

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

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

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

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Pursuant to 83 Ill. Adm. Code 200.830, Staff of the Illinois Commerce Commission (“Staff”), by and through its attorneys, hereby files its Reply Brief on Exceptions to the June 25, 2003 Proposed Order (“Proposed Order”) issued in this proceeding. Briefs on Exceptions (“BOE”) were filed on July 3, 2003 by Illinois-American Water Company (“IAWC”, “Illinois-American” or “Company”), Large Water Consumers (“LWC”), Attorney General on behalf of the People of the State of Illinois (“AG”), Cities of Lincoln and Streator (“Lincoln/Streator”), City of O’Fallon, the Village of Bolingbrook (“Bolingbrook”) and Staff.

I. RATE BASE ISSUE DISCUSSION

A. The Proposed Order Reaches The Proper Conclusion Regarding The Company’s Cash Working Capital Requirement.

LWC takes exception to the Proposed Order’s rejection of LWC’s proposed adjustments to the Company’s calculation of its cash working capital requirement. (LWC BOE, pp. 3-5.) However, the very arguments that LWC makes demonstrate that the Proposed Order’s conclusions about the Company’s cash working capital requirements are correct.

LWC states:

The record shows that IAWC included items of operating expense in its test year working capital, which it could not reasonably claim were paid ahead of the point in time it received revenue to pay the expense. Absent a lag between the time IAWC pays the expense and receives the revenues from its customers, there is no need to carry an amount of cash on hand to pay these expenses. (LWC BOE, p. 3.)

Essentially, LWC argues that the Commission should consider, for specific items, the timing difference between when the Company pays its bills and when its customers pay the Company. Staff agrees with LWC that this is a legitimate approach to calculating a company's working capital requirement; however, the difficulty is that LWC applied its reasoning only to selected items of the Company's operations rather than to all relevant items as a full lead-lag study would do.

LWC's arguments only serve to demonstrate that Staff witness Pugh was correct in her assessment that:

Adjusting the 1/8th method for these selected items in isolation would not necessarily produce a more accurate cash working capital requirement. This is because doing so would not consider all other changes that might be appropriate. An analysis of the operating expenses in aggregate would determine the lead-lag of these specific issues as well as all operating expenses and revenues. This analysis is a lead-lag study that Mr. Gorman and Staff are recommending the Company perform in its next rate case. (ICC Staff Exhibit 15.0, p. 5.)

For this reason, Staff recommends that the Commission let stand the Proposed Order's conclusions regarding the Company's cash working capital requirement.

B. The Commission Should Let Stand The Proposed Order's Conclusions Regarding The Company's Lead-Lag Study.

The Company takes exception to the Proposed Order's conclusion that if the Company elects to request a positive amount for cash working capital in rate base in its next rate filing, it will be required to include a lead-lag study in that filing. (IAWC BOE, pp. 51-53.) IAWC contends that the Proposed Order's conclusion is unsupported in the evidence and contrary to prior Commission Orders. (IAWC BOE, p. 51.)

Staff disagrees with the Company in both respects. First, there is sufficient evidence to support the Proposed Order's conclusion. The very definition of a lead-lag study is that it more accurately establishes the amount that the 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. The fact that the established amount is more accurate is beneficial to the Company. The Company should only want to require the investors to fund the most accurately estimated amount for the cash working capital requirement.

Second, the fact that the Company has expanded its territory and operations through various mergers and acquisitions since its last rate case demonstrates the need for a more comprehensive lead-lag study. In a prior IAWC rate case, the Commission concluded that a lead-lag study could be examined in future rate cases. (Order, Docket No. 95-0076, p. 20.) Mr. 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 has had two rate cases (Docket Nos. 97-0102 and 00-0340) since Docket No. 95-0076. Therefore, the conclusion in Docket No. 95-0076 that a lead-lag study could be examined in the future demonstrates that the conclusion drawn in this Proposed Order is appropriate.

Finally, the Proposed Order is not contrary to prior Commission Orders. As previously stated, the Commission in Docket No. 95-0076 specifically contemplated the use of a lead-lag study in IAWC's next rate proceeding. Furthermore, in Docket No. 89-0276, the Commission ordered Illinois Power Company to present a lead-lag study in its next rate proceeding, as has been recommended for IAWC in this proceeding. (Order, Docket No. 89-0276, p. 94.) 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. The most important objective is to determine a reasonable amount of cash working capital, which would be achieved through the preparation and review of a lead-lag study in IAWC's next rate filing.

For these reasons, the Proposed Order reaches the correct conclusion regarding the Company's requirement to include a lead-lag study in its next rate filing if the Company requests a positive cash working capital allowance.

II. OPERATING REVENUES AND EXPENSES ISSUE DISCUSSION

A. The Proposed Order Correctly Concludes That Staff's Adjustment To Disallow Incentive Compensation Plan Amounts That Are Based On Financial Goals Is Appropriate.

1. No Demonstration of Net Benefits

The Company persists in its unsupported claim that the benefits of incentive compensation outweigh the costs. (IAWC BOE, p. 47.) IAWC is in fact attempting to place the burden of proof on the Commission to distinguish between two prior Orders where the Commission allowed incentive compensation after the respective companies

had shown that net benefits were achieved through incentive compensation plans. (IAWC BOE, p. 48.) However, the Company conveniently ignores one critical point; the Company has demonstrated no net benefits in this case. Therefore, the Proposed Order correctly concludes that the Company has provided no evidence to support the Company's claim that it provided evidence of net benefit in the record in this docket.

2. Prior Commission Orders

The Company offers two prior Commission Orders that allowed incentive compensation as support for its position. (IAWC BOE, p. 48.) Staff noted in its Reply Brief ("RB") that in the following Dockets the Commission supported Staff's proposed disallowance of incentive compensation that is based on financial goals: 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. (Staff BOE, p. 24; ICC Staff Exhibit 12.0, p. 15; Staff Initial Brief pp. 52-53.) In addition, the Proposed Order correctly takes into consideration that in many recent cases, such as the rate Orders in Docket Nos. 01-0465/01-0530/01-0637 (Cons.) entered March 28, 2002 and Docket No. 00-0802, entered December 11, 2001, and the rate Order in Docket Nos. 99-0199/99-0131 (Cons.), the Commission has consistently disallowed recovery of payouts that are tied to overall company financial goals.

The Proposed Order correctly concludes that Staff's adjustment to disallow those incentive compensation plan amounts that are based on financial performance goals is appropriate.

B. The Proposed Order Reaches The Correct Conclusion Regarding The Company's Recovery Of Community Relations Expenses.

The Company takes exception to the Proposed Order's acceptance of Staff's proposed adjustment to the Company's Community Relations expenses. The Company states that disallowance of these items is contrary to the evidence and to Section 9-227 of the Public Utilities Act ("Act"). (IAWC BOE, pp. 49-51.)

Staff strongly disagrees with the Company's assessment of the Community Relations expenses for two reasons. First, the Company continues to characterize these items as charitable contributions. These items were not listed on Schedule C-7, Charitable Contributions, in the Company's initial filing. They were itemized separately on a Business Plan schedule titled "Community Relations". The Company did not characterize these items as charitable contributions until Staff took issue with them. (Staff RB, p. 32.) The Company's attempt to reclassify these costs as charitable contributions is without merit and it should be given no weight by the Commission.

Additionally, the items listed on the Community Relations schedule 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 RB, p. 33.) The Company itself identified the costs in question as community relations expenses in its own business plan. Company witness Stafford acknowledged that these items are of a promotional and goodwill nature. (IAWC Exhibit SR-4.0, p. 3.) Staff notes that 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. (220 ILCS 5/9-225(2).)

Although Section 9-225(2) of the Act refers specifically to gas and electric utilities, the principle of the concept remains valid for water utilities. 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 determined that shareholders, rather than ratepayers, should bear the cost of interfacing with such organizations. (Staff RB, p. 34.)

The Company argues that the donations are recoverable under Section 9-227 of the Act. (IAWC BOE, p. 50.) Notwithstanding the Company'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. Furthermore, the Company fails to apply its charitable contributions argument in a consistent manner. Staff witness Pugh proposed an adjustment to remove 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. (Staff RB, p. 33; ICC Staff Exhibit 5.0, p. 9.) The Company did not contest, for the purposes of this proceeding, the charitable contributions expense adjustment at IAWC Exhibit R-4.0, p. 2. However, when Staff takes issue with similar amounts listed by the Company as community relations expenses, such costs suddenly become charitable contributions. (Staff RB, p. 33.)

Essentially, the Company would have the Commission find that payments for Illini football and basketball tickets constitute charitable contributions. (Tr., p. 152.) 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 operating expenses recoverable in base rates.

For these reasons, Staff recommends that the Commission let stand the Proposed Order's conclusions regarding the adjustment to Community Relations Expense.

C. The Proposed Order Correctly Concludes That IAWC's Operating Agreements Should Be Reviewed By The Commission.

IAWC argues that the effect of the Proposed Order is to rescind the Order in Docket No. 88-0303 wherein the Company's operating agreement was approved. (IAWC BOE, p. 56.) This is not an accurate reflection of the Proposed Order. The Proposed Order states that the operating agreement should be brought before the Commission for review; it has not ordered that the Company consider the agreement null and void or ordered the Company to cease using the current operating agreement in the interim.

D. The Proposed Order Correctly Refuses To Adopt Lincoln/Streator's Merger Savings Argument.

The Proposed Order correctly concludes that Lincoln and Streator's proposal for an accounting of merger savings arising from Docket No. 99-0457 should not be adopted. Lincoln and Streator make the assertion that the merger savings promised to Lincoln in the Commission's Order in Docket No. 99-0457 were not passed on to ratepayers and that the total is in excess of one million dollars. (Lincoln/Streator BOE,

p. 2.) As Staff stated in its Reply Brief, 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.

Lincoln/Streator mischaracterizes the response given by Staff to its question regarding the ultimate disposition of merger savings resulting from Docket No. 99-0457 by indicating that the Company has been unwilling or unable to quantify savings. (Lincoln/Streator BOE, p. 3.) A response by Staff to a Lincoln/Streator data request stated that it was Staff's understanding that the Order in Docket No. 99-0457 directed that:

...all merger savings included in data for the rate case test year should be reflected in rates and, thereby, allocated to ratepayers...

It is also Ms. Everson's understanding that under traditional cost of service-based ratemaking that all savings accrue to the ratepayers. Further, it is Ms. Everson's understanding that these savings therefore, were reflected in the revenue requirement schedules provided by IAWC and thus the savings are reflected in the revenue requirement schedules adjusted by Staff. Since the Order in Docket 99-0457 does not specifically state that an amount will be calculated, it is Ms. Everson's understanding that no separate amount was identified by IAWC and communicated to Staff. (Lincoln Cross Exhibit 1.)

Lincoln/Streator's arguments demonstrate a misunderstanding of the effect of savings in traditional cost of service-based ratemaking and confuse what was ordered in Docket No. 99-0457 with the situation that occurred in the CUCI merger. (Docket No. 00-0476, Order entered May 15, 2001.) 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. (Staff RB, pp. 25-26.)

The Proposed Order properly concludes that any savings would already be reflected in the form of lower costs incurred and recorded on the Company’s books and that no adjustment for merger savings resulting from Docket No. 99-0457 is necessary in the current proceeding.

E. The Proposed Order’s Conclusions Regarding Security Related Issues Should Be Adopted.

1. Test Year Level of Security Related Expenses

The Proposed Order correctly approves the test year level of security costs of \$5,313,530 as proposed by Staff. (Proposed Order, p. 38.) The Lincoln/Streator Brief on Exceptions states that test year security costs should be eliminated or significantly reduced. (Lincoln/Streator BOE, p. 5.) Lincoln/Streator continues to contend that only salary costs should be considered. Staff disagrees. The fair and reasonable costs for security guards must include both the guard salary costs and the other costs incurred to recruit, train, equip, and manage the guard force. (Tr., pp. 587-588.)

The Large Water Consumers’ exceptions to the Proposed Order state that the test year security expenses are overstated because of double counting of certain security related costs in relation to the Company’s labor expense and management

fees. (LWC BOE, p. 9.) Staff disagrees. Staff's recommended costs, which are the basis for the security costs provided in the Proposed Order, specifically exclude costs of IAWC current employees for monitoring and sampling. Staff found no double counting in its analysis. Therefore, the Proposed Order's conclusion was correct and should remain unchanged.

2. Allocation Of Test Year Security Costs

Staff believes that the Proposed Order is correct in its concise conclusion that Staff's direct assignment method of security costs was the proposal that most reflected cost causation and should therefore be accepted. (Proposed Order, p. 41.)

a. Lincoln/Streator

Lincoln/Streator's main argument against the Proposed Order's conclusion is that it is not equitable to the smaller districts, particularly when those ratepayers have no control over the decision to serve them with one type of facilities or another. (Lincoln/Streator BOE, p. 6.) Staff believes that this argument made by Lincoln/Streator is unpersuasive and should be given no weight by the Commission. Staff notes that the ratepayers have little control over any management decision, yet are still expected to pay their cost of service. Therefore, the Proposed Order should not be modified in the manner proposed by Lincoln/Streator.

b. IAWC

The Company, in its BOE, reemphasizes its argument that it is confiscatory to not allow the Company to recover all security operating costs that have been found prudent and recoverable. (IAWC BOE, p. 54.) Staff finds it necessary to reiterate its argument that the Company inappropriately singles out security expense as the only expense item

that will be under-recovered in Lincoln and Sterling. (Staff IB, p. 42.) Staff's revenue requirement schedules reflect the total Staff-adjusted amount for all expenses. The Company can mathematically show that if Staff had not proposed the direct assignment of test year security expenses, then the Staff-proposed revenue requirement amount for Lincoln and Streator would not have been greater than what was requested by the Company. (IAWC RB, p. 21.) However, the Company makes a logical leap to conclude that only one expense will be under-recovered, instead of comparing revenues to the aggregate level of expenses. In general rates, no such reconciliation of specific revenue to specific expenses occurs.

The Proposed Order gives two main reasons for accepting Staff's proposal. The reasons are that it best represents cost causation and that the Company's approach is results-driven. (Proposed Order, p. 41.) The Company does not address the results-driven assertion. The Company addresses the cost causation reasoning by stating that Staff proves the Company's point by saying the level of security necessary is related to the facilities, which the Company equates to rate base. Furthermore, the Company gives tank painting as an example, and states that the tank painting costs are not allocated to the district where the painting occurred. (IAWC BOE, p. 55.)

Once again, as explained more fully in Staff's Reply Brief, Staff's use of the term "facilities" is not equivalent to rate base and it is disingenuous for the Company to suggest that it is. (Staff RB, p. 30.) It is also inaccurate for the Company to state that tank painting costs are not allocated to the district where the painting occurred. Concerning tank painting adjustments, Appendix A to the Proposed Order refers to ICC Staff Exhibit 14.0, Schedules 14.6. A review of the Schedules 14.6 for all water rate

areas shows that tank painting costs are only assigned to the rate areas that are having tanks painted before the end of the test year. These schedules also show all rate areas have inspection costs, that are related to the Company's new normalization plan and schedule, allocated to them based upon the most identifiable cost causation factor for tank painting, tank capacity. There is nothing in the tank painting schedules at ICC Staff Exhibit 14.0 that contradict Staff's proposal for the allocation of test year security costs.

As demonstrated above, all of the Company's arguments concerning the allocation of test year security expenses are either contradictory to ratemaking practices (disaggregating expenses when comparing to revenue), disingenuous (equivocating rate base and facilities), or inaccurate (stating tank painting costs are not allocated to districts in which the painting occurs). Staff believes that the Commission should find these types of arguments unpersuasive and give them no weight. Therefore, the Commission should reject the Company's proposal to modify section V(J)(2)(d) of the Proposed Order.

3. Deferred Security Costs

The Company's Brief on Exceptions, in great part, reemphasizes arguments previously made by the Company, yet soundly refuted by Staff in its briefs. Furthermore, the Proposed Order considers these arguments, finds them to be lacking, and correctly concludes that deferred security costs should not be included in rates. The majority of the Company's arguments contained in its Brief on Exceptions concerning deferred security expenses are more fully refuted by Staff in its Initial Brief, pages 7 through 24, and Reply Brief, pages 7 through 16. Consequently, the same arguments will not be fully reiterated here. Staff, however, will respond to arguments

that the Company makes for the first time in its Brief on Exceptions or to specific criticisms it has regarding the Proposed Order.

a. Public Policy

The Company has repeatedly stated that it would be contrary to sound public policy to disallow the recovery of deferred security expenses. In its Brief on Exceptions, IAWC lists some specific cases that purport to demonstrate that “public policy must be respected in adjudication of disputed issues”. (IAWC BOE, p. 18.) Furthermore, the Company argues that courts look at the Constitution, statutes, and relevant judicial opinions in determining “whether a well-defined and dominant public policy can be identified.” This argument is irrelevant as no party has argued that public policy should not be given weight in deciding the issue of deferred security. The Company further demonstrates that this argument is irrelevant by providing citations to cases concerning the following issues: safe and effective fire protection service, protection of senior citizens against abuse, safe nursing care, public duty performed by railroads, and remedies employees have under the Workman’s Compensation Act. (*Id.*, pp. 18-19.) These cases have no bearing on the security issue disputed in the instant proceeding and should be given no weight. There simply is no well-established public policy concerning enhanced security costs, regardless of the Company’s attempts to equate enhanced security to environmental compliance. Furthermore, by implying that a well-established policy exists regarding enhanced security costs, the Company contradicts its other argument that these costs are unique, unusual, and extraordinary.

b. Nature Of Deferred Security Costs

IAWC lists several specific assertions made in the Proposed Order that it

believes are incorrect. IAWC's first assertion is that the Proposed Order is incorrect in stating that the deferred security costs are in the nature of operating expenses, not capital items. (Id., p. 27.)

Contrary to the Company's position, the Proposed Order is absolutely correct when it states that, "it should first be noted that the deferred security costs in question are in the nature of operating expenses, not capital expenditures. Hence, for ratemaking purposes, they are the type of cost that would normally appear in an operating statement, not capitalized in rate base as the Company seeks to do here." (Proposed Order, p. 61.) The enhanced security measures that were capital expenditures are already included in the rate base in this proceeding and have not been a disputed issue.

The Company places its reliance that the deferred security costs are capital related in its argument that the costs were for measures which immediately protected its water facilities from terrorism. (IAWC BOE, p. 21.) This argument made by the Company is contrary to the most basic accounting principles that define and contrast assets and expenses. Several types of expenses ultimately are for the purpose of protecting, enhancing, or in some manner bettering capital assets. Nevertheless, the purpose of the expense does not mystically transform the expense into an asset as the Company would have the Commission believe is appropriate concerning the deferred security expenses.

A more significant problem inherit in the Company's arguments is its willingness to render the whole accounting framework meaningless to support its position. This is not only evident in its incorrect assertion that the deferred security costs are capital

related, thus not operating expenses, but as will be more fully discussed below, evident in its arguments that these are not operating expenses, but are rather, extraordinary expenses.

c. Rate Base Capitalization

The Company's second assertion is that the Proposed Order is incorrect in stating that the Company seeks to capitalize Deferred Security Costs in rate base. The Company states that its proposal is to amortize the Deferred Security Costs and include the unamortized balance in the rate base. (Id., p. 28.)

The distinction being made here by the Company is purely semantic. When plant items are capitalized, they are included in rate base net of accumulated depreciation. This is synonymous to the unamortized portion of Deferred Security Costs being included in the rate base, as proposed by the Company. The differences are not substantive, nor are they useful to the current dispute. Thus, this argument by the Company should be given no weight by the Commission.

d. Problematic Nature Of Deferred Operating Expenses

The Company's third assertion is that the Proposed Order is incorrect in concluding that the inclusion of deferred operating expenses in a test year filing is problematic. The Company states that this is not true because the amortization of deferred operating expenses are included in test year revenue requirements under court and Commission precedent. (Id., p 28.)

Staff has consistently demonstrated that the court and Commission Orders offered by the Company as precedent are not analogous to the current proposal. (Staff IB, pp. 16-23.) Consequently, the Proposed Order correctly states, "Staff also asserts,

and the Commission agrees, that in some of the other cases cited by the Company, the items in question were not in the nature of ongoing operating expenses, such as in Docket No. 93-0184 where extraordinary property losses were suffered due to flooding.” (Proposed Order, p. 63.) Further, the Proposed Order also correctly concludes that the precedent cited by the Company does not match the current situation when it states the following:

Generally speaking, in reviewing the cases cited, they do not appear to be general rate cases involving types of costs that were clearly in the nature of operating expenses, where a utility was permitted, over the objections of other parties, to recover both (1) an annual level of ongoing expense and (2) an additional amount for pre-test year balances resulting from previous deferrals of such expenses that were recorded as deferrals without Commission authorization. (*Id.*, p. 63.)

IAWC’s assertion that it is not problematic to include normal operating expenses in the revenue requirement as deferred items is unsupported as its cited precedence lacks a true similarity to the present proposal. Therefore, the Commission should give no weight to the Company’s argument.

e. Illinois Supreme Court Decision In *Citizens Utility Board*

The Company’s fourth assertion is that the Proposed Order is incorrect in its conclusion that the Illinois Supreme Court decision in *Citizens Utility Board vs. ICC* (“*Citizens*”), 166 Ill. 2d 111 (1995), does not support the Company’s position regarding deferred security expenses. (IAWC BOE, p. 28.) The Company states that the decision does support its proposal because the decision holds that deferred environmental costs are recoverable and that if the deferred environmental costs are recoverable in a rider, they are also recoverable in general rates.

The Company's argument here totally disregards the Proposed Order concerning its discussion of recoverability, which states, "[i]n the instant rate case, the underlying recoverability of the type of expense is simply not at issue. This is obvious from the fact that an annual amount for enhanced security expenses is being included in test year operating expenses. Hence, IAWC's repeated references to that portion of the Court's opinion are not useful." (Proposed Order, p. 62.)

The Proposed Order also clearly demonstrates that *Citizens* does not support including deferred security costs, as well as test year operating costs in the revenue requirements, when it provides the following analysis:

What is at issue in the current case is whether ratepayers should also be required to pay for amounts incurred and deferred prior to the test year selected by a utility in a general rate proceeding. That this issue was not addressed by the Court in its *Citizens Utility Board* decision is clear from a reading of Section II of its analysis, "Rider Mechanisms". In fact, in the Commission's consolidated coal tar docket, as noted by the Court in *Citizen's Utility Board*, some parties had cited *BPI II* as support for an argument that the Commission's approval of a rider recovery mechanism violates the Commission's own test year rules.

In addressing this issue, the Court observed, "The test year rule is designed to avert mismatching of revenues and expenses that might permit a utility to inaccurately portray a higher need for rate increases." After discussing the test-year rule, the Court stated, "We agree with the Commission and the utilities that the test-year rule seeks to avoid a problem not present when expenses are recovered through a rider." (166 Ill. 2d 111 at 139-40) The Court added, "As the Commission notes, the case at bar does not attempt to evaluate or adjust all aspects of the utilities' base rates, and thus the test-year filing is not a prerequisite." (*Id.*, p. 62.)

It is an illogical stretch for the Company to argue that expenses recoverable in a rider are recoverable in base rates based upon a case in which the court's analysis

specifically states that it did not attempt to evaluate aspects of base rates. In general rate cases, test year rules clearly apply. It does not follow that, because one particular type of deferred cost is recoverable through riders, all other types of costs may be deferred and recovered through base rates, particularly when doing so violates test year rules. Therefore, the Company's argument should be given little weight.

f. Deferred Security vs. Deferred Tank Painting

The Company's fifth assertion is that there is no difference between deferred security expenses and deferred tank painting costs. (IAWC BOE, p. 28.) This argument is incorrect for two reasons. First, the Company states the Proposed Order's reasoning concerning the normality of the test year is erroneous, pointing out that Staff rejected the Company's proposal to normalize tank painting costs. This statement implies that Staff is against the normalization of expenses, which is a false implication. The Company fails to consider that Staff's opposition to the Company's original tank painting proposal was not related to the theory of normalization, but was related to the changing of a long-standing practice of deferring and amortizing tank painting costs as they do not represent ongoing and recurring annual operating costs (incidentally, security expenses do represent ongoing and recurring annual operating costs). Furthermore, the Company's initial tank painting normalization plan was brand new, not reviewable regarding its effectiveness or sustainability, and not even fully planned out. (Staff Exhibit 14.0, p. 25; ICC Staff Exhibit 4.0, p. 13.)

Second, the Company states that, "the ALJPO's proposed treatment of steel structure painting in this case results in recovery of both a test year allowance for ongoing tank painting in the test year and a ratable portion of prior deferred tank

painting expense.” (IAWC BOE, p. 28.) Once again, the suggestions implicit in the Company’s statement are incorrect. By stating the Proposed Order proposes to allow a test year allowance for ongoing tank painting, the Company implies that there is an ongoing test year operating expense piece and the deferred piece. This is incorrect. The Proposed Order allows deferred accounting for all tanks painted through the end of the test year. The unamortized cost of painting these tanks would be allowed in rate base and the amortization expense would be included in the operating statement. This is not the same as the Company’s deferred security expense proposal, which produces three, rather than two, revenue requirement components. In the Company’s proposal: (1) there would be a similar unamortized cost in rate base; (2) there would be a similar amortization expense included in the operating statement; and additionally, (3) there would be a full test year operating expense amount included in the operating statement.

As demonstrated above, the Company’s only support is based on incorrect statements and should, therefore, be given no weight by the Commission.

g. Deferred Security Costs Are Extraordinary

The Company’s sixth assertion is that the Proposed Order misses the point when it states that deferring operating expenses is not the norm because, in the Company’s view, deferred security costs are extraordinary costs. (IAWC BOE, p. 29.)

As discussed previously in the section titled Nature of Deferred Security Costs, the Company has attempted to render meaningless the accounting framework in order to support its position. As Staff has explained, at a minimum, extraordinary expenses must be unusual and infrequent expenses. (Staff IB, p. 13.) Deferred security expenses cannot be considered infrequent as they represent the same costs that are

continuing indefinitely and are being allowed in the revenue requirements. Furthermore, they are not unusual. Regardless of the level of security made necessary due to the heightened state of alert in the United States, for a water utility, or any Company with tens or hundreds of millions of dollars invested in physical assets, securing those assets is not unusual, even if the level of such actions is unprecedented.

Instead of providing evidence to the contrary, the Company has simply and repeatedly attempted to sidestep the accounting framework concerning extraordinary expenses. In so doing, it has presented an argument that is self-defeating. The Company has stated that the accounting rules are “narrow” and only should be used for “ordinary” expenses. (IAWC BOE, p. 21.) Yet, it is only by applying accounting rules, which the Company would set aside, that costs could be defined as extraordinary. The Company cannot have it both ways. Either accounting rules apply or they do not. If the Company would classify these costs as extraordinary, then it must show them to be extraordinary based upon the applicable accounting rules. Yet, the Company never provides a credible argument that the security costs meet the definition of extraordinary expenses. Furthermore, not only does the Company attempt to sidestep the established accounting rules concerning extraordinary expenses, it attempts to install new rules. This is evident in the Company’s Brief on Exceptions when it states the following:

In other words, the Company’s initial enhanced security costs cannot be viewed as ordinary operating expenses. Now that threat and security assessments have been made, as Staff expert witness Jaehne has confirmed, future security costs can be viewed as operating costs because compliance requirements and necessary security measures now have been confirmed. (Id., p. 21.)

This statement demonstrates that the Company's proposal is results-oriented. Allowing the deferred security costs to be considered extraordinary while considering the ongoing expenses to be ordinary gives the Company the best of both worlds. Either the security expenses (deferred and future) are extraordinary or they are not. The existence of a rate case does not change the nature of the costs. Yet, the Company essentially argues that security expenses incurred prior to the Order in this proceeding should be deferred because they are extraordinary while security expenses incurred subsequent to the Order should be treated as ordinary expenses. Staff has shown that these do not meet the definition of extraordinary expenses; the Company has not provided a credible counterargument. Furthermore, the Company's attempt to install a timeline in which the same expenses transform from extraordinary into ordinary has no basis in any accounting framework of which Staff is aware. Finally, the Company's argument implies that its security enhancements are static, that the Company has done all that it can do. Conversely, the Company, as well as Staff's security expert, has testified that its approach to enhancing securing has been dynamic and that it is adaptable to meet changing needs. (ICC Staff Exhibit 20.0, p. 7; IAWC Exhibit R-2.0, p. 4.)

Security expenses are normal operating expenses. The Proposed Order is correct when stating that deferral and recovery of operating expenses is not the norm in a general rate case. The Commission should give little weight to the Company's argument.

h. Prior Approval To Defer Costs

The Company's seventh assertion is that the Uniform System of Accounts ("USOA") does not require the Company to get prior approval to defer extraordinary

costs. (IAWC BOE, p. 29.) The Company supports this argument by stating the “deferred by authorization of the Commission” phrase in the USOA relates only to “losses on disposition of property net of income tax” and “unusual or extraordinary expenses” don’t have the same qualification of needing authorization from the Commission. (IAWC BOE, p. 27.)

As Staff has shown above, the extraordinary phrase is irrelevant, as security expenses do not meet the definition of extraordinary expenses. Furthermore, Staff believes that a reading of Account 186 in the USOA for water utilities shows that “deferred by authorization of the Commission” is not a qualifying phrase only for losses on disposition of property, but is rather one item among a list of items that are debits to be charged to this account. Regardless, as explained in Staff’s Initial Brief, the very coal tar cases on which the Company relies in its environmental costs argument, demonstrated the well-established practice of receiving Commission approval before deferring operating costs. (Staff IB, p. 15.) In one of these coal tar cases, the Commission clearly indicated its view on the matter:

The Commission concludes that the \$120,768.71 of MGP costs incurred by IIGE in 1990 and 1991 are not eligible for recovery through its proposed MGP riders since IIGE has not made a timely request for the deferral of such costs to the Director of Accounting or to the Commission. Only on rehearing in this case, has the Company clearly requested deferral of pre-1992 MGP costs. The Commission determines that it would be improper to allow the Company to retroactively defer MGP costs. A request for deferral of such costs should have been submitted by IIGE to the Director of Accounting at a much earlier date. (Emphasis added.) (Order on Rehearing, Docket Nos. 92-0292/92-0357 (Cons.).)

i. Cited Cases Not Supportive

The Company's eighth assertion is that the Proposed Order is incorrect in concluding that the cases cited by the Company do not involve cases of recovery of an annual level of ongoing expense recorded without approval. To support this argument, the Company states examples that include Dockets No. 95-0220 and 93-0184, and rate case expense and tank painting expense within the current docket. (IAWC BOE, p. 29.)

As explained in Staff's Initial Brief, in Docket No. 95-0220, the Company (Northern Illinois Water Company, a predecessor company of IAWC) recorded its study and investigation costs in Account 183, consistent with the USOA. It was not until the Commission adopted Staff's proposal to have the costs deferred in Account 186 that the Company did so. (Staff IB, p. 15.) In that case, unlike the present one, the Company acted entirely within the bounds of the USOA, so no waiver of the USOA was needed. However, in the current case, the Company did not act within the bounds of the USOA, by deferring ongoing operating expenses as has previously been discussed.

As also explained in Staff's Initial Brief, Docket No. 93-0184 does not support the Company's proposal, as the deferral issue in that docket was the extraordinary loss of plant damaged by flood. (*Id.*, p. 18.) This case simply does not involve the deferred recovery of an operating expense, but an extraordinary property loss.

The Company also uses Staff's proposals concerning rate case expense and tank painting expense in the current proceeding to argue its point that prior authorization from the Commission is not necessary in order to defer operating expenses. As explained in Staff's Initial Brief, the difference is that there is a long pattern of the Commission ordering the deferral and recovery of these specific expenses, rate case and tank painting, whereas there is no pattern of Commission authorizing the deferral of

security operating expenses. (Staff IB, p. 15.)

The Proposed Order is correct in stating that the cases cited by the Company do not appear to support the current proposal of recovering both an annual level of operating expense and an additional amount for deferrals of the same expense that were recorded and deferred without Commission authorization. (Proposed Order, p. 63.) The Company's arguments to the contrary do not withstand scrutiny and should be given no weight by the Commission.

j. Mismatch Of Test Year Revenue And Prior Period Expenses

The Company's ninth assertion is that there is no mismatch of test year revenue and prior period expenses, otherwise every allowance for recovery of a deferred cost creates a mismatch, by definition of a deferred cost. (IAWC BOE, p. 29.)

This argument fails to recognize that in several of the cases that the Company itself has cited for its support, deferral recovery has been allowed and there was no mismatch because the deferred item was a nonrecurring, extraordinary event, not a normal operating expense as is being proposed in this proceeding. This argument does not withstand scrutiny and should be given no weight by the Commission.

2. Summary

As demonstrated above, the arguments the Company makes against the Proposed Order's conclusions regarding deferred security costs do not withstand scrutiny. Consequently, Section V (J)(3)(h) of the Proposed Order should not be modified, as proposed by the Company in its Brief on Exceptions.

F. The Proposed Order Correctly Disallows The Deferred Reverse Osmosis Costs.

1. Test Year Concept

The Proposed Order states that many of the arguments for disallowing the reverse osmosis deferral are the same as those made with regard to the deferred security issue. The decision reflected in the Proposed Order regarding deferred security indicates notes that the Company's test year level of expense included normal ongoing levels of expense for security costs. (Proposed Order, p. 48.) In its Reply Brief, Staff stated that the Company had also included an ongoing level of test year reverse osmosis expense in its filing which has not been contested by Staff. (Staff RB, p. 17; ICC Staff Exhibit 12.0, p. 7; Staff IB, p. 49.)

2. "Pilot Study"

IAWC persists in rewriting the history of this case. In its BOE, IAWC quotes its witness claiming that the costs were incurred to perform a full scale pilot study. (IAWC BOE, p. 37; IAWC Ex. SR-3.0, pp. 2-3.) The quote used by IAWC is from the Surrebuttal testimony of its witness, which occurs somewhat late in the proceeding. Staff notes that on cross-examination the Company's witness 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 Illinois Environmental Protection Agency 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. (Staff RB, p. 20.)

The Proposed Order properly concludes that the Company's last minute attempt to redefine the 2001 reverse osmosis operating expense as a pilot study is not supported by evidence in the record. (Proposed Order, p. 68.)

3. Prior Precedent

IAWC asserts that a prior identical precedent was set in Docket No. 95-0220 regarding the recoverability of deferred pilot study costs. (IAWC BOE, p. 37.) Staff provided a clarification to IAWC's confusion about the identical nature of the reverse osmosis operating expense and a true pilot study of a particular treatment option. In its Reply Brief, Staff states that 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. (Staff RB, p. 19; Docket No. 95-0220, 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 RB, p. 19; 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 Illinois Environmental Protection Agency permit. All of these activities are now characterized by the Company as a "pilot study". (Staff RB, p. 19; Staff IB, p. 47.)

The Proposed Order correctly states that IAWC's citing of the decision in *Citizens* as precedent for deferrals is not useful. (Proposed Order, p. 62.) IAWC argues that deferred reverse osmosis expense should be recoverable, contrary to the test year concept, on the basis that the decision in *Citizens* mandates that environmental cleanup costs would always be recoverable. (IAWC BOE, p. 36.) The Company relies on this decision to support its proposal to ignore the test year concept by proposing to include 2001 and 2003 projected operating expense amounts in this rate case filing. (IAWC RB, p. 14.) Contrary to the Company's assertion that the decision in *Citizens* renders test year rules irrelevant, the Proposed Order correctly states that in a general rate case filing, the test year rules clearly apply. (Proposed Order, p. 62.)

Other Commission and court decisions were offered by the Company in support of its position to defer operating expense items such as reverse osmosis. (IAWC RB, p. 14.) The Proposed Order correctly notes that in a rate case proceeding it is appropriate to include a projected normal ongoing level of operating expense, but not appropriate to include operating expense amounts that were incurred in prior years. (Proposed Order, p. 62.) The Proposed Order also properly concludes that the cases cited by IAWC do not appear to allow over the objections of other parties, recovery of both ongoing levels of operating expense and pre-test year amounts without prior Commission authorization.

4. Double Recovery of Nitrate Removal Costs

IAWC continues to confuse the issue raised by Staff regarding the nature of double recovery of an operating expense. As Staff clearly indicated in testimony and briefs, 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. The Company took Staff witness Everson's statement out of context to further its distorted view of this issue. Staff witness Everson did not state that the Company would recover the exact same cost 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 in the test year, at the same time, both past and expected future costs to remove nitrates. The Company's proposal would, by including prior years' costs, require ratepayers to pay for more than the annual amount for nitrate removal. (Staff RB, p. 17; ICC Staff Exhibit 12.0, p. 7; Staff IB, p. 49.) IAWC now has decided to rewrite Staff witness Everson's testimony by making the specious argument that she "acknowledged that there is no double counting". (IAWC BOE, p. 40.) There is no evidence in the record that Ms. Everson used the phrase "double counting" when referring to deferred reverse osmosis expense recovery.

Some of the Company's other scattered arguments that attempt to intertwine double recovery with prior Commission Orders and other court cases, and the decision in *Citizens* in IAWC's BOE are addressed in this RBOE *supra*.

5. Improper Recording Of Deferred Operating Expense Without Prior Commission Approval

The Proposed Order properly concludes that deferring pre-test year operating expenses is not the norm. (Proposed Order, p. 63.) IAWC's claim that no prior

approval is necessary is erroneous. As Staff asserted in its Reply Brief, IAWC 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. (Staff RB, pp. 18-19; ICC Staff Exhibit 12.0, p. 6; Staff IB, p. 48.)

The Proposed Order properly resolves the issue of recoverability of reverse osmosis treatment expense based on the facts in evidence, which clearly indicate that the 2001 reverse osmosis nitrate removal expenses occurred outside the 2003 test year. To allow recovery of both ongoing and prior operating expenses would violate the test year concept.

III. RATE OF RETURN ISSUE DISCUSSION

In its Brief on Exceptions, the Company criticizes the Proposed Order's conclusions on the cost of the variable rate debt issues and proposes a change for

incorporation into the Final Order. (IAWC BOE pp. 43-45.) The issue is largely the same argument the Company previously lodged, which Staff has addressed. However, the Company has made several statements that Staff believes require further response. Thus, below Staff provides a brief explanation of the general issue and addresses many of the Company's specific claims. Staff believes that the Company's argument is not valid and that the change the Company proposed should not be incorporated into the Final Order.

The Company argues that interest rates are at historical lows and "will not be maintained over the life of the rates established in this proceeding." (IAWC RBOE, p. 43.) IAWC's belief that the interest rates for variable interest debt will be higher during the effective period for the new tariffs is purely speculative. No one can predict with certainty how long the new tariffs will remain effective, let alone which way interest rates will move in the future. However, in Ms. Kight's April 2003 Rebuttal testimony, she testified that the consensus among analysts surveyed is that the Board of Governors of the Federal Reserve ("Fed") will leave rates unchanged or cut them in the near term. (ICC Staff Exhibit 16.0, p. 5.) In fact, the Fed cut its federal funds interest rate 0.25% on June 25, 2003.¹

In addition, 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, since the spot rate is "unrealistically" low and the Company would pay a higher interest rate if it converted the issues to fixed rate debt. (IAWC BOE, p. 43-45.) Ms. Kight agreed that short-term interest rates are low by recent, historical standards, but disagreed that an

¹ Federal Reserve Releases, June 25, 2003.
<http://www.federalreserve.gov/boarddocs/press/monetary/2003/20030625/default.htm>

interest rate that IAWC actually paid on its variable rate debt may ever be properly characterized as “unrealistic.” If the Commission were to accept an upward adjustment to variable interest rates when those interest rates are historically low, then to be fair to ratepayers, the Commission should also follow a policy of adjusting variable interest rates downward when those interest rates are historically high. While that principle of even-handedness in variable interest rate adjustments sounds simple in theory, its application is problematic in practice because identifying the minimum interest rate is easy (i.e., 0%), while identifying the maximum likely interest rate is impossible. Thus, a bias will exist in favor of adjusting historically low interest rates upward in comparison to adjusting historically high interest rates downward. Obviously, that bias would be favorable to utilities. Further, determining the appropriate size of the interest rate adjustment is problematic as well. The use of current interest rates, even if such interest rates are historically low, is the best means to be fair to both utilities and ratepayers. (ICC Staff Exhibit 16.0, pp. 4-5.)

Ms. Kight asserted that the use of a 5-year forecast period is an inappropriate interest rate for IAWC’s variable rate debt. She explained that if a forecasted interest rate is used in place of the current interest rate, the forecast should be short-term in outlook. The longer the forecast period, the less accurate the forecast. The illustration in ICC Staff Exhibit 16.0, on page 6, demonstrated that forecast consistently overestimated interest rates and the farther out the forecast period, the greater the amount of the interest rate overestimation.

The Company’s BOE indicates that Ms. Kight supports the use of a forecasted rate of 1.5% for the two variable rate issue.” (IAWC BOE p. 44.) However, Ms. Kight

testified that she believes that current rates should be used rather than forecasted rates. Ms. Kight only presented the more reasonable alternative forecasted rate as an option for the Commission to consider if it decided that a forecasted rate was more appropriate in this case. (Tr., p. 699.)

The Company's BOE points out that IAWC would pay 3.74% to 3.94% upon conversion of the \$23,325,000 Citizens Series debt and the \$24,860,000 Tax Exempt Series debt to fixed interest rates. (IAWC BOE, p. 43.) These fixed interest rates should have no bearing on the interest rate that should be used for the purpose of setting rates in this proceeding. Ratepayers should not be charged for costs that IAWC is not incurring. Since IAWC has not converted the \$23,325,000 Citizens Series debt and the \$24,860,000 Tax Exempt Series debt from variable interest rates to fixed interest rates, IAWC's authorized rate of return on rate base should not reflect a fixed interest rate for those debt issues. Furthermore, at 3.74% to 3.94%, the cost of the Citizens Series debt would exceed the 2.61% cost the Commission-approved formula estimates for the assumed Citizens debt. According to the Commission's Order in Docket No. 01-0556, IAWC must absorb any increase in the cost of the assumed Citizens debt. Thus, even if IAWC converted the Citizens Series debt to a fixed interest rate, the highest interest rate that could be reflected in rates is 2.61%. (ICC Staff Exhibit 16.0, p. 9.)

Finally, the Company reiterates that Ms. Kight said that she would accept updated actual rates. (IAWC BOE, p. 44.) 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 (Staff RB, p. 36.) The Proposed Order correctly notes that since Ms. Kight did not accept the newer rates subject to check, they are not in the record. (Proposed Order, p. 73.)

For the reasons stated above, the Company's proposal to increase the interest rate for its variable rate debt should be rejected.

IV. COST OF SERVICE AND RATE DESIGN ISSUE DISCUSSION

A. The Proposed Order Is Correct In Concluding That Staff's Cost Of Service Study And Rate Design Are Appropriate For The Single Tariff Pricing Group.

The Large Water Consumers once again criticize Staff's cost of service study and rate design for the Single Tariff Pricing ("STP") group, which previously consisted of the Southern Division and Peoria District, with the Streator District added in this docket through the Proposed Order. (LWC BOE, pp. 11-18.) Contrary to the Proposed Order, LWC prefers an across-the-board increase. (Id., pp.11-18.)

In addition to the result that LWC customers would have lower rates with an across-the-board increase, assuming the Proposed Order's revenue requirement is not significantly increased in the Commission's Order, the LWC's preference for an across-the-board increase is based upon its stated belief that the customer class demand factors in Staff's cost of service study are flawed. (LWC BOE, p. 12.) LWC's criticism is

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

based on two aspects of the demand factors used in the Staff cost of service study; first, that the demand factors were developed over five years ago, and second, that the demand factors were not adjusted to include the effects of the addition of the Streator District to the Southern Division and Peoria District for Single Tariff Pricing. Both criticisms have some fact, but neither criticism merits the LWC's preference for an across-the-board increase applied to rates developed from a cost of service study prepared from cost and billing data of three years ago in Docket No. 00-0340 and which used the same demand factors that the LWC finds stale in the current Staff cost of service study. The LWC have not shown that the demand factors are materially inaccurate. The LWC have only shown that the demand factors were prepared more than five years ago, which does not prove that the demand factors have significantly changed and are therefore inappropriate for this docket. The Proposed Order recognizes the shortcomings in the LWC position, and properly rejects the LWC proposed across-the-board increase.

The LWC appear to imply that the Staff demand factors used in this docket for the STP group are irrelevant, as if the demand factors are based upon data from some other billing area and applied to the STP group when it says the “. . . demand ratios which were developed more than five years ago in Docket 97-0102 and were applied to Districts for which they were not originally designed.” (LWC BOE, p. 12.) LWC's proposed across-the-board increase would be based upon the same demand factors that it criticizes as not designed for the Districts to which they were applied because Staff used the demand factors from the cost of service study accepted in the Order in Docket No. 00-0340, which serves as the basis for the rates that LWC would increase

by an across-the-board percentage. In the current docket, Staff applied the demand factors to current costs and billing information, and added the Streator District to the STP group.

The Streator District added only 4.6% more usage billing units to the STP group, so the demand factors in the current Staff cost of service study were designed for more than 95% of STP group usage. Adjusting the demand factors to include weighted Streator demand factors would not likely change rates because large customers pay only 86.7% to 99.5% of cost of service under Staff's proposed rates, and residential and smaller commercial customers would pay 105.5% and 101.2%, respectively, of cost of service to make up for the shortfall in recoveries from large water customers. (Staff Initial Brief, Appendix B, Schedule 1 – S/P/St., p. 2.) Since the Streator industrial demand factor is smaller than the Southern Division and Peoria District industrial demand factor, it is probable that cost of service for large water users would slightly decrease, but the reduction would not likely increase Staff's proposed large water user rates above cost of service. The LWC's criticisms of the Staff cost of service study have no significant value and do not merit its suggested across-the-board increase, which would be based upon outdated cost and billing information. Staff's cost of service study in this docket is superior to the LWC's recommendation because it is based upon current cost and billing information. The Proposed Order properly finds that the Staff cost of service study is sufficient as a basis for determining rates in this docket and requires IAWC to prepare new customer class demand factors for use in its next rate proceeding for the STP group. (Proposed Order, pp. 113-114.)

B. The Proposed Order's Proposed Tariff Effective Date Of Five Working Days Should Be Adopted.

Illinois-American is attempting to push through new tariffs without allowing Staff adequate time to review the filing. Staff has found that the previous review period of two to three days was inadequate for an in-depth and proper review. This case involves seven rate areas with numerous tariffs. Other cases, such as Docket No. 01-0663, allowed for an effective date of ten business days, which only involved one Company with one rate area. The Proposed Order in this case also allows for tariff sheets to be corrected within the five working days time period if necessary. The five working day period allows enough time for the Company to file the corrected tariffs, if needed. Staff has been involved in many cases where corrected tariffs were necessary. With a two-day period there is not enough time for Staff to review the tariff, contact the Company and have it re-file corrected tariffs, and then review the tariff again.

C. The Proposed Order Adequately Discusses The Topic Of Single Tariff Pricing.

The AG is promoting the addition of single tariff pricing ("STP") language that is very subjective in nature. The proposed language insinuates that the Commission is interested in moving toward complete STP for the entire Illinois-American territory. (AG BOE, pp. 2-5.) Nothing could be further from the truth. Staff has discussed this issue extensively in its testimony and Initial Brief at pages 38-40. The Commission should reject the AG's proposal for additional STP language. However, if additional language is needed, then the language contained in Staff's Initial Brief at pages 38-40 should be added as well.

D. The Proposed Order Correctly Adopts Staff's Cost Of Service Studies.

There is nothing wrong with Staff's cost of service study. Exception 2 of the AG's Brief on Exceptions insinuates that there are problems with Staff's cost of service ("COS") study. The AG mentions stale data, insufficient billing information, and a failure to update the cost of service study to accommodate new company accounting systems (AG BOE, p. 6.) Staff has repeatedly discussed the appropriateness of its cost of service studies and has even pointed out that they are all consistent in that all districts use the same uniform system of accounts and allocation factors, that were used in the Company's last rate case. (Staff IB, p. 70.)

The Proposed Order has addressed demand factors (stale data) by agreeing with Staff that the Company should provide updated demand factors for each rate area in its next rate case. (Proposed Order, p. 113.) The reference to insufficient billing information is not a COS problem but simply a lack of information from the Company. The Proposed Order again agrees with Staff that the Company should provide additional information in its next rate proceeding. (Id.)

Finally, the AG's mention of a failure to update the cost of service study to accommodate new Company accounting systems is simply incorrect. Staff's Initial Brief, at page 70, discusses how some of the rate areas have just been introduced to the new uniform system of accounts since IAWC's last rate case; however, in this case they are all consistent in that all districts use the same uniform system of accounts and allocation factors. Staff does not need to update its COS study. The new system of accounts is a Company refinement and therefore is not a reflection of the COS study but of the Company's accounting records. The Proposed Order correctly accepts Staff's

COS studies and addresses those concerns where additional information is needed in future proceedings.

E. The Proposed Order Correctly Accepts Staff's Small Main Adjustment.

The AG has reservations about Staff's small main adjustment. (AG BOE, p. 9.) These reservations are unwarranted. Staff has discussed this issue extensively in its Initial Brief at page 71 and Reply Brief at pages 45-46.

F. The Proposed Order Correctly Accepts Staff's Rate Design Methodology.

The Village of Bolingbrook (Bolingbrook BOE, p. 22) and the AG (AG BOE, p. 13) argue for the movement towards standardizing rates across all IAWC rate areas. Staff has argued throughout this proceeding that the Commission should move gradually and cautiously when it comes to STP and the ALJ has eloquently addressed STP in the Proposed Order. The AG, again, mentions that the 5/8-inch meter charge for the Lincoln rate area is much cheaper than the other rate areas and therefore there must be problems with Staff's rate design approach (AG BOE, pp. 13-14.) A complete discussion of this argument can be found in Staff's Reply Brief at page 45.

V. CONCLUSION

For the reasons set forth, Staff respectfully requests that the Commission approve the June 25, 2003 Proposed Order in this proceeding with the modifications contained herein and in Staff's July 3, 2003 Brief on Exceptions.

Respectfully submitted,



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