

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois-American Water Company	:	
	:	02-0690
Proposed general increase in water	:	
and sewer rates.	:	

**REPLY BRIEF OF THE STAFF OF
THE ILLINOIS COMMERCE COMMISSION**

(REDACTED VERSION)

STEVEN L. MATRISCH
Office of General Counsel
Illinois Commerce Commission
527 East Capitol Avenue
Springfield, IL 62701
Phone: (217) 785-3808
Fax: (217) 524-8928
e-mail: smatrisc@icc.state.il.us

LINDA M. BUELL
Office of General Counsel
Illinois Commerce Commission
527 East Capitol Avenue
Springfield, IL 62701
Phone: (217) 557-1142
Fax: (217) 524-8928
e-mail: lbuell@icc.state.il.us

**Counsel for the Staff of the Illinois
Commerce Commission**

I.	INTRODUCTION	3
II.	ARGUMENT	3
A.	REVENUE REQUIREMENT ISSUES	3
1.	Rate Base	3
a.	The Commission Should Deny IAWC’s Attempt To Recover Deferred Reverse Osmosis Expense	3
b.	Illinois-American Should Be Required To Perform A Lead-Lag Study In Its Next Rate Case	4
c.	IAWC’s Deferred Security Expenses Should Be Rejected.....	7
2.	Operating Revenues and Expenses.....	16
a.	Illinois-American Should Not Be Able To Recover Deferred Reverse Osmosis Expense.....	16
b.	The Commission Should Accept Staff’s Recommendation Regarding The Recovery Of Incentive Compensation Costs	22
c.	Lincoln And Streator’s Argument Regarding Merger Savings Is Misguided And Must Be Ignored.	25
d.	IAWC’s Security Expenses, As Adjusted By Staff, Are Prudent And Reasonable.....	26
e.	The Commission Should Adopt Staff’s Allocation Of Costs For Test Year Security Expense.....	30
f.	The Commission Should Accept Staff’s Adjustment To Community Relations Expenses.	31
3.	Rate Of Return And Cost Of Capital	35
a.	The Commission Should Accept Staff’s Recommendations For The Cost Of Long-Term Debt.....	35
b.	The Commission Should Accept Staff’s Recommendations Regarding The Cost Of Common Equity.....	36
c.	The Commission Should Accept Staff’s Overall Cost Of Capital Recommendation.	38
B.	COST OF SERVICE AND RATE DESIGN	38
1.	Reply To AG Arguments That Affect All Rate Areas	38
a.	The AG Is Correct In Stating That The Commission Has Expressly Promoted Movement Toward Single Tariff Pricing (“STP”) For IAWC Both Historically And Currently.	38
b.	AG Witness Rubin’s Perception About Perfect Cost Based Rates Does Not Grasp Reality.	40
c.	The AG’s Advocacy Of An Overall STP For All Rate Areas Fails To Account For The Differences Inherent In District Specific Issues Related To Source Of Supply.....	41
d.	The AG’s Suggestion That Its Rate Proposal Is Tempered By Gradualism, Rate Continuity And Fairness Is Far From The Truth.....	43
e.	The AG’s Obvious Tilt Towards Residential Customers Leads It	

	To Mischaracterize Staff's Small Main Adjustment.	45
	f. AG Witness Rubin's Rate Design Is A Radical Departure From The Cautious But Well Contemplated Movement Toward STP Followed By The Commission In Past Cases, And Should Be Rejected By The Commission.....	46
2.	Champaign And Sterling Rate Areas	47
	a. Reply To IAWC.....	47
3.	Lincoln Rate Area.....	48
	a. Reply To City Of Lincoln.....	48
4.	Southern Division, Peoria District, And Streator District.....	48
	a. Reply To LWC	49
	b. Reply To AG	53
	c. Reply To City Of Streator.....	55
5.	Chicago Metro Sewer Rate Area.....	56
	a. Response To IAWC.....	56
III.	CONCLUSION.....	57

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois-American Water Company	:	
	:	02-0690
Proposed general increase in water	:	
and sewer rates.	:	

**REPLY BRIEF OF THE STAFF OF
THE ILLINOIS COMMERCE COMMISSION**

Pursuant to 83 Ill. Adm. Code 200.800, Staff of the Illinois Commerce Commission (“Staff”), by and through its attorneys, hereby files its Reply Brief in the above-captioned proceeding.

I. INTRODUCTION

On May 21, 2003, Initial Briefs (“IB”) were filed in this matter by Staff, Illinois-American Water Company (“Illinois-American”, “IAWC” or “Company”), Large Water Consumers (“LWC”), Office of the Attorney General on behalf of the People of the State of Illinois (“AG”), the Village of Bolingbrook (“Bolingbrook”), the City of O’Fallon (“O’Fallon”), the City of Lincoln (“Lincoln”), the City of Streator (“Streator”) and the Citizens Utility Board (“CUB”). Staff hereby submits this Reply Brief in reply to several claims made by the parties in their Initial Briefs.

II. ARGUMENT

A. REVENUE REQUIREMENT ISSUES

1. Rate Base

- a. The Commission Should Deny IAWC’s Attempt To Recover Deferred Reverse Osmosis Expense.**

Staff witness Everson proposed an adjustment to remove deferred reverse osmosis expense from the Company's rate base. (ICC Staff Exhibit 12.0, p. 3.) IAWC argues that the Commission should allow recovery of deferred reverse osmosis costs. (IAWC IB, pp. 24-30.) Staff's reasons for its proposed disallowance are presented in the Operating Revenues and Expenses portion of this Reply Brief.

b. Illinois-American Should Be Required To Perform A Lead-Lag Study In Its Next Rate Case.

Staff believes that it is appropriate to require IAWC to present a lead-lag study in its next rate case if the Company proposes to include in its rate base an amount for cash working capital for the following reasons:

- A lead-lag study more accurately establishes the amount that investors' funds are used in sustaining utility operations from the time expenditures are made in providing services to the time revenues are received as reimbursement for these services; and,
- The Company has significantly expanded its service territory and operations through various mergers and acquisitions since Docket No. 95-0076. (Staff IB, pp. 26-27.)

The Company urges that this recommendation be rejected for the following reasons:

- The Commission has approved use of the 1/8 formula method by the Company in all its prior rate orders and in several rate orders of other utilities; and
- A lead-lag study would add additional rate case expense without demonstrated benefits. (IAWC IB, p. 46.)

Staff disagrees with the Company's assessment of the Commission's approval of the use of the 1/8 formula in Docket No. 95-0076 and other cited utility dockets.

In IAWC Docket No. 95-0076, the Commission did not state that the Company should only calculate cash working capital by using the 1/8 formula method. To the contrary, the Commission's Order specifically contemplated the use of a lead-lag study in the next rate proceeding. (Order, Docket No. 95-0076, p. 20.) In the current proceeding, IAWC witness Stafford, under cross-examination, agreed that the Commission concluded that a lead-lag study could be examined in future rate cases. (Tr., p. 149.) The Company's reliance on this Order is misplaced.

Staff notes that the Commission stated in Docket No. 95-0076 that the appropriateness of a lead-lag study should be examined in future rate proceedings. (Order, Docket No. 95-0076, p. 20.) The Company has had two rate cases (Docket Nos. 97-0102 and 00-0340) and has significantly expanded its service territory and operations through various mergers and acquisitions since Docket No. 95-0076. The Commission should not allow the Company to avoid a more thorough review and determination of its cash working capital requirements based upon the Company's misplaced reliance upon an Order that clearly contemplated the possibility of such an analysis, but stopped short of requiring it in the next rate case. This is especially true in light of the Company's significant changes and growth since the Commission's Order in Docket No. 95-0076. The most important objective is to better determine a reasonable amount of cash working capital. A lead-lag study provides a more accurate estimate of cash working capital.

In Inter-State Water Company, Docket No. 94-0270, the Commission approved the 1/8 formula in calculating the cash working capital that the Company presented in its initial filing over the objections of the City of Danville's witness Smith who recommended a one-twelfth formula. (Order, Docket No. 94-0270, p. 19.) The Commission rejected the 12-month formula and defaulted to the filed 1/8 formula. The Commission did not state that lead-lag studies in the future were inappropriate.

In United Cities Gas Company, Docket Nos. 90-0008 and 90-0152 (Consol.), the Company modified the 1/8 formula and included an average cash balance amount that is a duplication of the formula method. The Commission found that the Company failed to justify its position and agreed with Staff's criticism of the Company's calculation. As a result, the Commission approved of the 1/8 formula of computing cash working capital not the Company's modified formula. (Order, Docket Nos. 90-0008/90-0152 (Consol.), p. 24.) Again, the Commission defaulted to the 1/8 formula. The Commission did not state that a lead-lag study in the future was inappropriate.

In Interstate Power Company, Docket No. 90-0196, the Commission adopted Staff's working capital disallowance and Staff's recommendation that cash working capital be computed using the formula method. The lead-lag study was specifically objected to because the Company used a disparate lead-lag study, based upon 1989 revenue leads and a 1985 expense lag study. (Order, Docket No. 90-0196, pp. 7-8.) Here again, the Commission approved the 1/8 formula as a default calculation. The Commission did not state that a lead-lag study in the future was inappropriate. In Docket No. 90-0196, the reasons for accepting the 1/8 formula were inaccurate calculations and disparate data further demonstrating the need for a lead-lag study.

IAWC's attempts to claim the findings in these Orders as rationale for not requiring a lead-lag study are misplaced.

The Company also argues that the Commission should not require a lead-lag study in the Company's next rate case because a lead-lag study will add additional rate case expense. (IAWC IB, p. 47.) Based upon this reasoning, a lead-lag study would never be appropriate and the Commission would have acted improperly in ordering a utility to perform one as it did in Illinois Power Company, Docket No. 89-0276. (Order, Docket No. 89-0276, p. 94.) The Company's reliance upon this reasoning is, again, misplaced. The benefits of a lead-lag study's more comprehensive analysis outweigh the additional expense. A lead-lag study more accurately establishes the amount that investors' funds are used in sustaining utility operations from the time expenditures are made in providing services to the time revenues are received as reimbursement for those services. Therefore, Staff recommends the Commission require the Company to provide a lead-lag a study in its next rate proceeding if the Company proposes to include in its rate base an amount for cash working capital.

c. IAWC's Deferred Security Expenses Should Be Rejected.

Removing the emotion from this issue, the Company's argument boils down to this: the deferred security expenses (enhanced security) were not contemplated when base rates were set in the Company's prior general rate case, Docket No. 00-0340; consequently, the Company did not recover these costs, nor did it earn its authorized rate of return; and because these were prudent costs, deferral and recovery from ratepayers is guaranteed. These arguments do not outweigh the fact that the Company proposal violates the test year rule by matching operating expense outside of a test year

with revenues of the test year. Furthermore, the Company's proposal is improper because when combined with the ongoing security expenses, the Company would recover more than the agreed-upon test year amount included in rates for ongoing security expenses.

Inserting the emotion back into the argument, the Company gives us comparisons to Pearl Harbor, endless references to articles and reports detailing terrorism threats, citations to numerous laws and regulations concerning water safety, and Attorney General Ashcroft's characterization of security measures. (IAWC IB, pp. 1, 7-12.) These arguments are irrelevant to the ratemaking process. Furthermore, these points are not in dispute. As far as Staff understands, no one has testified that 9/11 was not a horrific event in American history, that terrorism is not a continuing threat to America and its interests, or that utilities do not have a responsibility to ensure the continuation of safe and reliable service.

The majority of the Company's arguments contained in its Initial Brief concerning deferred security expenses are refuted by Staff in its Initial Brief, pages 7-24. Consequently, the same arguments will not be reiterated by Staff. However, there are some mischaracterizations and illogical conclusions made by IAWC in its Initial Brief to which Staff is compelled to respond.

i. IAWC's Claim That Staff Used Narrow Accounting Concepts Is Misguided.

The first implausible argument made by the Company is its characterization of Staff witness Sant's testimony as "attempting to shoehorn extraordinary, but prudent, security costs into narrow accounting concepts reserved for ordinary operating expenses." (IAWC IB, p. 2.) It is not clear whether the Company is referring to Mr.

Sant's testimony concerning extraordinary expenses (ICC Staff Exhibit 14.0, p. 13) or his explanation of his understanding of the test year rules. (ICC Staff Exhibit 4.0, p. 5.) In any event, as will be shown below, it is the Company's perspective that is too narrow, not Staff's.

As stated in Mr. Sant's testimony, to be considered extraordinary, expenses must be unusual and infrequent. (ICC Staff Exhibit 14.0, p. 13.) As related by Company witness Ruckman upon cross-examination, before 9/11 the Company performed security measures, albeit at a modest level compared to today's heightened level. (Tr., p. 68.) The fact that security is provided post-9/11 cannot then be considered unusual when security was provided beforehand. The primary question then becomes whether the level of security to be provided is unusual. There can be no doubt that the enhanced security measures are not infrequent, considering they occur day after day into the foreseeable future. The Company may not agree with the accounting rules concerning extraordinary expenses, may even consider them "narrow", yet it has no authority to artificially change the rules as it likes.

The other possibility is that the Company considers the test year rule to be a narrow accounting concept only relevant to "ordinary" expenses such as chemicals and power. Imagine the chaos ratemaking would become without such "narrow accounting concepts" as the test year rule, the prohibitions against retroactive ratemaking and single-issue ratemaking, the distinguishing between rate base items and operating expenses, the choosing of a test year, etc. If a fundamental ratemaking principle such as the test year is too narrow a concept, then ratemaking itself becomes too narrow a concept. It seems that the Company's gauge of narrowness has more to do with the

results it wishes to achieve rather than the thoughtful application of ratemaking principles to the facts in evidence before the Commission in this proceeding. The Company's argument fails to consider other relevant facts, such as the fact that during the same period the Company incurred the security expenses it now wishes to defer and recover, the Company also incurred a lower cost of debt than was reflected in its authorized rate of return. LWC witness Gorman calculated a resulting annual savings of \$3.5 million per year. (LWC Exhibit MPG-1, p. 8.) This compares to an annual amortization expense of \$2.13 million¹ for the deferred security costs. If anything is too narrow, it is the Company's arguments regarding deferred charges, not the fundamental ratemaking principles that the Company now finds inconvenient. Those fundamental ratemaking principles, such as test year, would appropriately exclude from the Company's revenue requirement both of these offsetting items that relate to periods prior to the test year.

ii. Illinois-American Mischaracterizes The Description Of Deferred Security Costs.

The second item that Staff is compelled to respond to is the Company's mischaracterization of deferred security costs. The Company lists several enhanced security measures and states that these are its deferred security costs. (IAWC IB, p. 4.) To clarify, over half of the measures stated by the Company are plant items that have been included in rate base by the Company. Staff has never opposed these additions' inclusion in rate base. The deferred security costs at issue in this proceeding are only the operating expenses that are included in this list and are similar in amount and

¹ The deferred security annual amortization amount filed by the Company was originally \$2.494 million as reflected on Company workpaper A-5, p. 4. The Company has estimated a new amount for total deferred security at \$10.651 million. (IAWC Exhibit SR-4.0, p. 15.) A five-year amortization of this amount would result in an annual amortization of \$2.13 million.

purpose to the ongoing security expenses accepted, with adjustment, by Staff.

iii. IAWC Is Wrong In Its Suggestion That Staff's Position Regarding Deferred Expenses Is Inconsistent.

The Company erroneously argues that Mr. Sant is inconsistent by recommending in this proceeding that the Company recovers steel structure painting expenses and rate case expenses as deferred costs and also that he could not explain his inconsistency. (IAWC IB, p. 13.) Once again, Staff is compelled to correct a mischaracterization of facts made by the Company. First, Mr. Sant made no recommendation whatsoever concerning rate case expenses. Second, Staff has explained the differences between the steel structure painting expenses and deferred security costs and has also explained that it deems there to be no inconsistency in proposing differing ratemaking solutions to costs with distinct dispositions and circumstances. (ICC Staff Exhibit 14.0, p. 15; Staff IB, p. 17.) Third, the Company's comment concerning Mr. Sant's inability to explain his inconsistency is totally without merit. Mr. Sant explained the consistency in his recommendations (ICC Staff Exhibit 14.0, p. 15), and the Company asked him no questions regarding this during cross-examination.

The Company defies logic when it further argues that Mr. Sant's position is also inconsistent because of his statement during cross-examination that a recoverable deferred debit, including operating expense, is anything in USOA Account 186 that the Commission has ruled recoverable. (IAWC IB, p. 13.) When the Commission has ordered the recovery of a deferred item, for whatever reason, by definition, that item is now "recoverable." This argument does nothing to further the Company's argument and should be given no weight by the Commission.

iv. Illinois-American's Claim That It Has Met The Test For Recovery Of Deferred Expenses Is Unpersuasive.

The Company states its review of deferrals approved by the Commission and the courts have three things in common, and because the deferred security expenses also have these things in common, it has met its test for recovery. (IAWC IB, p. 15.) However, this list is an interpretation by the Company rather than a Commission-sponsored requirements listing. For instance, Staff has shown that the Commission has also refused to allow companies from recovering deferred costs and has even stopped a company from performing the actual step of deferring costs. As explained more fully in Staff's Initial Brief, the Commission did not allow CUCI to defer Y2K expenses nor did it allow Iowa-Illinois Gas and Electric to recover all of its deferred coal tar expenses. (Staff IB, pp. 8, 14.) Both of these expenses meet the Company's three-pronged test of: 1) not being included in revenue requirements used by the Commission to determine current rates; 2) being prudent costs incurred in providing service to customers; and 3) being incurred to comply with a legal, environmental or regulatory requirement, or to address an unanticipated event. The Company has more accurately prepared a list that describes most deferred costs rather preparing a list that is exclusive to deferred costs deemed recoverable by the Commission.

v. Staff Is Not Explicitly, Or Implicitly, Suggesting That The Company Should Recover Deferred Security Expenses.

The Company states, "[o]bviously, the facts that Staff asked Mr. Jaehne to review the prudence of Deferred Security Costs, and that Mr. Jaehne concluded that they are prudent, demonstrate that Staff intends that these costs are recoverable." (IAWC IB, p.

18.) The Company incorrectly suggests that prudence is the only factor in deciding recoverability. The Company conveniently forgets that other rules and precepts of ratemaking also play a part in deciding the recoverability of a cost. In this proceeding, the test year rule is an example of another relevant factor.

vi. Illinois-American's Public Policy Argument Is Unfounded And Should Be Disregarded By The Commission.

The Company argues that if the Commission accepts Mr. Sant's proposal, the Commission would be discouraging public utilities from responding immediately and appropriately to the emergency conditions brought by the risks of terrorism "unless and until there is assurance of rate recovery." (IAWC IB, pp. 1, 18, 22.) The Commission should not reward the Company for its attempt to skirt the rules that shape ratemaking by appealing to the emotions concerning the 9/11 tragedy. The Company responded to 9/11 by enhancing its security before being assured of rate recovery. There is no reason to believe other utilities have not also responded and would also respond to future threats and emergencies. Furthermore, Staff is proposing to allow the Company to recover its ongoing security expenses. This will undoubtedly help the Company respond to any future risk of terrorist intrusion or destruction.

Regardless of the emotional appeals, the Company cannot avoid its own obligation to demonstrate why issues regarding its non-capital, pre-test year security costs warrant setting aside the test year principle. Such a demonstration should show that the Company would suffer an operational or financial hardship without recovery of these costs and that recovery outside of the normal test year paradigm is the best solution. The evidence shows no such demonstration by the Company. All the

Company has demonstrated is that the prior rate case reflected costs associated with a much lower level of security and that this is the first rate case since the Company enhanced its security measures. That demonstration does not outweigh the test year principle. This is especially true when the record contains evidence that there may also have been savings, such as a lower actual cost of debt, to offset the security costs incurred prior to this proceeding. (LWC Exhibit MPG-1, p. 8.) The real question in this proceeding is whether the test year principle will remain intact.

vii. A Decision By The California Public Utilities Commission Regarding Security Expenses Provides A Valuable Perspective From Another State.

The Company believes that this Commission should consider that the Florida Commission has allowed incremental power plant security costs through a fuel clause. (IAWC IB, p. 20.) If the Commission is going to consider inter-jurisdictional decisions relevant, it should also consider the California Public Utilities Commission's ("CPUC") decision concerning an affiliate of IAWC, the California-American Water Company ("CAWC"). The CPUC denied a petition by CAWC to establish a special and temporary Security Cost Memorandum Account. (Public Utilities Reports, 220Pur4th—No. 3, December 15, 2002, p. 556.) Similar to IAWC and its deferred security expenses in this proceeding, CAWC sought special treatment for expenditures for security programs and projects it initiated subsequent to 9/11 and argued that none of these expenses were included in previous rate case filings and its ability to earn its authorized rate of return would be adversely impacted. (*Id.*, p. 557.)

The CPUC denied CAWC's petition to establish a security memorandum account but did not close the door for CAWC to pursue recovery of additional security costs in

upcoming general rate cases. (Id., p. 558.) Of special note however, the CPUC, in its Order, said the following concerning CAWC's ability to meet its authorized rate of return:

This means that the rates of Cal-Am are based on estimated rate base and expenditures for a future test year. Actual rate base and expenditures can and do change between the time rates are set and the time events occur.

There is no requirement of the utility to spend exactly, or only, the projected amount on each rate base or expenditure component used to set rates. Similarly, there is no requirement or guarantee that the utility earn its authorized rate of return. In other words, if a utility fails to earn its authorized rate of return, ratepayers are not assessed the short-fall, and if the utility earns more than authorized, it does not rebate the excess to ratepayers.

We leave the fine-tuning of a utility's operation to the discretion of its management. Management discretion is exercised in allocating total dollars for capital and expense items to those areas where the capital and expense is most necessary, as dictated by constantly evolving priorities. This discretion also affects whether the utility realizes its authorized rate of return. (Id., p. 558.)

Other states' public utility commissions' thoughts concerning recoverability of enhanced security measures can hardly be deemed unanimous. In any event, the Commission should make its decision regarding IAWC's deferred, prior-period security expenses based upon the evidence in the record in this proceeding.

viii. IAWC's Bomb Analogy Is Unpersuasive And Amounts To Pure Supposition.

The Company gives an emotive analogy concerning the recoverability of destroyed plant due to terrorism assuming enhanced security measures had not been put into place. (IAWC IB, p. 24.) First, it is impossible for the Company to state with certainty that the net original cost of the destroyed facility and the replaced plant would be recovered in rates. That has been the result in prior cases cited by the Company, yet for this hypothetical, it is pure supposition. Second, the hypothetical given by the

Company concerns plant items rather than continuing operating expenses, which are at issue in this proceeding. The Company has once again failed to provide precedence that is analogous to the instant proceeding.

ix. The Commission Should Accept Staff's Recommendations Regarding The Recovery Of Deferred Security Expenses.

The Company concludes by stating that precedent, sound policy and common sense indicate that the deferred security costs are recoverable. (Id.) To the contrary, Staff has shown that none of the dockets used by the Company as "precedent" have facts analogous to the instant proceeding. Furthermore, Staff has shown that not all prior dockets and court cases allow for the recovery of all prudently incurred costs that have been deferred.

Common sense indicates that the inability to contemplate a new cost or the inability to reach an authorized rate of return are not automatic grounds for disregarding the test year rule as the Company proposes. It is in the face of such common sense, that the Company finds it must resort to emotional appeal. To preserve the test year rule, the Commission should accept Staff's proposal to disallow all deferred security expenses.

2. Operating Revenues and Expenses

a. Illinois-American Should Not Be Able To Recover Deferred Reverse Osmosis Expense.

i. IAWC's Attempt To Recover Reverse Osmosis Costs Is A Double Recovery Of Nitrate Removal Costs.

IAWC argues that the Commission should allow recovery of deferred reverse osmosis costs. (IAWC IB, pp. 24-30.) Staff continues to support the position espoused

in its Initial Brief. (Staff IB, pp. 46-50.) As discussed more fully in Staff's Initial Brief, the Commission should accept Staff witness Everson's adjustment to reverse osmosis expense because it is an out of period expense, improperly deferred to the test year. However, in several instances, IAWC has mischaracterized or misstated Staff's position or attributed statements to Ms. Everson that are inaccurate. These misstatements and conflicting arguments require further discussion.

IAWC incorrectly states that Ms. Everson contradicted herself regarding the issue of double recovery of the reverse osmosis expense. (IAWC IB, p. 29.) That is clearly not the case. Staff witness Everson's statement was taken out of context to further IAWC's distorted view of this issue. What Staff witness Everson said was that the Company would not be recovering the same costs twice, rather, the Company has incurred or will incur for the same purpose, costs for nitrate removal. In 2001, the Company incurred costs for the nitrate removal with reverse osmosis equipment. In the test year, 2003, the Company expects to incur a projected level of expense for current and ongoing nitrate removal using the ion exchange equipment, which Staff has not contested as a test year operating expense. Thus, the Company's position proposes to recover both past and expected future costs to remove nitrates from the water in the test year. The Company's proposal would require ratepayers to pay for nitrate removal twice. (ICC Staff Exhibit 12.0, p. 7; Staff IB, p. 49.) IAWC's proposal is contrary to traditional ratemaking theory.

ii. The Reverse Osmosis Expenses Are Out Of Test Year Operating Expenses.

The expenses for nitrate removal using reverse osmosis equipment occurred in 2001. The test year principle provides that only expenses incurred during the test year

be used to offset revenue accrued during the test year. To improperly include expenses incurred in 2001 in a 2003 test year creates a mismatch of 2001 expenses with 2003 revenues in the Company's test year. (ICC Staff Exhibit 2.0, p. 6; Staff IB, p. 46.) The reverse osmosis expenses incurred in 2001 were operating expenses such as rental of equipment, site preparation and installation, electricity, fuel, and materials and labor to operate the equipment. These should be classified as operating expenses in the year they are incurred. These expenses were not of an investigative nature; they were incurred for nitrate removal activities. (ICC Staff Exhibit 12.0, p. 4 and Attachment A; Staff IB, p. 46.)

iii. IAWC's Recording Of The Reverse Osmosis Expenses Was Improper.

Staff continues to support its proposal to disallow the reverse osmosis expense amortization on the basis of improper accounting treatment. IAWC had recorded the nitrate removal expense in 2001 in Account 183, Preliminary Survey and Investigative Charges. In support of her position, Ms. Everson pointed out the instruction for Account 183, which states:

This account shall be charged with expenditures for preliminary surveys, plans investigations, etc., made for the purpose of determining the feasibility of projects under contemplation. If construction results, this account shall be credited and the appropriate utility plant account charged. If the work is abandoned, the charge shall be to account 426-Miscellaneous Nonutility Expenses, or to the appropriate operating expense account unless otherwise ordered by the Commission. (Emphasis added.)

At the time of either construction or abandonment, a decision should be made as to the whether the expenses should be expensed in the year incurred or capitalized depending on the outcome of the project. If the Company wishes to use alternative

recording to that specified in the instruction, it should then come to the Commission to request approval for the alternative treatment. (ICC Staff Exhibit 12.0, p. 6; Staff IB, p. 48.) Subsequent to June 2001, IAWC began construction of a permanent ion exchange nitrate removal facility. As Mr. Johnson admitted on cross-examination, the reverse osmosis equipment was used for a period of 28 days and then dismantled and returned to the vendor. (Tr., pp. 293-294.) Pursuant to the Uniform System Of Accounts, at the time the equipment was dismantled and returned to the vendor, the Company should have expensed the rental costs since no permanent construction resulted from that rental. Instead, IAWC improperly and without permission from the Commission, deferred the expense for a period of two years into the 2003 test year in this proceeding.

iv. The Reverse Osmosis Treatment Expense Was Not The Result Of A Pilot Study.

It was only after Staff filed its direct testimony that IAWC brought up the term “pilot study” to describe the reverse osmosis treatment expense incurred in 2001. In its rebuttal testimony, surrebuttal testimony and Initial Brief, the Company attempts to complete the transformation from last minute operating expense to a “full scale pilot study”. However, the Company provided no argument to rebut the applicability of the test year principle because the circumstances of the rental of reverse osmosis equipment simply do not justify special deferral treatment.

Instead, in rebuttal testimony, the Company describes the out of period operating expenses as a “pilot study” that is required by the Illinois Environmental Protection Agency (“IEPA”). (IAWC Exhibit R-3.0, pp. 6-7.) On cross-examination, however, Company witness Johnson admitted that the decision to perform the “pilot study” was

made on the same day that the decision was made to rent the nitrate removal equipment and also on the same day that the decision was made to file for an IEPA permit. (Tr., p. 290; Staff IB, p. 47.) These actions are not indicative of a carefully thought out and planned study of a different type of technology, but that of a last minute decision driven by the need to comply with safe drinking water standards. Compliance with safe water standards is an ongoing and expected facet of the water treatment and distribution business, not an unexpected development. Therefore, the Company should not be allowed to treat these out of period operating expenses in any special manner.

To further its unsupportable contention that the reverse osmosis treatment expense was a “pilot study”, IAWC states that the IEPA required the Company to test the reverse osmosis equipment. (IAWC Exhibit SR-3.0, p. 6; IAWC IB, p. 26.) However, when questioned about this requirement, IAWC witness Johnson admitted that the IEPA does not, in fact, require testing of each and every type of equipment available, only the type of equipment that will be installed permanently. (Tr., p. 293.) Interestingly, the Company had tested ion exchange equipment and that is the type of equipment that was permanently installed at the Streator Water Treatment Facility. There was no IEPA requirement to test reverse osmosis equipment. (Staff IB, p. 47.) IAWC now claims that the situation in Northern Illinois Water Company Docket No. 95-0220 is identical to the one at issue in this proceeding. (IAWC Exhibit 3.0, pp. 8-9; IAWC IB, p. 7.) That is an erroneous contention. In Docket No. 95-0220, Staff witness Garret E. Gorniak stated in direct testimony that the expenses related to the Vermilion Watershed Study should be amortized. These expenses for which Mr. Gorniak recommended amortization were part of a legitimate study. Mr. Gorniak’s testimony

also clearly states that the Company at that time was still studying its options; that is, no permanent treatment method had been determined. (Docket No. 95-0220, ICC Staff Exhibit 1.0, pp. 24-25.) That is not an identical situation to this proceeding; here, IAWC has decided on a permanent treatment method. (Staff IB, p. 47.) In the instant proceeding, the record is clear regarding the events of June 26, 2001, when the Company simultaneously decided to conduct a study, rent the equipment on a near-emergency basis and apply for an IEPA permit. All of these activities are now characterized by the Company as a “pilot study”. (Staff IB, p. 47.)

v. The Commission’s Approval Of Deferred Expenses In Prior Dockets Is Not Dispositive Of IAWC’s Deferral Of Expenses In The Current Proceeding.

Staff continues to support its position regarding the applicability of prior instances of Commission-approved deferral of expenses. It is Staff’s position that each proposal for deferral of expenses should be judged on its own merits. IAWC’s proposal for deferral of reverse osmosis expenses violates the test year principle. (Staff IB, pp. 17-24.)

vi. The Commission Should Deny IAWC’s Attempts To Recover The Reverse Osmosis Expense For A Variety Of Reasons.

The Commission should accept Staff’s adjustment to reverse osmosis expense. IAWC has included in its test year operating expense and rate base, amounts related to ongoing nitrate removal. The nitrate removal expenses incurred in 2001 were clearly operating expenses incurred outside of the test year, and were improperly deferred without approval. IAWC’s arguments for deferral and amortization conflict with the facts and each of its other arguments. The event or transaction that occurred on June 26,

2001 cannot be both a carefully thought out and planned “full scale pilot study” (IAWC IB, p. 24) and at the same time “a one-time extraordinary event”. (Tr., p. 294.) The Commission should accept Staff’s adjustment to remove the deferred reverse osmosis expense amounts from rate base and the amortization of those expenses from operating expense in the test year.

b. The Commission Should Accept Staff’s Recommendation Regarding The Recovery Of Incentive Compensation Costs.

IAWC argues that the Commission should allow full recovery of incentive compensation costs. (IAWC IB, pp. 34-35.) Staff continues to support the position stated in its Initial Brief. (Staff IB, pp. 50-53.) As discussed more fully in Staff’s Initial Brief, the Commission should accept Staff witness Everson’s adjustment to incentive compensation expense because of the circular effect of including incentive compensation amounts that are determined based on corporate financial goals in rates that are determined using those incentive compensation amounts. However, IAWC has mischaracterized or misstated Staff’s position. This mischaracterization requires further discussion.

Staff continues to support its position disallowing 60% of incentive compensation due to the circular effect of including incentive award amounts based on financial goals, and the vague description of the financial goals in the 2003 Annual Incentive Plan (“AIP”).

i. IAWC’s Financial Performance Goals Has A Circular Effect.

IAWC claims that it will not be a financially healthy utility if Staff’s adjustment to incentive compensation is adopted. (IAWC IB, p. 34.) This claim is baseless. There is

no evidence in the record to indicate that Commission acceptance of Staff's adjustment will result in IAWC becoming financially unhealthy. To the contrary, Staff asserts that for ratemaking purposes, a financial performance goal results in a circular effect, that is, the larger the increase in rates granted by the Commission, the more success the Company will have in achieving a financial performance goal. This circular effect benefits the shareholders, but not the ratepayers. With the use of a financial performance goal, the incentive compensation awards increase with the financial performance of the Company, which has been enhanced by the increased rates. With the increase in rates and financial performance, the subsequent incentive compensation awards increase. This cycle can continue indefinitely. The process provides benefits to the shareholders in the form of increased share prices, higher dividends resulting from the increased financial performance, and the potential to retain the award amounts not actually paid out to employees, but provides little benefit to ratepayers. (ICC Staff Exhibit 12.0, pp. 295-309; Staff IB, pp. 51-52.)

ii. Illinois-American's Description Of Financial Goals Contained In The Incentive Plans Is Vague.

Staff asserts that another argument supporting disallowance of incentive award amounts is that in the 2003 AIP the financial goals are too vaguely described. According to the description in the 2003 AIP, the goals "operating results" and "net debt" are left for the employee's supervisor to define. As this plan is written, it does not provide sufficient information to enable the Commission to determine that ratepayers should pay rates that reflect costs based on these vaguely defined financial goals. (ICC Staff Exhibit 12.0, p. 15; Staff IB, p. 53.) IAWC relies on its baseless argument

regarding the financial health of the utility to feebly attempt to rebut Staff's position. (IAWC IB, p. 34.) It falls significantly short of the mark.

iii. Staff's Incentive Compensation Adjustment Is Supported By Prior Commission Decisions.

IAWC relies on past Commission decisions where incentive compensation has been allowed. (IAWC IB, pp. 34-35.) Staff has noted that the Commission has in many prior cases accepted Staff's adjustment for incentive compensation based on the circular effect of financial goals and that these goals provide more benefits to shareholders than to ratepayers. The Commission has made similar adjustments for incentive awards based on financial goals in the following prior dockets: Illinois Power Company Docket No. 93-0183, Citizens Utilities Company of Illinois ("CUCI") Docket No. 94-0481, Central Illinois Light Company Docket No. 94-0040, and MidAmerican Energy Company Docket No. 99-0534. (ICC Staff Exhibit 12.0, p. 15; Staff IB pp. 52-53.)

iv. Staff Accepts Operational And Individual Goals Provided For In The Incentive Compensation Plan.

Staff does not oppose allowing payments based on the 2003 AIP that include provisions for employees to be awarded incentive compensation payments that are based on operational and individual goals as separate components. Although the plan still includes financial goals on which incentive compensation can be based, the operational and individual goals can be considered and paid independently of the financial goals. In other words, awarding the operational and individual goals does not depend on the overall financial goals. (Staff IB, p. 52.)

IAWC argues that direct benefits accrue to ratepayers and that it would be inappropriate to disallow incentive compensation awards that are based on financial goals especially when major elements are tied to customer service and individual employee standards. (IAWC IB, p. 34.) This is a misstatement. Staff's allowance of 40% of the incentive compensation awards is based on the amount to be determined for operational and individual goals in the plan. The 2003 AIP includes provisions for employees to be awarded incentive compensation payments that are based on financial, operational and individual goals as separate components. Although the plan still includes financial goals on which incentive compensation can be based, the operational and individual goals can be considered and paid independently of the financial goals. In other words, awarding the operational and individual goals does not depend on the overall financial goals. (Staff IB, p. 52.) Staff's adjustment allows for the inclusion of incentive awards that are based on operational and individual goals. It is inappropriate for IAWC to characterize Staff's adjustment as one that does not consider the individual and operational goals, when in fact, Staff's adjustment does consider and allow payments related to those operational and individual goals.

The Commission should accept Staff's adjustment to disallow the incentive compensation awards that are based upon corporate financial goals because of the circular effect of including those goals and the vague description of the financial goals in the 2003 AIP.

c. Lincoln And Streator's Argument Regarding Merger Savings Is Misguided And Must Be Ignored.

Lincoln and Streator state that IAWC was required by the Order in Docket No. 99-0457 to pass the merger savings through to the ratepayers. They further contend

that no adjustment was made by IAWC or Staff to the Lincoln proposed rates to reflect merger savings. (Lincoln/Streator IB, p. 8.)

No adjustment was made because no adjustment is necessary in order to reflect these savings. To the extent savings were achieved, they were achieved in the form of lower costs incurred and already recorded on the Company's books. Thus any savings that were achieved would already be reflected as lower costs in the revenue requirement initially filed by the Company. Therefore, no adjustment to reflect savings is necessary.

The situation is different regarding the "Savings Sharing" related to the acquisition of the CUCI system. With the "Savings Sharing" scheme, an adjustment must be made in order to prevent ratepayers from receiving all of the savings. That adjustment effectively increases the lower costs that would otherwise be reflected in the Company's revenue requirement. This allows the Company to recover an imputed higher level of costs than those it actually incurred, and thus allows the Company to retain a portion of the savings in the form of higher costs.

Therefore, Lincoln and Streator's contention that an adjustment is necessary in order to reflect the savings resulting from the acquisition of the Lincoln system is incorrect. No such adjustment is necessary because the savings, by their very nature, are already reflected in the Company's filing.

d. IAWC's Security Expenses, As Adjusted By Staff, Are Prudent And Reasonable.

The Cities of Lincoln and Streator state that Company security costs "are not just and reasonable." (Lincoln/Streator IB, p. 16.) In its Initial Brief, Staff detailed how Staff's adjusted test year XXXXXXXXXXXXXXXXXXXXXXXXXXXX were reasonable. (Staff IB,

p. 40; ICC Staff Exhibit 10.0, Schedule 10.1 Revised, Column E, line 13.) This schedule reflected the [REDACTED] [REDACTED]. Staff's Initial Brief further detailed how the [REDACTED] [REDACTED] was calculated. (Staff IB, p. 40.)

The Cities of Lincoln and Streator further state, "[REDACTED] [REDACTED]."

(Lincoln/Streator IB, p. 17.) The Cities of Lincoln and Streator further state that the

"[REDACTED]." (Id.) These statements recognize

only the [REDACTED] and the latter is simply not true. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

(Tr., pp. 588-589.)

The assertion that [REDACTED]

[REDACTED]

[REDACTED]

XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

Lincoln and Streator, in reference to Staff witness Jaehne, claim XXXXXXXX

XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

XXXXXXXXXXXXXXXXXXXX
 XXXXXXXXXXXXXXXXXXXXXXX

XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
 XXXXXXX

(Tr., p. 585.)

Staff continues to challenge the testimony of O’Fallon witness James Brooks and reasserts the testimony of Staff witness Jaehne concerning the prudence and

reasonableness of [REDACTED] Lincoln and Streator agree with O'Fallon witness Brooks, noting that [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

Based upon the evidence, the Commission should accept Staff's adjusted security costs as just, reasonable, and prudent.

e. The Commission Should Adopt Staff's Allocation Of Costs For Test Year Security Expense.

The Company makes two completely irrelevant arguments in refuting Mr. Sant's proposal to allocate security costs based on cost causation. First, the Company states that Mr. Sant appears to agree with allocation based on rate base because of his comment during cross-examination concerning the cost of security being related to "facilities." Second, the Company states that Mr. Sant acknowledges that other costs, such as tank painting and corporate headquarters costs are not allocated by district. (Id., p. 37.)

Facilities and rate base are not synonymous terms. The Company could have the same type of facilities, identically sized with identical equipment yet be drastically different in rate base because one facility is fifty years older than the other. A more pertinent example in the instant proceeding is the Chicago Metro Water rate area. Chicago Metro Water has approximately \$72.6 million in rate base as proposed by Staff. That is roughly 16.5% of the total company rate base proposed by Staff. (See Staff IB, Appendix A.) However, ongoing security costs in Chicago are only \$177,000 of the total \$5.3 million proposed by Staff, roughly 3.3%. That is because the nature of the facilities in Chicago lend themselves to needing different security measures than are needed in other rate areas. Thus, the Company's proposal to allocate security costs based on rate base does not follow.

The second argument by the Company, that Mr. Sant acknowledges that other costs, such as tank painting and corporate headquarters costs are not allocated by district, is no more relevant. Mr. Sant does mention during cross-examination that he allocated some of the tank painting costs using a different methodology, but he then

corrects himself because those allocated tank painting costs were allocated based on capacity, which was the cost-causation factor. (Tr., p. 512.) Furthermore, IAWC mentions the corporate headquarters expenses. Indeed, during cross-examination, Mr. Sant acknowledged that all the costs would not be allocated to the rate area in which the headquarters are located. (Id., p. 513.) However, that acknowledgement serves only to underscore Mr. Sant's proposal, that cost-causation is a key factor in allocating costs. To Staff's knowledge, no party has argued that all of the corporate headquarters costs should be allocated to only one rate area, or that all of the headquarters' costs are caused by the operations in that one rate area.

These two arguments made by the Company are irrelevant, without merit, and should be given no weight by the Commission. The Company has failed to present any coherent argument against allocating the ongoing security expenses based upon cost-causation, as Staff proposes.

f. The Commission Should Accept Staff's Adjustment To Community Relations Expenses.

The Company's attempt to mischaracterize Community Relations expenses as Charitable Donations should be rejected. (IAWC IB, pp. 35-36.) Staff's adjustment to disallow Community Relations expenses should be approved because they are operating expenses that are of a promotional and goodwill nature designed primarily to bring the utility's name before the general public and, therefore, should not be considered acceptable operating expenses for rate making purposes. (Staff IB, pp. 44-45.)

The Company's argument that these items are charitable contributions and acceptable operating expenses considered for ratemaking purposes does not withstand

scrutiny. The Company did not identify these costs as charitable contributions in its initial filing and IAWC witness Stafford recharacterized these items as charitable contributions only after Staff took issue with them. They are community relations expenses that are of a promotional and goodwill nature designed primarily to bring the utility's name before the general public. Comparison of the Company's charitable donations listed on IAWC Exhibit 12.0, Schedule C-7, with the community relations expenses listed on IAWC Exhibit R-4.5 shows the difference in the nature of these items. Mr. Stafford acknowledged that these items are of a promotional and goodwill nature. (IAWC Exhibit SR-4.0, p. 3.)

Stafford argues in his surrebuttal testimony that these donations are for the public welfare and for educational purposes, within the meaning of Section 9-227 of the Public Utilities Act ("Act"). He further states that these items are charitable donations within the meaning of Section 9-227 of the Act and can also be said to be promotional and goodwill in nature. (IAWC Exhibit SR-4.0, p. 3.) Notwithstanding Mr. Stafford's assertion, the items listed on the Community Relations schedule are not charitable contributions and are expenses designed to promote the utility's name before the general public. The items in question include:

- Illini Football Tickets,
- Illini Basketball Tickets,
- Univ. of Ill. Football and Basketball Tickets,
- Rotary Baseball Team,
- Oktoberfest,
- Marigold Festival,
- Chamber Business Connection,
- Civic Affairs,

- Taste of Peoria,
- IHSA-March Madness,
- Sweetcorn Festival,
- ISPE Golf,
- Chamber of Commerce Picnic (Breakfast Series, Annual Gala, and Golf),
- Little League Sponsorship,
- First Night,
- St. James Hospital Golf Challenge,
- IBEW Golf Outing,
- Christmas Gifts, and
- The Illinois Economic Development.

These items are not charitable donations and are not essential in providing utility service.

Furthermore, the Company fails to apply its charitable contribution argument in a consistent manner. Staff witness Pugh proposed an adjustment to remove from the Company's charitable contributions amounts paid to the Illinois High School Association for the March Madness Experience that were of a promotional and goodwill nature designed primarily to bring the utility's name before the general public in such a way as to improve the image of the utility. (ICC Staff Exhibit 5.0, p. 9.) The Company did not contest, for the purposes of this proceeding, the charitable contribution expense adjustment. (IAWC Exhibit R-4.0, p. 2.) However, when Staff took issue with similar amounts listed by the Company as community relations expenses, such costs suddenly become charitable contributions.

Section 9-225(2) of the Act provides:

In any general rate increase requested by any gas or electric utility company under the provisions of this Act, the Commission shall not consider, for the purpose of determining any rate, change, or classification

of costs, any direct or indirect expenditures for promotional, political, institutional or goodwill advertising, unless the Commission finds the advertising to be in the best interest of the Consumer or authorized as provided pursuant to subsection 3 of this Section.

Although Section 9-225(2) is specifically for the purposes of gas and electric utilities, the principle of the concept remains valid for water utilities. Furthermore, the Commission has applied this principle to items other than advertising. The Commission, in its Order in Commonwealth Edison Company's Electric Rate Case, Docket No. 90-0169, recognized the importance of utility companies interfacing with these types of organizations, yet ruled that the shareholders, rather than the ratepayers, should bear the cost of interfacing with such organizations.

The Company criticizes Ms. Pugh because she did not examine each item of community relations expense to make sure that it was not, instead, a charitable donation. (IAWC IB, p. 35.) This point is relevant only to the extent that it is the Company's position that the Commission should not rely upon the veracity of the Company's filing or the integrity of its accounting system. Staff is not aware that the Company has taken such a position. The Company itself identified the costs in question as community relations expenses in its own business plan (ICC Staff Exhibit 5.0, p. 11) and then omitted these costs from its own schedule of charitable donations filed in this proceeding. (IAWC Exhibit 12.0, Schedule C-7.) Unless the Company wishes to call into question the integrity of its filing, its criticism of Ms. Pugh's review is without merit.

The evidence demonstrates that the costs in question are either of a promotional, goodwill or institutional nature; and, accordingly, should not be included in the Company's revenue requirement. The Company's attempt to reclassify these costs as charitable contributions is without merit. Company witness Stafford acknowledged that

these costs are promotional and goodwill in nature. (IAWC Exhibit SR-4.0, p. 3.) Therefore, the Commission should accept Staff's proposed adjustment to reduce the Company's test year community relations amount.

3. Rate Of Return And Cost Of Capital

a. The Commission Should Accept Staff's Recommendations For The Cost Of Long-Term Debt.

Staff continues to differ with the Company regarding the balance and interest costs of the two Bolingbrook debt issues and interest rates for the variable rate debt issues. Staff's Initial Brief detailed flaws in Mr. Ruckman's analysis. In this Reply Brief Staff will expose the spuriousness of the Company's criticisms of Ms. Kight's recommendation for the costs of the debt issues.

i. Bolingbrook Debt

The Company asserts that Ms. Kight did not follow the Commission's findings in Docket No. 01-0001. (IAWC IB, p. 31.) The Order in Docket No. 01-0001 approved neither an acquisition adjustment nor a cost rate of 9.87% for the Bolingbrook debt issues. (Staff IB, p. 59.) This was explained in the rebuttal testimony of Staff witness Thomas Q. Smith. (ICC Staff Exhibit 13.0, pp. 7-8.)

The Company offers many examples in which the Commission used the authorized rate of return as the appropriate financing rate to charge on an investment. (IAWC IB, p. 31.) In the cases IAWC cited in its Initial Brief, the investments were assets, whose specific sources of funding cannot be identified. Thus, an asset is assumed to earn the overall rate of return granted to a company in its most recent rate case. In contrast, the Bolingbrook debt issues are liabilities, not assets. Liabilities are either debt or equity. In this case IAWC's obligation to make payments to Bolingbrook

is debt. The cost of debt is determinable, and does not include the cost of equity in its computation. This was fully explained in Staff's Initial Brief. (Staff IB, pp.58-59.)

ii. Cost Of Variable Rate Debt

The Company contends that a 5-year future average interest rate should be used as the rate for the Company's two variable rate issues. (IAWC IB, pp. 32-33.) Staff's position was fully explained in Staff's Initial Brief. (Staff IB, pp.59-62.) The Company also points out that Ms. Kight said that she would accept updated actual rates. (IAWC IB, p. 33.) However, the Company did not update its data request responses related to this issue before the record was marked "Heard and Taken". See Staff's Motion to Strike, filed May 22, 2003. The evidentiary record indicates that the most recently verified interest rates on the Citizens' debt and the Tax-Exempt debt are 1.25% and 1.20%, respectively. Because the Company did not provide timely supplemental responses to data requests, Staff has not had the opportunity to verify whether the post-record interest rate the Company cites in its Initial Brief are even correct, let alone, reasonable.²

b. The Commission Should Accept Staff's Recommendations Regarding The Cost Of Common Equity.

O'Fallon asserts that if the Commission does not approve the competitive alternative rate agreement, it should rely on the testimony of Charles King in the determination of the rate of return for IAWC. (O'Fallon IB, p. 9.)

i. Sample Selection

Mr. King asserted that the business risk of gas distribution companies is greater

² To assess whether the post-record interest rates are reasonable, Staff would compare them to other concurrent interest rate benchmarks.

than that of water companies. Therefore, gas company returns are not relevant or appropriate, and factoring them into an average leaves the average irrelevant and inappropriate. (O'Fallon Exhibit R1.0, pp. 4-5.) Mr. King's basis for excluding the gas distribution companies is unfounded. S&P business profile scores reflect the operating risk (i.e., business risk) of a utility. S&P focuses on industry characteristics as well as the company's competitive position and management. Utilities' business profiles are evaluated on a scale of one to ten. A rating of one denotes below average business risk. A rating of ten denotes above average business risk. The gas companies in Ms. Kight's utility sample have the same business profile score, and thus the same business risk, as that implied for IAWC. Therefore, S&P's assessment of business risk contradicts Mr. King's contention that gas distribution companies have greater business risk than water utilities. (ICC Staff Exhibit 16.0, p. 10.)

ii. Interest Rate Trends

Mr. King argued that since the interest rates on bonds has declined since IAWC's last rate case, investors' required rate of return on equity likewise should have declined. Mr. King asserted that there is no justification whatsoever for assuming that IAWC's equity cost is higher now than it was two years ago. (O'Fallon Exhibit R-1.0, pp. 3-4.) Staff disagrees with Mr. King's assertion for which he provided no evidence in support. The investor required rate of return is not constant; it changes to reflect the current investment environment. Present investment fundamentals differ markedly from the last IAWC rate case. Today's fundamentals reflect a "bear" market for equities that has entered its third year, the impact of the September 11, 2001 terrorists' attack, the Iraq War, and significant uncertainty concerning future economic growth. (IAWC Exhibit SR-

7.0, p. 2.) All of these factors lead investors to demand higher returns to accept the increased risk associated with investing in equities.

iii. CAPM

Mr. King claimed that the CAPM is only useful in checking the results of other more reliable methods of measuring equity return, such as the DCF procedure. (O'Fallon Exhibit No. 1.0, p. 22.) Mr. King provided no evidence to support his claim that the DCF procedure is more reliable than the CAPM. The Commission has approved the CAPM in numerous rate cases as an appropriate method with which to estimate an investor's required rate of return on equity. The theoretical basis for the CAPM was summarized in Staff's Initial Brief. (Staff IB, p. 62.)

c. **The Commission Should Accept Staff's Overall Cost Of Capital Recommendation.**

The Commission should accept Staff witness Kight's overall cost of capital recommendation. The cost of debt for the Bolingbrook and the variable rate issues were properly calculated and reasonable. In addition, the methodologies Staff used to determine the cost of equity are theoretically valid and Ms. Kight's implementation of those models was well-reasoned and reflected the best available inputs including stock prices, growth rates, and interest rates.

B. COST OF SERVICE AND RATE DESIGN

1. Reply To AG Arguments That Affect All Rate Areas

a. **The AG Is Correct In Stating That The Commission Has Expressly Promoted Movement Toward Single Tariff Pricing ("STP") For IAWC Both Historically And Currently.**

The AG correctly identifies the Commission's apparent recognition of STP. (AG

IB, pp. 4-8.) However, what the AG does not state is that the Commission has not moved toward complete STP. Staff has discussed the differences between the STP groups (i.e., Chicago Metro STP rate area and Southern & Peoria, Streator, and Pontiac rate area) when it comes to source of supply. (ICC Staff Exhibit 17.0, pp. 5-6.) As Staff has discussed extensively, the Commission has not allowed well systems to be included in the STP group (Southern & Peoria, Streator, and Pontiac rate area) because of differences between well and surface water source of supply and treatment costs. (See Order in Docket No. 95-0076.) For example, the minimal treatment facilities needed for well water (generally well water is chlorinated and fluoridated) is substantially less than the investment in surface water treatment plants which must treat water that contains bacteria and suspended solids in addition to other contaminants. Additionally, while there may be common depreciation rates for well and surface systems, those rates are applied to different plant amounts in each area, which would result in different costs in each area. The treatment plants alone would contain substantial costs that well systems would not have. (ICC Staff Exhibit 17.0, p. 6.)

The Chicago Metro rate area has STP customer charges and separate STP consumption charges for lake water, well water, and the Moreland service area. (IAWC Exhibit 14.0, Schedule E-1, pp. 9-11.) The Commission approved STP for the Chicago Metro area in Docket Nos. 95-0181\0182 (Consol.)

The Commission's acceptance of partial STP in certain rate areas, in Staff's opinion, does not constitute an acceptance of complete STP over the whole State especially with respect to source of supply issues. The final Order for the acquisition of the Chicago Metro rate area (Citizens Utilities Company of Illinois) was completed on

May 15, 2001 (Docket No. 00-0476); the final Order for the acquisition of the Lincoln rate area (United Water Illinois, Inc.) was completed on May 10, 2000 (Docket No. 99-0457); and the final Order for the acquisition of the Champaign, Pontiac, Streator, and Sterling rate areas (Northern Illinois Water Company) was completed on March 29, 2000. The Commission has been moving gradually and cautiously towards STP in some of the rate areas; Staff believes it should continue that way. Staff believes that complete statewide STP for different source of supplies should not be allowed.

b. AG Witness Rubin's Perception About Perfect Cost Based Rates Does Not Grasp Reality.

The AG states that IAWC's existing rates deviate substantially from the cost-based rate. (AG IB, p.11.) The AG also suggests that problems with below cost rates would persist under Staff's proposal. Staff discussed the many factors that must be considered when setting rates for utilities in its rebuttal testimony. (ICC Staff Exhibit 17.0, pp. 9-10.)

AG witness Rubin mentions gradualism, fairness, rate moderation, and rate continuity in his direct testimony. (AG Exhibit 1.0, p. 8.) Besides those mentioned by Mr. Rubin, a few other things must also be considered when setting rates such as practicality, customer impact, stability of rates, avoiding undue discrimination, efficiency of rates in discouraging wasteful use, and potential loss of significant customers to competitively priced alternatives for the service needed. Ultimately, perfect cost responsibility by individual or class is difficult. Rate design should weigh many factors during the decision process and then implement those that best fit the utility and situation. For example, Mr. Rubin's Schedules SJR-4, page 5 of 38 and SJR-6, page 5 of 38, show his proposed rate design for the University of Illinois in the Champaign rate

area under the Company's proposed revenue requirement and a hypothetical \$15 million increase. His proposal is for four consumption blocks. However, the University of Illinois has an agreement with IAWC that calls for a fifth consumption block. (Docket No. 97-0254). Staff is unsure of the implications for the agreement if the fifth block is eliminated.

Additionally, the Company's Southern Division has an industrial competitive rate and an other water utility competitive rate that are under contract. Many times utilities offer competitive rates to large customers to keep them on the system to the benefit of all customers, however, the rates charged may be below cost of service ("COS"). The effect of this is that remaining customers must contribute more to cover the shortfall in revenues caused by the lower rate offered to competitive customers. If large customers were allowed to leave because of an alternative water supply, remaining customers would have to pay a much larger share of revenues resulting in substantial rate increases.

The purpose of these examples is to show that many variables are present when designing rates. The analyst must consider these variables and then design rates to meet the challenges that they offer. Staff has consistently attempted to set rates that recover COS by class taking into consideration the many variables associated with each case. While below cost rates may occur, as discussed above, there are good reasons why some rates are set at below cost to the benefit of all.

c. The AG's Advocacy Of An Overall STP For All Rate Areas Fails To Account For The Differences Inherent In District Specific Issues Related To Source Of Supply.

The AG suggests that since expenses continue to be centrally incurred, it makes

individual cost of service studies for each district more cumbersome and less reliable. (AG IB, p. 12.) If the AG wants to examine what constitutes cumbersome, it should have attempted to perform its own cost of service study and experienced the workings of the very large COS study associated with the STP rate area of Southern & Peoria, Streator, and Pontiac. It is one thing to assume, theoretically, that since some expenses are centrally incurred that charges should be similar, and another thing to see if that theory holds up to reality. If, as AG witness Rubin believes, many costs are incurred centrally such as billing and customer service, as time goes on customer charges for each rate area should start to parallel each other. That is the reality check of the AG's suggestion. Staff agrees that if common ownership exists then many costs should be similar, especially on the customer charge side. However, there are differences from a source of supply and treatment perspective that will always exist and create differences in usage charges. There are other differences as well. For example, in Docket No. 94-0481, the Commission found that the characteristics and COS for the Moreland district, which is in the Chicago Metro rate area, were sufficiently different from the remaining lake systems to warrant rejection of complete STP. Specifically, the Company had no investment in pumping, storage, treatment and source of supply plant in the Moreland district. (ICC Staff Exhibit 17.0, p. 7.)

Additionally, the AG claims that it cannot quite figure out why large volume users may pay different rates depending on where they are located within the IAWC system. (AG IB, p. 11.) Again, each district has different sources of supply that affect costs. Each rate area has various projects, such as main replacement, that vary depending on how serious the replacement needs are. Certain rate areas may have competitive rates

that call for certain levels of charges depending on such factors as the ability to bypass or, as in the case of the University of Illinois, an agreement for a fifth rate block. (ICC Staff Exhibit 17.0, pp. 9-10.)

d. The AG's Suggestion That Its Rate Proposal Is Tempered By Gradualism, Rate Continuity And Fairness Is Far From The Truth.

Under Staff's direct testimony proposal, the Pekin rate area would see an overall decrease in its revenue requirement (-3.08%). (ICC Staff Exhibit 1.0, Schedule 1.1-P.) According to AG witness Rubin's Schedule SJR-R4, the Pekin rate area will see an overall revenue increase of 14.5% under Staff's proposed revenue requirement. On cross-examination Mr. Rubin was asked the following question:

- Q.** Would you agree that since you are proposing to recover more revenues from Pekin customers than Staff's proposed revenue requirement calls for, that your rate design proposal shifts costs from one or more rate areas to the Pekin rate area?
- A.** It shifts costs if we accept the Staff's revenue requirement, and by that I mean the Staff's revenue requirement specifically for Pekin."

(Tr., pp. 313-314.)

It is apparent that the Pekin rate area customers would not be treated fairly under the AG's proposal with Staff's proposed revenue requirement. It is unknown what the AG increase for the Pekin customers would be under Staff's latest revenue requirement or what it will be under the Commission's final revenue requirement. Nevertheless, this is a good example of what can happen to a rate area with a well system when it is incorporated into STP with surface water rate areas. Staff's COS studies are consistent with past cases in that they use the same allocation factors, demand factors, and each uses the Base-Extra Capacity method of cost allocation to distribute costs to customer classes.

No other party has offered a COS study in this proceeding. AG witness Rubin complains about the costs allocated to fire protection. (AG IB, p. 20.) Staff's fire protection charges are based on the same methodology used and approved in the last case (ICC Staff Exhibit 7.0, p. 10; ICC Staff Exhibit 8.0, pp. 3-4; ICC Staff Exhibit 9.0, p. 4), except for the Chicago Metro water rate area which did not use Staff's COS study in its last case. Nothing has changed in Staff's COS studies (a new uniform system of accounts has been incorporated into Staff's COS study since the Pekin and Lincoln rate areas filed rate cases, all other districts used the new uniform system of accounts in their last cases) just the numbers provided by the Company. A thorough examination of Staff's COS studies by Mr. Rubin would have led him to notice that fire protection costs include not just direct costs such as hydrant costs, but also base, max day, max hour, and billing costs. (Staff IB, Appendix B, Schedule 1.0-P, p. 12, Schedule 1.0-C, p. 12, and Schedule 1.0-S/P/St., p. 12.) Actual hydrant costs may not have increased but fire protection must take into account that, for example, mains and storage must be in place to not only meet regular system demands, but also the added demands of fighting a fire. Any addition to either mains, storage, or any other max hour, max day, base, and billing expense will add to fire protection costs. Section 9-223 of the Act states that any fire protection charge imposed shall reflect the costs associated with providing fire service. Mr. Rubin provides criticism but has not provided a COS study to determine fire protection charges nor has he even defended his position by proposing an alternative. (Staff IB, p. 70.)

The AG describes Staff's COS studies as having major inconsistent changes in the 5/8 inch meter costs. (AG IB, p. 21.) Staff's COS studies all use the same meter

ratios, found on the equivalent meter ratio schedule attached to each COS, to determine customer charges. (Staff IB, Appendix B, Schedule 1.0-P, p. 15, Schedule 1.0-C, p. 15, and Schedule 1.0-S/P/St., p. 16.) These ratios were used, and approved by the Commission, in the last rate cases for each rate area and have been used by Staff on countless cases. The meter ratios are taken from the AWWA Water Meters-Selection, Installation, Testing, and Maintenance Manual (M6), 1972 pages 32-33. (ICC Staff Exhibit 7.0, p. 13.)

The AG claims that it cannot understand why the cost of billing a Lincoln customer would be more than that of a Pontiac or Streator customer. (AG IB, p. 21.) The Lincoln rate area was acquired by IAWC on May 10, 2000 and has not filed a rate case since Docket No. 94-0183. The costs of providing service are simply not the same for Lincoln as other districts when the other districts have filed rate cases as recently as 2000 and Lincoln has costs and investments that have been put off since 1995. There should be cost differences. However, as Staff witness Johnson pointed out customer charges for each rate area should start to parallel each other as time goes on. (Staff IB, p. 71.)

e. The AG's Obvious Tilt Towards Residential Customers Leads It To Mischaracterize Staff's Small Main Adjustment.

The AG claims that Staff's small main adjustment lacks a solid theoretical basis and unfairly distorts the results of the COS studies to the benefit of large users. (AG IB, p. 22). Yet, AG witness Rubin states in rebuttal testimony that he does not have enough information to either agree or disagree with the theory as it applies to IAWC. (AG Exhibit 2.0, p. 12.) The Commission in IAWC rate case, Docket No. 90-0100,

approved Staff's small main adjustment. Staff agreed with the concept of a small main adjustment in that case, which was initiated by an IAWC witness. Staff has used the small main adjustment in its COS study, for pertinent areas, since its inception in Docket No. 90-0100. (Staff IB, p. 71.) Thus, the "theoretical foundation" is grounded in prior Commission approval.

The AG notes that, in theory, large volume users may not take service from small mains, but in fact a significant portion of IAWC's large customers take service from meters that are one inch or smaller. (AG IB, p. 22.) Again, the AG has made innuendos and false claims without bothering to take the time to examine the issue thoroughly. If the AG had examined the COS study, it would have noticed that the shift in costs from large users to small users ends up in the usage charge rates for the first two blocks. If, as the AG claims, large customers are taking service from meters that are one inch or smaller then they are more than likely just using enough water to fall into the first two usage blocks. In that case, they are paying the same rates as smaller customers. Even large users must pass through the first two blocks in order to get to the lower priced blocks. So in essence, if the majority of usage is in the first two blocks, no matter what class the customer is in (residential or industrial), they will pay for the largest customers on the system who do not make use of the small mains.

f. AG Witness Rubin's Rate Design Is A Radical Departure From The Cautious But Well Contemplated Movement Toward STP Followed By The Commission In Past Cases, And Should Be Rejected By The Commission.

AG witness Rubin stated that his proposal does not result in uniform rates – only a standardized rate structure and his consumption rates reflect the cost of water in the various rate areas. (AG IB, p. 26.) As discussed earlier with reference to the Pekin rate

area, Mr. Rubin himself admits that his proposal shifts costs from one rate area to another. (Tr., pp. 313-314.) As much as Mr. Rubin wants to lead everyone into believing that his proposal is not a move towards complete STP, the results lead to a different conclusion. The AG suggests that its rates will allow the Commission to set a unified rate or different rates in different districts in future cases. However, if the AG's current proposal is to shift costs from non-STP rate areas to STP rate areas, then the move toward complete STP has begun. Those rate areas that are not in a STP rate area will have STP costs included in their revenue requirement. They would no longer be district specific (independent) rate areas and the sudden shift in costs and rates that would occur if the Commission decided that they should not be part of the STP rate area would undermine all rate design principles. The Commission should reject the AG's proposal outright since it clearly transcends past Commission decisions and is at a minimum murky with respect to how it would affect future proceedings.

2. Champaign And Sterling Rate Areas

a. Reply To IAWC

i. The Standby Rates For The Champaign And Sterling Rate Areas Should Not Be Increased, But Instead, Left Alone Until Further Experience Has Been Obtained.

The Company recommends an increase in the standby rate for the Champaign and Sterling rate areas so that the rates will not become seriously outdated. (IAWC IB, p. 58.) The Company is proposing to increase the standby rates using the same method used for all other rates of across-the-board revisions to all rates for all rate areas in accordance with revenue requirements applicable to each rate area. Staff proposed to leave the standby rate the same in the Champaign and Sterling rate areas

based on the Commission's Order in the last rate case for this utility, since no further experience has been obtained in the two rate areas. There are currently no customers on standby rates for the Champaign or Sterling rate areas. Staff still stands by its original recommendation of no increase for Standby rates in the Champaign and Sterling rate areas.

3. Lincoln Rate Area

a. Reply To City Of Lincoln

i. Staff's Proposed Rates For The Lincoln Rate Area Should Be Accepted By The Commission Because Of Their Adherence To COS Principles.

The Cities of Lincoln and Streator claim to be troubled by the magnitude of the increase in revenue requirement proposed by Staff. (Lincoln/Streator IB, p. 1.) Staff determined all rates for each individual rate area based on separate COS studies and no comparisons were made to other rate areas to determine rate design for the City of Lincoln or any other rate area. Staff's residential increase for Lincoln is higher than other rate classes because the residential class is still below cost of service by over 21% and other rate classes are either over their cost of service or are within 5% of the cost of service for their class.

4. Southern Division, Peoria District, And Streator District

Staff discussed its COS study and rates for IAWC's Southern Division, Peoria District, and Streator District ("S/P/St."). (Staff IB, pp. 81-87, Appendix B, Schedules 1 and 2 – S/P/St.) Three parties disagreed with Staff's COS study and rates. They were the Large Water Consumers (LWC IB, pp. 16-23), the AG, (AG IB, pp. 3-27), and the Cities of Lincoln and Streator (Lincoln/Streator IB, pp.3-7). IAWC generally agreed with

Staff's approach for rate design and had no specific recommended changes for the S/P/St. billing area. (IAWC IB, pp. 58-59.)

The perspective of each party that disagrees with Staff's COS study and rates differs and is largely, if not completely, irreconcilable with the perspective of other parties. LWC criticizes Staff's COS study and rates as too heavily weighted toward industrial and other large-volume customers, with the result that residential and smaller commercial customers should pay more of the IAWC revenue requirement through higher rates. The AG, on the other hand, criticizes Staff's COS studies and rates as being too heavily weighted toward residential and commercial customers, with the result that industrial and other large-volume customers should pay more of the IAWC revenue requirement through higher rates. Lincoln and Streator criticize Staff's COS studies and rates for raising rates by too high of a percentage in their service areas, and would leave other service areas to pick up the tab through higher rates. It is therefore impossible for the Staff and the Commission to mollify the interests of each party criticizing Staff's COS study and rates. Staff's COS study and rate design is the most balanced and objective perspective, and should be accepted by the Commission as the basis for determining rates in this docket.

a. Reply To LWC

i. LWC's Criticism Of Staff's COS Study And Rate Design For The Southern Division, Peoria District, And Streator District Is Exaggerated.

LWC casually and liberally tosses around some version of the words "severely flawed" in characterizing Staff's COS study and rates. (LWC IB, pp. 16-19.) LWC's criticism is itself severely flawed in that it lacks an alternative COS study and rates.

LWC's alternative is the across-the-board percentage increase proposed by the Company in its direct testimony, which is an alternative that the Company is no longer actively pursuing with the Company's general support of Staff's cost of service study and rate design. (IAWC IB, p. 58.) The Company did not suggest any changes in Staff's rate design for S/P/St, so the Commission should not give any weight to the LWC's suggestion to implement the Company's across-the-board proposal that the Company is no longer actively pursuing.

In addition, LWC's suggestion to implement the Company's original across-the-board percentage increase is contradictory when considering that LWC's characterization of Staff's COS study and rates as "severely flawed" is based upon Staff's use of demand factors from Docket No. 00-0340. Part of the Company's reasoning behind proposing an across-the-board increase was that current rates are based upon a COS study that is only three years old for S/P/St. (IAWC Exhibit 4.0, p. 8.) Staff's COS study in the present docket uses the same demand factors as the COS study that served as the basis for current Southern and Peoria rates, which are the same demand factors that the LWC characterizes as "stale" and "severely flawed", yet the COS study from Docket No. 00-0340 would also serve as the basis for an across-the-board increase. The Commission should reject the contradictory reasoning behind LWC's isolated support for the Company's since-abandoned proposed across-the-board increase, and accept Staff's approach in determining cost of service and rate design.

LWC complains that the demand factors in Staff's COS study were not changed to include the effects of the addition of Streator to the Southern Division and Peoria District in determining cost of service. Technically, LWC is correct because Staff did not

change the demand factors in the S/P/St. COS study as a result of Streator's addition to the Southern Division and Peoria District in determining cost of service. On a practical basis, however, the effect of Streator on the demand factors is immaterial. The allocation factors that are based upon demand factors for the customer groups were adjusted to include the effects of Streator usage, as demonstrated by comparing ICC Staff Exhibit 8.0 – S & P, page 11 with ICC Staff Exhibit 18.0 (Revised), Schedule 18.1 – S/P/St. (Revised), page 11. The industrial Maximum Day percentage increased to 10.39% from 10.27% and the industrial Maximum Hour percentage increased to 8.41% from 8.29%. Both increases totaled only 0.12% when subtracting 10.27 from 10.39 and subtracting 8.29 from 8.41. The change in the Southern and Peoria industrial allocation of Maximum Day and Maximum Hour costs are not, therefore, severely overstated with the addition of Streator.

Streator added only 4.6% more industrial billing units (4,093,237 – from ICC Staff Exhibit 18.0 (Revised), Schedule 18.1 – S/P/St. (Revised), page 1, divided by 3,914,062 – from ICC Staff Exhibit 8.0 – S & P, page 1), so an adjustment of demand factors would properly weight Southern and Peoria industrial demand factors at 95.4% and Streator 4.6%.

The Southern and Peoria Maximum Day and Maximum Hour industrial demand factors are 1.65 and 2.00 respectively. (ICC Staff Exhibit 8.0 – S & P, p. 3.) Streator Maximum Day and Maximum Hour industrial demand factors are 1.50 and 1.75 respectively (ICC Staff Exhibit 8.0 – Streator, p. 3), which represent differences of 10 and 15% from the comparable Southern and Peoria Maximum Day and Maximum Hour industrial demand factors. With a Streator weighting factor of 4.6%, the reduction in the

combined S/P/St. industrial Maximum Day demand factor from the Staff COS study would be .0046 (4.6% multiplied by 10%), and the reduction in the Maximum Hour demand factor from Staff's COS study would be .0069 (4.6% multiplied by 15%). Adjusting the Maximum Day and Maximum Hour costs to include weighted Streator effects, industrial Maximum Day costs would be 10.34% (1 minus .0046, or .9954, multiplied by 10.39% in Staff's COS study), and industrial Maximum Hour costs would be 8.37% (1 minus .0069, or .9931, multiplied by 8.41% in Staff's COS study). LWC's complaints would therefore result in reductions in the recovery of Maximum Day and Maximum Hour costs from industrial customers of five-one hundredths of one percent and four-one hundredths of one percent respectively. Simply put, LWC's criticism of Staff's COS study is more hypercritical than it is pointing out a "severe flaw."

LWC expresses its "concern" for IAWC's competitive situation and the effects upon other customer classes in attempting to sell its request for lower rates at the expense of other customer classes. (LWC IB, p. 18.) Since Industrial, Other Public Authority, and Other Public Utility customers would not fully pay cost of service through Staff's proposed rates, and would pay less under an across-the-board increase supported by LWC, LWC's denigration of the Staff COS study is an obvious attempt to exaggerate a trivial observation to advance LWC's self-interest. The Commission should recognize that LWC's "concern" for IAWC and other customer classes is nothing more than a self-interested attempt to secure lower rates at the expense of those other customer classes, and should disregard LWC's recommended across-the-board increase.

b. Reply To AG**i. Staff's Proposed Rates For The Streator District Are Reduced As A Result Of Single Tariff Pricing And Do Not Result In Higher Rates For A Streator District Customer Compared To A Similar Southern Division Customer.**

The AG contends that Staff's addition of Streator to the STP group that includes the Southern Division and Peoria District somehow violates the purposes of STP because Staff rates would result in an increase of 42.1% to Streator. (AG IB, p. 18.) Since the percentage increase noted by the AG is based upon Staff's proposed rates in direct testimony (ICC Staff Exhibit 8.0 - Streator, p. 2, \$4,036,475 Staff Total Revenues divided by \$2,840,168 Present Total Revenues), Staff's proposed rates in rebuttal testimony supercede rates proposed by Staff in direct testimony. Staff's proposed rates for the Streator District are reduced by the inclusion of Streator in the STP group for fire protection.

Regardless of whether Streator is treated on a stand-alone basis for fire protection or whether Streator is included in the STP group for fire protection, the AG's observation on the percentage of the Streator increase ignores the fact that Streator customers would pay no more than comparable Southern Division customers for customer charges and usage charges, and that Streator customer charges and usage charges would have been higher if Streator had been treated entirely on a stand-alone basis. Streator had a stand-alone revenue requirement of \$4,490,282. (ICC Staff Exhibit 8.0 – Streator, p. 10, DIRECT CUSTOMER REVENUES line, Net Cost column.) Staff's proposed rates in direct testimony that treated Streator on a stand-alone basis for fire protection, with the same customer charge and usage charges as the Southern

Division and Peoria District, resulted in Streator revenues totaling \$4,036,475 (ICC Staff Exhibit 8.0 – Streator, p. 2, Staff Total Revenues), which is \$453,807 less than Streator’s \$4,490,282 cost of service at the time of filing direct testimony. Staff’s proposed rebuttal rates reduce Streator fire protection rates by including Streator in the STP group for fire protection as well as for customer charges and usage charges, which increases the benefits to Streator from STP. Despite STP, Streator incurs a greater increase than the Southern Division and Peoria District because Streator rates are currently lower than Southern Division and Peoria District rates. Instead of inflating the Streator increase, however, as the AG appears to suggest, STP buffers the increase.

ii. Staff’s Proposed Rates Do Not Undercharge Industrial Customers In The S/P/St. Billing Group.

The AG also describes its belief that Staff’s proposed rates undercharge industrial customers. (AG IB, p. 25). The AG references AG Exhibit 2.0, Schedule SJR-R7 prepared by Mr. Rubin. The comparison of the \$1.2861 average rate per CCF that Staff’s proposed rates from direct testimony would recover from Southern and Peoria industrial customers to an average \$1.5532 per CCF cost of service calculated by AG witness Rubin includes competitive customers in the calculation of the average rate per CCF. Eliminating usage under competitive rates reduces industrial CCF to 2,578,641 and industrial revenues to \$3,965,178. (AG Exhibit SJR-R7, p. 2.) \$3,965,178 divided by 2,578,641 CCF equals an average of \$1.5377 per CCF, which is 99% of \$1.5532. Since competitive rates are set by contract and are not subject to rate design in this docket, it is appropriate to compare Staff proposals for full tariff industrial customers in determining whether Staff-proposed rates appropriately recover cost of service from various customer classes.

Staff's proposed rates would increase S/P/St. industrial revenues by 20.7%. (Staff IB, Appendix B, Schedule 1 – S/P/St., p. 2.) Staff's proposed increase to full tariff industrial customers is actually larger than 20.7% because industrial revenues include competitive revenues that are only 9.1% higher under contract. (Id., p. 2, USAGE CHARGES, Industrial Competitive, \$0.8519 divided by \$0.7811.) Residential and commercial revenues increase 10% and 14.9% under Staff's proposed rates, respectively, less than the industrial revenues increase. At 99% of cost of service for industrial customers that do not have a competitive rate, and with a greater than a 20.7% increase, Staff's proposed S/P/St. rates are reasonable and do not represent favorable treatment for industrial customers relative to other customer classes.

c. Reply To City Of Streator

i. Since Current Streator Rates Are Lower Than Current Rates For Other Customers In The STP Group, Staff's Proposed Increase In Streator Rates Is Greater Than The Increase For Other Customers In The STP Group, But Would Have Been Higher If Streator Rates Had Been Determined On A Stand-Alone Basis.

The City of Streator, along with the City of Lincoln, objects to the increase in rates proposed by Staff. (Lincoln/Streator IB, pp. 3-6.) The Staff-proposed increase in Streator rates is greater than the Staff-proposed increase for the Southern Division and Peoria District, but the Streator rates are no higher than the Southern Division. Current Streator rates are lower than current Southern Division rates, which results in a greater increase for Streator customers when adding Streator to the STP group.

In direct testimony, Staff capped Streator customer charges and usage charges at Southern Division rates, which resulted in an under-recovery from the Streator

District. (Streator cost of service of \$4,490,282 at ICC Staff Exhibit 8.0 – Streator, p. 10, DIRECT CUSTOMER REVENUES line, Net Cost column compared to Streator revenues under Staff's proposed rates in direct testimony of \$4,036,475 at ICC Staff Exhibit 8.0 – Streator, p. 2, Staff Total Revenues.) If Streator remained a stand-alone billing area, Staff's proposed Streator rates would have been more than Staff's proposed rates with Streator included in the STP group. If Streator rates were to be artificially capped at lower than the STP group, rates in other districts would have to be artificially raised above cost of service in order to provide the Company with an opportunity to recover its cost of service. Since Streator rates are reduced under STP compared to stand-alone rates, Staff's inclusion of Streator in the STP group is reasonable and does not cause inflated rates at Streator.

5. Chicago Metro Sewer Rate Area

a. Response To IAWC

i. The Commission Should Only Allow The Company To Recover Revenues Equal To The Company Requested Rates In The Chicago Metro Sewer Rate Area.

The Company recommends that Staff design rates to recover the total revenue requirement determined in this case. (IAWC IB, p. 59.) When IAWC filed its rate case, specific rates were proposed in order to collect the revenue requirement requested. Staff and intervenors, including customers, assumed that the revenues requested, which is the proposed billing units multiplied by proposed rates, were the highest that would be allowed. Staff, however, found some inconsistencies that included adjustments to billing units. Additionally, the Company inadvertently used different rates for the residential multi-unit customers, than those filed, when calculating total

revenues. (ICC Staff Exhibit 7.0, pp. 20-23.) When the Company filed its proposed rates with the Commission, it set into motion a request for specific rates. If the Commission had not suspended the filing, the requested rates would have gone into effect. It is Staff's position that the Company's filed rates multiplied by pro forma billing units are now the revenue requirement for the Chicago Metro sewer rate area. This issue was addressed in the Order for Docket Nos. 00-0513/00-0514 (Consol.). In that case, Staff's revenue requirement was higher than the Company's proposed revenue requirement but the final rates were designed based upon the filed tariffs. (Order, Docket No. 00-0513/00-0514 (Consol.), p. 12.)

III. CONCLUSION

For the reasons set forth in its Initial Brief and this Reply Brief, Staff of the Illinois Commerce Commission respectfully requests that the Commission's Order reflect Staff's modifications to the Company's proposed general increase in rates as presented in Appendices A and B to its Initial Brief.

Respectfully submitted,



STEVEN L. MATRISCH
LINDA M. BUELL

Counsel for the Staff of the
Illinois Commerce Commission

STEVEN L. MATRISCH
LINDA M. BUELL
Office of General Counsel
Illinois Commerce Commission
527 East Capitol Avenue
Springfield, IL 62701
smatrisc@icc.state.il.us
(217)785-3808
<mailto:lbuell@icc.state.il.us>
(217)557-1142
Fax: 217-524-8928