appropriate because "cash received by IAWC in rates for deferred income taxes is not currently paid." (IIWC/FEA/CUB

Ex. 1.0 at 16:301-02.) He stated that "[e]xpenses such as deferred income tax are recorded … but do not reflect any payment to a vendor or third party." (IIWC/FEA/CUB Ex. 2.0 (Rev.) at 36:667-69.) It is clear from these statements that Mr. Gorman has confused the components of the lead-lag study. As discussed above, there are two components of cash working capital: the revenue lag, and the expense lead. Mr. Gorman's proposal is to modify the *revenue lag*, yet his argument focused on when or whether IAWC incurs an *expense* for deferred income taxes. IAWC's lead-lag analysis *already* accounted for the fact that there is no current expense associated with deferred income taxes by applying a zero-day expense lead. (IAWC Ex. 12.00SR at 3.) IAWC also accounted for this by subtracting the deferred taxes from rate base. (*Id.*) Given Mr. Gorman's confusion on this issue, his testimony provides no support for his proposed adjustment.

Second, Mr. Gorman argues that a zero-day revenue lag should be applied to deferred income taxes because the taxes are "a cost-free source of cash." (IIWC/FEA/CUB Ex. 1.0 at 16:309.) But the fact that deferred income taxes are a cost-free cash item has been accounted-for outside of the cash working capital analysis because IAWC subtracted the deferred taxes from rate base. (IAWC Ex. 12.00SR at 3.) For purposes of determining the appropriate revenue lag in the cash working capital analysis, the relevant inquiry is when the Company collects cash from its ratepayers. (*Id.*) Deferred tax amounts cannot become a "cost-free source of cash" to the Company until the Company actually collects the cash amounts from its customers. (*Id.*)

Third, Mr. Gorman argues that the deferred income taxes should be considered equivalent to depreciation and uncollectibles expenses, which are assigned a zero-day revenue lag. (IIWC/FEA/CUB Ex. 1.0 at 16-17.) But IAWC's calculation of cash working capital for depreciation, uncollectibles, and deferred tax expense is consistent with past Commission

findings in IAWC cases. (IAWC Ex. 12.00SR at 4.) Mr. Gorman has presented no compelling reason to depart from Commission practice. His proposal should be rejected.

B. Resolved Issues

1. Accrued Liability for OPEB

The Company has agreed to reflect in rate base an $1,898,284 accrued liability for other (non-pension) post-employment benefits (OPEBs), which represents the cumulative excess of accrued OPEB costs over actual cash disbursements for OPEB. (IAWC 4.00R at 15; AG Ex. 1.0 at 7.)

2. Capitalized Prior Performance Plan Costs

AG witness Effron proposed to remove the capitalized costs of incentive compensation plans that were not included in the revenue requirement in IAWC's last rate case, Docket 11-0767. (AG Ex. 1.0 at 10.) Mr. Effron's adjustment removed the costs of these plans that were capitalized from 2012 through 2016. (AG Ex. 1.0 at 10.) The Company accepted the portion of this adjustment that removed previously disallowed capitalized incentive compensation costs. (IAWC Ex. 4.00R at 16.) Mr. Effron made additional corrections to the calculation as agreed upon in discovery. (AG Ex. 3.0 at 6.) Therefore, the Company considers this issue resolved.

3. Cash Working Capital

a. Income Available for Return on Equity in Cash Working Capital

IIWC/FEA/CUB witness Gorman proposed a correction to the amount of income available for common equity included in cash working capital. (IIWC/FEA/CUB Ex. 1.0 at 16.) The Company accepted Mr. Gorman's correction, and considers this issue resolved. (IAWC Ex. 12.00R at 3.)

b. Tank Painting Amortization

Staff witness Hathhorn and IIWC/FEA/CUB witness Gorman proposed corrections to exclude tank painting amortization from the cash working capital calculations of depreciation and amortization expense and from maintenance-other expense. (ICC Staff Ex. 2.0 at 4; IIWC/FEA/CUB Ex. 1.0 at 17.) IAWC accepted Staff's corrections in discovery, (*see* ICC Staff Ex. 2.0 at 4), and IIWC/FEA/CUB acknowledged that these corrections resolved their concerns. (IAWC Ex. 12.00R at 3-4.) Therefore, this issue is resolved.

c. Rate Case Expense Amortization

IIWC/FEA/CUB witness Gorman proposed a correction to remove rate case expense amortization from the cash working capital calculation. (IIWC/FEA/CUB Ex. 1.0 at 17.) IAWC accepted this correction in discovery. (*See* IAWC Ex. 12.00R at 3-4.) Therefore, this issue is resolved.

4. Accumulated Deferred Income Taxes

a. Deferred Tax Assets for UPAA and Deferred Rate Proceedings

Staff witness Hathhorn proposed to adjust rate base to exclude accumulated deferred income taxes for two accounts that the Company acknowledged it inadvertently included in each rate zone. Accounts for Net UPAA (utility plant acquisition adjustment) and Deferred Rate Proceedings should not have been included in the deferred tax calculation as the associated assets and liabilities are not included in rate base. (ICC Staff Ex. 2.00 at 5.) IAWC agreed to these adjustments. (IAWC Ex. 4.00R at 3.)

b. Restated for Change in State Income Tax Rate

Staff witness Hathhorn and AG witness Effron both accepted IAWC's proposal to use the 7.75% state income tax rate, which is based on a 100% apportionment factor reflecting IAWC's activities in Illinois, rather than on a five-year average estimate of American Water Company's

apportionment factor. (ICC Staff Ex. 10.0 at 4; AG Ex. 3.0 at 2.) Mr. Effron and Ms. Hathhorn accordingly proposed to reflect the Company's state and federal ADIT balances at the 7.75% state income tax rate. (ICC Staff Ex. 10.0 at 4; AG Ex. 3.0 at 6-7.) IAWC accepted these adjustments. (IAWC Ex. 4.00SR at 4, 10.)

5. Deferred Charges related to Cairo Filter Project

In discovery, IAWC agreed to an adjustment to reduce rate base by $2,162,500 to correct the balance of deferred charges on Schedule B-10 for two filter projects in Cairo that should not be included as deferred maintenance. (IAWC Ex. 4.00R at 4.) Staff and AG witnesses acknowledged this adjustment in testimony. (*See* AG Ex. 1.0 at 10; ICC Staff Ex. 2.0 at 4.) Therefore, this issue is resolved.

6. Accumulated Depreciation Correction

Staff witness Hathhorn proposed adjustments to the Company's accumulated depreciation correction, "adjust[ing] rate base downward to include accumulated depreciation for two accounts" inadvertently omitted by the Company from each rate zone, as well as corrections to Rate Zone 1 for accumulated amortization and depreciation and amortization expense. (ICC Staff Ex. 2.0 at 4-5: 90-94.) IAWC accepted these proposed adjustments. (IAWC Ex. 4.00R at 3.) Therefore, this issue is resolved.

C. Original Cost Determination

IAWC accepts Staff's recommendation "that the Commission conclude and make a finding in the Final Order in this proceeding that the Company's September 30, 2015 plant balance of $1,570,415,946 as reflected on Company's WPB 5a, be approved for purposes of an original cost determination, subject to any adjustments ordered by the Commission in this proceeding." (ICC Staff Ex. 2.0 at 14:340-44; IAWC Ex. 4.00R at 5.)

D. Recommended Rate Base

IAWC's recommended Total Company test year rate base is $884,343,956, as shown on IAWC Exhibit 4.03SR (Rev.). The rate bases for each Rate Area are shown on pages 2-5 of IAWC Exhibit 4.03SR (Rev.).

IV. OPERATING EXPENSES AND REVENUES

A. Contested Issues

1. Payroll Expense

Productivity enhancements have allowed IAWC to reduce employee headcount since its 2011 rate case, saving $300,000 in test year payroll expense. Any further, artificial, reductions to employee headcount should be rejected.

IAWC employs people, and its employees need to be paid. Payroll expense is an ordinary and necessary cost of doing business that must be recovered in rates. *People ex rel. Madigan v. Ill. Commerce Comm'n,* 2011 IL App (1st) 100654, ¶ 49 (*citing Bus. & Prof'l People for Pub. Interest v. Ill. Commerce Comm'n*, 146 Ill. 2d 175, 247 (1991); *Villages of Milford v. Ill. Commerce Comm'n*, 20 Ill. 2d 556, 565, (1960)).

The Company's projected test year headcount is already less than in its 2011 rate case. Instead of recognizing this achievement for what it is, Staff, the AG, and IIWC/FEA/CUB proposed to impute an even greater reduction in employee headcount. These parties refused to acknowledge evidence establishing the soundness of test year staffing levels, which already includes a vacancy factor. They simply assumed that historical staffing trends will be repeated in the future. This assumption is wrong, and so are the proposed adjustments. Payroll expense should be established as forecasted by IAWC.

a. IAWC's payroll expense will enable IAWC to employ the staff necessary to meet service obligations.

IAWC's test year payroll expense reflects the staffing level that IAWC projects it will need to meet its water and sewer service obligations to customers in 2017—an average of approximately 470 full-time positions. That's an average of 482 average full-time positions (479 full-time permanent positions each month of the test year, and 13 full-time temporary summer positions, June through August), reduced by 2.5% (approximately twelve positions) to account for anticipated vacancies in the test year. (IAWC Exs. 2.00 at 18-19; 2.00R (2d Rev.) at 2, 3.) Notably, IAWC's current headcount of 442 and the 24 positions it is actively recruiting for—466 total positions—already approximate the 2017 test year projection of 470 average full-time positions.

The test year staffing projection is the result of IAWC's current staffing needs and its continuous focus on appropriate staffing levels. (IAWC Ex. 2.00 at 18.) When IAWC staffs its water and sewer operations, it reviews each vacant position for overall need and considers, among other things, whether the position should be transferred, modified, or even eliminated. And IAWC similarly evaluates new positions that it may need to meet changing regulatory requirements, optimize new technology, and most effectively serve customers. (*Id*. at 18-19.) IAWC's continuous focus on identifying appropriate staffing needs allows it to effectively control labor costs while maintaining the workforce necessary to meet its service obligations to Illinois customers. (IAWC Ex. 2.00R (2d Rev.) at 3-4.)

Employing this focus on appropriate staffing levels, as of June 2016, IAWC has been recruiting for or planning to add 24 full-time positions to its May 31, 2016 442-person staff—for a current staff of 466 full-time positions. (IAWC Ex. 2.00R (2d Rev.) at 2-3.) IAWC identified those 24 positions on IAWC Exhibit 2.01R, and explained why each one is essential to the core

functions of IAWC's operations: construction, operation, and maintenance of IAWC's water distribution and wastewater collection systems, meter testing and repair, customer service, and management of the personnel who perform that critical work. (*Id*. at 3; IAWC Ex. 2.01R.)

IAWC, for example, has been recruiting a union-represented Field Services Technician in its Peoria service area, to fill a position vacant due to a retirement. This employee performs JULIE locates, b-box and valve inspections and maintenance, fire hydrant flushing inspections, and leak detection, and reads, tests, and installs water meters, among other customer service responsibilities. (IAWC Ex. 2.01R.) As another example, IAWC has also been recruiting a Water Quality and Environmental Compliance Supervisor in its Woodbridge service area, to fill a position again vacant due to a retirement. This employee manages personnel and operations to ensure that IAWC meets Clean Water Act requirements, among other water quality, environmental, and regulatory compliance-related duties. (*Id*.)

All of the positions on IAWC Exhibit 2.01R are critical to serving IAWC's customers. (IAWC Ex. 2.00R (2d Rev.) at 3.) Therefore, IAWC's President and Vice President of Operations have approved those positions. (*Id*. at 4.) Before the end of 2016, and into the 2017 test year, IAWC may need to recruit for additional, but currently unplanned, full-time positions as business circumstances dictate, to meet its service obligations to Illinois customers. (*Id*. at 3.)

b. IAWC's test year payroll expense and headcount already account for anticipated position vacancies.

IAWC's test year payroll expense also accounts for 12 anticipated position vacancies in the test year. (IAWC Ex. 2.00R (2d Rev.) at 2.) This is because, historically, IAWC has been unable to fill all of its full-time position needs, for several reasons. First, the utility workforce is aging and retiring; IAWC has lost employees due to attrition. (*Id*. at 5.) Second, it is difficult to attract new STEM-qualified (Science, Technology, Engineering, Mathematics) talent to the

public utility industry, to fill vacancies left by retiring talent. (*Id*.) And IAWC has recently increased its focus on diversifying its workforce, with great success: in 2014 and 2015, the majority of IAWC's new hires identified with a minority population. This focus, however, means that there may be delays in filling open positions. (*Id*.)

So, while IAWC continuously strives to fill all open positions, it reasonably anticipates some vacancies in the test year. IAWC reduced its projected 482 average 2017 head count by 2.5%, or approximately 12 positions, to appropriately account for this. (*Id*.) This means that IAWC is already near its 2017 projected 470 average full-time position headcount, considering IAWC's May 2016 headcount and the positions IAWC has been recruiting for or is planning to hire in 2016.

c. IAWC's test year payroll expense and headcount are already reduced.

Notably, IAWC's test year staffing level in this case is 26 positions *less* than IAWC's approved staffing level in Docket 11-0767, including anticipated vacancies. This means that the payroll expense here is less, too—by over $300,000. (IAWC Ex. 2.00 at 19.)

The reduction is the result of IAWC's organizational streamlining efforts and technology initiatives, like its Advanced Meter Reading program, which has allowed IAWC to eliminate 16 full-time equivalent positions, and Business Transformation, American Water's system-wide deployment of new, integrated information technology systems to improve technological efficiencies, increase automation, and promote more effective business processes. (*Id*. at 10, 16, 19.) These initiatives allow IAWC to complete more work with fewer people, at lower labor and related costs to IAWC's customers than in 2011. (*Id.* at 19.)

d. Staff and Intervenors' further reductions to IAWC's test year headcount and payroll expense are unreasonable, and should be rejected.

No party disputed that IAWC's approach to staffing its operations is reasonable, and no party disputed IAWC's current headcount, or the need for the 24 full-time positions that IAWC is recruiting for and plans to fill in 2016, or the need for the attendant work. Further, no party disputed that IAWC may need to recruit for more positions in 2016 and 2017, to meet its service obligations to Illinois customers. (IAWC Ex. 2.00SR at 6.)

But Staff witness Kahle, AG witness Effron, and IIWC/FEA/CUB witness Gorman proposed to further reduce IAWC's test year headcount and payroll expense, based on nothing more than IAWC's historical position vacancies since 2014, albeit each to varying degrees. (*Id*. at 2.) Mr. Kahle would reduce the expense by 5.40%; Mr. Effron, by 5.77%; and Mr. Gorman, by 7.59%. (IAWC Ex. 2.00SR at 7; IIWC/FEA/CUB Ex. 2.0 (Rev.) at 26.)

IAWC's undisputed approach to staffing and its staffing needs—and not the Company's recent historical vacancy experience, in isolation—should dictate its 2017 headcount and payroll expense. Otherwise, the result is unjust and unreasonable, for a host of reasons: it ignores the context of IAWC's historic employment levels; it ignores IAWC's immediate need for additional staffing and would disallow currently planned positions that no party disputes are necessary; and it ignores management's need for flexibility in future hiring decisions. Moreover, it ignores that, when headcount is below budget, overtime hours exceed budget, and this offsets any decrease in payroll expense. Simply put, someone has to do the work to meet IAWC's service obligations to customers. When planned positions remain unfilled, that someone is IAWC's current workforce.

i. IAWC is already operating with a lean staff, so its historical vacancy experience is not representative of its future staffing needs.

No party disputed IAWC's planned hires represent a lean staff—IAWC has already significantly reduced its headcount by 26 full-time positions since its last rate case, not even accounting for IAWC's anticipated 12 position vacancies. (IAWC Ex. 2.00R (2d Rev.) at 6.) This is one benefit of Business Transformation, which was established in 2013. Business Transformation changed the way IAWC employees work; they perform the same functions, just differently and more efficiently. The new systems, for example, enabled a field resource center at the Service Company, which provides centralized scheduling for field work for IAWC and other American Water operating companies, and thus reduced the number of IAWC employees necessary to perform that function. (*Id*.) The advent of Business Transformation in 2013 meant a period of "right-sizing" for IAWC's workforce—in 2014 and 2015. (*Id*.) Thus, IAWC's vacancy experience those years just isn't a good predictor of its future staffing needs.

Moreover, necessarily, IAWC can reduce its workforce only so much; it needs talented employees to meet its service obligations to customers. And the lower the number of full-time positions, the fewer vacancies there can reasonably be. (*Id*. at 8.) Since IAWC is already operating with a lean staff, to reduce that staff even further is unreasonable.

ii. The proposed adjustments to payroll expense would disallow currently planned positions that no party disputes are necessary.

As discussed above, IAWC is already near its test year projected headcount of 470, considering IAWC's May 2016 442 headcount and the 24 positions it is currently recruiting or planning to hire in 2016. Neither Mr. Kahle, Mr. Effron, nor Mr. Gorman disputed the need for the 24 full-time positions that IAWC is currently recruiting for and plans to hire in 2016 alone.

(IAWC Ex. 2.00SR at 6.) And none of them identified any 2016 or 2017 test year activities as unnecessary, which would warrant leaving any positions unfilled those years. (*Id*.)

Yet, in disallowing IAWC's planned test year headcount based on nothing but IAWC's historical headcount, these witnesses arbitrarily removed the cost for the planned 2016 positions that they don't dispute are necessary. Mr. Kahle's 5.40% vacancy adjustment would disallow five positions planned for 2016 that he doesn't dispute the need for. (*Id*. at 7.) Mr. Effron's 5.77% vacancy adjustment would disallow seven, even though Mr. Effron expressly testified that he "do[es] not argue that the positions are unnecessary." (*Id*.; AG Ex. 3.0 at 8:164.) And Mr. Gorman's 7.59% vacancy adjustment would disallow nearly *all* of the positions that IAWC is recruiting for and plans to fill in 2016. In fact, Mr. Gorman advocated a workforce of approximately *64 fewer* employees than in IAWC's last rate case. (IAWC Ex. 2.00SR at 7.) Although, again, neither he nor Messrs. Kahle or Effron disputed the need for *any* of IAWC's currently planned workforce.

iii. The proposed adjustments to payroll expense would effectively eliminate IAWC's flexibility to hire critical personnel in the future.

Staffing utility operations is a dynamic, ongoing process. Headcount requirements aren't static; they vary continuously, depending on operational needs. (IAWC Ex. 2.00R (2d Rev.) at 3.) Those needs may require additional staffing that is not currently planned, like the staff necessary to remedy an unanticipated increase in main breaks due to inclement weather. (IAWC Ex. 2.00 at 18-19.) Utility management must have the flexibility to hire that staff, as circumstances demand, to meet service obligations to customers. (IAWC Ex. 2.00SR at 8.)

Messrs. Kahle's, Effron's, and Gorman's adjustments all would deprive utility management of that flexibility, because the adjustments would limit IAWC to its planned June 2016 staffing needs alone. (Less, in fact, as explained above.) This removes IAWC's flexibility

to recruit for and fill new positions in 2016 and 2017, beyond its currently planned staffing needs in IAWC Exhibit 2.01R, as new positions become necessary. (*Id.*)

iv. At a minimum, any payroll expense adjustment requires an offsetting adjustment for increased overtime expense.

When IAWC cannot fill a budgeted position, current employees must perform the work—at time-and-a-half pay—in additional to their other responsibilities, so IAWC can meet its service obligations to Illinois customers. (IAWC Exs. 2.00R (2d Rev.) at 7; 2.00SR at 2, 3-4.) Therefore, where historical headcount vacancies have exceeded budget, IAWC's historical overtime expenses likewise have exceeded budget—by $742,000 in 2013; by $808,000 in 2014; and by $459,000 in 2015. (IAWC Ex. 2.00R (2d Rev.) at 7.) As of May 2016, IAWC's 2016 overtime expense was 69% over budget. (IAWC Ex. 2.00SR at 4.) In other words, on average, 2013 to date, IAWC's overtime expenses have exceeded budget by 43%, offsetting budgeted payroll expense reductions those years.

Additional hires are required to reduce overtime for the current employees, or IAWC's overtime expenses will continue to exceed budget. (*Id.*) The Commission should authorize IAWC's requested payroll expense so that IAWC can appropriately staff its operations. If, however, the Commission finds reason to further reduce IAWC's test year headcount based solely on its historical vacancy experience, as Messrs. Kahle, Effron, and Gorman advocate, then, for symmetry, the Commission should also recognize the consequent increase to IAWC's test year overtime expense that will result. (IAWC EX. 2.00SR at 4.)

Staff witness Kahle agreed. (IAWC-Staff Stip. Cross Ex. 1.0 at. 18, 20.) IAWC's projected test year overtime expense is $1,311,710. (IAWC Ex. 2.00SR at 4.) Applying IAWC's historical average overtime expense variance of 43% to the test year expense level produces an increase in overtime expense of $559,444. (*Id.*) In discovery, Mr. Kahle agreed that

increase appropriately offsets his $702,756 payroll expense adjustment, reducing the adjustment to $143,312. (IAWC-Staff Stip. Cross Ex. 1.0 at 18, 20.)

IAWC has already significantly reduced its workforce, which has mitigated the payroll expense that customers pay through rates. The Commission should support such efforts. It shouldn't constrain payroll expense—and, consequently, IAWC's ability to fill necessary positions with talented, diverse personnel—further. It should reject any adjustment to IAWC's 2017 test year payroll expense.

2. Annual Performance Plan Expense (Resolved between IAWC and Staff)

Part of IAWC's Annual Performance Plan successfully encourages its employees to achieve IAWC's operational goals—safety, customer satisfaction, environmental leadership, and operational efficiency—with pay that depends on their annual performance and IAWC's. Year-over-year 2013 to 2015, IAWC drove down safety incident rates and increased customer satisfaction rates, under annual performance pay metrics. And IAWC has so increased its operational efficiency that its overall operating expenses in this case reflect a 3% *decrease* from those in the Company's 2011 rate case. Unquestionably, Illinois customers have benefitted from these operational successes.

IAWC initially requested full recovery of its Annual Performance Plan expense. However, to narrow the issues, it accepted Staff's proposed adjustment to allow only the portion that encourages IAWC's operational successes. Therefore, Staff, IAWC, and IIWC/FEA/CUB now agree that portion of the Annual Performance Plan expense is recoverable.

AG witness Effron, however, would disallow IAWC's entire Annual Performance Plan expense, including the portion that encourages IAWC's operational successes. But, notably, Mr. Effron doesn't dispute that IAWC reasonably compensates its employees, or that the Annual

Performance Plan encourages their operational achievements, or even that those achievements benefit Illinois customers. Rather, Mr. Effron homes in on one feature of the Annual Performance Plan that ensures that IAWC can fund it before payouts are made. From this alone, Mr. Effron decides that the plan expense should be disallowed in its entirety.

Mr. Effron's position ignores the facts and the law. The Commission should reject so disproportionate a result. It should approve Staff's proposed partial recovery of IAWC's Annual Performance Plan expense, which IAWC has accepted to narrow the issues.

a. Prudent and reasonable employee compensation expenses are recoverable.

Utility rates must allow the utility to recover its prudent and reasonable costs of service. *Citizens Util. Bd. v. Ill. Commerce Comm'n*, 166 Ill. 2d 111, 126 (1995). This includes the utility's prudent and reasonable expenditures to compensate employees. *See People ex rel. Madigan v. Ill. Commerce Comm'n*, 2011 IL App (1st) 100654, ¶ 49 (*citing Bus. & Prof'l People for Pub. Interest v. Ill. Commerce Comm'n*, 146 Ill. 2d 175, 247 (1991); *Villages of Milford v. Ill. Commerce Comm'n*, 20 Ill. 2d 556, 565 (1960)).

b. Performance pay that benefits customers is specifically recoverable.

Generally, when part of the compensation a utility pays its employees is at risk (like incentive or performance pay), recovery of the expense hinges on whether it benefits customers. *See, e.g.*, *N. Shore Gas Co. et al.*, Dockets 07-0241/0242 (cons.), Order at 66 (Feb. 5, 2008) ("The main and guiding criterion is that the [incentive pay] expense be prudent, reasonable and operate in a way to benefit the utility's customers."); *Madigan*, 2011 IL App (1st) 100654, ¶¶ 51, 55 (affirming the Commission's customer benefit standard). The Commission has consistently found that performance pay that promotes safety, increases customer satisfaction, and controls operating expenses benefits utility customers, is rate recoverable. *See, e.g.*, *Ameren Ill. Co.*,

Docket 15-0142, Order at 44-46 (Dec. 9, 2015); *N. Shore Gas Co. et al.*, Dockets 12-0511/0512 (cons.), Order at 130 (June 18, 2013) ("One of the goals that the Commission encourages public utilities to incentivize through [incentive pay] plans is the control and reduction of operating costs since . . . this should have the effect, all else being equal, of lowering the costs to be recovered in future rate cases.").

c. IAWC prudently and reasonably compensates its employees.

Like its industry peers, IAWC compensates employees with a mix of base pay, overtime pay, and short- and long-term performance pay. Performance pay is pay that varies depending on the individual employee's and the broader Company's performance. (IAWC Exs. 9.00R at 4; 2.00 at 20.) *See also N. Shore Gas Co. et al.*, Dockets 07-0241/0242 (cons.), Order at 66 (Feb. 5, 2008) ("Being a large utility means that management depends on the dutiful work performance of its employees. To motivate and maintain high standards, a utility may reasonably offer incentive compensation, as the best way to match both employer and employee interests and to ensure quality work performance."). Also like its peers, to compete for talented employees, IAWC targets its employees' total compensation—base pay plus performance pay—at the market median for comparable positions. (IAWC Ex. 9.00 at 4-5.)

In 2015, the total compensation that IAWC paid its employees was somewhat below both the national and Midwest market medians, by 16% and 15%, respectively. (IAWC Ex. 9.00 at 8.) IAWC employees' 2015 base pay alone was substantially below those market medians, by 28% and 25%, respectively. (*Id*. at 9.) In other words, any way you slice it, IAWC's employees are not overcompensated. Further, if IAWC employees did not receive their performance pay—and received base pay alone—they would be significantly underpaid relative to their peers. (*Id*. at 9; IAWC Ex. 7.00R (Rev.) at 23.) *Cf. Commonwealth Edison Co.*, Docket 14-0312, Order at

49-50 (Dec. 10, 2014) (finding the utility should be allowed to recover close to market-level employee compensation, including incentive pay).

d. IAWC employees' compensation includes performance pay that benefits customers.

IAWC awards its employees short-term performance pay under the Annual Performance Plan. (IAWC Ex. 2.00 at 20, 22-23; ICC Staff Ex. 3.0, Attach. G at 4-16 (plan document).)[17] Payouts under the Annual Performance Plan depend 50% on the Company's financial performance, assessed via earnings per share metrics, and 50% on its operational performance, assessed via safety, customer satisfaction, environmental leadership, and operational efficiency metrics. (IAWC Exs. 2.00R (2d Rev.) at 12; 9.01 (Rev.) at 7-8.) The plan also requires that the Company be financially able to fund it, assessed as attaining 90% of an earnings per share goal, before payouts can be made. (IAWC Ex. 9.00 at 10.) This isn't, however, a performance metric under the plan on which employees are paid. (*Id.*)

The Annual Performance Plan's operational goals benefit IAWC's customers. In 2013, 2014, and 2015, IAWC employees achieved these incremental and sustained operational successes, under its short-term performance pay plans:

OPERATIONAL METRIC	2015	2014	2013
OSHA Recordable Incident Rate	1.24	1.80	2.38
OSHA Days Away/Restricted or Job Transfer Rate	0.62	1.20	1.79
Customer Satisfaction	93%	92%	90%
Service Quality	87%	85%	85%
Commission Complaints	245	502	284
O&M Efficiency Ratio	38.3%	42.0%	44.3%

(IAWC Ex. 2.00R (2d Rev.) at 12-13.)

[17] The Long Term Performance Plan, under which IAWC awards long-term performance pay, is not at issue here. *See infra* § VI.B.12.

Safety incidents went down. Customer satisfaction and service quality went up. And operational efficiency increased such that the total test year operating expenses that IAWC initially requested in this case—$98.7 million—were *3% less* than in its last rate case, despite inflation and despite that, in this case unlike Docket 11-0767, IAWC requested recovery of its performance pay expenses. (IAWC Exs. 2.00 at 5; 2.00R (2d Rev.) at 11; 7.00SR (Rev.) at 11.) This reduction has not only mitigated the operating costs that IAWC's customers ultimately pay through rates, but also delayed the time between IAWC's rate cases. (IAWC Ex. 2.00R (2d Rev.) at 11-12, 14.)

IAWC's customers unquestionably have benefited from its achievement of the operational goals incentivized by the Annual Performance Plan. (IAWC Ex. 7.00R (Rev.) at 34.) Therefore, Staff, IAWC, and IIWC/FEA/CUB agreed that the attendant costs should be recoverable. IAWC initially requested 100% recovery of its Annual Performance Plan expense. But, to narrow the issues, IAWC accepted Staff's proposed adjustment to allow recovery of the portion that encourages IAWC's operational successes. (ICC Staff Ex. 3.0 at 10, Sch. 3.07; IAWC Exs. 7.00SR (Rev.) at 10-11; 4.00SR at 6-7; IAWC-Staff Stip. Cross Ex. 1.00 at 17, 19.) IIWC/FEA/CUB witness Gorman proposed an adjustment that approximates Staff's. (IIWC/FEA/CUB Exs. 1.0 at 14; 1.4; 2.0 (Rev.) at 34 (advocating partial recovery of IAWC's short-term performance pay costs).)

AG witness Effron, however, would disallow all of IAWC's Annual Performance Plan expense, including the operational goal related portion. It is that portion—the portion that incents IAWC's operational successes—that remains at issue.

e. AG witness Effron would disallow the entire plan expense, even though he didn't dispute the prudence and reasonableness of IAWC's pay practices or that the Annual Performance Plan's operational goals benefit customers.

AG witness Effron didn't dispute that IAWC prudently compensates its employees, or that IAWC employees' total compensation is reasonable. (IAWC Ex. 9.00R at 2-3; IAWC-AG Stip. Cross Ex. 1.00 at 1-2, 4.) Nor did he dispute that IAWC employees' operational achievements under the Annual Performance Plan have benefited customers. To the contrary, AG witness Effron expressly agreed that customers benefit when a utility reduces its operating expenses—like IAWC has here—so long as safe, reliable, and least-cost service isn't compromised—which clearly hasn't happened here: safety and customer service have improved. (*Id.* at 3; *supra* § IV.A.2.d.)

Nevertheless, Mr. Effron asked the Commission to disallow *all* of IAWC's Annual Performance Plan expense. He homes in on the plan feature that requires its financial viability to fund it, and, from this, summarily concludes that the entire plan primarily benefits shareholders. (AG Ex. 1.0 at 14.) Mr. Effron's position is simply too narrow. It ignores the record evidence and the law, and would unfairly disallow the cost of operational metrics that he doesn't dispute benefit customers.

f. Mr. Effron's position, in focusing on only the financial viability feature of the Annual Performance Plan, ignored the record evidence.

Mr. Effron's position also ignored key record facts. It first ignored that the financial viability aspect of the Annual Performance Plan isn't a performance metric on which participants are paid. (IAWC Ex. 9.00 at 10.) In other words, increasing earnings per share doesn't affect payouts under the operational side of the plan. Instead, the only way that IAWC employees can earn that performance pay, and even increase it, is to meet or exceed IAWC's operational

goals—safety, customer satisfaction, environmental leadership, and operational efficiency. (IAWC Exs. 2.00R (2d Rev.) at 12; 9.01 (Rev.) at 7.) Again, these are goals that benefit customers—a point Mr. Effron did not dispute.

Mr. Effron's position also ignored that, despite the financial viability aspect of its short-term performance pay plans, IAWC employees have consistently received performance pay under the plans every year, for at least the last seven. (IAWC-AG Stip. Cross Ex. 2.00 at 2.) In fact, on average, payouts have exceeded the target level—the level at which IAWC set performance pay in its revenue requirement in this case. (*Id.*; IAWC Ex. 2.00 at 21.) This means that IAWC employees can reasonably be expected to meet or exceed their Annual Performance Plan operational goals in the test year; IAWC can reasonably be expected to award them for that performance; and customers can reasonably be expected to benefit, the financial viability aspect of the plan aside. *See N. Shore Gas Co. et al.*, Dockets 07-0241/0242 (cons.), Order at 67 (Feb. 5, 2008) ("Taken together, the goal of the [incentive pay] plan, the large pool of potential awardees and the wide-reaching motivational impact, make it more likely than not, that ratepayers will benefit from the race to excellence.")

g. Mr. Effron's position, in focusing on only the financial viability feature of the Annual Performance Plan, also ignored the law.

Mr. Effron's position ignored that the Commission consistently approves cost recovery for performance pay operational metrics that benefit customers, such as safety, customer satisfaction, and operational efficiency. *See, e.g.*, Dockets 07-0241/0242 (cons.), Order at 66 (when incentive pay tied to "matters of customer service, customer satisfaction, the reduction of operating expenses, and the like is at hand, it is incumbent upon the Commission to take a close and considered view"); *supra* § IV.A.2. These are the very goals that the Annual Performance Plan incentivizes, to the undisputed benefit of IAWC's customers in 2013, 2014, and 2015.

Moreover, recognizing that operational performance pay metrics benefit customers, the Commission has approved cost recovery even when the governing plan includes a financial feature, to avoid an unjust and disproportionate result. *See, e.g.*, *Commonwealth Edison Co.*, Docket 14-0312, Order at 48-51 (Dec. 10, 2014).

In Docket 14-0312, the Commission approved partial recovery of ComEd's Annual Incentive Plan, which consisted of eight operational metrics on which ComEd employees received annual incentive pay as well as a "Shareholder Protection Feature" that relied on a reference to Exelon's earnings per share performance. *Id.* Like the financial viability feature of IAWC's Annual Performance Plan, ComEd's Annual Incentive Plan's Shareholder Protection Feature could limit the amount of annual incentive compensation paid, but it was not a metric on which ComEd employees earned their annual incentive compensation. *Id*. at 29.

In Docket 14-0312, like here, no party disputed that ComEd's Annual Incentive Plan metrics incented employees to meet goals that are beneficial to ratepayers. *Id*. And there, like here, the record showed that if employees did not receive their annual incentive pay, they would receive below market wages. *Id*. In light of this, the Commission found that ComEd should recover its Annual Incentive Plan costs, at 102.9% payout, which the Commission concluded "insures that ComEd recovers the market-based salary for their employees plus a reasonable bonus which further serves to encourage employees continued achievement of the operational goals to the befit of ratepayers, without allowing for excess cost recovery." *Id*. at 50. The Commission rejected the AG's proposed 100% disallowance of ComEd's Annual Incentive Plan—based only on the existence of the Shareholder Protection Feature—as disproportionate. *Id*. at 49.

h. Mr. Effron's position is disproportionate—it would disallow 100% of indisputably reasonable compensation expense that benefits customers.

Mr. Effron's proposed 100% disallowance of IAWC's Annual Performance Plan expense here, like the AG's proposed disallowance in Docket 14-0312, is disproportionate. Again, no party disputed the customer benefits from IAWC's Annual Performance Plan operational metrics. And even including *all* of IAWC employees' short-term performance pay (IAWC has already accepted Staff's adjustment to recover only a portion), IAWC employees' total compensation is already slightly below market. To allow recovery of $0 of the Annual Performance Plan expense, as Mr. Effron advocated, would be unjust and unreasonable.

The Commission should avoid so disproportionate a result. It should accept Staff's adjustment to allow partial recovery of the Annual Performance Plan expense, which IAWC has accepted to narrow the issues.

3. Purchased Power Expense

IAWC relies on electricity to power its buildings, pumping stations, and treatment plants. Like many large consumers of electricity, IAWC hedges its electricity costs by entering into power supply agreements. (*See* IAWC Ex. 2.00R (2d Rev.) at 15.) Rates under these agreements are based on the wholesale price of energy and capacity in the PJM[18] and MISO[19] regions. (*Id.*) The capacity component is based on annual auctions. (*Id.*) Test year purchased power expense is based on two power supply agreements (one each for MISO and PJM), which the Company entered in September 2015. (*Id.*; IAWC Ex. 4.00 at 13. *See also* Sch. C-2.2.) Capacity costs account for 15-20% of total retail power costs under these agreements. (*Id.*)

[18] PJM Interconnection
[19] Midcontinent Independent System Operator

After IAWC filed its case, MISO announced lower capacity costs for its June 1, 2016 through May 31, 2017 planning year. (AG Ex. 1.0 at 20-21.) The AG argued that purchased power expense should be reduced by $219,000 to account for these new capacity prices. (*Id.* at 21.) The Commission should reject this adjustment because it is overstated.

The AG's adjustment is overstated in two important ways. First, lower capacity prices will go into effect only in the MISO region, and only then for half of the test year. (IAWC Ex. 2.00R (2d Rev.) at 16.) The PJM contract prices will remain as forecast. (*Id.* *See also* AG Grp. Ex. 1.0, AG-14.001 and AG-14.001 Attach.)

Second, the AG's proposed adjustment to reflect a capacity cost decrease does not account for increases in other components of IAWC's purchased power costs, including increases in Ameren Illinois Company and ComEd distribution rates. (IAWC Ex. 2.00R (2d Rev.) at 17.)

The AG's proposed adjustment assumes that capacity prices for the final seven months of the 2017 test year will continue at the level announced for the first half of 2017, but there is no reason to believe that this will be the case. (IAWC Ex. 2.00R (2d Rev.) at 16.) Recent history shows that MISO capacity prices have been extremely volatile: costs for the 2013/2014 planning year were $1.05/megawatt day; they rose to $16.75/megawatt day in 2014/2015; rose again, significantly, to $150/megawatt day in 2015/2016; and then fell to $72/megawatt day for the 2016/2017 planning year. (*Id.* at 15; AG Ex. 1.0 at 20-21.) These dramatic swings highlight the likelihood that capacity charges will increase again in the latter seven months of 2017. And if that happens, the AG's adjustment would shortchange IAWC's full recovery of purchased power costs. (IAWC Ex. 2.00R (2d Rev.) at 16-17.)

The Commission should reject the AG's adjustment and approve recovery of purchased power costs incurred under the September 2015 power supply agreements.

4. Test Year Sales Level

In a general rate case, the Commission sets a utility's revenue requirement based on the utility's expenses during a test year plus a return on invested capital, or rate base. (*See* IAWC Ex. 4.00 at 4); *see also People ex rel. Madigan v. Ill. Commerce Comm'n*, 2015 IL 116005 at P7. The Commission then authorizes the utility to charge rates designed to collect revenues equal to the revenue requirement. When the utility uses a future test year, as IAWC has done in this case, its expenses during the test year must be forecasted to develop a revenue requirement. (IAWC Ex. 4.00 at 5.) Likewise, because utility rates incorporate a volumetric charge, the total sales volumes must be forecasted to ensure that rates will recover the total revenue requirement. The objective in a future test year case is to forecast sales as accurately as possible, so that the forecast reflects actual conditions in the test year, and the utility can set rates that allow it to earn its authorized revenues. If actual revenues from sales in the test year do not match forecasted revenues in the test year, the utility will either under- or over-recover its costs. (ICC Staff Ex. 8.0 at 4.)

a. IAWC's sales volumes are declining

It is undisputed that IAWC's sales volumes are declining. IAWC estimates that the decline in use per residential customer is approximately 2.03% per year, (IAWC Ex. 8.00SR at 6, Table 8.02), while use among commercial customers is declining at a rate of 0.4% per year. (IAWC Ex. 8.00 at 6.) Staff agreed that IAWC's sales volumes have "a downward trend in average monthly use per residential customer," of approximately the same percentage as the Company forecasted. (ICC Staff Ex. 8.0 at 5:104-105.) IIWC/FEA/CUB witness Gorman agreed that IAWC's water usage has exhibited a declining trend, (IIWC/FEA/CUB Ex. 2.0

(Rev.) at 3), and IIWC/FEA witness Collins did not dispute the existence of a declining trend in usage. (IIWC/FEA Ex. 1.0 at 12.)

The decline in residential and commercial usage is driven by customers' installation of new low-flow fixtures and appliances, as well as customer awareness of water conservation and efficiency initiatives. (IAWC Ex. 8.00 at 9-11.) Federal law mandates water efficiency standards for fixtures and appliances, which have been growing more stringent over time. (*Id*. at 11.) More than 87% of homes in Illinois were constructed before federal water efficiency standards took effect, and were constructed with more water-intensive fixtures. (*Id*. at 17.) As customers replace older water-intensive fixtures with fixtures that meet the federal mandates, their demand for water declines. (*Id*. at 11-12.) The decline in usage among IAWC's customers over the last ten years is evidence of the effectiveness of the federal mandates and education programs. However, the mandates are relatively new in comparison to the life expectancy of appliances and fixtures, and many customers have not replaced all of their older water-intensive fixtures with newer efficient ones. (*Id*. at 17; 8.00R (Rev.) at 4.) In addition, more stringent efficiency standards are under consideration. (IAWC Ex. 8.00 at 17-18.) Therefore, usage will likely continue to decline through the 2017 test year—and beyond. (IAWC Ex. 8.00R (Rev.) at 4.)

The decline is significant, both in terms of gallons and in terms of revenue dollars. From 2006 through 2015, IAWC sold 17.8 billion fewer gallons than was used to determine its Commission-approved revenue requirements. (IAWC Ex. 8.00 at 15.) Over 60% of IAWC's revenues are variable—recovered via per-gallon volumetric charges—but over 90% of the Company's costs are fixed. (IAWC Ex. 7.00 at 6-7.) When customer usage and sales volumes decline, as IAWC's have, and its rate structure relies heavily on volumetric charges, as IAWC's

does, the rates do not produce enough revenue to cover the utility's costs. (*Id*. at 5.) Because IAWC's rate structure relies heavily on volumetric charges, (*id*. at 6), this shortfall in gallons sold led IAWC to under-recover its approved revenue requirements by approximately $51 million between 2006 and 2015. (IAWC Ex. 8.00 at 15.)

b. In order to accurately forecast its test year sales in a declining use environment, IAWC used a statistical model that produced highly reliable results.

IAWC developed its forecasted test year sales volumes by conducting a statistical regression analysis using base usage data. (IAWC Ex. 8.00 at 5-6.) A regression analysis is the best method for modeling a trend in data, because the analysis estimates the relationship between variables—in this case, time and usage per customer. (IAWC Ex. 8.00SR at 3.) A regression analysis calculates a trend line that best matches and incorporates singular data points—in this case, data points representing usage per customer at particular points in time. (*See* IAWC Exs. 8.01, 8.02.) Mr. Gorman and Mr. Collins agreed that a regression analysis is the appropriate method for calculating a trend in data. (IAWC Ex. 8.00SR at 3 (citing data request responses IAWC-IIWC/FEA/CUB 2.06, IAWC-IIWC/FEA 2.04).)

IAWC's regression analysis relied on a robust data set, and produced highly reliable results. The data set included the average usage per customer per day in each month, for each customer in the residential and commercial classes, over the 10-year period 2006 through 2015. (IAWC Ex. 8.00 at 5.) The 10-year period is appropriate because, in statistics, a greater number of observations, a larger data set, yields more significant explanatory values. (IAWC Ex. 8.00R (Rev.) at 10.)

For purposes of conducting the regression analysis, IAWC excluded weather-dependent usage from its data set. (IAWC Ex. 8.00 at 7-8.) It is necessary to separate weather-sensitive usage from base usage in order to ensure that the result of the analysis (the trend line) measures

only trends that exist independently from fluctuations in weather. (IAWC Ex. 8.00SR at 4.) In addition, unlike an analysis based on weather normalization, which requires an assumption that weather in the forecasted period will be equal to "normal" weather, an analysis of base usage does not require the Company or the Commission to make *any* assumptions regarding weather during the forecasted period because it considers only usage that is not driven by weather. (*Id*. at 7.)

The results of IAWC's regression analysis are highly reliable. The trend line that resulted from the regression has a 99.5% change of correctly predicting usage in the test year. (*Id*. at 2.) In other words, there is a 0.05% chance that usage in the test year will be significantly different than usage predicted by IAWC's regression analysis.

c. Intervenors' use of an averaging methodology to forecast test year sales is unreliable.

Although all parties agreed that IAWC's residential sales volumes are trending down, the parties disagreed about how the decline should be forecasted into the test year. Staff and IAWC agreed that residential usage should be forecasted using the 2.03% decline per year, and commercial usage should be forecasted using the 0.4% decline per year. (IAWC Ex. 8.00 at 6; ICC Staff Ex. 8.0 at 5.) But Mr. Gorman and Mr. Collins argued that residential usage in the test year should be assumed to be equal to average usage over the 2011-2015 period, while commercial usage in the test year should be set equal to usage in 2015. (IIWC/FEA/CUB Ex. 2.0 (Rev.) at 9; *see also* IIWC/FEA Ex. 2.0 at 7.) In the face of the Company's statistical evidence, and despite their agreement that a regression analysis is an appropriate method for analyzing trends in data, Mr. Gorman and Mr. Collins argued that a simple average of monthly usage over the five-year period 2011-2015 is a suitable predictor of residential usage in the test

year, and that the entire regression analysis should be ignored when forecasting commercial usage. These contentions must be rejected, for several reasons.

First, an average cannot account for a trend in the data being averaged. Consider the example provided by IAWC witness Roach: the simple number set 12, 11, 10, 9, 8 represents a trend. "Given the trend, the next number in the set would logically be 7. But if one were to average the data points, as Mr. Gorman and Mr. Collins did, the result would be 10." (IAWC Ex. 8.00R (Rev.) at 3:49-52.) This same logic holds true here. Residential usage among IAWC's customers exhibited a declining trend over the five years between 2011 and 2015. (IAWC Ex. 8.00SR at 5; *see also* IIWC/FEA/CUB Ex. 2.0 (Rev.) at 3 (expressing Mr. Gorman's agreement that usage is subject to a declining trend).) According to IAWC's regression analysis, and in accordance with the logic of the example above, forecasted usage in 2017 will be lower than actual usage in 2015. According to Mr. Gorman, however, usage in the 2017 test year will equal average usage between 2011 and 2015. (IIWC/FEA/CUB Ex. 2.0 (Rev.) at 9.) But that average amount of usage is *higher than actual* usage among IAWC customers in 2013, 2014, and 2015. (IAWC Ex. 8.00SR at 4.) In other words, usage has already declined below the level Mr. Gorman and Mr. Collins proposed to incorporate into the forecast. (*Id*.) These examples illustrate that a forecast based on an average is inaccurate when the data being averaged is subject to a trend.

Second, because the data Mr. Gorman and Mr. Collins relied upon in developing their average includes weather-sensitive usage, it requires acceptance of the inherent assumption that weather in the forecasted period will be similar to weather in the period averaged. Mr. Gorman explicitly recognized that his analysis relies on assumptions about weather during the test year, stating, "weather and rainfall during the period 2011-2015 was representative of normalized

weather conditions for Illinois." (IIWC/FEA/CUB Ex. 2.0 (Rev.) at 7:70-71.) However, because water usage is driven in large part by precipitation, rather than primarily by temperature (like electric and natural gas usage), there is no generally-accepted weather normalization methodology in the water industry. (IAWC Ex. 8.00 at 8.) Therefore, Mr. Gorman's technique of averaging five years of usage as an attempt to normalize for weather is entirely arbitrary.

In addition, Mr. Gorman's contention that weather during the 2011-2015 period was "relatively close to normal" is demonstrably untrue. (*See* IIWC/FEA/CUB Ex. 1.0 at 7:108.) During 2012, weather in Illinois was extraordinarily hot and dry; it was between 25 and 30% warmer than the 40-year average and between 34 and 60% drier than the 40-year average. (IAWC Ex. 8.00R (Rev.) at 6.) But data from 2012 represents one-fifth of the data on which Mr. Gorman's analysis relied upon. Because Mr. Gorman must assume that weather in the test year will correspond to weather during the five-year period he averaged, but that five-year period includes extraordinary weather, his approach is unreliable. In contrast, the Company's analysis, which relied on data regarding base usage, requires *no such assumptions* regarding weather in the forecasted period. (IAWC Ex. 8.00SR at 7.) As such, it is a far more reliable basis for a forecast. (IAWC Ex. 8.00 at 8.)

The Commission should forecast residential usage per customer using the results of IAWC's regression analysis. All parties agreed that usage is declining, and that regression analysis is an appropriate method to measure the rate of decline over time. Even though the intervenors agreed on these points, they did not conduct a regression analysis of their own. The averaging approach the intervenors propose to use instead cannot capture the trend in usage data, is arbitrary, and is based on data that does not reflect normal usage. The Commission should

reject the intervenors' proposal to forecast residential usage per customer using a simple average of usage over the 2011-2015 period.

d. Mr. Gorman's proposal to set commercial sales equal to those in 2015 is not supported.

In his rebuttal testimony, Mr. Gorman states, "test year commercial sales should be left at the 2015 level." (IIWC/FEA/CUB Ex. 2.0 (Rev.) at 9:113-14.) The only argument in support of that proposal is a statement that IAWC witness Roach's "analysis of trends in base [c]ommercial usage is flawed." (*Id*. at 5:56.) The testimony contains no explanation of the purported flaws in IAWC's analysis of commercial usage. Without this key information, the proposal is unsupported and must be rejected. The Commission should instead rely on the Company's regression analysis to forecast sales and revenues in the test year.

5. Uncollectible Rate in Lincoln

To provide a reasonable, consistent approach across its service territories, IAWC used a 0.95% uncollectible rate for all of its districts. AG witness Effron, however, proposed a separate uncollectible rate of 0.92% for the Lincoln district only. (AG Exhibit 1.0 at 5.) Maintaining separate uncollectible rates for each rate zone adds to the complexity of preparing a rate case and preparing the Company's annual business plan. (IAWC Ex. 4.00R at 15.) During the budgeting process, the Company incorporated an overall uncollectible rate that was used for all service districts. The Company used one set of depreciation rates for all rate zones, for example, rather than preparing multiple costly depreciation studies. The Company's use of one uncollectible rate to forecast uncollectibles for the entire Company is similarly reasonable, and the use of one uncollectible rate, and one gross revenue conversion factor, for all tariff groups is consistent with the Company's last rate case, Docket 11-0767, and previous rate cases, Dockets 07-0507, 02-0690, and 00-0340.

Mr. Effron's proposal is also unnecessary: it reduces the Lincoln revenue requirement by less than $1,500, or $0.01 per typical residential customer bill. (IAWC Ex. 4.00R at 15.) Mr. Effron's proposal should be rejected.

6. Demand Study Costs

AG witness Rubin agreed with IAWC's proposal that its demand study be discontinued, but recommended that the Company's revenue requirement be reduced by approximately $69,000 for test year demand study costs. (AG Exs 2.0 at 16-17; 4.0 at 1-2.) This adjustment is unnecessary. Mr. Rubin is correct that IAWC expects to incur this amount for demand study data collection and analysis in 2017. (IAWC Exs. 4.00R at 19; 4.00SR at 11.) But these costs are accounted for as deferred expenses, so they are not reflected in the test year revenue requirement and IAWC is not seeking to recover them in the current rate case. (IAWC Exs. 4.00R at 19; 4.00SR at 11-12.) As a result, Mr. Rubin has proposed to disallow costs that are already not in the test year.

IAWC's treatment of the demand data collection costs is consistent with its prior cases. In the Company's last rate case, internal demand study costs were incurred during the test year ending September 30, 2013, but those costs were deferred to Account 186 to be recovered in the current rate case. The Company has also included in deferred current rate case expense actual and forecasted internal demand study costs through the end of December 2016. These deferred costs are then amortized as rate case expense. The amount Mr. Rubin proposed to remove is recorded in a deferred account, and so is already not part of the test year. No adjustment is needed to remove an amount that is already not reflected in the test year. (IAWC Ex. 4.00SR at 12.)

B. Resolved Issues

1. State Income Tax Rate

IAWC proposed to revise the state effective income tax rate in developing the gross revenue conversion factor and income tax expense for IAWC in this case. The state effective income tax rate that correctly reflects IAWC's cost of state income taxes in Illinois is 7.75%, calculated using the Illinois statutory state income rate of 5.25%, plus the Illinois replacement tax rate of 2.5%, multiplied by an apportionment factor of 100%. (IAWC Ex. 13.00R at 3.) IAWC determined that it was incorrectly using a five-year average estimate of American Water's apportionment factor when it should have been using the 100% apportionment factor reflecting IAWC's activities in the State of Illinois, since all of IAWC's sales are sourced to Illinois. (*Id.*) Using a 100% apportionment for IAWC properly represents IAWC activities and the amount it will ultimately pay as its share of the American Water combined group. (*Id.*)

Staff witness Hathhorn and AG witness Effron both accepted IAWC's proposal to use the 7.75% state income tax rate, based on a 100% apportionment factor. (ICC Staff Ex. 10.0 at 4; AG Ex. 3.0 at 2.) Therefore, this issue is resolved.

2. Income Tax Expense

In rebuttal, AG witness Effron stated that while the Company appears to agree with his corrections to the calculation of income tax expenses, the Company still had not made those corrections. (AG Ex. 3.0 at 15.) In surrebuttal, IAWC witness Kerckhove explained that the current income tax was calculated correctly in the Company's rebuttal testimony. However, the adjustment to income tax expense used in the Company's rebuttal filing was an error since it used the Company's initial rate case filing as the starting point for the adjustment. The current income taxes in the Company's surrebuttal exhibits match the calculation of income tax expense

on Company Pro Forma Present. (IAWC Ex. 4.00SR at 11.) As a result, this issue should be resolved.

3. Advertising Expense

Schedule C-8 presents IAWC's expenses for advertising that informs consumers how they can conserve water or reduce peak demand, advertising required by law, and advertising regarding service interruptions, safety measures, and emergency conditions. (IAWC Ex. 4.00 at 19.) Staff witness Kahle proposed an adjustment to reduce the Company's proposed advertising expense level by items he deemed of a promotional, goodwill or institutional nature. (ICC Staff Ex. 3.0 at 7, Sch. 3.03 at 1.) IAWC accepted that adjustment. (IAWC Ex. 4.00R at 4.) Therefore, this issue is resolved.

4. Lobbying Expense

Schedule C-2.5 presents lobbying expenses that IAWC removed from the test year revenue requirement. (IAWC Ex. 4.00 at 14.) Staff witness Kahle proposed an additional adjustment for employee expenses related to lobbying that IAWC inadvertently included in test-year operating expenses. (ICC Staff Ex. 3.0 at 9, Sch. 3.05.) IAWC accepted that adjustment. (IAWC Ex. 4.00R at 4.) Therefore, this issue is resolved.

5. Outside Professional Services Expense

Schedule C-6.2 presents expenses for Outside Professional Services 2014 through 2017. (IAWC Ex. 4.00 at 18.) Staff witness Kahle and AG witness Effron each proposed an adjustment to remove certain outside professional expenses that IAWC inadvertently included in test-year operating expenses. (ICC Staff Ex. 3.0 at 10, Sch. 3.06; AG Ex. 1.0 at 25.) IAWC accepted that adjustment. (IAWC Ex. 4.00R at 4.) Therefore, this issue is resolved.

6. Invested Capital Tax

Schedule C-2.10 presents an adjustment to the test year forecast for invested capital tax that aligned with IAWC's initially-proposed capital structure balances. (IAWC Ex. 4.00 at 15.) Staff witness Kahle recommended that the final amount of invested capital tax be based on the average combined long-term debt and common equity from the capital structure adopted by the Commission. (ICC Staff Ex. 3.0 at 9.) AG witness Effron agreed. (AG Ex. 3.0 at 17.) In light of the parties' agreement regarding the capital structure balances, IAWC accepted the adjustments to invested capital tax. (IAWC Exs. 4.00R at 13, 4.00SR at 10.) Therefore, this issue is resolved.

7. Unaccounted-For Water Expenses

Staff witness Kahle originally recommended an adjustment to reduce chemical and power expenses associated with the unaccounted-for water over the maximum allowance in IAWC's tariffs. (ICC Staff Exs. 3.0, Sch. 3.02, 7.0 at 6.) IAWC already removed, however, the excess production costs above the tariff limitations, as shown in workpapers WPC-2.2c and WPC-2.2d. (IAWC Ex. 4.00R at 11.) Further, Staff's calculations overstated the appropriate adjustment—already included in IAWC's calculations—because they did not reflect the full amount of water not used for billed sales but used for known purposes, and because they included a weighted factor for the lower unaccounted-for water tariff limits in the Chicago Metro district's purchased water areas. (*Id*. at 12.) Staff witness Sperry did not object to IAWC's calculations, and recommended that the Commission accept IAWC's adjustment for unaccounted-for water. (ICC Staff Ex. 15.0 at 5.) Therefore, the issue is resolved.

8. Depreciation/Amortization Adjustment

IAWC included a depreciation adjustment in its revenue requirement, as shown on IAWC Schedules C-12 and C-2.11. (IAWC Ex. 4.00R at 18.) Staff witness Effron proposed an

adjustment to the depreciation expense shown on Schedule C-2, "in the calculation of adjusted operating income under present rates, to comport with the depreciation expense shown on Schedules C-2.11 and C-12. (AG Ex. 1.0 at 22:502-04.) Mr. Effron's proposal, however, adjusted amortization expense recorded in Accounts 406 and 407 and that was included in IAWC's last three rate cases. (IAWC Ex. 4.00R at 18). Mr. Effron agreed and withdrew his proposal. (AG Ex. 3.0 at 14.) Therefore, the issue is resolved.

9. Miscellaneous/Other Revenues

IIWC/FEA/CUB witness Gorman proposed an adjustment to IAWC's test year Miscellaneous/Other Revenues to more closely align with 2014 and 2015 Miscellaneous/Other Revenues levels. (IIWC/FEA/CUB Ex. 1.0 at 8-9.) AG witness Effron also proposed an adjustment to these revenues to reflect actual revenues through September 2015 and proposed revenues for October through December 2015. (AG Ex. 1.0 at 11-12.) IAWC accepted Mr. Gorman's proposal in part, and proposed that the adjusted level of Miscellaneous/Other Revenues through the 12 months ending May 2016 be used for the 2017 test year. (IAWC Ex. 4.00R at 17, 19-20.) Mr. Effron accepted this adjustment; Mr. Gorman also accepted, it and recommended an increase in Miscellaneous/Other Revenues for the Chicago-Metro Sewer district, since IAWC's proposed time period did not reflect normal operations in this district. (AG Ex. 3.0 at 7; IIWC/FEA/CUB Ex. 2.0 (Rev.) at 22-23.) IAWC accepted Mr. Gorman's adjustment. (IAWC Ex. 4.00SR at 7-8.) Therefore, the issue is resolved.

10. Current Rate Case Expense

IAWC requested rate recovery of $2,829,388 in rate cases expenses, amortized over two years. (IAWC Ex. 4.00 at 19-21.) Of that total, $2,682,915 is the projected cost for outside and affiliate expertise to prepare and litigate this rate case. (*Id*. at 19.) The remaining $146,476 is

the unamortized balance of Docket 11-0767 rate case expense, already approved by the Commission as just and reasonable in that rate case. (*Id*. at 20; Sch. C-10, page 1.)[20]

Section 9-229 of the Public Utilities Act requires the Commission to assess the justness and reasonableness of IAWC's rate case expenses. 220 ILCS 5/9-229. In 2015, the Commission adopted the Part 288 rules, which are intended to guide this assessment. 83 Ill. Admin. Code, Part 288; *Ill. Commerce Comm'n on Its Own Mtn.*, Docket 11-0711, Final Order at 1 (June 3, 2015). Consistent with that authority, IAWC has supplied for the Commission's review extensive documentation supporting the justness and reasonableness of its current rate case expenses and, as explained below, IAWC has otherwise complied with Part 288's requirements.

Staff recommended that the Commission approve IAWC's $2,829,388 rate case expenses as just and reasonable under Section 9-229. (ICC Staff Ex. 11.0Rev at 14.) And the parties have agreed to identify this issue as uncontested. In light of this, the record evidence, and IAWC's Part 288 compliance, the Commission should approve IAWC's requested level of rate case expense. *See* 83 Ill. Admin. Code 288.40(a).

a. IAWC has supplied extensive documentation supporting the justness and reasonableness of its current rate case expenses.

IAWC's $2,682,915 current rate case expense projection is composed of expenses for the following rate case work, performed by the following professionals, as shown on Schedule C-10:

- Cash Working Capital study and support – Harold Walker III, Gannett Fleming;
- Cost of Service study and support – Paul R. Herbert, Gannett Fleming;
- Demand Study and support – Paul R. Herbert, Gannett Fleming;
- Forecast Audit – Rick Gratza, Kerber, Eck & Braeckel, LLP;

[20] IAWC also initially requested recovery of $586,491 of unamortized, unrecovered rate case expense approved by the Commission in Docket 09-0319. To narrow the issues in this proceeding, however, IAWC no longer pursues that rate case expense. *See infra* § IV.B.11.

- Rate of Return study and support – Paul R. Moul, Paul Moul & Associates;
- Legal support – Whitt Sturtevant LLP;
- Revenue Requirement support[21] – American Water Works Service Company; and
- Compensation study and support – Robert V. Mustich, Willis Towers Watson.

(IAWC Ex. 4.00 at 29-31; AG Grp. Ex. (Part 1) at 46 (Sch. C-10).)[22]

In direct testimony, IAWC explained what the anticipated rate case work entailed, why it is prudent to anticipate that rate case work, and why IAWC chose the professionals it did to perform the rate case work, including their qualifications and the reasonableness of their fees. (IAWC Ex. 4.00 at 29-45.) IAWC explained, for example, that it engaged Mr. Herbert to perform the cost of service study necessary to support IAWC's proposed rate design because he has substantial experience performing cost of service studies for regulated utilities and for IAWC specifically, including in the Company's last rate case. (*Id.*) Further, the cost for his services reflect reasonable market rates, and are comparable to the same cost in Docket 11-0767. (*Id*. at 31, 41.)

IAWC engaged the same or similar professionals to prepare and litigate Docket 11-0767. The total amount of rate case expense approved in that case for those professional services was $2,332,541; the total amount actually incurred was $2,414,670. (IAWC Ex. 4.00 at 20.) IAWC explained that its current $2,682,915 rate case expense projection is slightly higher due to moderate increases in consultant costs, including the costs for necessary rate case studies, and the

[21] Revenue requirement support is Service Company personnel assistance in preparing revenue requirements, testimonies and exhibits, data request responses, analyses, as necessary, and final tariffs. (IAWC Ex. 4.00 at 29.) It also includes the expense for Service Company personnel to attend hearings. (*Id*.)

[22] Schedule C-10 also shows IAWC's projected $250,000 "Internal Demand Study Costs," the costs for utility personnel to continue the data collection and analysis required for the Demand Study ordered in Docket 11-0767, through final resolution of this case. (*See* IAWC-AG Stip. Cross Ex. 2.00 at 6; IAWC Ex. 15.03SR at 11, 33, 63.) Schedule C-10 also includes $200,000 in "Other" costs for customer communications related to the rate case, $110,000 of which IAWC had incurred at the time of its surrebuttal filing. (IAWC-AG Stip. Cross Ex. 2.00 at 6; IAWC Exs. 4.00SR at 14; 4.11SR.)

costs to comply with new legal requirements, such as the enhanced customer notice required by recent amendments to the Public Utilities Act. (*Id*. at 20-21, 30.) *See* 220 ILCS 5/9-201(a).

b. IAWC has otherwise complied with Part 288.

Part 288 governs outside and affiliate rate case expenses for which recovery is sought by the utility through rates. 83 Ill. Admin. Code 288.10. IAWC also supplied the information required by that rule, related to its current rate case expenses. *See* 83 Ill. Admin. Code 288.40(a).

As required by Part 288, IAWC provided in discovery (and in its direct case) this information to assist Staff and other parties in developing a recommended amount of rate case expense:

- requests for production, engagement agreements, and direct testimony describing the terms of engagement between IAWC and outside counsel and technical experts, including their support staff, which describe the nature of the services to be provided, by whom, the attendant hourly rates, and whether specific overhead expenses are excluded from those rates, 83 Ill. Admin. Code 288.30(a)(1), (d); (IAWC Exs. 4.00 at 32-45; 4.00R at 9; 4.00SR at 13; 15.01SR at 3-43, 112-13);

- for outside counsel services, which were provided under hourly rate contracts, invoices that clearly indicate the services provided, who provided them, the time spent providing them, and the applicable hourly rates, 83 Ill. Admin. Code 288.30(a)(2); (IAWC Ex. 15.01SR at 91-107, 297-312, 349-64, 380-406, 409-38);

- for outside technical expert services, which were provided under hourly rate contracts, some of which included a not-to-exceed component,[23] invoices that clearly indicate the services provided, who provided them, the time spent providing them, and the applicable hourly rates, 83 Ill. Admin. Code 288.30(a)(3); (IAWC Ex. 15.01SR at 44-80, 108-10, 114-296, 315-48, 367-79, 407-08, 439-47); and

- for American Water Works Service Company services, documentation that describes the services provided, the employee number and title of the persons providing those services, the time spent providing the services on a daily basis, the hourly rates, without gross-up for benefits, like performance pay, and the

[23] IAWC did not use flat fee contracts. *Cf.* 83. Ill. Admin. Code 288.30(a)(4), (5).

resultant total amounts charged, 83 Ill. Admin. Code 288.30(a)(6); (IAWC Exs. 15.02SR; 15.03SR at 8, 30, 60; 4.10SR).

IAWC also provided with its direct case:

- the information required by 83 Illinois Administrative Code 285.3085 (Schedules C-10 and C-10.1), 83 Ill. Admin. Code 288.30(b)(1); (IAWC Ex. 4.00 at 19-21);

- explanations of the processes, procedures, and controls IAWC uses to ensure that (a) work performed by outside professionals does not duplicate the work of IAWC personnel, and (b) bills from outside professionals are accurate, reasonable, and not redundant, before payment is made, 83 Ill. Admin. Code 288.30(b)(3)-(4); (IAWC Ex. 4.00 at 34, 37-38, 40-43);

- explanations of the reasonableness of the fees to be paid to outside professionals, considering factors enumerated in 83 Illinois Administrative Code 288.40, such as the nature and extent of the work required, the skill required to perform that work, and the professionals' credentials, 83 Ill. Admin. Code 288.30(b)(5), 288.40; (IAWC Ex. 4.00 at 29-45); and

- the rationale for IAWC's proposed two-year amortization period—the Company's historical rate case frequency and the effect on rate case timing of the Commission's order in Docket 15-0017, the rulemaking to amend 83 Illinois Administrative Code, Part 656, "Qualifying Infrastructure Plant Surcharge," 83 Ill. Admin. Code 288.30(b)(6); (IAWC Ex. 4.00 at 19-20).

IAWC also provided with its direct, rebuttal, and surrebuttal cases summary schedules of its rate case expenses, which showed the total projected, total incurred, and total remaining rate case expenses for each professional. 83 Ill. Admin. Code 288.30(c)(1)-(4); (IAWC Exs. 4.03 (Rev.); 4.12R; 4.10SR; 15.02SR; 15.03SR.) IAWC Exhibit 4.10SR also indicates where in IAWC's discovery responses the invoices supporting each expense incurred to date can be found. (IAWC Ex. 4.10SR. *See also* IAWC Exs. 15.01SR-15.03SR (collecting those responses).)

On July 19, 2016, consistent with Part 288, IAWC filed the Affidavit of Rich Kerckhove, attesting that the compensation paid or to be paid by IAWC to outside and affiliate professionals for their rate case work is supported by billings or other documentation that are true and accurate; support costs that were reasonable to prepare and litigate the rate case; were reviewed and approved by IAWC management prior to payment; and are not duplicative. (IAWC Ex.

14.00SR.) Mr. Kerckhove also attested that IAWC has paid, or will pay, the billed amounts for which IAWC requests rate recovery as rate case expense. 83 Ill. Admin. Code 288.30(e)(1)-(3); (IAWC Exs. 14.00SR; 4.00SR at 15).

Finally, as explained and as required by Part 288, IAWC submitted all of its rate case expense support—including testimony, summary schedules, outside professional requests for proposals, engagement agreements, invoices, and discovery responses—for the evidentiary record to aid the Commission's assessment of the expense. 83 Ill. Admin. Code 288.30(f); (IAWC Exs. 4.00SR at 12-13; 4.11SR; 15.01SR; 15.02SR; 15.03SR). Additionally, the work product of the professionals that performed the rate case work, including IAWC's testimony, exhibits, and legal filings on the Commission's e-Docket system, further support the justness and reasonableness of IAWC's rate case professionals' expenses.

In light of the surfeit of record evidence that IAWC has supplied supporting the justness and reasonable of its rate cases expenses, the Company's compliance with Part 288, the recommendation of Staff regarding IAWC's rate case expenses, and the agreement of the parties, the Commission should approve IAWC's requested $2,829,388 level of rate case expense.

11. Unamortized Docket 09-0319 Rate Case Expense

IAWC originally requested recovery of unamortized, unrecovered Docket 09-0319 rate case expense inadvertently omitted from Docket 11-0767. (IAWC Ex. 4.00 at 20.) Staff witness Kahle and AG witness Effron opposed recovery of the expense, and proposed an adjustment to remove it from the revenue requirement. (ICC Staff Ex. 3.0 at 4; AG Ex. 1.0 at 20.) To narrow the issues in this case, IAWC accepted that adjustment. (IAWC Ex. 4.00SR at 7.)

12. Long-Term Performance Plan Expense

Like the overwhelming majority of its peers (93%), IAWC awards long-term performance pay to attract and retain the critically skilled employees needed to run its business,

and to focus those employees on the long-term financial success of the Company. (IAWC Exs. 9.00 at 10; 9.01 (Rev.) at 8-9; 7.00R (Rev.) at 26. *See also* ICC Staff Ex. 3.0, Attach. G at 17-38 (plan document).)

IAWC firmly believes that customers benefit when their utility is financially healthy, because this mitigates the costs that customers ultimately pay through rates. (*See* IAWC Ex. 7.00R (Rev.) at 21-36.) For example, financial success demands attention to operating efficiency; that is, unless the utility controls or reduces its costs, it cannot achieve earnings per share or other financial goals. (*Id*. at 24.) And a financially healthy utility can secure the debt capital that it needs to operate at reasonable costs. (IAWC Exs. 7.00R (Rev.) at 26; 2.00 at 23.)

For these reasons—and because its employees' total compensation, which may include long-term performance pay, is prudent and reasonable (*see supra* § VI.A.2.a)—IAWC initially requested recovery of its test year Long-Term Performance Plan expense in this case. However, to narrow the issues in this case, and without waiving its right to seek recovery of long-term performance pay costs in future proceedings, IAWC no longer seeks recovery of the expense here. (IAWC Ex. 7.00SR (Rev.) at 10-11.) IAWC has accepted Staff's proposed adjustment to its Long-Term Performance Plan expense, as corrected by Staff in discovery. (*Id*.; IAWC Ex. 4.00SR at 6-7; IAWC-Staff Stip. Cross Ex. 1.00 at 17, 19.)

C. Recommended Operating Revenues and Expenses

On a Total Company basis, the base rate revenue requirement is $269,909,873, meaning additional annual revenue of $42,526,413 is needed to afford IAWC the opportunity to earn a reasonable rate of return, as shown on IAWC Exhibit 4.01SR (Rev.). The operating income statement for each Rate Area is shown on pages 2-5 of IAWC Exhibit 4.01SR (Rev.).

V. RIDERS

A. Contested Issues

1. Rider VBA

The Commission, and the Illinois Supreme Court, have found that decoupling a utility's sales and revenues—by truing up rates to approved revenues—addresses the cost recovery problems posed by declining or variable usage for utilities whose costs are mostly fixed. IAWC has both declining and variable usage, and most of its costs are fixed. IAWC's proposed decoupling mechanism, Rider VBA, is therefore an appropriate tool to address the effect of this—with benefits to both IAWC and its customers.

IAWC's Rider VBA is a tariff modeled after the Rider VBA first approved by the Commission for the Peoples Gas Light and Coke Company and North Shore Gas Company (Peoples/North Shore) in 2008. *See N. Shore Gas Co., et al.*, Dockets 07-0241/0242 (cons.), Order at 150 (Feb. 5, 2008). IAWC's proposal is supported by Commission Staff, and adoption of Rider VBA is not opposed by IIWC[24] or AG witness Rubin. (ICC Staff Ex. 8.0 at 2; *see generally* AG Ex. 2.0 at 12-16.)

The basic methodology for IAWC's Rider VBA, if adopted, is also not in dispute. Rider VBA would compare the rate case authorized amount of volumetric revenues to actual volumetric revenues, net of production expenses (power, chemicals, and water waste disposal) that vary directly with sales levels, and provide a credit (if revenues exceed the authorized level) or a volumetric surcharge (if revenues are below the authorized level). (IAWC Ex. 7.00 at 11-12.) Netting production costs will ensure that customers pay only those production costs for the actual amount of water delivered. (*Id.* at 12.)

[24] In communications on August 26 and 27, 2016, counsel for IIWC informed counsel for IAWC that IIWC will not oppose Rider VBA.

As it did for the gas utilities, Rider VBA would resolve for IAWC serious concerns about declining and variable sales. Like the gas utilities, most of IAWC's costs are fixed, and do not vary with usage. (*Id.* at 4-5.) Under traditional ratemaking, however, IAWC relies on volumetric charges (which are based on the number of gallons of water a customer consumes), to recover the majority of its costs. (*Id.* at 5.) Thus, IAWC's cost recovery is heavily dependent on water sales volume. (*Id.*) Declining usage, weather, or both, can push IAWC's sales volumes, and so revenues, below the point where the utility has a reasonable opportunity to recover its costs. (*Id.*)

Decoupling resolves these concerns by producing a determined amount of revenue regardless of how much water (or energy) a utility delivers, and so ensuring the utility can recover its Commission-authorized revenue requirement. IAWC thus proposed to adopt Rider VBA to true up IAWC's volumetric revenues (net of sales-related production costs) to their authorized level. IAWC's proposed Rider VBA follows Illinois' established decoupling approach and benefits both the utility and its customers.

a. Revenue decoupling is a well-established Illinois regulatory mechanism for addressing the problem of fixed cost recovery through usage dependent charges.

Revenue decoupling in Illinois is not new. The Commission first considered a Rider VBA decoupling mechanism over eight years ago, when it approved Rider VBA for Peoples/North Shore on a pilot basis in Dockets 07-0241/0242. *N. Shore Gas Co., et al.*, Dockets 07-0241/0242 (cons.), Order at 150. And even at that time, the Commission noted that the concept of a regulatory mechanism designed to address "usage patterns and margin recovery fluctuations" was not novel. *Id.*

The Commission has since made the Peoples/North Shore Rider VBA permanent, *see N. Shore Gas Co., et al.*, Dockets 11-0280/0281 (cons.), Order (Jan. 10, 2012). The Illinois

Supreme Court upheld the Commission's Order in Dockets 11-0280/0281 in January 2015, finding that the Rider VBA mechanism was legal. *People ex rel. Madigan v. Ill. Commerce Comm'n*, 2015 IL 116005 (holding that Rider VBA did not violate either the prohibition against single-issue ratemaking or the rule against retroactive ratemaking). And the Commission has since recently approved a Rider VBA for Ameren Illinois Company. *Ameren Ill. Co.*, Docket 15-0142, Order at 109 (Dec. 9, 2015).

i. The Commission has approved Rider VBAs to address concerns about declining usage and usage that varied due to weather.

In Dockets 07-0241/0242, Peoples/North Shore explained that a very large percentage of their costs are fixed, and a significant portion of fixed costs will be recovered through volumetric distribution charges. Thus, cost recovery would vary with changes in consumption due to "conservation measures, warming weather trends, the involvement of the Utilities in gas efficiency programs, and other events." *See N. Shore Gas Co., et al.*, Dockets 07-0241/0242 (cons.), Order at 126, 136, 138-39. Rider VBA was thus proposed "to remove both the incentive utilities have to increase sales and the disincentives that utilities have to encourage energy efficiency for their customers." *Id.* at 126.

The Commission adopted Rider VBA as a pilot, finding "it reflects the particulars of declining and variable customer usage patterns and the concomitant revenue recovery impacts." *Id*. at 150. Otherwise, improvements in efficiency would actually harm the utility: "efficiency strategies and improvements, by their very nature, will worsen the Utilities' ability to recover margin revenues in the immediate future. Furthermore, unlike simple conservation activities, efficiency improvements have more long-term sustained effects." *Id.* at 151.

Four years later, the Commission relied on similar reasoning to make Rider VBA permanent for Peoples/North Shore, in Docket 11-0280. *N. Shore Gas Co., et al.*, Dockets 11-

0280/0281 (cons.), Order at 163. The Commission found that "decoupling means that customers do not overpay when weather is colder than normal or underpay when weather is warmer than normal. Decoupling also addresses load changes, including declining load attributable to energy efficiency." *Id.* at 164. Additional benefits included a reduction in the reliance on forecasting customers and usage to set rates. *Id.* at 163.

Later in 2015, Ameren Illinois Company proposed, and the Commission approved, a Rider VBA similar to Peoples/North Shore's Rider VBA. No party in that case objected to the rider's adoption, and it was approved as an uncontested issue. *Ameren Ill. Co.*, Docket 15-0142, Order at 109.

ii. The Illinois Supreme Court has affirmed that the Rider VBA decoupling mechanism is lawful.

The Commission Order making Peoples/North Shore Rider VBA permanent was appealed, ultimately to the Illinois Supreme Court. The Supreme Court affirmed the Commission's approval of Rider VBA and the legality of the revenue decoupling mechanism. *People ex rel. Madigan*, 2015 IL 116005. In so doing, the Supreme Court recognized three fundamental aspects of the Rider, each of which applies to IAWC's Rider VBA here. *Id.*

First, Rider VBA eliminated concerns about utility cost recovery in the face of declining usage:

> The rider helps the companies bridge the increasingly problematic disconnect between their fixed costs and their revenue losses due to a diminishing customer base and aggressive energy efficiency programs. It also guards the customers against the negative effects of inevitably incorrect forecasting. Decoupling stabilizes both utility revenues and customer bills.

Id. ¶ 33.

Second, Rider VBA eliminated "perverse" incentives to increase sales:

> Before Rider VBA, the companies recovered their fixed distribution costs through volumetric charges, which meant that the revenue they collected from those

> charges was either higher or lower than the revenue requirement, depending on how much gas that their customers used. Such a rate design created perverse incentives for the companies to increase demand or under-forecast usage. . . . Rider VBA accepts the revenue requirement and offers a way for the companies to recover it—no more or less—via the annual true-up calculation.

Id. ¶ 32.

And third, Rider VBA provided an incentive to utilities to manage their costs:

> Under this rider, the amount of revenue that the company can recover is capped, regardless of its actual costs. If those costs increase beyond the amounts used to calculate the revenue requirement, the companies' profits will decrease. Rider VBA does not allow them to earn more than that to which they are already entitled. It does, however, encourage them to manage their business effectively, so the revenue requirement not only covers their costs, but also ultimately provides a reasonable return.

Id.

The Court concluded that because Rider VBA accepts the revenue requirement and provides a mechanism to recover it accurately, it has no impact on the revenue requirement and so poses no risk of distorting the ratemaking process. *Id.* ¶ 40.

b. Like the gas utilities, IAWC has high fixed costs but experiences both declining usage and weather variability, with the same adverse impact on cost recovery.

Approximately 93% of IAWC's costs are fixed. But only approximately 39% of its revenues are fixed; approximately 61% are variable. (IAWC Ex. 7.00 at 6.) IAWC, therefore, relies heavily on variable (or volumetric) revenues for collecting fixed costs. (*Id.* at 7.) Because IAWC is so dependent on volumetric sales for revenue, it is incented to sell more water and penalized if it promotes the more efficient use of resources. (*Id.*) This rate design creates a "throughput incentive": the more water customers use, the more revenue the Company collects and, to the extent this revenue exceeds variable costs, the better its financial performance. (*Id.*)

Over the last decade, IAWC's investment has shifted largely from plant needed for serving new customers to non-revenue producing infrastructure replacement and compliance

with new drinking water standards. (IAWC Ex. 3.00 at 4.) At the same time that investment is shifting away from new customers, however, both weather and declining usage per customer cause IAWC's sales volumes and revenues to vary from Commission-approved levels. (IAWC Ex. 7.00 at 7-8.)

For these reasons, IAWC has seen a continued and persistent trend of declining usage per customer. Residential usage per customer is steadily declining. (IAWC Ex. 8.00R (Rev.) at 10.) This decline in customer usage has a substantial effect on IAWC's actual sales volumes, and so on its revenues. (IAWC Ex. 7.00 at 8.) As Staff witness Brightwell explained, "[w]hether or not test year forecasts are accurate, problems occur in years beyond the test year if sales continue to decline. . . . If sales continue to decrease, then fixed costs recovered through volumetric charges will lead to an under recovery of costs in out years." (ICC Staff Ex. 8.0 at 4:84-90.)

Weather variability also affects IAWC because a water rate design that relies heavily on sales volumes means that revenues are greater when the weather is hot and dry and less when the weather is wet and cool. (IAWC Ex. 7.00 at 7-8.) Therefore, lower revenues in a cool, wet summer can exacerbate the declining usage trend. (*Id.*)

That IAWC experiences both declining usage and weather variability is not disputed: Staff witness Brightwell recognized that sales are declining, and the potential for sales variability caused by conservation efforts and weather. (ICC Staff Ex. 8.0 at 3-5.) IIWC/FEA/CUB witness Gorman also acknowledged that sales are declining. (IIWC/FEA/CUB Ex. 2.0 at 3.)

The net effect of declining usage and weather variability is that IAWC's revenue is decreasing. Over the course of the last eight calendar years, IAWC has not recovered the authorized revenues approved in its rate cases. (IAWC Ex. 8.00 at 16.) This constrains IAWC's ability to make necessary investments in its facilities. (IAWC Ex. 7.00 at 5.) Water utilities

operate their source of supply, treatment, and transmission and distribution systems to provide water service to a customer's premises no matter how much water is used. (*Id.*) This requires a significant infrastructure to provide and deliver water to customers, to provide customer service, and to administer accounting and billing systems, among other critical internal and external services. (*Id.*) However, if most revenues come from sales volumes, and revenues are declining (due to declining usage, weather, or both), then the utility may be faced with sales volumes, and so revenues, too low to allow the utility to recover its costs. (*Id.*)

The reductions in water sales are therefore a significant concern: when sales volumes decline, volumetric charges do not produce enough revenue to recover fixed costs. (*Id.*) Declining and variable usage become a source of fiscal stress for IAWC, and are a potential disincentive to further investment in water efficiency. (*Id.* at 8.) IAWC is proposing to resolve these concerns through adoption of Rider VBA.

c. Rider VBA resolves the concerns with declining and variable usage while providing customer benefits.

To resolve the concerns above, IAWC proposed a tariffed decoupling mechanism that is designed to ensure IAWC collects the revenues authorized by the Commission, independent of changes in sales volume. (IAWC Ex. 7.00 at 8.) Rider VBA compares IAWC's actual volumetric revenues with authorized volumetric revenues, net of sales-related production costs, and trues up the actual revenues to the authorized amount through a credit to customers (if revenues exceed the authorized level) or a volumetric surcharge (if revenues are below the authorized level). (IAWC Exs. 7.01SR, 7.02SR.) This lets prices flow up or down as sales volume changes in between rate cases but holds revenues at authorized levels. (IAWC Ex. 7.00 at 9.)

Rider VBA removes the incentive to sell more water and any disincentive to promote water efficiency, reduces the adverse impacts of weather variability for both IAWC and its customers, and supports revenues for programs and investments that improve water efficiency. (*Id.* at 10.) Rider VBA also allows for periodic adjustments (credits and surcharges) in between rate cases, and so should reduce rate case frequency. (*Id.* at 11.) Under conventional ratemaking, in an environment of falling sales, a utility will suffer revenue erosion in between rate cases that will prompt more frequent rate cases. (*Id.*) With Rider VBA, IAWC would not need to file frequent rate cases to recover revenue shortfalls resulting from declining sales. (*Id.*) Customers benefit from a reduction in contested issues in rate cases, a reduction in the frequency of rate cases, and as a result, reduced rate case expense. (*Id.*) And, on the other hand, when IAWC does experience sales growth, it will credit the revenue in excess of the authorized amount back to its customers. (*Id.*)

d. The basic methodology and formula for Rider VBA is not in dispute; only the AG has contested proposals about where to apply the Rider.

In surrebuttal, IAWC agreed to Mr. Brightwell's formula for Rider VBA, which limits the rider's production cost netting adjustment to those changes in production costs that occur due to deviations from sales forecasts, and which recovers only volumetric revenues through Rider VBA. (IAWC Ex. 7.00SR at 2.) IAWC also agreed to various changes to the Rider VBA tariff proposed by Staff witness Hathhorn. (IAWC Ex. 7.00R (Rev.) at 3-4.) IIWC has indicated that it does not oppose adoption of Rider VBA using Staff's methodology. IAWC Exhibits 7.01SR and 7.02SR set forth the tariffs to match this agreed methodology.

AG witness Rubin also accepted Mr. Brightwell's proposed methodology, subject to two proposals, discussed below, about the Rate Zones Rider VBA should apply in. IAWC opposes these proposals. (IAWC-AG Stip. Cross Ex. 2.00 at 1.)

i. AG witness Rubin's proposal to have a separate Rider VBA for purchased water areas should be rejected.

Mr. Rubin first proposed to have a separate Rider VBA for purchased water areas. But this will cause the rider to become administratively burdensome. Separating out purchased water districts would create at least three Rider VBA calculations: Zone 1 without Chicago Metro Lake and South Beloit, Chicago Metro Lake, and South Beloit. (IAWC Ex. 7.00R (Rev.) at 8.) By adding additional groups, the preparation of the filings and costs to track expenses and revenues will increase, and audits and reviews by the Commission's Staff likewise will increase in time and therefore cost. (*Id.* at 8-9.)

Also, the Commission has approved Rate Zone 1 to be a consolidated rate zone. *See Ill.-Am. Water Co.*, Docket 11-0767, Order at 150-52 (Sept. 19, 2012). Attempting to now separate purchased water areas moves in a direction contrary to consolidation. (*Id.* at 9.) The purchased water areas have production costs that are not recovered through the purchased water rider, so these areas are no different from a rate consolidation perspective than others in the consolidated rate area. (*Id.*) And to separate them out would effectively undo the consolidation of these areas into Zone 1. (IAWC Ex. 7.00SR (Rev.) at 5.) And there would be little point to this exercise—there is not a significant difference in customers' bills from separating out purchased water customers. (*Id.* at 7-8.)

ii. AG witness Rubin's proposal to exclude Chicago Metro Wastewater from Rider VBA should be rejected.

IAWC's sewer rate area faces the same issue as its water rate areas: fixed revenues do not recover the full amount of fixed costs, so fixed cost recovery is still dependent on usage volumes. (IAWC Ex. 7.00R (Rev.) at 13.) In the Chicago Metro Wastewater district, 92% of the costs are fixed. (*Id.*) However, fixed wastewater revenues proposed in this case are only 81.8%. (*Id.*)

Since the fixed costs are not recovered by the fixed revenues, a Rider VBA is needed here to ensure the Company recovers the fixed costs of service. (*Id.*)

Leaving the wastewater district out of Rider VBA could compound the issue of declining usage too. (*Id.*) If customers conserve water or usage otherwise declines, less wastewater is billed. Therefore, IAWC would not be able to recover the fixed costs for either water or wastewater without the Rider VBA. (*Id.*) Mr. Rubin's proposal to exclude Chicago Metro sewer from Rider VBA should be rejected.

The overwhelming majority of IAWC's water and wastewater costs of service are fixed. IAWC recovers those costs mostly through volumetric revenues. This is a problem for IAWC, in light of recent declining usage, increased water conservation, and weather. Rider VBA solves that problem, because it decouples IAWC's revenues from its sales in a way that benefits both IAWC and its customers. The Commission and the Illinois Supreme Court have already concluded that such a decoupling mechanism is the appropriate means of addressing utility usage that doesn't cover utility fixed costs. The Commission should do that again here. It should approve IAWC's proposed Rider VBA tariff, as agreed by Staff and IAWC.

B. Resolved Issues

1. Pension/OPEB Rider

IAWC initially proposed a rider to recover pension OPEB costs, which may fluctuate greatly for reasons outside IAWC's control and are difficult to predict, to protect both IAWC and its customers from those wide cost variations. (IAWC Ex. 1.00 (Rev.) at 18; *see also* IAWC Exs. 7.00 at 20-25; 7.00R (Rev.) at 17-21.) To narrow the issues, however, IAWC withdrew this proposed rider. (IAWC Ex. 7.00SR (Rev.) at 10.) IAWC reserves the right to propose a Pension/OPEB rider in future cases. (*Id.*)

2. Rider QIP Recommendation

IAWC included in its rate base investments that would qualify as Qualifying Infrastructure Plant (QIP) under the Commission's Part 656 Rules, 83 Ill. Admin. Code, Part 656, effective at the time of IAWC's January 2016 direct case filing. In discovery, it provided these QIP amounts by rate zone, including accumulated depreciation, cost of removal less salvage, and depreciation expense. (ICC Staff Ex. 2.0, Attach. A.) Staff witness Hathhorn testified that it's possible that that information may be needed in future QIP reconciliation proceedings or other matters. (*Id*. at 6.) Ms. Hathhorn thus proposed that the information, which she attached as Attachment A to her direct testimony, be attached as an appendix to the Commission's final order in this case. (*Id*.) IAWC agreed with Ms. Hathhorn's proposal, with the caveat that the information in Attachment A was based on the Commission's Part 656 Rules effective in January 2016; if new rules are approved, that information would no longer be accurate. (IAWC Ex. 4.00R at 5.) The Commission revised its Part 656 Rules effective July 1, 2016. *See* 83 Ill. Admin. Code, Part 656; *Aqua Ill., Inc., et al.*, Docket 15-0017, Order (June 29, 2016).

VI. RATE DESIGN AND COST OF SERVICE

A. Contested Issues

1. Purchased Power Cost Allocation

In its cost of service study, IAWC allocated its purchased power costs using Factor 1, which is based on average daily usage. (IAWC Ex. 11.00R at 6-7.) IIWC/FEA witness Collins proposed that IAWC's purchased power costs should be allocated using Factor 6, which is based on maximum day and hour demands. (IIWC/FEA Ex. 1.0 at 17; *see also* IAWC Ex. 11.00 (Rev.) at 7 (describing Factor 6).) Mr. Collins argued that Factor 6 allocation is appropriate because that factor "recognizes the base and extra capacity components of purchased power costs, and is

consistent with the allocation of IAWC's other pumping expenses and the allocation of rate base associated with electric pumping equipment." (IIWC/FEA Ex. 1.0 at 17:335-37.) Both of Mr. Collins's arguments fail.

Contrary to Mr. Collins's first assertion, Factor 6 does not accurately account for the base and extra capacity components of IAWC's purchased power costs. Electric rates are structured to include three components: a customer charge, a demand charge, and commodity charges. (IAWC Ex. 11.00R at 7.) The American Water Works Association Manual provides that "the demand portion of power costs should be allocated to extra capacity to the degree that it varies with the demand pumping requirements." (*Id*. at 7.) IAWC's electricity bills include a demand charge, even when the Company is at its lowest demand for power. (*Id*. at 7.) This is the base component of IAWC's purchased power costs. The extra capacity component of IAWC's purchased power costs is the amount by which the demand charge varies with the demand pumping requirements. (*Id*. at 7.) IAWC witness Herbert determined that only 1.25% of IAWC's total purchased power expense is attributable to extra demand. (*Id*.) If Factor 6 was applied to purchased power costs, as Mr. Collins proposes, 42.6% of IAWC's power costs would be allocated to extra demand. (*Id*.) Thus, the application of Factor 6 clearly does not accurately account for the base and extra capacity components of IAWC's electric demand costs.

Second, even though Factor 6 is used to allocate non-power pumping costs, it is not an appropriate allocator for purchased power costs. First, purchased power is conceptually similar to other costs allocated using Factor 1, such as purchased water, treatment chemicals, and sewer disposal. (IAWC Ex. 11.00 (Rev.) at 6.) Second, Factor 6 is appropriate for the "capital and associated O&M costs because the system is designed to meet average demand and as well as maximum day and hour demands." (IAWC Ex. 11.00R at 6:130-32.) However, unlike the

capital and O&M costs, the power that runs the pumping facilities "varies with the amount of water being pumped, and varies *only minimally* with peak usage." (IAWC Ex. 11.00R at 7:134-35.) Because purchased power varies only minimally with peak usage, Factor 1, which is based on average daily consumption, is a more reasonable and appropriate allocator.

Thus, neither of Mr. Collins's stated bases for his proposal to use Factor 6 rather than Factor 1 withstands scrutiny. Factor 6 does not accurately reflect base and extra capacity components of IAWC's electric demand costs. And power costs do not vary significantly with maximum water demand, so they should not be treated like other pumping expenses. The Commission should reject Mr. Collins's proposal to utilize Factor 6 rather than Factor 1.

2. Simplification of Metered Large User Water Tariff

IAWC's Metered Large User water tariff is available to customers that use at least 187 million gallons of water per year. (ILL.C.C. No. 24, Sec. 1, Eight Rev. Sheet 14.1.) Charges to customers under the tariff are equal to the customer's maximum day demand ratio, multiplied by approximately $0.19. (*Id.*) The maximum day demand ratio is the customer's maximum day demand divided by the customer's average day demand. (*Id.*) The maximum day demand ratio serves two important purposes. First, it incentivizes customers to smooth their demand so that their maximum day demand is as close as possible to their average day demand, because it increases charges when the maximum demand is higher than average demand. (IAWC Ex. 11.00SR at 8.) A customer whose maximum day demand is close to its average day demand requires less extra capacity and peak facilities, so smooth demand means that the utility must invest less in these costly facilities. (*Id.*) The incentive is particularly appropriate for customers taking service under the Metered Large User tariff, because those customers must use at least 187 million gallons per year to qualify for the tariff. (*Id.*) Second, the maximum day demand

ratio variable in the current tariff ensures that customers' rates are determined individually, and customized to match their usage. (*Id.*)

In his direct testimony, IIWC/FEA witness Collins proposed that IAWC's Metered Large User water tariff "should be simplified … to provide more cost certainty to customers" served under the tariff and attract additional customers to the tariff. (IIWC/FEA Ex. 1.0 at 18:361-66.) However, throughout the proceeding, Mr. Collins has not offered a substantive suggestion as to how the tariff should be simplified, nor has Mr. Collins explain why such simplification is desirable. The Commission should reject IIWC/FEA's unsupported recommendation.

At no point during this proceeding has Mr. Collins explained exactly how the "simplified" tariff he proposes would differ from IAWC's current tariff. Mr. Collins's original proposal was that "rate formula [should] be eliminated … and the rate simply be based on the utility's cost of providing service to customers served under this tariff." (IIWC/FEA Ex. 1.0 at 18:361-63.) Although Mr. Collins did not specify which portion of the existing formula he proposed to eliminate, IAWC witness Herbert surmised that Mr. Collins's concern is rooted in the fact that the current tariff includes a variable for customers' Maximum Day Demand Ratio. (IAWC Ex. 11.00SR at 7.) As discussed above, the maximum day demand ratio serves important purposes, provides appropriate incentives, and should not be eliminated.

Mr. Collins now appears to have backed away from that proposal. When IAWC requested that IIWC/FEA provide an explanation or calculation of its proposed simplification in discovery, Mr. Collins responded that he had not "recommended a specific rate design, but proposes that a specific cost-based rate design be developed cooperatively" by IAWC and IIWC/FEA. (*See* IAWC Ex. 11.00R at 8.) Then, in his rebuttal testimony, Mr. Collins suggested that the Commission order the parties in this case to participate in a workshop "to discuss

possible revisions to this tariff." (IIWC/FEA Ex. 2.0 at 6:101-102.) As a result, there is no substantive proposed "simplification" that the Commission can approve in its order. Nor is there any reason to hold a workshop on this matter, since IIWC/FEA have not made a specific, substantive suggestion in this proceeding.

Finally, the rationale IIWC/FEA offers in support of its proposed simplification is illogical. Mr. Collins noted that only two customers currently take service under the Metered Large User tariff (IIWC/FEA Ex. 1.0 at 18), and stated that simplifying the tariff would be beneficial because it would "attract additional customers to take service under this tariff." (IIWC/FEA Ex. 2.0 at 6:102.) If Mr. Collins's proposal to charge Metered Large User customers based on cost of service rather than a rate formula is adopted, and is successful in attracting additional customers to the tariff, there may well come a point at which it is more efficient to use a formula than to calculate rates at the cost of service. (IAWC Ex. 11.00R at 8-9.) But IAWC's current tariff already utilizes a rate formula. There is no need to make unspecified, unsupported changes to the tariff.

3. Customer Records, Collection Labor, Uncollectible Accounts

AG witness Rubin recommended that customer accounts and uncollectibles expenses be recovered via volumetric charges, rather than fixed customer charges, (AG Ex. 2.0 at 8), so that residential customers would contribute "an equivalent percentage of their bill to support billing, collections, and uncollectible accounts," rather than an equal dollar amount. (AG Ex. 4.0 at 6:120-21.) Mr. Rubin argued that, although "there is no single 'right way' to collect these funds from customers," his methodology "is fairer to all residential customers." (*Id*. at 133.)

Mr. Rubin is incorrect—his proposal to recover customer accounts and uncollectibles expense via equal percentages of customers' bills, rather than equal dollar amounts, is not fairer to customers because "there is no difference in the cost to generate and collect a water bill for

$40, and the cost to generate and collect a water bill for $80 (or $100, $500, or $1000)." (IAWC Ex. 11.00SR at 3:45-47.) IAWC incurs customer accounts and uncollectibles expenses on a per-bill basis, not based on the dollar amount of the bill. But the AG's proposal would result in a customer with an $80 water bill paying *double* the amount of collections and uncollectibles expense that a customer with a $40 water bill would pay, even though the underlying costs to the Company are the same. (*See* IAWC Ex. 11.00SR at 4 (detailing a cost-comparison calculation).) Thus, the AG's proposal would cause higher-use customers to subsidize lower-use customers with respect to collections and uncollectibles expenses. (*Id.*) Mr. Rubin failed to explain why this subsidy is just and reasonable, or why it is "fairer." Simply put, it's not. The Commission should reject Mr. Rubin's proposal.

4. Zone 1 5/8 Meter Charge

As a corollary to his proposed adjustment for customer records, collection labor and uncollectible accounts expenses, discussed above, AG witness Rubin proposed an additional adjustment to set the customer charge for Zone 1 customers with 5/8-inch meters to no more than $18.50. (AG Ex. 2.0 at 11; *see supra* § VI.A.3.) Mr. Rubin arrived at this figure by removing the customer records, collection, and uncollectible accounts expenses from IAWC's proposed customer charge. (AG Ex. 2.0 at 8.) For the reasons explained above, his proposal to remove these expenses from the customer charge should be rejected. Mr. Rubin offered no compelling support for his proposal to set the customer charge to $18.50. As a result, the Commission should reject that proposal as well.

5. Limitation of Increase by Class

AG witness Rubin proposed that rate increases for all customer classes should be limited so that no class receives an increase of more than 1.5 times the system-average increase, and no class receives an increase that is less than 0.5 times the system-average increase. (AG Ex. 2.0 at

10.) Mr. Rubin based this proposal on the ratemaking principles of gradualism and rate continuity. (*Id.*) Although IAWC agrees that, generally, rate increases should be gradual and continuous, and that the 0.5 – 1.5 times system average increase limitation is generally reasonable, the Company cannot accept Mr. Rubin's proposal to apply this limitation to all customer classes. (IAWC Ex. 11.00R at 12.) Applying this limitation to all rate classes would result in increases to customers that are served under contract. (*Id.*) IAWC's contractual rates are fixed in the contracts, which provide the specific provisions for how the rate can be increased. They simply do not allow for the increases Mr. Rubin proposes.

The overall increase in IAWC's rates is approximately 21.6%. (IAWC Ex. 11.01 (Rev.) at 114.) Therefore, under Mr. Rubin's proposed limitations, no class would receive a rate increase of less than 10.8% or more than 32.4%. (AG Ex. 2.0 at 10.) But in applying these limitations, Mr. Rubin did not account for IAWC's limited ability to increase rates for the customer classes served under contract: the Large Commercial, Competitive Industrial, and Large Other Water Utility customer classes. The table below compares IAWC's rate increase for the contractual customer classes allocation against Mr. Rubin's:

CUSTOMER CLASS	**IAWC PROPOSED % INCREASE**[25]	**AG PROPOSED % INCREASE**[26]
Large Commercial	3.4	32.4
Competitive Industrial	0.5	32.4
Large Other Public Authority	19.3	32.4
Large Other Water Utility	5.4	32.4

Mr. Rubin's proposal would result in the maximum increase of 32.4% for the Large Commercial, Competitive Industrial, and Large Other Water Utility customer classes. (AG Ex. 2.4.) However, the rates for those classes are set by contract, and the contractual rates cannot be

[25] IAWC Ex. 11.01 (Rev.)
[26] AG Ex. 2.4.

increased as Mr. Rubin proposes. (IAWC Ex. 11.00R at 12.) The Commission should reject his proposal.

6. Demand Factors

Consistent with the Commission's directive in Docket 11-0767, IAWC conducted a direct demand study in preparation for this case, in which the Company directly measured the demand of a sample group of customers between May 2011 and October 2015. (IAWC Ex. 11.00R at 3); *see also Ill.-Am. Water Co.*, Docket 11-0767, Order at 113-14 (instructing the Company to collect demand data and update its demand factors in future rate cases). IAWC used the results of that demand study to develop the demand factors it proposed in this case. (IAWC Ex. 11.00R at 3.) Staff and AG witnesses accepted those proposed demand factors, but IIWC/FEA witness Collins recommended that the Commission ignore the results of the demand study, and rely instead on demand factors developed and approved in IAWC's last rate case, Docket 11-0767. (IIWC/FEA Ex. 1.0 at 15.) The Commission should reject Mr. Collins's proposal and approve the updated demand factors IAWC has proposed here, and which Staff and AG support.

IAWC's proposed demand factors reflect the most recent available actual data regarding IAWC customers' demand. (IAWC Ex. 11.00R at 3.) In contrast, the demand factors Mr. Collins advocates are based on very limited direct measurement data that was collected prior to the filing of IAWC's rate case in 2011. (*Id.*) In the years since Docket 11-0767, IAWC has collected more comprehensive data, and its proposed demand factors are based on that more recent, more comprehensive data. (*Id.*)

The Commission has expressed a preference for demand factors based on the most recent available data. *See, e.g., Ill.-Am. Water Co.*, Docket 09-0319, Order at 149-50 (April 30, 2010); *Ill.-Am. Water Co.*, Docket 07-0507, Order at 121 (July 30, 2008); *Ill.-Am. Water Co.*, Docket 02-0690, Order at 119-20 (Aug. 12, 2003). Mr. Collins has not offered a compelling reason to

reject the more recent, more comprehensive data IAWC presented in this proceeding, or reconsider the Commission's preference for more recent data. Tellingly, Mr. Collins did not respond to IAWC's criticisms of his proposal. (*See* IIWC/FEA Ex. 2.0 at 4-7.) Therefore, Mr. Collins's proposal to utilize demand factors from Docket 11-0767 should be rejected.

B. Resolved Issues

1. Declining Block Usage Charge for Non-Residential Customers in Chicago Metro Sewer

Staff witness Boggs recommended that IAWC continue to apply a declining block usage charge to Collection Only and Collection and Treatment customer classes in the Chicago Metro Sewer District, as had been approved in prior cases. (ICC Staff Ex. 6.0 at 22.) IAWC accepted this proposal. (IAWC Ex. 11.00R at 5.) Therefore, the issue is resolved.

2. Public Fire Charges

Staff witness Boggs recommended that the Public Fire Protection rate for each of IAWC's three water districts be set so that the revenues recovered are equal to the cost to serve the respective district. (ICC Staff Ex. 6.0 at 29.) This recommendation required IAWC to increase the Public Fire Protection rates in Zone 1 and Lincoln, but decrease the rates in Pekin. (*Id.* at 29-30.) IAWC did not object to Staff's proposal. (IAWC Ex. 11.00R at 5.) This issue is therefore resolved.

3. Certain Large User

IAWC originally excluded a certain customer in the Large Industrial class from its cost of service study. IIWC/FEA witness Collins and IIWC/FEA/CUB witness Gorman recommended that the customer be included in the study. (IIWC/FEA Ex. 1.0 at 7; IIWC/FEA/CUB Ex. 1.0 at 6.) Mr. Collins stated that, although the customer's usage had "declined due to economic circumstances," the customer "did not intend to cease all operations at its facilities served by

IAWC." (IIWC/FEA Ex. 1.0 at 7:134-36.) IAWC proposed to account for the decline in the customer's usage by utilizing the customer's most recent 12-month usage level. (IAWC Ex. 4.00R at 21-22.) Mr. Collins and Mr. Gorman agreed this revised usage was reasonable. (IIWC/FEA Ex. 2.0 at 3; IIWC/FEA/CUB Ex. 2.0 (Rev.) at 2-3.) Therefore, this issue is resolved.

4. Distribution Main Allocation to Large Users

AG witness Rubin proposed to modify IAWC's Factor 4, which allocates costs associated with distribution mains for purposes of the cost of service study. (AG Ex. 2.0 at 5-7.) IAWC's proposed Factor 4 excludes usage from the Large Commercial, Large Industrial, Competitive Industrial, Large Other Public Authority, Other Water Utilities, and Large Other Water Utilities classes because generally, these customers are served from transmission mains, rather than distribution mains. (IAWC Ex. 11.00R at 11.) Mr. Rubin reviewed maps of the IAWC system and determined that eleven of the thirty-four customers excluded from the allocation of distribution main costs were served by distribution mains. (AG Ex. 2.0 at 5-7.) Therefore, Mr. Rubin added the usage from those eleven customers into his calculation of Factor 4. (*Id.*) IAWC witness Herbert also reviewed the maps of the customer connections, and determined that six of the eleven customers at issue were served by short stub distribution-diameter mains, and should not be considered connected to distribution mains. (IAWC Ex. 11.00R at 11.) However, Mr. Herbert determined that the remaining five customers could be considered served from a distribution main, and added their consumption into the calculation of Factor 4. (*Id.*) Mr. Rubin agreed with IAWC's revised Factor 4. (AG Ex. 4.0 at 7.) Therefore, the issue is resolved.

VII. CONCLUSION

For the reasons set forth in this Brief, IAWC requests the Commission authorize for IAWC a base rate revenue requirement of $269,909,873, reflecting additional annual revenue of

$42,526,413, to afford IAWC the opportunity to recover its expenses and earn a reasonable rate of return, as shown on IAWC Exhibit 4.01SR (Rev.).

Dated: August 31, 2016

Respectfully submitted,

ILLINOIS-AMERICAN WATER COMPANY,

By: */s/ Albert D. Sturtevant*

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CERTIFICATE OF SERVICE

I, Albert D. Sturtevant, an attorney, certify that on August 31, 2016, I caused a copy of the foregoing *Initial Brief of Illinois-American Water Company* to be served by electronic mail to the individuals on the Commission's Service List for Docket 16-0093.

/s/ Albert D. Sturtevant
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