STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois-American Water Company	)	
	)	
	)	Docket No. 16-0093
Proposed Rate Increase for Water	)	
and Sewer Service	)	

REPLY BRIEF ON EXCEPTIONS OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION

NOW COMES the Staff of the Illinois Commerce Commission ("Staff"), by and through their undersigned counsel, pursuant to Section 200.830 of the Illinois Commerce Commission's Rules of Practice (83 Ill. Adm. Code 200.830), and the direction of the Administrative Law Judges ("ALJs"), and respectfully submits its Reply Brief on Exceptions to the Proposed Order issued by the ALJs on October 19, 2016.

I. Introduction

In its October 28, 2016 Brief on Exceptions ("BOE"), Staff took exception to certain portions of the ALJ's Proposed Order ("ALJPO"). Illinois-American Water Company ("IAWC" or the "Company") and the following parties also filed BOEs: The People of the State of Illinois ex rel. Lisa Madigan, Attorney General of the State of Illinois ("AG"); United States Steel Corporation-Granite City Works, Prairie Farms Dairy, Inc., and the University of Illinois appearing collectively as the Illinois Industrial Water Consumers, together with the Federal Executive Agencies ("IIWC/FEA"); and IIWC and FEA, together with the Citizens Utility Board ("IIWC/FEA/CUB"). Staff's position on exceptions taken by various parties is set forth in detail below. To the extent that a party takes exception to a portion

of the ALJPO and Staff does not address that exception, Staff stands on its position as set forth in its Initial and Reply Briefs and Brief on Exceptions.

II. Exception of IAWC to Capital Structure and Rate of Return (Section IV.B.1.)

The Company takes exception to the ALJPO's recommended conclusion with respect to return on common equity ("ROE") and to the ALJPO's recommended capital structure, to the extent it incorporates the recommended ROE. The Company's arguments and exception are infirm and should be rejected.

A. The Record Evidence Does Not Support the Company's Arguments

In its BOE, IAWC argues that the ROE awarded by the ALJPO would "render the Company uncompetitive in attracting capital from investors that have the opportunity to invest in any comparable company with corresponding risks." (IAWC BOE, 2.) This argument is without support in the record evidence and, in fact, is contrary to the evidence adduced in this proceeding.

Nothing in the record supports the Company's contention that it will be unable to attract capital with an approved ROE of 8.92%. While the Company provided testimony regarding the methodology it used to calculate its ROE recommendation, no testimony establishes that the Company would not be able to attract necessary capital at the ROEs recommended by other parties. In fact, the Company acknowledged that, even if the Commission granted Staff's recommended ROE of 8.12%, which is lower than the recommended ROE in the ALJPO, it would not prevent the Company from pursuing any capital projects beyond 2017. (IIWC/FEA/CUB Cross Ex. 1, 7.) If the Company is prepared to continue making capital investments with an 8.12% return, it follows *a fortiori*

that it will continue making capital investments with a return that is a full 80 basis points greater.

IAWC would have the Commission believe that its investors will only compare the ROE awarded to the Company to the ROEs awarded to other companies and make investment decisions based on that narrow comparison alone. The necessary corollary to this assumption in the Company's rationale, however, is the assumption that these investors will make investment decisions based solely on the authorized ROE, rather than considering that ROE in the context of the Company's overall capital structure and total risk. In other words, IAWC would have the Commission believe that its investors would be deterred from investment by what it hyperbolically characterizes as a "punitive" ROE, while at the same time unable or unwilling to consider that ROE in context. This is contrary to the Company's own argument that investors will consider the ROE "in the context of undisputed evidence of management excellence and achievement of excellent results in various fields including productivity, customer service, and workplace diversity." (IAWC BOE, 5.)

Further, IAWC continues to advance the counterfactual notion that comparing one company to another based solely on awarded ROE is meaningful. The Company's argument is akin to saying vehicle A should cost the same as vehicle B, simply because both vehicles are cars. Such simplistic reasoning ignores the numerous factors that determine the market price of an automobile – age, mileage, make, model, features, etc. Similarly, the Company's "we want what they have" reasoning ignores the numerous interrelated factors that the Commission takes into consideration in establishing an ROE, including but not limited to prevailing interest rates, capital structure and financial

analyses. The ALJPO correctly notes that comparisons to other companies based solely on awarded ROEs are neither useful nor informative. Additionally, basing the ROE of a company on the ROE awarded to another company would precipitate a cycle of ROEs trending ever upward, as companies press for ROEs that are higher than those previously awarded. The Commission should reject the Company's argument in this regard.

IAWC suggests that "a 9.84 percent ROE is consistent with the returns [awarded to] other enterprises having similar risks," including Staff's water proxy (9.65 percent). (IAWC BOE, 9.) This misstates the evidence. Staff's water proxy had an average investor-based rate of return on common equity of 7.98%. (Staff Ex. 5.0, 31.) Staff did not consider the authorized ROEs for the water group because current authorized ROEs can be several years old and there is no evidence whether and to what extent the market conditions have changed since those ROEs were authorized. (Staff RB, 4.) Additionally, assuming entirely for the sake of argument that the Company's contention that 9.84% is comparable to enterprises with similar risks is factually accurate (which it isn't), this is not the ROE the Company recommends. Rather, it argues that the ROE should be adjusted upward to 10.00% based on the Company's past performance. However, there is no record evidence to support this contention; the Company advanced this argument for a "reward" adjustment for the first time in post-hearing briefs, as evidenced by the fact that the only authority offered by the Company in its BOE is a cite to its IB. (IAWC BOE, 8.) Post-hearing briefs are clearly not part of the evidentiary record.

The Commission should reject the Company's suggestion that the recommended ROE is somehow "punitive," in the same way it should reject the Company's argument that the ROE should be adjusted upward as a "reward." The recommended ROE

represents a return on common equity that is just and reasonable for both the Company and ratepayers. The recommended ROE is what is necessary for the Company to attract capital without unduly burdening consumers. It is neither a punishment nor a reward but an appropriate and accurate reflection of the cost of this facet of doing business.

B. The Company Suggests Flawed Methodology to Calculate the ROE

Not only is the Company's rationale not supported by the record evidence in this case, the methodology it uses to calculate the ROE it now recommends is flawed. The Company asserts that "the most straight-forward way for the Commission to give consideration to all parties' studies" is to average their recommendations. (IAWC BOE, 7.) Before calculating the average, however, the Company ignores Staff's actual recommended ROE and instead selects a different number as "Staff's" input. In its IB, Staff noted that only 72 basis points separated Staff's recommended ROE of 8.12% from the Company's unadjusted DCF and CAPM results of 8.84%. (Staff IB, 5.) While Staff opined that an approved ROE anywhere in this range would be just and reasonable, Staff did not recommend 8.84%; it is clear that this is a Company figure. Despite this, the Company unilaterally decided to use the high end of that range as "Staff's" ROE. Should the Commission elect to average the three ROE recommendations, it should use Staff's actual ROE recommendation of 8.12%.

Further, the Company does not advocate use of a simple average. Instead, the Company states that the parties' recommendations must be "properly weighted," and suggests proper weight is achieved by averaging the result of "Staff's" ROE analyses (as altered by the Company to suit its purposes) with those of IIWC/FEA/CUB, simply because the recommendations are so close together, and then averaging that result with

the Company's ROE. (IAWC IB, 7.) This is illogical, as the fact that the Company's unadjusted results and IIWC/FEA/CUB ROE recommendations are so similar simply underscores the validity of those recommendations and the complete *invalidity* of the aberrational 10.75% ROE recommendation advanced by the Company. What the Company suggests is that greater weight should be given to its statistically-outlying figure. However, valid results should be given more weight, not less; if anything, the Company's figure should be given lesser weight.

Similarly, averaging the Company's unadjusted results and the recommendation of IIWC/FEA/CUB does not "give equal weight to the utility position." Id. Rather, it would do the opposite; it unfairly discounts the recommendations of IIWC/FEA/CUB and completely ignores the recommendations of Staff. The Company's methodology weights IIWC/FEA/CUB's ROE recommendation 25%, the Company's unadjusted ROE estimate 25%, and the Company's ROE recommendation – which, significantly, the ALJPO found to be unreasonable - 50%. Far from being "properly weighted," the Company's recommendations are given 75% of the weight under the Company's methodology while Staff's are afforded no weight at all.

As Staff noted in its BOE, the average results of the DCF and CAPM analyses determined by the Commission to be reliable should be weighed equally, regardless of which party made a recommendation. However, if the Commission choses to reject Staff's exception, and further decides to calculate an average ROE using each Party's ROE recommendation (rather than the results from analyses the ALJPO determined to be credible), the simple average of Staff's 8.12%, IIWC/FEA/CUB's 9%, and the Company's 10.75% ROE recommendations is 9.29%.

C. The Company Offers No Support for Size and Leverage Adjustments

The Company suggests that, if the Commission determines that it will average the parties' models, it should use the Company's numbers as presented, rather than adjusting them to remove the size and leverage adjustments. (IAWC BOE, 7.) There are several defects in this reasoning. The suggestion that the Commission must accept at face value the ROE recommendations presented by a party is not only wrong – especially where, as here, the Company advances an aberrational recommendation which the ALJPO considered unreasonable - but tantamount to advocating that the Commission ignore its responsibilities. The Commission has a right to evaluate the validity of each party's financial analysis. The approved rate must be fair and reasonable, not just to the Company but also to ratepayers. The most obvious flaw with the Company's reasoning is that it would simply motivate companies to advance higher and higher requested ROEs, with the expectation that higher inputs will result in higher averages.

As Staff argued in its IB, before any averaging can be done, the inputs must be evaluated to ensure they are reasonable and supported by the record evidence. (Staff IB, 4.) The Company agrees with this point. The Company recognizes that "the Commission should not engage in a simple average of parties' final recommendations without first exercising informed judgement about those recommendations." (IAWC BOE, 7.) This is precisely what the ALJPO does. The Company established its recommended ROE by first conducting its financial analyses and then making upward adjustments based on size and leverage to the results. The ALJPO thoughtfully considers the Company's adjustments and then details why those adjustments are rejected. The

decision to reject size and leverage adjustments is in keeping with Commission precedent and wholly appropriate in this docket.

In support of a size adjustment, the Company suggests that it must either be evaluated as a stand-alone company, in which case it suggests a size adjustment is appropriate, or as a subsidiary of American Water, in which case IAWC should have the same ROE as the parent company.[1] The Company's argument in this regard has no merit. It is entirely consistent to evaluate IAWC as a stand-alone company and make an ROE recommendation accordingly but decline to make an adjustment because the company is a subsidiary of a larger parent company, as the size adjustment is determined separately from analyses used to estimate the ROE. While IAWC is a stand-alone company, it is also a subsidiary of a much larger organization[2] and the benefits it derives from this relationship obviate the need for any adjustment based on size.

Similarly, the Company's arguments in favor of a leverage adjustment lack merit. The Company does not cite to record evidence but rather to the flawed arguments it made in its RB. The Company states "IAWC faces financial risk over and above the risk faced by companies in the proxy group." (IAWC BOE, 10.) As Staff noted in its RB, this is an argument that was raised for the first time by the Company in its IB and thus, it is unsupported by the record evidence. (Staff RB, 8.) The argument made by the Company that is actually reflected in the record evidence is that, in order to apply a measurement of a return based on a firm's market-value capitalization compared to a book-value

[1] The Company did not provide investor required returns for any of the companies in its proxy group. However, the ROE of American Water can be calculated from the data in the record for Staff's analysis, which suggests the ROE for American Water is 7.41%.

[2] IAWC's parent, American Water, claims to be "the largest publicly traded water and wastewater utility company in the United States[.]" http://www.amwater.com/About-Us/page22960.html (accessed November 4, 2016).

capitalization, the measurement must be adjusted before it is applied to the firm's capitalization based on book value, a practice known as fair-value rate making. Id. at 8-9. As the Commission has routinely recognized, the only investment that is serving utility customers is the authorized book value rate base. Capital that is not invested in used and useful rate base serving utility customers should not earn a return from ratepayers. By adjusting the ROE to account for market value investment above and beyond the book value, the Company's proposal would effectively nullify the Commission's decision to remove any non-utility assets from rate base. Id. The ALJPO correctly determined that a leverage adjustment was not necessary or reasonable.

III. Exceptions of IIWC/FEA

IIWC/FEA take exception to various findings in the ALJPO. Three of these exceptions should be rejected, as discussed more fully below.

A. Purchased Power Cost Allocation (Section VI.B.1.)

The IIWC/FEA exception to the Purchased Power Cost allocation approved by the ALJPO should be rejected. (IIWC/FEA BOE, 2-4.) Staff provided arguments in support of its Purchased Power Cost allocation in testimony and Briefs and will not revisit those arguments here. The allocation factors and procedures the Company used were approved in the Company's last case; the Company conformed to the procedures in the AWWA Manual M1; and Mr. Collins did not provide convincing reasons or data that would justify deviating from the previously approved process. (Staff Ex. 14.0, 13-16.) Staff maintains its recommendation that the Commission reject Mr. Collins' proposal to use Factor 6 to allocate purchased power instead of Factor 1 (Staff IB, 44-46) and supports the ALJPO's finding in this regard.

B. Simplification of Metered Large User Water Tariff (Section VI.B.2.)

The IIWC/FEA exception to the ALJPO's conclusions on the Simplification of Metered Large User Water Tariff should be rejected. (IIWC/FEA BOE, 4-9.) The ALJPO correctly finds that IIWC/FEA did not present a convincing argument to support elimination of the current formula, nor did the IIWC/FEA present a sufficiently detailed proposal for all parties to consider as an alternative to the current formula. While Staff generally supports setting cost-based rates, it must be able to review specific descriptions and/or calculations of a cost-based rate design to determine whether the recommended design is one that can be usefully developed to recover costs and mitigate rate impacts for a specific customer class. (Staff Ex. 14.0, 16-18.) Without a specific rate design proposal for these customers, the ALJPO correctly rejected the IIWC/FEA's proposal.

C. Demand Factors (Section VI.B.6.)

The IIWC/FEA exception to the ALJPO's conclusions on the Demand Factors should be rejected. (IIWC/FEA BOE, 10-14.) Mr. Collins' analysis is unpersuasive and his recommendation to use the existing demand factors approved in the Company's last rate case should be rejected. Mr. Collins does not provide a convincing argument for his recommendation to use outdated and stale demand data when more recent, direct, and comprehensive data is available. (Staff Ex. 14.0, 11-13.) Therefore, IIWC/FEA's exception should be rejected and the Commission should adopt the language in the ALJPO that accepts Staff and IAWC's recommendation that the Company only conduct a demand study using the AWWA-method once every ten years, and submit evidence in future rate cases indicating that there has not been a significant change in the ratio of peak to average demand.

IV. Conclusion

WHEREFORE, for all the reasons discussed above, Staff respectfully requests that the Proposed Order be adopted subject to Staff's Exceptions set forth its Brief on Exceptions and consistent with the arguments set forth herein.

Respectfully submitted,

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