STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

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

ORDER

DATED: August 12,2003

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By the Commission:

I. PROCEDURAL HISTORY

On September 20, 2002, Illinois-American Water Company ("Illinois-American," "IAWC," "Respondent" or the "Company") filed its new and/or revised tariff sheets for water and sewer service identified as: Ill. C.C. No. 1 (Formerly United Water Illinois Inc.) 1st Revised Sheet Nos. 1, 1.1, 2 and 3, 3rd Revised Sheet No. 4, 1st Revised Sheet Nos. 4.1, 23 and 24, ILL. C.C. No. 4 (Formerly Citizens Utilities Company of Illinois) 2nd Revised Sheet Nos. 36-37, 1st Revised Sheet Nos. 38, 45, 46 and 47, 2nd Revised Sheet No. 49, ILL. C.C. No. 5 (Formerly Citizens Utilities Company of Illinois) 5th Revised Sheet No. 37, 2nd Revised Sheet No. 53, 1st Revised Sheet No. 58, 2nd Revised Sheet No. 59, ILL. C.C. No. 5 (Formerly Northern Illinois Water Corporation) 30th Revised Sheet No. 1, 17th Revised Sheet No. 1.1, 25th Revised Sheet No. 2, 22nd Revised Sheet No. 2.1, 20th Revised Sheet No. 2.3, 11th Revised Sheet No. 2.7, 3rd Revised Sheet Nos. 2.10 and 2.11, 30th Revised Sheet No. 8, 7th Revised Sheet Nos. 8.1 and 8.2, 5th Revised Sheet No. 8.3, 23rd Revised Sheet No. 10, 14th Revised Sheet No. 10.2, 23rd Revised Sheet No. 11, 26th Revised Sheet No. 13, 15th Revised Sheet No. 14, 23rd Revised Sheet No. 18, 21st Revised Sheet No. 19, 14th Revised Sheet No. 19.2, 8th Revised Sheet No. 21, ILL. C.C. No. 22 (Southern Division & Peoria District) 3rd Revised Sheet No. 21.1, 8th Revised Sheet No. 1, 7th Revised Sheet No. 2, 9th Revised Sheet No. 3, 13th Revised Sheet No. 4, 7th Revised Sheet No. 7, 4th Revised Sheet No. 16.1, hereinafter referred to as "Proposed Tariffs", in which it proposes a general increase in water and sewer rates, to be effective November 4, 2002.

Prior to its rate case filing, IAWC filed a request for waiver from certain requirements of 83 Ill. Adm. Code 285 on April 24, 2002 in Docket No. 02-0285. On May 22, 2002, the Commission granted the Company's waiver request, thereby allowing the Company to make its rate filing in accordance with Staff's proposed revisions to Standard Filing Requirements filed March 11, 2002 for Part 285 and for Parts 286 and 287 filed March 20, 2002.

Notice of the filing of the proposed rate increase was posted in IAWC's District business offices and was published twice in newspapers of general circulation within

each District, in accordance with the requirements of Section 9-201(a) of the Public Utilities Act (the "Act") (220 ILCS 5/9-201(a)) and the provisions of 83 Ill. Adm. Code 255. In addition, the Company sent notice of the filing to its customers with the first billing after filing.

The Proposed Tariffs were suspended by the Commission to and including February 16, 2003. On January 23, 2003, the Commission resuspended the Filed Rate Schedule Sheets to and including August 16, 2003.

On October 18, 2002, Respondent was notified of certain deficiencies in its filing in accordance with 83 Ill. Adm. Code 285, Standard Filing Requirements for Electric, Gas, Telephone, Water and Sewer Utilities in Filing for an Increase in Rates. The deficiency letter required Respondent to provide various revised and additional schedules or an explanation as to why certain schedules need not be provided. Respondent timely provided information in response to the deficiency letter on November 18, 2002.

Petitions for Leave to Intervene were filed by the Citizens Utility Board ("CUB"); People of the State of Illinois ("Attorney General," "People" or "AG"); Air Products and Chemicals Inc., Caterpillar, Inc., Cerro Copper Products, and Granite City Steel, as the Illinois Industrial Water Consumers or "IIWC"; City of Pekin; City of Waterloo, City of O'Fallon ("O'Fallon"), Village of Bolingbrook ("Bolingbrook or "VOB"); Fosterburg Water District ("Fosterburg"), Jersey County Rural Water Company, Inc. ("Jersey County") and Bond-Madison Water Company; Mitchell Public Water District ("MPWD"); United States Executive Agencies ("USEA); International Union of Operating Engineers, Locals No. 2, AFL-CIO ("I.U.O.E."); and the City of Peoria. The City of Streator and the City of Lincoln filed appearances (jointly, "Lincoln/Streator"). The IIWC, City of Waterloo, Bond-Madison Water Company, Fosterburg Water District, Mitchell Public Water District, Jersey County Rural Water and Scott Air Force Base jointly filed testimony and briefs as the "Illinois Large Water Consumers" or "LWC".

Pursuant to due notice, a pre-hearing conference was held in this matter before a duly authorized Administrative Law Judge of the Commission at its offices in Springfield, Illinois on November 19, 2002. Thereafter, evidentiary hearings were held on April 30, May 1 and May 2,2003. Appearances were entered by counsel on behalf of IAWC, the LWC, O'Fallon, Bolingbrook, Lincoln/Streator, the AG, CUB, Waterloo, USEA, and Commission Staff ("Staff').

At the evidentiary hearings, seven witnesses on behalf of Illinois-American, nine witnesses on behalf of Staff, one witness on behalf of CUB, three witnesses on behalf of O'Fallon, one witness on behalf of the LWC, one witness on behalf of the AG, one witness on behalf of Bolingbrook, one witness on behalf of Streator and one witness on behalf of Lincoln presented testimony and exhibits. At the conclusion of the hearing on May 2,2003, the record was marked "Heard and Taken."

Initial briefs and reply briefs were filed by IAWC, Staff, CUB, the AG, the LWC, O'Fallon, Bolingbrook and Lincoln/Streator. The administrative law judge's Proposed Order was served on the parties. Briefs on exception ("BOEs") and reply briefs on exception ("RBOEs") were filed by IAWC, Staff, the AG, the LWC, O'Fallon, Bolingbrook and Lincoln/Streator.

II. NATURE OF ILLINOIS-AMERICAN'S OPERATIONS

IAWC is a wholly owned subsidiary of American Water Works Company. Illinois-American states that it provides residential, commercial, industrial, and sale-for-resale water service, including fire protection service in four Divisions. The Northern Division consists of the Peoria, Pekin and Lincoln Districts, the latter being the former service area of United Water Illinois Inc.).The Southern Division consists of Alton, Cairo, and Interurban (including East St. Louis) Districts. The Eastern Division, which is the former service area of Northern Illinois Water Corporation, consists of the Champaign, Sterling, Streator and Pontiac Districts. The Chicago Metro-Water Division, which is the former service area of Citizens Utilities Company of Illinois, consists of Alpine Heights, Arbury, Arrowhead, Central States, Chicago Suburban, Country Club, DuPage, Fernway, Hollis, Liberty Ridge West, Liberty Ridge East, Lombard, Midwest Palos, Moreland, Nettle Creek, Potter Golf/Sunset Manor/Forest Estates, Ridgecrest, River Grange, Rollins/Elgin, Santa Fe, Southwest Suburban, Terra Cotta, Valley Marina, Valley View, Waycinden, West Suburban, Wheaton Water/Derby Glen Districts.

In addition to its public utility water service, IAWC provides public utility wastewater service in the following Districts of its Chicago-Metro Division: Alpine Heights, Arbury, Central States, Chicago Suburban, Country Club, DuPage, Fernway, Moreland, Nettle Creek, Potter Golf/Sunset Manor/Forest Estates, Ridgecrest, River Grange, Rollins/Elgin, Santa Fe, Southwest Suburban, Terra Cotta, Valley Marina, Valley View, Waycinden and West Suburban. IAWC has wastewater treatment facilities in eleven of the Districts of the Chicago Metro Division.

The Eastern Division is the former service area of Northern Illinois Water Corporation. The Chicago Metro is the former service area of Citizens Utilities Company of Illinois. In Docket No. 99-0418, the Commission approved the merger of NIWC into IAWC. In Docket No. 99-0457, the Commission approved the acquisition/merger of United Water Illinois, Inc. In January 2002, IAWC acquired the Illinois water and wastewater assets of Citizens Utilities Company of Illinois. The Commission approved the acquisition in Docket No. 00-0476 on May 15, 2001.

In the Lincoln District, the Company provides residential, commercial, industrial and municipal water service, including fire protection service, in and adjacent to Lincoln. It served approximately 5,907 customers as of June 30, 2002.

The Peoria District provides residential, commercial, industrial and municipal water service, including fire protection service, in the City of Peoria, West Peoria, the Village of Bartonville, the Village of Bellevue, the unincorporated community of Rome

and parts of several surrounding townships including Chillicothe, Peoria, Richwoods, Medina, Kickapoo, Limestone, and Hollis. The District also sells water to the Villages of Dunlap and Hanna City and to the Timber Logan Rural Water District for distribution. The Peoria District had approximately 50,042 customers as of June 30, 2002.

The Pekin District provides residential, commercial, industrial and municipal water service, including fire protection service, in the City of Pekin and surrounding areas to approximately 13,744 customers as of June 30, 2002.

The Alton District provides residential, commercial, industrial and municipal water service, including fire protection service, in the City of Alton and surrounding area. The Alton District also provides water for resale to Jersey County Rural Water Company, Fosterburg Water District, Brighton Water District, and Forest Homes Maple Park Water District. The Alton District had approximately 18,157 customers as of June 30, 2002.

The Cairo District provides residential, commercial, industrial and municipal water service, including fire protection service, in the City of Cairo and surrounding areas. As of June 30, 2002, the Cairo District had approximately 1,417 customers.

The Interurban District provides residential, commercial, industrial and municipal water service, including fire protection service, in the cities of East St. Louis, Belleville, Granite City, Madison, Venice, Fairmont City, Brooklyn, Sauget, Washington Park, Cahokia, Centreville, Alorton, Swansea, and other unincorporated areas. The Interurban District sells for resale to Scott Air Force Base, the City of O'Fallon, Village of Caseyville, City of Columbia, Bond Madison, Commonfields of Cahokia Public Water District, Mitchell Public Water System, Mitchell Water District, Pontoon Beach Water District, Village of Millstadt and City of Waterloo. The Interurban District is the largest of the nine Districts in the Company's service areas. As of June 30, 2002, the Interurban District served approximately 68,022 customers.

The Champaign District provides residential, commercial, industrial and municipal water service, including fire protection service, in and about Champaign, Urbana, Savoy, St. Joseph and Bondville, to the University of Illinois, to the Villages of Philo, Tolono, Tuscola, Arcola and Sidney, and to the Seymour Water District. The District served approximately 45,471 customers as of June 30, 2002.

The Sterling District provides residential, commercial, industrial and municipal water service, including fire protection service, in and about Sterling. The District served approximately 6,551 customers as of June 30, 2002.

The Streator District provides residential, commercial, industrial and municipal water service, including fire protection service, in and about Streator. It served approximately 7,838 customers as of June 30, 2002.

The Pontiac District provides residential, commercial, industrial and municipal water service, including fire protection service, in and about Pontiac. It served approximately 4,221 customers as of June 30, 2002.

In the Chicago Metro-Water District, the Company provides residential, commercial, industrial and municipal water service, including fire protection service, to approximately an aggregate 40,000 customers as of June 30, 2002. In the Chicago Metro-Sewer District, the Company provides wastewater service to approximately an aggregate 30,000 customers as of June 30, 2002.

IAWC's last increase in its base rates for the Peoria District, Southern Division and Eastern Division occurred in Docket No. 00-0340. According to IAWC, the Lincoln District has not had a rate adjustment since 1996; the Pekin District has not had a rate adjustment since 1998; and the Chicago Metro Division, which comprises the service areas recently acquired from Citizens Utilities Company of Illinois, has not had a rate adjustment since 1995.

III. SUMMARY OF ILLINOIS-AMERICAN'S PROPOSAL; TEST YEAR

The Company has proposed an increase in its rates and charges for general water service, general wastewater service, public fire protection service, and private fire protection service in all Districts.

The Company's rate increase request is based on a forecasted or "future" test year consisting of the 12 months ending December 31, 2003. No party objected to the use of this test year. The Commission concludes that the future test year proposed by the Company is appropriate for purposes of this proceeding.

In its direct testimony and exhibits, IAWC stated that its proposed new rates would increase annual total Company gross revenues by a total of $36,256,254, or an average increase of 24.96% over current revenues. The rates proposed for the Company's Southern, Peoria, Streator and Pontiac Districts were designed to produce an increase in annual revenues of $17,317,145. For the remaining Districts, the proposed rates were designed to produce an increase in annual revenues as follows: Champaign, $3,389,017; Sterling, $1,232,885; Pekin, $406,520; Lincoln, $392,867; Chicago Metro-Water $10,458,540; Chicago Metro-Sewer $3,059,280.

The Southern, Peoria, Streator and Pontiac districts are currently combined for revenue requirement purposes, and to some extent have uniform rates, in a Single Tariff Pricing or "STP" district known as "SPSP". The same is also true for the Chicago Metro district, which has separate usage charges depending on the source of water. In the present case, the Company does not propose to include any additional Districts in single-tariff pricing.

The Company is proposing changes to certain miscellaneous tariff charges, applicable to the Lincoln District and the Chicago Metro District. The Company is also

proposing a change to its Sewerage Treatment Plant Connection fee, based on the Construction Cost Index at June 2002. The Company also proposes changes in the charges for municipal franchise fees. It proposes to base the charges upon water revenues and the number of customers within the franchise boundaries.

IV. RATE BASE

Schedules showing the Company's rate base at present and recommended rates for the test year ending December 31, 2003 were presented by Company and Staff witnesses. For each current STP district, such as the "SPSP" district comprised of the Southern, Peoria, Streator and Pontiac areas, the schedules were provided on a consolidated or STP district-wide basis. For each rate area not part of an STP district, standalone schedules were provided. Staff and several other parties proposed a number of adjustments to the Company's proposed rate base, as discussed below.

A. Cash Working Capital; Lead-Lag Study

In it's filing, IAWC included in rate base a cash working capital allowance of $12,392,559 (Schedule B-2 revised). (LWC brief at 14-15) IAWC witness Stafford stated that the Company estimated its cash working capital requirement using the 1/8th formula method consistent with how it had been done by the Commission in prior proceedings. (IAWC Ex 4.0 at 12) This formula is used to calculate cash working capital based on 1/8th of annual operating expenses.

As explained in its briefs, primarily its reply brief at pages 9-10, and in its BOE at pages 3-4, the LWC recommend a number of adjustments reducing the Company's proposed allowance. Staff agrees with the Company that the 1/8th formula method should be used in this proceeding. Staff and IAWC disagree with LWC's adjustments as being inconsistent with use of the 1/8th formula method, except for the Savings/Sharing outlay associated with the acquisition of the Citizens Utilities assets, which Staff agrees should be excluded from the formula because the cash outlay in question was not a test year operating expense. (IAWC brief at 48-49; IAWC RBOE at 11-13; Staff brief at 5; Staff Ex. 15.0 at 5-6; Staff RBOE at 2-3)

The LWC also recommend that the Company be required to submit a lead lag study with its next rate filing. (LWC brief at 15; LWC reply brief at 7-9; LWC RBOE at 10-11) Staff supports this suggestion, while the Company opposes it.

According to **LWC** witness Mr. Gorman, the Company's costs have changed dramatically in the last few years due to acquisitions of other districts and increases in affiliate transaction fees. (LWC brief at 15, citing LWC Exs. MPG-2 at 9-11and MPG-1 at 20-21) To ensure that the Company does not overstate its cash working capital requirements, he believes it should be ordered to file a lead/lag study in its next rate proceeding. Mr. Gorman also stated that other American Water Works' subsidiaries support cash working capital allowances through use of lead/lag studies.

In Mr. Gorman's view, cash working capital should reflect the amount of money the Company needs to keep on hand to meet its cash operating expenses. He said that if the Company receives revenues, on average, faster than it pays expenses, then the cash working capital requirement may be negative, or significantly different than that estimated by the Company. For this reason, he recommended that IAWC be directed to perform a leadllag study in its next rate proceeding to measure all future allowances for cash working capital. (LWC Exs. MPG-1 at 18-19 and MPG-2 at 11-13)

Staff agrees with LWC witness Mr. Gorman that a leadllag study should be included in the Company's next rate filing if the Company proposes to include in its rate base in that filing an amount for cash working capital. (Staff brief at 26-27; Staff reply brief at 4-7; Staff RBOE at 3-5) Staff says a leadllag study more precisely establishes the amount of cash working capital needed by the Company. Staff also observes that the Company has significantly expanded its service territory and operations through various mergers and acquisitions in recent years. Given the circumstances, Staff believes the benefits of a leadllag study's more comprehensive analysis will outweigh the additional expense. (Staff brief at 26-27) Regarding Docket 95-0076 cited by the Company, Staff states that the Commission's Order in Docket No. 95-0076 specifically contemplated the use of a leadllag study in the next rate proceeding. (Staff brief at 26, citing order in Docket No. 95-0076 at 20)

IAWC contends that the Commission should not order the Company to perform a leadllag study in its next rate case. (IAWC brief at 46-47; IAWC reply brief at 22-23) The Company believes the formula method provides a reasonable estimate of the Company's cash working capital requirement, without the time and expense related to preparing a lead-lag study. (IAWC BOE at 51-53 and Appendix I)

IAWC says the Commission has approved the use of the formula method by the Company in all its prior rate orders, and in several rate orders of other utilities. In the order in Docket No. 95-0076, IAWC says the Commission specifically rejected a proposal by Staff that the Company be required to present a lead-lag study in its next rate case. (IAWC brief at 46-47)

IAWC also asserts that while the formula method is well-established and certain in its components and methodology, a leadllag study has the potential for substantial dispute and litigation over its components and how they are to be measured. For example, in *Interstate Power Company,* Docket No. 90-0196, IAWC says Staff objected to the company's leadllag study and proposed that the working capital allowance be computed using the formula method, and the Commission agreed with Staff.

The Company also cites testimony by Mr. Stafford that "a lead-lag study would add additional rate case expense estimated to be $134,166.69, without demonstrated benefits." He added, "As indicated on Exhibit R-4.7, that estimated cost does not include expected litigation costs and certain other computer and office costs, which could substantially increase the overall costs to prepare and litigate a lead-lag study." (IAWC Ex. SR-4.0 at 2)

With regard to the calculation of cash working capital in this proceeding, **the Commission finds** that the 1/8th formula method should be used, except that the Savings/Sharing outlay should be excluded from the calculation, as urged by Staff and the LWC. As Staff has observed, the cash outlay in question was not a test year operating expense. The Commission agrees with Staff and IAWC that the other adjustments proposed by the LWC should not be accepted because they are inconsistent with the use and purpose of the 1/8th formula method.

The Commission will next address the question of whether the Company should be required to include a leadllag study in its next rate filing as proposed by LWC witness Mr. Gorman and by Staff. Based on the record, it is the Commission's opinion that if the Company proposes to include a positive amount for cash working capital in rate base in its next rate filing, it should be required to include a lead/lag study in that filing.

As LWC and Staff have stated, the Company has significantly expanded its service territory and operations through various mergers and acquisitions in recent years. Certain of IAWC's sister companies support their cash working capital requests in other jurisdictions with leadllag studies, while the Company has not performed a leadllag study for Illinois ratemaking purposes in many years. Given these circumstances, as well as the amount of the Company's working capital allowance, the Commission believes the benefits provided by a leadllag study, such as a more comprehensive and accurate analysis of the Company's cash working capital requirements, will outweigh the additional expense associated with performing such a study.

Accordingly, it is the Commission'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 shall be required to include a lead-lag study in that filing.

B. Materials and Supplies

Staff witness Pugh proposed an adjustment to reduce Materials and Supplies Inventories by the amount of associated accounts payable. She said accounts payable represents vendor financing of purchased merchandise until it has been paid in full, and the Company should not earn a return on materials and supplies until it has been funded by the investors. (Staff Ex. 5.0 at **4)**

The resulting adjustment to Materials and Supplies Inventories amounted to decreases for the rate areas of Southern/Peoria/Streator/Pontiac, Champaign, Sterling, Pekin, Lincoln, Chicago Metro Water, and Chicago Metro Sewer. (Staff Ex. 15.0, Schedules 15.2- SPSP, 15.2-C, 15.2-S, 15.2-P, 15.2-L, 15.2-CMW, 15.2-CMS) The Company did not contest, for the purposes of this proceeding, the Materials and Supplies Inventories adjustment in IAWC Exhibit R-4.0, page 2. Ms. Pugh's adjustment should be approved.

C. Accumulated Deferred Income Tax on Plant Acquisition

Staff witness Smith proposed an adjustment to eliminate, as a deduction from rate base, accumulated deferred income tax associated with a plant acquisition adjustment. Mr. Smith explained that the accumulated deferred income taxes should not be considered in the development of rate base because the plant acquisition adjustment which gives rise to the accumulated deferred income taxes is properly excluded from rate base. (Staff Ex. 3.0 at 5) The appropriate version of this adjustment is calculated on Staff Exhibit 13.0, Schedule 3.2. Mr. Smith's adjustment should be approved.

D. Village of Bolingbrook Rate Base Issue

Under an **Asset Purchase and Exchange Agreement,** the Village of Bolingbrook conveyed its water utility assets to Illinois-American in exchange for certain cash payments and the Company's wastewater treatment assets located in the Village of Bolingbrook ("Village" or "Bolingbrook"). The Agreement is dated October 8, 1996 and originally was between Citizens Utilities Company of Illinois ("Citizens" or "CUCI") and the Village. Illinois-American states that the Agreement was assigned to it when Illinois-American acquired the water and wastewater assets of Citizens in 2002. (IAWC brief at 41) A copy of the Agreement was entered into the record as part of Bolingbrook Ex. 1.1.

In Docket No. 01-0001, the Commission entered an Order on April 10, 2002 granting IAWC a certificate of public convenience and necessity for the resulting additional water service area in the Village, determining the original cost less depreciation as of July 1, 2001 of the water assets to be acquired from the Village and approved accounting entries for the proposed transaction. The asset exchange took place on July 25, 2002. (IAWC brief at 41)

One of the provisions of the Agreement is Section 5.3, captioned "Rate Base Neutrality Covenant." A copy of Section 5.3 was presented as IAWC Ex. R-1.18. Section 5.3 provides as follows:

> Section 5.3. <u>Rate Base Neutrality Covenant</u>.
>
> Citizens and Bolingbrook recognize that, as a consequence of the exchange of the Bolingbrook water supply system for the Citizens sewage treatment plants, Citizens will petition the Illinois Commerce Commission to include the former Bolingbrook water supply system in its rate base for ratemaking purposes. Citizens and Bolingbrook agree that the exchange of their respective utility assets should be rate base neutral, i.e., after the exchange of assets, the average net rate base per water customer, living in Bolingbrook and served by Citizens, should neither increase nor decrease, except as provided in this Section 5.3. Citizens, therefore, agrees that it will only petition the Illinois Commerce Commission, in any

rate case subsequent to Closing, to add the following maximum amount to its water rate base as a result of the asset exchange:

CUCI's Net Water Plant Rate Base
for all Illinois Customers
–
The Total Number of CUCI's Illinois
Water Customers
x
The Total Number of Water Customers
Residing in the Bolingbrook Service Area

EQUALS :

Maximum Rate Base Increase as a Result
of the Asset Exchange

The Bolingbrook Service Area is shown on Exhibit D attached hereto and made a part hereof.

Thus, irrespective of the value of STP #2 or STP #1, the value of the Bolingbrook Water System, or the payments made pursuant to Section 5.1 hereof, Citizens and Bolingbrook agree that the Maximum Rate Base Increase as a result of the exchange shall not exceed the above-calculated amount.

Bolingbrook and Citizens further recognize and agree that the Lake Michigan water connection and storage facilities to be constructed by Citizens to serve Bolingbrook customers (at an estimated cost of $6.5 million), the cost of those facilities referenced in Section 5.4, the cost of any backbone facilities constructed by Citizens in the future to serve Bolingbrook customers and Citizens customers, and any New Customer Connection Payments made pursuant to Section 5.2 would be includable in Citizens' water rate base to the extent permitted by the Illinois Commerce Commission.

Under its interpretation of Section 5.3, the Company made its calculation of the "maximum rate base increase as a result of the asset exchange" based upon 2002 data because the exchange occurred in 2002. To properly calculate rate base in this proceeding, the Company states, it then updated the calculation for the 2003 test year increases in plant additions and depreciation. (IAWC Ex. R-1.0 at 23) This calculation is shown in IAWC Exhibit 11, Schedule B-2.3.

Bolingbrook's witness Mr. Drey proposed that the calculation of “Net Water Plant Rate Base for all Illinois Customers", in determining "maximum rate base increase as a result of the asset exchange", be made using CUCI's Rate Base as determined by the

Commission Order in Docket No. 94-0481, entered September 13, 1995, to be $28,236,543. (Bolingbrook brief at 5)

In explaining its proposal, **Bolingbrook** says that after the Asset Exchange Agreement was "approved" by CUCI and Bolingbrook, CUCI never initiated a subsequent ratemaking proceeding before the Commission in which CUCI's Net Water Rate Base for all Illinois Customers was revalued or adjusted. According to Bolingbrook, the term "rate base" is commonly understood as the original cost value of utility property on which a return is allowed by the Commission.

Bolingbrook says CUCI's Net Water Plant Rate Base for all Illinois Customers, both at the time that the Asset Exchange Agreement was executed and at the time that the closing occurred, was set at $28,236,543, which was the figure on which the Commission had allowed CUCI a return. Using this amount, Bolingbrook calculates the maximum rate base increase associated with the Bolingbrook assets should be limited to $6,462,132 pursuant to the Section 5.3 formula. (Bolingbrook reply brief at 5)

In addition, Bolingbrook argues, the plain language of Section 5.3 only refers to "CUCI's" Net Water Plant Rate Base for all Illinois Customers, not to the rate base of any other entity, such as the Chicago Metro District of Illinois-American Water Company. (VOB brief at 6-7) Bolingbrook says using the rate base for the Chicago Metro District of Illinois-American Water Company, as proposed by IAWC, raises the value used in the numerator of the formula to $76,403,411. (Bolingbrook brief at 7)

According to Bolingbrook, substituting the IAWC Chicago Metro District for "CUIC" constitutes a "unilateral amendment" to the Section 5.3 formula. Bolingbrook says it never agreed to such an amendment, which in Bolingbrook's view is contrary to the integration clause in Section 14.3 of the Agreement, which states, "This Agreement shall not be modified or amended in any way except in writing approved by the parties hereto." (Bolingbrook brief at 7-8; Bolingbrook reply brief at 2-4)

In response to this argument, **IAWC** asserts that when the asset exchange occurred, Citizens Utilities no longer existed as the operating utility, and Bolingbrook made the asset exchange with Illinois-American, the assignee of the Asset Exchange Agreement. Obviously, IAWC argues, no amendment to the agreement was needed, as Illinois-American became the assignee. (IAWC reply brief at 24) For a number of reasons, IAWC contends that Bolingbrook's calculation is erroneous and should be rejected. (IAWC RBOE at 20-25)

Although they disagree as to the inputs in applying the Section 5.3 formula as discussed above, neither party believes any ambiguity exists in the Section 5.3 formula. (VOB brief at 8; IAWC brief at 43-44) IAWC "submits that it is very clear." (IAWC brief at 44) Bolingbrook "submits that the Section 5.3 formula is unambiguous and must be enforced as written." (Bolingbrook brief at 8) In Bolingbrook's view, since the language is unambiguous, under the "four corners rule", the Commission may only consider that express language used by the parties in interpreting Section 5.3. Bolingbrook states

that the express language only refers to CUCI, not IAWC or any other entity. Therefore, Bolingbrook contends, the Commission should accept Bolingbrook's calculation of the rate base increment attributable to the Bolingbrook water utility assets. (Bolingbrook BOE at 1-5 and 15-16)

According to Bolingbrook, in the event the Commission determines, in the context of IAWC's acquisition of CUCI's assets, that the term "CUCI's Net Water Plant Rate Base for All Illinois Customers" has been rendered ambiguous, or susceptible of more than one meaning, then parol evidence may be considered. (VOB brief at 9, citing Martindell v. Lake Shore National Bank, 15 Ill.2d 272, 154 N.E.2d 683, 689 (1958)) In the event the Commission makes such a determination, and for purposes of clarifying the intent of the parties, Bolingbrook offered a letter written by CUCI's attorney in 1996 (identified but not admitted as Bolingbrook Exhibit R-1.1) explaining the respective positions of the parties with respect to Rate Base Neutrality. (Bolingbrook brief at 9-10; Bolingbrook Ex. R-1.O; Bolingbrook BOE at 15-16)

IAWC objects to the letter offered by Bolingbrook. IAWC argues that a contract is not ambiguous simply because the parties disagree on the meaning of its terms, and that in the absence of an ambiguity, the intention of the parties is to be ascertained by the contract language, not by the construction placed on it by the parties. (IAWC brief at 43, citing *Glenview* v. Northfield Woods Water and Utility Co., 216 Ill App. 3d 40 (1st Dist. 1991)) In IAWC's view, the contract provisions are clear. The Company also argues that even if the letter is considered, it supports IAWC's interpretation, not Bolingbrook's. (IAWC brief at 44; IAWC RBOE at 24)

Having reviewed the record, the **Commission finds** that IAWC's calculation of rate base is consistent with the terms of Section 5.3 of the Agreement. Both parties suggest, and the Commission agrees, that the formula in Section 5.3 is not ambiguous.

In the Commission's opinion, the use of such terms as "after the exchange of assets" and "in any rate case subsequent to closing," in the context in which they are used in Section 5.3, supports the Company's argument that the calculation should be based on 2002 data, not data from Docket 94-0481, because the asset exchange occurred in 2002.

As noted above, Bolingbrook's claim that CUCI's rate base must be used in calculating rate base under Section 5.3 is based, at least in part, on its argument that substituting the IAWC Chicago Metro District for "CUCI" constitutes a "unilateral amendment" to the Section 5.3 formula contrary to the integration clause of the Agreement. The Company asserts that it is the assignee of CUCI under the Agreement, and Bolingbrook does not appear to dispute that particular assertion. Such a challenge might be somewhat problematic, inasmuch as Bolingbrook actually closed on the exchange with IAWC.

As the Company has also observed, Bolingbrook's recommendation does not take into consideration the effect of rate base additions to be included pursuant to the

final paragraph of Section 5.3. The Commission also agrees with IAWC that even if the letter offered as Bolingbrook Exhibit R-1.1 were considered, it does not support Bolingbrook's calculation.

In conclusion, the Commission finds that the calculation of rate base by IAWC is consistent with the terms of Section 5.3 of the Agreement, and it should be accepted.

E. Accounting Treatment of Retirements

O'Fallon states that "solely as an alternative to preserve its other issues which would become moot upon approval of the competitive alternative rate agreement", it sets out certain arguments. One such argument relates to IAWC's accounting treatment of retirements. O'Fallon argues that with inflation and the consistently devaluing dollar being the consistent experience of life, the sinking fund approach to depreciation proposed by O'Fallon witness King is the only uninflated, intergenerationally fair, and reasonable spreading of facilities depreciation. (O'Fallon brief at 10-11)

In its exceptions, O'Fallon argues that approval of "the Letter of Intent with IAWC agreeing to a competitive alternative rate" would render moot the issue relating to IAWC's accounting treatment of retirements. (O'Fallon BOE at 1-3) O'Fallon also argues that the record "was an insufficient one" on which to make specific findings in the Proposed Order rejecting O'Fallon's position regarding the accounting treatment of retirements. (O'Fallon BOE at 1-3)

The Company provided testimony in opposition to O'Fallon's proposal. Specifically, IAWC witness Robinson testified that SFAS 143 will not require IAWC to change the manner in which it recovers retirement costs. He alleges that O'Fallon's proposal will improperly defer the recovery of costs that IAWC will incur in conjunction with the use of its plant in service to provide service. (IAWC Ex. R-5.0 at 4-6)

Mr. Robinson also testified that O'Fallon's proposal to link rate making depreciation expense to accounting treatment of a liability is counter to proper capital recovery treatment. He says the proposal is simply a method to defer appropriate recovery of the total cost of the property providing customer service. (IAWC Ex. R-5.0 at 8)

Mr. Robinson asserts that the Uniform System of Accounts requires that the cost of removing plant be charged to the book depreciation reserve. He also argues that due to the high cost to retire assets it is important that such costs be correctly recovered from the customers who benefit from the use of those assets. (IAWC Ex. R-5.0 at 13, 9)

IAWC also argues that the issue should be disposed of on the merits in the Commission's order in this proceeding. (IAWC RBOE at 38)

Staff witness Sant also objected to O'Fallon's proposed accounting treatment of retirements. Mr. Sant disagreed with O'Fallon's proposal because: 1) it goes beyond SFAS 143 and discounts all assets not just assets with legal retirement obligations, 2) it only addresses half of SFAS 143's equation, the discounting of future retirement costs, while ignoring the accretion expense, and 3) it shifts costs from one asset to another which is not proper accounting. (Staff Ex. 14.0 at 32-33)

Having reviewed the positions of the parties, the **Commission concludes** that the record does not support O'Fallon's proposal. The Commission finds that the proposal is inconsistent with the scope of SFAS 143 and that the Company's method of accounting is consistent with the Uniform System of Accounts. Finally, the Commission finds that O'Fallon's proposal would cause intergenerational inequity because current customers would not pay the full cost of facilities used to provide utility service. As a result, future generations of customers would be improperly burdened with paying costs associated with utility plant that provides no benefit to them, but instead was used to provide service to current customers. Accordingly, the Commission rejects O'Fallon's proposed accounting treatment of retirements.

F. Approved Rate Base

Upon reflecting the effects of the determinations made above, the rate bases for IAWC's respective districts are approved as shown in the Appendix attached hereto. Generally speaking, contested issues that affect both rate base and operating expenses are addressed in the next section of this Order.

V. OPERATING REVENUES, EXPENSES AND INCOME

Schedules showing the operating revenues, expenses and income at present and recommended rates for the 2003 test year were presented by Company and Staff witnesses. For each current STP district, such as the "SPSP" district comprised of the Southern, Peoria, Streator and Pontiac areas, the schedules were provided on a consolidated or STP district-wide basis. For each rate area not part of an STP district, standalone schedules were provided. Staff and several other parties proposed a number of adjustments to the Company's proposed operating statements, as discussed below.

A. Uncontested Issues

Staff witness Smith proposed an adjustment which coordinates the Company's **income tax expense** for ratemaking purposes with the Company's net income for ratemaking purposes. (ICC Staff Ex. 3.0 at 3-4) The appropriate version of this adjustment is calculated in Staff Ex. 13.0, Schedule 3.1 and in the case of the Pekin District, Staff Exhibit 13.0, Schedule 3.1-P Revised. In rebuttal testimony the Company accepted this adjustment. (IAWC Ex. R-4.0 at 1-2) Mr. Smith's adjustment appears reasonable and it should be approved.

The Company assigned all **fuel and chemical cost** in the Chicago Metro rate area to water operations. Because sewer operations also benefit from the fuel and chemical expenditures, Staff witness Smith proposed an adjustment to allocate portions of these expenses to sewer operations. (Staff Ex. 3.0 at 5-6) The appropriate versions of these adjustments are calculated on Staff Exhibit 13.0, Schedule 3.3 and 3.4. In rebuttal testimony the Company accepted this adjustment. (IAWC Ex. R-4.0 at 1-2) Mr. Smith's adjustment appears reasonable and it should be approved.

Staff witness Pugh proposed an adjustment to remove revenues and expenses related to the **Purchased Sewage Treatment Surcharge** Rider in the Chicago Metro rate area because both revenues and expenses are passing through the Rider. (Staff Ex. 5.0 at 6-7) She also proposed an adjustment to remove revenues and expenses related to the **Purchased Water Surcharge** Rider in the Chicago Metro rate area because both revenues and expenses are passed through that Rider. (Staff Ex. 5.0 at 5) The Company did not contest these adjustments. Ms. Pugh's adjustments appear reasonable and they should be approved.

Staff witness Pugh proposed an adjustment to limit the **waste disposal expense** for the Champaign rate area to the maximum amount of $110,000 provided for in the contract, thereby reducing test year waste disposal expense for that area. (Staff Ex. 5.0 at 7) The Company did not contest that adjustment for purposes of this proceeding, and it should be approved.

Staff witness Pugh proposed an adjustment to reduce **rent expense,** resulting in decreases for the rate areas of Southern/Peoria/Streator/Pontiac, Champaign, Sterling, Pekin, Lincoln, Chicago Metro Water, and Chicago Metro Sewer. (Staff Ex. 5.0 at 7-9) Staff says the rent expense was reduced "because terms of two leases cannot be increased due to leases not terminating until 2005 and leased computer equipment was replaced with purchased equipment." (Staff brief at 31) The Company did not contest the adjustment for purposes of this proceeding, and it should be approved.

Staff witness Pugh proposed an adjustment to reduce **charitable contributions** to remove contributions made to the Illinois High School Association for the March Madness Experience. Ms. Pugh said these contributions 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, image of the utility. (Staff Ex. 5.0 at 9) For purposes of this proceeding, the Company did not contest that adjustment, and it should be adopted.

Staff witness Pugh proposed an adjustment to remove **advertising expenses** that Staff contends are not recoverable under the provisions of Section 9-225 of the Act. (Staff Ex. 5.0 at 12) For purposes of this proceeding, the Company did not contest that adjustment, and it should be accepted.

Staff witness Pugh proposed an adjustment to remove dues and memberships for certain **community organizations.** (Staff Ex. 5.0 at 13.) She said the Company receives membership benefits in return for payment of dues, and that participation in

such organizations is a promotional and goodwill practice and is not necessary in providing utility service. For purposes of this proceeding, the Company did not contest that adjustment. Ms. Pugh's adjustment should be approved.

Staff witness Pugh proposed an adjustment to increase **general office expense** for the test year based upon more current information provided by the Company. (Staff Ex. 15.0 at 15) She said the total expense for the telephone frame relay was determined to be substantially higher than the projected test year amount, and that the Company provided documentation to support the higher costs. Ms. Pugh's adjustment should be approved.

Staff witness Sant proposed adjustments to **depreciation expense** and accumulated depreciation to make depreciation rates uniform across all rate areas of the Company. (Staff Ex. 4.0 at 8) The rates used by Mr. Sant are those approved by the Commission in the Company's prior rate case, Docket No. 00-0340. The Company accepted Staff's adjustments and has agreed to perform a depreciation study prior to its next rate case. Mr. Sant's adjustment should be approved. Accordingly, the Company is hereby directed to perform a depreciation study prior to its next rate case.

Staff witness Everson proposed an adjustment to remove **lobbying expense** from the Company's revenue requirement. (Staff Ex. 12.0 at 17) Staff asserts that Section 9-224 of the Act prohibits the Commission from considering political or lobbying expense when establishing rates. For purposes of this proceeding, the Company did not contest the adjustment, and it should be approved.

B. Tank Painting Expense

Staff witness Sant proposed to disallow what he referred to as the Company's proposal to convert steel structure maintenance expenses ("tank painting") from deferral and amortization to a normalized expense. (Staff brief at 24, citing Staff Exs. 4.0 and 14.0) Mr. Sant proposed that the Company continue to defer and amortize its tank painting expenses, and that the amortization period for tanks painted in the test year be increased from 10 years to 15 years as new painting techniques have lengthened the life of the painting.

Staff states that in order to narrow the issues in this proceeding, the Company has agreed to accept Staff's proposal. (Staff brief at 24-25) In its brief, the LWC, which had also contested approval of the Company's proposal, indicated that it does not oppose the method that Staff proposes. (LWC brief at 6)

In reaching its conclusion on this issue, the Commission first observes that because of wide fluctuations in tank painting costs from one year to the next, the amount projected to be expended in any given test year may not be representative of a normal year. Hence, for ratemaking purposes, other methods of calculating such expenses may be used. Based on the record, the Commission finds that Staff witness Sant's recommendation, described above, is a reasonable method for calculating the

annual amount of tank painting costs to be recovered through rates. For purposes of this proceeding, it should be accepted.

C. Incentive Compensation Expense

In her direct testimony, Staff witness Ms. Everson proposed an adjustment to remove the costs of the Company's incentive compensation plan from the revenue requirement based on what Staff characterized as the circular effect of the financial goals in the 2002 incentive plan. (Staff Ex. 2.0 at 7) After reviewing additional information provided by the Company, Staff witness Everson modified her proposed adjustment to allow recovery of incentive compensation costs for those parts of the program that operate independent of the Company's financial performance. IAWC believes the Commission should allow full recovery of incentive compensation costs.

In her direct testimony, **Staff** witness Everson's proposed adjustment to incentive compensation was based on the "gatekeeper effect" of the financial goals in the Company's 2002 annual incentive plan. The 2002 incentive compensation plan's provisions included an overall Company financial performance goal of earnings per share of American Water Works Company ("AWWC") that had to be met before any award was given. AWWC owns 100% of IAWC. In response to data request MHE-2.06, the Company stated "[t]he first criteria is that AWWC achieve targeted earnings per share ("EPS") in order for any award to be made under the program."

Staff witness Everson testified 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. She said 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. (Staff Ex. 2.0 at 7-8)

In rebuttal, IAWC witness Stafford stated that the Company had a new annual incentive compensation plan ("AIP") for 2003 which had a different method of calculating individual incentive awards than the method used in the 2002.

As explained in Staff's briefs, after Ms. Everson reviewed the new AIP, she proposed a modified adjustment to incentive compensation plan expense based on the 2003 AIP. (Staff brief at 50-54; Staff reply brief at 22-25) 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, Staff states, awarding of the operational and individual goals does not depend on the overall financial goals. (Staff brief at 52, citing Staff Ex. 12.0 at 13) Ms. Everson's modification to her original adjustment included allowing the

40% of the total payouts that are tied to achievement of operational and individual goals.

The modification proposed by Ms. Everson still would disallow the payouts that are tied to overall company financial goals because those goals provide many benefits to shareholders but few benefits to ratepayers. Staff says the Commission has made similar adjustments in prior dockets, citing *Illinois Power Company* Docket No. 93-0183, *Citizens Utilities Company of Illinois* Docket No. 94-0481, *Central Illinois Light Company* Docket No. 94-0040, and *MidAmerican Energy Company* Docket No. 99-0534.

Another reason Ms. Everson cites to disallow incentive awards based on financial goals in the 2003 AIP is that in her opinion, the 2003 AIP 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 employees' supervisor to define. As this plan is written, it does not, in Staff's view, provide sufficient information to enable the Commission to determine that ratepayers should pay rates that reflect costs based on these vaguely defined financial goals. (Staff Ex. 12.0 at 15)

In Staff's view, its adjustment to the Company's incentive compensation plan expense is consistent with prior Commission orders and should be accepted. (Staff RBOE at 5-6)

The position of **IAWC** is that the Commission should allow full recovery of the Company's incentive compensation costs. (IAWC brief at 34-35; IAWC reply brief at 19-20; IAWC BOE at 47-49 and App. G) Company witness Stafford alleged that the portion of the plan related to achievement of financial goals directly benefits customers in that it helps to assure that customers are served by a company which is committed to providing the most efficient and least cost service possible, consistent with safety and reliability. (IAWC Ex. R-4.0 at 4)

He further asserted that a financially healthy utility is able to attract the capital investments necessary to provide safe and reliable service and to maintain the technological expertise necessary to operate the Company and to comply with increasing water quality standards. He believes disallowance of any incentive compensation simply because it is tied to achieving this desirable goal would be inappropriate and counterproductive, especially when major elements of incentive compensation are specifically tied to customer service and individual employee development standards. (IAWC brief at 34, citing IAWC Ex. R-4.0 at 15)

The Company also argues that Staff's position is inconsistent with prior Commission orders approving full recovery of incentive compensation plan expense even though the plan contained financial goals. The Company asserts that in *Notthern Illinois Gas Company,* Docket No. 95-0219, the Commission allowed recovery of the full cost of a plan, including the portion related to financial goals, noting that the company's financial strength can, in part, be attributed to the plans, "thereby directly benefiting ratepayers." In *Consumers Illinois Water Company,* Docket No. 97-0351, IAWC says

the Commission allowed full recovery of plan expense, even though 60% was determined by financial goals.

Having reviewed the positions of the parties, the **Commission finds** that the recommendation of Staff witness Everson is appropriate. In recent cases, such as the rate orders in Dockets 01-0465, 01-0530 and 01-0637 (cons.) entered March 28, 2002 and Docket 00-0802, entered December 11, 2001, and the rate order in Dockets 99-0199/99-0131 (cons.), the Commission has consistently disallowed recovery of payouts that are tied to overall company financial goals.

As noted on pages 18-19 of the Commission order in 00-0802, "the Commission has generally disallowed such expenses except where the utility has demonstrated that its incentive compensation plan has reduced expenses and created greater efficiencies in operations." On page 19 of that order, the Commission also stated, "Generally speaking, the Commission believes that if a utility is seeking to recover such projected expenses from ratepayers, the utility should demonstrate that its plan can reasonably be expected to provide net benefits to ratepayers."

In the instant case, no such showings have been made with respect to the portion of the expense that Staff proposes be disallowed. Furthermore, as stated in the order in 00-0802, if projected payouts tied to financial targets are included in revenue requirement, such amounts would continue to collected from ratepayers even if actual payouts do not occur because financial targets are not met.

Accordingly, while the Commission believes that incentive compensation plans have the potential to provide benefits in terms of improving performance and reducing costs, and that the recovery of expenses associated with incentive compensation plans may be appropriate in some circumstances, the Commission concludes, for the reasons set forth above, that the disallowance proposed by Staff in Docket 02-0690 should be adopted.

D. Community Relations Expense

Staff witness Pugh proposed an adjustment to remove items on the 2003 Business Plan Community Relations schedule from the Company's operating expenses because, in her view, they are either of a promotional, goodwill or institutional nature. (Staff brief at 43, citing Staff Ex. 5.0 at 11-12; Staff reply brief at 31-35) The resulting adjustment to community relations expense amounted to decreases for the rate areas of Southern/Peoria/Streator/Pontiac, Champaign, Sterling, Pekin, Lincoln, Chicago Metro Water, and Chicago Metro Sewer. (Staff Ex. 15.0, Sch. 15.8) The Company regards these expenditures as charitable donations, and it objects to Ms. Pugh's adjustment.

In support of Ms. Pugh's adjustment, **Staff** cites Section 9-225(2) of the Act which 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) specifically refers to gas and electric utilities, Staff believes the concept remains valid for water utilities. Furthermore, Staff states, the Commission has applied this principle to items other than advertising. Staff says the Commission, in its Order in a *Commonwealth Edison Company* 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.

Staff takes issue with IAWC's assertion that the expenses in question are for the public welfare and for educational purposes, within the meaning of Section 9-227 of the Act. Staff says the Company did not identify these costs as charitable contributions in its initial filing and that IAWC witness Mr. Stafford recharacterized these items as charitable contributions only after Staff took issue with them. In Staff's opinion, 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. (Staff brief at 44; Staff RBOE at 7-9) Staff cites examples from the list of items, including Octoberfest, Rotary baseball team and sweet corn festival. (Staff brief at 44)

IAWC argues that the Commission should allow recovery of the subject expenses which the Company characterizes as "charitable donations." (IAWC brief at 35-36; IAWC reply brief at 20; IAWC BOE at 49-51 and App. H) The Company complains that Ms. Pugh made no attempt to examine each donation, but instead proposed to disallow all of them on a wholesale basis, apparently because of the title of the list, "Community Relations". The Company says the recoverability in rates of donations is governed by statute, not by titles. Section 9-227 of the Public Utilities Act, 220 ILCS 519-227, provides:

> It shall be proper for the Commission to consider as an operating expense, for the purpose of determining whether a rate or other charge or classification is sufficient, donations made by a public utility for the public welfare or for charitable scientific, religious or educational purposes, provided that such donations are reasonable in amount. In determining the reasonableness of such donations, the Commission may not establish, by rule, a presumption that any particular portion of an otherwise reasonable amount may not be considered as an operating expense. The Commission shall be prohibited from disallowing by rule, as an operating expense, any portion of a reasonable donation for public welfare or charitable purposes.

The Company says Ms. Pugh's position is whether a donation is recoverable depends on the intent of the giver, not the purpose of the donation (Tr. 531-533), is contrary to Section 9-227, provides that a recoverable donation is one made for the public welfare or for the charitable scientific, religious or educational purposes.

The Company states that the items in question include donations to the Boy Scouts, National Theater for Children, Museums, a University, a symphony, United Way, Special Olympics, March of Dimes, Little League, and Boys & Girls Club, and that Mr. Stafford testified these "are donations for the public welfare and for educational purposes." (IAWC brief at 36)

Having reviewed the record, the **Commission concludes** that Ms. Pugh's adjustment should be adopted. The Commission notes that the Company's rate filing contains a separate schedule, C-7, for "Charitable Contributions", that were addressed in Schedule 15.7 of Staff Exhibit 15.0 and are not the subject of the instant dispute. The adjustments to "Community Relations" expenses, to which the Company objects, are shown in Schedule 15.8 of Staff Exhibit 15.0. Schedule 15.8 reflects the amounts, by district, which are presented in total in IAWC Ex. R-4.5. As noted above, the Company claims these Community Relations expenses also include items that qualify as a recoverable charitable contributions.

As Staff has asserted, however, a number of these items simply do not appear to qualify as charitable donations. While the Company believes some of the items qualify as recoverable charitable contributions, it has not provided a clear breakdown in this regard or a method for doing so. Rather, the Company appears to be standing by its argument that the schedule on the whole qualifies as charitable contributions. A review of the expenses listed on IAWC Ex. R-4.5 reveals numerous donations for golf tournaments, sports sponsorships, and other promotional items. Inclusion of these items in the Company's proposal casts doubt on the other items, which may or may not be allowable under the Act, but for lack of evidence, cannot be determined as such.

Of the two "all or nothing" proposals before the Commission, the Commission believes the one advanced by Staff is the more reasonable, for the reasons set forth in the two paragraphs immediately above, and should be adopted. On a final note, the Commission does agree with the Company that the recoverability of the donation should not depend on the intent of the donor, and the conclusion reached above is not based on the Company's intent.

E. Pension Expense

In its initial filing, the Company requested an annual test year pension expense of $2,757,060, based on an updated actuarial study for the 2003 test year. (LWC brief at 12)

As explained in its briefs, **Large Water Consumers** witness Mr. Gorman recommended that the Company's test year pension expense instead be based on its pension expense estimate for 2002. (LWC brief at 12-14; LWC reply brief at 13-15; LWC Ex. MPG-2 at 16) LWC assert that this adjustment would reduce the Company's revenue deficiency by $0.99 million. (LWC brief at 3) According to LWC, "the 2002 pension expense estimate while still over stated for the reasons identified by the LWC appears to be more reliable than the 2003 estimate which is significantly over stated because of the use of inconsistent economic factors as pointed out by the LWC." (LWC BOE, Att. A at 4)

LWC witness Mr. Gorman stated that the Company's pension expense as shown on the Company's Schedule C-2, Exhibit 12, Page 1, changed from a negative expense in 2000 to a positive expense of $1,763,128 in 2002, and another large increase for the 2003 test year of $2,757,000. (LWC brief at 12)

He recommended rejection of the Company's updated test year pension expense due to what he views as unreasonable assumptions and inconsistent economic factors used in the 2003 updated actuarial study. (LWC reply brief at 13) Therefore, Mr. Gorman recommended rejection of the Company's 2003 pension expense estimate and recommended the use of IAWC's actuarially derived 2002 pension expense estimate as the test year pension expense estimate. (LWC Ex. MPG-2 at 16)

The LWC say Mr. Gorman recommended the Company's 2003 pension expense estimate be rejected for principally two reasons. First, he stated that the actuarial study used to derive the annual pension expense was derived using an annual escalation of labor expense of 4.75%. Mr. Gorman observed that this estimate of labor expense escalation was significantly higher than the Company's salary expense escalation factor used in its rate filing of 3% to 4%. He stated the labor expense escalator in the Company's rate filing was directly comparable to the labor expense escalator in the actuarial study used to develop the pension expense. He observed that because the Company's actuarial study overstates IAWC's escalation in salary expenses for 2003, its updated actuarial expense was unreasonably high. Had the Company used its actual labor expense allocator, Mr. Gorman says it would have lowered its pension expense. (LWC Ex. MPG-1 at 11; LWC Ex. MPG-2 at 16-17)

Second, Mr. Gorman said the Company made asset value adjustments which conflicted with the actuarial study assumptions. He stated that the Company's updated pension expense estimate for 2003 was based on an asset balance as of June 30,2003 projected for a return on assets of a negative 5% for July 2002 and a 0% return through December 31, 2002, and that this conflicted with the actuarial expected return on assets assumption of 9% per year. Mr. Gorman testified that this was unreasonable because the long-term expected return on assets of 9% reflects the variability in annual achieved returns and the Company's short-term analysis does not capture that variability. Mr. Gorman said it is reasonable to expect pension assets would achieve returns above and below 9% from year to year, and that it would be reasonable to anticipate that in some months during the year, returns could be negative. However, he asserted, these

periods of low returns could be expected to be offset by periods of high returns. (LWC brief at 13)

Mr. Gorman also stated the Company had an economic incentive to overstate its pension expense in this proceeding. He said the Company's annual pension was $2.7 million in its rate filing, but that it intended to make a pension expense contribution of only $1.17 million (LWC Ex. MPG-2 at 17), with the difference to be retained by IAWC to enhance its cash flow. Mr. Gorman reasoned that because the Company had overstated its labor escalation rates actuarial study and because it was probable that the Company would be able to permanently retain the difference between the annual pension expense included in rates in the plan cash contribution, the Company had incentive to overstate pension expense. (LWC Ex. MPG-2 at 18)

Mr. Gorman also stated the Company's proposal in this case for pension expense was considerably more expensive than that requested by the Company's affiliate in Tennessee. There, he said, the Company requested only that it be permitted to include its actual or planned contribution to its pension fund in its rates, not its estimated pension expense. (LWC Ex. MPG-2 at 18)

In the instant case, Mr. Gorman recommended setting revenue requirements using the 2002 pension expense estimate. He asserted that using the 2002 pension expense estimate would be reasonable and conservative because it provides funding in excess of the amount IAWC actually planned on depositing into the pension expense trust fund during the test year, and was based on an overstated labor escalation rate. (LWC brief at 14)

IAWC recommends that the Commission reject the LWC's adjustment to pension expense. (IAWC RBOE at 13-17) According to the Company, LWC witness Gorman proposed that the Company recover pension expense calculated on a cash outlay or "ERISA basis rather than on an accrual or "FAS 87" basis. IAWC asserts that FAS 87 requires pension expense to be calculated on an accrual basis, and that in Docket No. 92-0116, and every subsequent rate order, the Commission approved the Company's recovery of pension expense under FAS 87. (IAWC brief at 53)

The Company cites the Commission Order in Inter-State Water Company, Docket No. 94-0270. In approving the utility's proposal to move to the FAS 87 accounting method for pension expense, the Commission noted its strong preference for the accrual method, observing that this approach is supported by the view that current ratepayers benefit from the service of an employee and should be responsible for paying rates that reflect the employee's post-retirement costs, irrespective of when cash payments are ultimately made. (IAWC brief at 53-54)

The Company also states that Mr. Gorman is not a licensed actuary, has never performed calculations of pension costs, has never determined an expense level under FAS 87, and never performed actuarial calculations for pension cost calculations.

Company witness Stafford testified that its pension expense was calculated in accordance with the requirements of FAS 87, and that the economic and demographic assumptions were made in accordance with Actuarial Standards of Practice No. 27 and 35. (IAWC Ex. R-4.0 at 23) He also said that the actual pension expense for 2003 is greater than the projected amount proposed by the Company in this rate case by approximately $200,000. (Id. at 25)

Mr. Stafford also claimed Mr. Gorman's criticisms of the Company's cost estimate were incorrect. For example, Mr. Stafford said that in one instance, Mr. Gorman attempted to compare one component of the calculation of trust fund returns (actual 2002 results) with an entirely different component of the calculation of compensation costs (long-term escalator).

Mr. Stafford said Mr. Gorman also appears to criticize the Company for not using the prescribed actuarial assumption of 9% for 2002, when actual information supporting a much lower return was known for that period. In criticizing use of a compensation rate greater than what was projected for the test year, what Mr. Gorman is failing to acknowledge, Mr. Stafford asserts, is that the compensation rate used should consider long-term expectations of all salary adjustments, including promotions, over the working life of eligible employees, and not simply be based on a very short-term assumption. According to Mr. Stafford, if Mr. Gorman's approach were applied to return on assets, he would utilize a 0% return on assets over the entire life of the pension plan. That is not only unrealistic, Mr. Stafford asserts, but it would result in a much higher test year pension expense than what the Company has proposed in this proceeding." (IAWC brief at 55; IAWC Ex. SR-4.0 at 9-10)

IAWC also states that neither Staff nor any Intervenor has any objection to the Company's calculation of pension expense. (IAWC reply brief at 30)

Having reviewed the record on the issue of pension expense, the **Commission concludes** that the Company's proposal should be accepted. As noted above, LWC witness Gorman believes the Company's proposal contains unreasonable assumptions, and he recommended setting revenue requirements using the 2002 pension expense estimate.

In other words, as a result of its criticisms of the actuarial study performed for the Company, LWC's proposal would essentially default to a cash outlay method. As the Company has noted, for pension expense, the Commission has stated a strong preference for use of the accrual or "FAS 87" method as opposed to the cash outlay or "ERISA method. The Company also observes that its pension cost calculations were preformed by a licensed actuary, while the LWC's proposal was not. (IAWC Ex. R-4.0 at 22-23) The Company also asserts that the proposed expense was calculated in accordance with the requirements of SFAS 87, and that the economic and demographic assumptions were selected in accordance with Actuarial Standards of Practice No. 27 and No. 35, and that the record does not support any conclusions to the contrary.

Of the two recommendations on the table in this proceeding, the Commission finds that the Company's proposal is better supported by the record, is more consistent with prior Commission decisions, and should be used in setting rates in this proceeding.

F. Management Fees

LWC witness Mr. Gorman recommended an adjustment reducing the Company's management fees by $877,725, purportedly based on application of an escalation rate of 2.5% to 2002 fees. (LWC Ex. MPG-1 at 16) This issue was not addressed in LWC's initial brief, but was addressed on pages 11-12 of its reply brief and on pages 7-8 of its BOE. Mr. Gorman stated that the level of test year management fees proposed by IAWC had increased by 32.6% over the expense in 2002 and by 91.5% over the expense in 2000. (LWC Ex. MPG-1 at 13-14) Mr. Gorman suggested these fees were not reasonable and that at these levels management services might be obtained more economically from a competitive supplier. (LWC Ex. MPG-1 at 14-15) In the LWC's view, the Company has failed to demonstrate that it cannot obtain these management services on a less costly basis from competitive suppliers.

In response to criticism by IAWC that Mr. Gorman failed to annualize call center costs and shared service center costs and failed to reflect the increased number of customers associated with the CUCI acquisition, Mr. Gorman testified in his rebuttal testimony that he adjusted the 2002 actual management fees to reflect 12 months worth of call center and shared services costs as well as the additional CUCI customers. (LWC reply brief at 11-12, citing LWC Ex. MPG-2 at 20)

Mr. Gorman also stated that if an increase in management fees allocated to IAWC is due a loss of customers in other states, such a reallocation would not be reasonable. (LWC reply brief at 11-12)

IAWC disagrees with LWC's proposed adjustment. (IAWC RBOE at 17-19) Mr. Stafford stated that under the agreement approved by the Commission in Docket No. 88-0303, Service Company costs other than directly assigned costs are allocated to Illinois-American based upon the number of customers served. Thus, he asserted, as Illinois-American's customer base grows compared with the Service Company's customer base, increased management fees will be allocated to the Company. (IAWC brief at 50)

Mr. Stafford also stated, in part, that IAWC's allocable share of management fee costs have increased from 1999 to 2003 due to increased customers, primarily resulting from acquisitions by Illinois-American of the former Northern Illinois Water Corporation, the former United Water-Illinois, and the former Citizens Utilities systems, as well as changes in customer levels for other states, including acquisitions by other System companies and the divestiture of certain properties in the New England region. (IAWC Ex. R-4.0 at 29-30)

He further testified that total American Water Works Service costs have increased due to system acquisitions; conversion of personnel to the Service Company's payroll who perform services on a regional basis (e.g. Belleville office associates performing services on behalf of Iowa-American and American Lake Water Company), who previously were on Illinois-American's payroll; increases in operating costs such as pensions, insurance, and security programs designed to protect the Company's facilities from terrorism threats, implementation of the National Call Center and Shared Services Center, and expanded utilization of the Hershey Data Center as billing and programming support for the ECIS system employed at the National Call Center. (Id.)

Mr. Stafford also took issue with what he referred to as the application by LWC of a 2.5% escalation factor to recorded 2002 fees. He said two factors were not taken into account. First, he alleged that recorded 2002 costs would need to be annualized to reflect a full year of Call Center costs and shared services costs, and that it is necessary to annualize the addition of the former Citizens Utilities operations and customers. Of the $6,843,171 estimated total management fee for 2003, he said $1,849,359 is for the former Citizens Utilities operations and customers, on an annual basis.

Second, he said the Service Company has provided to Illinois-American the escalation factor for 2003, which it estimates at 6%. According to IAWC, of this total, 2% is related to Information Systems, and is necessary to reflect the shift of certain personnel capitalizing time to the Orcom conversion to other projects that are expensed rather than capitalized, including a concentrated effort to keep conversion of all remaining companies to the Alton Call Center on target. Mr. Stafford alleged this "timely conversion" is already reflected in economies of scale benefits from how Alton Call Center costs are allocated to Illinois-American. (IAWC Ex. R-4.0 at 30-31)

In its brief on exceptions and reply brief on exceptions, IAWC takes issue with a finding in the Proposed Order that the Company should be required to file a petition in six months seeking approval of its management agreements with its affiliates. (IAWC RBOE at 7-8) IAWC asserts that the Company's agreement with the Service Company was approved by the Commission in Docket No. 88-0303; that no party claimed the agreement was inappropriate; that no party questioned the use of the number of customers as the basic allocator of costs; that "no party questioned that services were not provided at cost"; and that no party presented evidence that alternative providers were available or less costly. (IAWC BOE at 56-57) According to IAWC, the agreement is not an issue in this proceeding. IAWC says the Illinois Supreme Court has held that the Commission cannot enter an order which is broader than the scope of the case. (IAWC BOE at 56, citing Alton & S.R. Co. v. Illinois Commerce Commission, 316 Ill 625 (1925))

IAWC also argues that the Proposed Order, in effect, rescinds the order in Docket 88-0303, without notice and an opportunity to be heard, and that it somehow constitutes retroactive ratemaking. According to the Company, the Proposed Order "implies that the approved management agreement is not approved from the date of the

order herein forward", thereby calling into question all transactions under the agreement until the agreement is re-approved. (IAWC BOE at 56-57)

In its RBOE, the Company contends that "there is no evidence of any need for re-approval" of any of the agreements cited in Staff's BOE, as discussed below. (IAWC RBOE at 8)

In its brief on exceptions, **Staff** suggests that the Proposed Order should be modified to specifically identify the agreements to be reviewed. In that regard, Staff identifies the operating agreements with affiliates that would be subject to that review. They are Docket No. 88-0303, American Water Works Service Company; Docket No. 95-0037, American Anglian Environmental; Docket No. 00-0306; American Water Capital Corporation; Docket No. 00-0476, American Water Services; and Docket No. 01-0418, Iowa-American and American Water Works Service Company. Staff also proposes that the agreements to be reviewed should be updated by IAWC prior to filing "to consider that the Company has significantly expanded its service territory and operations through mergers and acquisitions and that the amount and type of management services and fees has increased significantly." (Staff BOE at 3-4)

In its RBOE, Staff takes issue with IAWC's argument that Proposed Order somehow "rescinds" the order in Docket 88-0303. According to Staff, "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." (Staff RBOE at 9) In Staff's view, the Company's operating agreements with its affiliates should be reviewed.

The **LWC** also support the Proposed Order's conclusion that the Company's management agreement with its affiliate should be reviewed by the Commission. (LWC RBOE at 12-15) LWC asserts that "[t]he Company made the management agreement itself an issue in its defense of the exorbitant management fees it has requested in this case." (LWC RBOE at 13) The LWC also says the Company's argument that the Proposed Order "rescinds" the order in Docket 88-0303 without notice and opportunity to be heard is without merit.

The **Commission** has reviewed the positions of LWC and the Company on the issue of management fees. As indicated above, LWC has raised concerns over the large increases in these fees, and suggests that many of these management services may be available on a less costly basis from competitive suppliers. IAWC identifies reasons that it believes adequately explain the increases.

It appears that LWC's position essentially revolves around the assumption that the magnitude of the increases in such fees somehow creates a strong presumption that the amount of fees is unreasonable. The Commission believes LWC's assumption is problematic. In the Commission's view, the percentage increase information identified by LWC, while relevant, is not sufficient, in and of itself, to create such a

presumption. Rather, the Commission should rely on the record as a whole to decide this issue, as discussed below.

In addition to its explanations for the increases, including that such services cover an increasing number of centralized functions and systems, the Company has asserted that the allocation of management fees was done in the manner prescribed in an agreement approved by the Commission, and this assertion was not refuted. For purposes of context, the Commission also notes that in the SPSP district, management fees represent less that 5% of total operating expenses before taxes. While the Commission reaches no conclusion on whether this percentage is reasonable or unreasonable, the Commission observes that there was no contention that the ratio of management fees to overall operating expenses is excessive.

In conclusion, it is the Commission's opinion that based on the evidence of record in this proceeding, the adjustment proposed by LWC should not be adopted. The Commission does believe, however, that the time has come to review the Company's current operating agreements with its affiliates. The Company says the agreement that it cites was the subject of a 1988 docket. In recent years, the Company has significantly expanded its service territory and operations through various mergers and acquisitions, and the amount of management services and fees has increased significantly.

In order to facilitate the review of management fees in the next rate case and to ensure that ratepayers are being adequately protected by the terms of the current agreements, including those relating to allocation and competitive pricing procedures, the Company should be required to file a petition within six months after the entry of the instant order. That petition shall seek approval of IAWC's operating agreements with American Water Works Service Company, American Anglian Environmental, American Water Capital Corporation, and with Iowa-American and American Water Works Service Company, and any other currently approved operating agreements with affiliates. The six month period is intended to give the Company time to review the agreements and incorporate any proposed revisions it deems appropriate.

As correctly observed by Staff and LWC, the instant order obviously does not somehow "rescind" any existing agreements that have been approved by the Commission. Such agreements will remain in effect unless modified or superceded by further order of the Commission. Further, as noted by LWC, the instant order actually allows the Company's management fees in the current docket over the objections of LWC. Thus, the Company's complaint that ordering a future review of its management agreements with affiliates would constitute "retroactive ratemaking" is illogical and incorrect.

G. Citizens Acquisition Savings

Staff witness Everson and Company witness Stafford provided testimony regarding IAWC's Savings Sharing Plan ("Plan") ordered in Dockets Nos. 00-0476 and 01-0556. (Staff Ex. 2.0 at 11-12; IAWC Ex. 4.0 at 23-28)

By way of background, it is noted that the transactions by which IAWC acquired the properties of Citizens Utilities Company of Illinois ("CUCI" or "Citizens") were the subject of Docket 00-0476. The Company says that in Docket 00-0476, the Commission ordered, in rate proceedings filed within three years after the order, that savings resulting from the acquisition be shared between IAWC's shareholders and customers on a 50-50 basis

In Docket 01-0556, the Commission entered an order approving a methodology for acquisition savings, with the savings to be quantified in the next rate proceeding. A two-part methodology was approved, whereby one component covered savings related to cost of capital and the other covered savings not related to cost of capital.

In the instant case, IAWC Exhibit 12.0, Schedule C-2.4 contains IAWC's calculation of Acquisition Savings/Sharing by district. The schedule identifies five categories of costs: (1) labor and labor-related; (2) management fees; (3) rate case expense; (4) non-Citizens rate area long-term debt; and (5) Citizens rate area long-term debt. IAWC's witness, Ronald Stafford, describes IAWC's calculation methodology in his direct testimony, IAWC Exhibit 4.0, pages 24-28.

Staff reviewed the Company's calculation of savings/sharing. Ms. Everson said the Plan increases the revenue requirement to reflect 50% of calculated savings derived from the merger of IAWC and CUCI. Ms. Everson stated that the Company's filing determines amounts labeled as savings that increase revenue requirement for various savings categories as ordered by the Commission in Docket Nos. 00-0476 and 01-0556, the merger of IAWC and CUCI.

Ms. Everson observed that "savings" are not recorded in the financial records of any corporation, and there are not accounts the Company can provide to substantiate the amounts labeled as savings. She said these amounts are not readily provable in the traditional sense, as they do no exist as separate numbers within revenue requirement categories. According to the witness, in the traditional ratemaking model, savings would exist in the revenue requirement in the form of a reduced level of expense; however, the Commission has ordered that calculated amounts be labeled as savings with 50% to be included in the calculation of revenue requirement in this docket as an addition to operating expenses.

Ms. Everson also explained that the methodology for calculating amounts labeled as savings according to Dockets 00-0476 and 01-0556 established that expenses recorded by CUCI during 1998 would serve as the base year. The base year of 1998 was chosen to be the starting point because the merger between IAWC and CUCI had

not been announced and, therefore, the levels of expense were considered to be unaffected by the announcement of the merger between IAWC and CUCI.

Amounts from 1998 were then to be restated in test-year dollars (2003 in this rate case) for purposes of the calculation. Fifty percent of the calculated amounts labeled as savings are then added to the revenue requirement to achieve the sharing. Ms. Everson said the sharing is evident in the effect on the revenue requirement: amounts labeled as savings are added to operating expense and rate base components of the revenue requirement.

With regard to "Non-Cost of Capital Savings Sharing", Staff witness Everson proposed an adjustment to Illinois-American's methodology for calculating rate case savings from the former Citizens Utilities Company of Illinois due to a difference in the starting amount; the method of escalation to test year levels; and the number of months the expense was recorded. (Staff brief at 34-35) For purposes of this proceeding, the Company did not contest that adjustment.

With regard to "Cost of Capital Savings Sharing", the acquisition-related cost of capital savings ("Savings") for the former Citizens' service territory was determined using the methodology approved in Docket No. 01-0556. (Staff brief at 35-36) The Savings on the Assumed Debt was multiplied by the amount of assumed debt to calculate the total Savings in dollars. Next the total Savings was multiplied by 50% to determine the Savings to be included in the revenue requirement for the former Citizens' service territory. Savings to be shared with IAWC for the former Citizens' service territory equals $158,464 and is presented in Staff Exhibit 16.0, Schedule 16.05. Staff states that if the Commission approves a higher cost for the assumed debt than the 1.25% that Staff recommends, the Savings to be shared with IAWC for the former Citizens' service territory will decline.

The Savings for the non-Citizens' service territories was also determined based on the methodology approved in Docket No. 01-0556. (Staff brief at 36) Ms. Kight calculated the embedded cost of debt excluding the Assumed Debt and the embedded cost of debt including the Assumed Debt. The embedded costs of debt are shown in Staff Exhibit 16.0, Schedules 16.04 and 16.06. Ms. Kight then multiplied the dollar balance of long-term debt in the capital structure by the difference between the Cost of Debt including Assumed Debt and the Cost of Debt Excluding Assumed Debt. The Savings to be shared with IAWC for the non-Citizens' service territories was calculated to be $469,524 and is presented in Staff Exhibit 16.0, Schedule 16.06. Staff states that if the Commission approves a higher interest rate than the Staff recommended for either variable rate debt issue, the Savings for the non-Citizens' service territories must be recalculated or it will be overstated. As discussed later in this order, the Commission approves a higher interest rate than proposed by Staff for one of the debt issues. Therefore, consistent with Staff's recommendation, the Commission concludes that the appropriate cost of capital savings sharing applicable to the non-Citizens' service territory is $496,368,which is reflected in the Appendix attached hereto.

Staff witness Everson "presented the adjustment of Staffs Cost of Capital witness, Ms. Kight, for Cost of Capital Savings Sharing". (Staff brief at 36-37; citing Staff Ex. 16.0, Schedules 16.05 and 16.06) The total Company amount provided by Staff witness Kight was allocated to the rate areas in this proceeding according to the allocation method provided by IAWC on IAWC Exhibit 12.0, Schedule C-2.4, Adjustment of Savings/Sharing. IAWC indicated in the rebuttal testimony of Ronald D. Stafford, that it did not contest this adjustment. (IAWC Ex. R-4.0 at 1)

In its brief, the Village of **Bolingbrook** disputes the manner in which "labor and labor-related savings" were calculated by IAWC in this docket. (Bolingbrook brief at 11-17; Bolingbrook BOE at 17-20) Bolingbrook argues that there is a flaw in the labor cost portion of the calculation and its inputs if a labor cost increase since IAWC assumed control can be somehow characterized as labor cost savings. Bolingbrook further argues that "IAWC has failed to meet that burden in this case with respect to the labor cost component of the Acquisition Savings calculation." (Bolingbrook brief at 17)

Bolingbrook acknowledges that "the Company has made a prima facie case, with respect to the existence of labor and labor-related savings relative to the CUCI asset acquisition." (Bolingbrook BOE at 20) However, Bolingbrook argues, "the Company's prima facie case has been rebutted by other evidence in the record." (Id.) Specifically, Bolingbrook asserts, "[IAWC] Exhibit 12.0, Schedule C-2, pp. 7 and 8 shows that no labor or labor-related savings have, in fact, occurred since the Company acquired CUCI's assets." (Id.)

As noted by **IAWC,** neither Bolingbrook nor any other party offered testimony taking issue with the Company's calculation of "labor and labor-related savings" in the Company's proposed adjustment for acquisition savings/sharing.

In its reply brief, IAWC contends that the position appearing in Bolingbrook's brief is untimely and unsupported by any evidence. IAWC states that Mr. Stafford explained in detail the methodology used to calculate savings in pages 23-28 of his direct testimony, that IAWC Exhibit 12.0, Schedule C-2.4, provides a summary of the Company's calculated savings directly related to the acquisition of the properties of Citizens Utilities Company of Illinois, and that the calculations were supported by workpapers. (IAWC reply brief at 24-25)

The Company claims that Bolingbrook's brief incorrectly references 2001 data as a starting point for measuring changes in labor costs; whereas, in Docket No. 01-0556, calendar year 1998 was approved as the correct starting point for measurement of labor and labor-related savings. (IAWC reply brief at 24-25)

IAWC also says Bolingbrook had ample opportunity to present testimony in opposition to labor and labor-related savings or any other acquisition savings, but elected not do so in the instant proceeding or any other proceeding, including the proceeding approving the acquisition in Docket No. 00-0476 and the proceeding approving the Savings Sharing Methodology in Docket No. 01-0556.

In response to Bolingbrook's BOE, the Company notes that Bolingbrook acknowledged that the Company had established a prima facie case. This being true, IAWC argues, the burden of proof shifted to Bolingbrook to present evidence in support of its opposing position. According to IAWC, "Once a utility makes a showing of the costs necessary to provide service under its proposed rates, it has established a prima facie case, and the burden then shifts to others to show that the costs incurred by the utility are unreasonable because of inefficiency or bad faith." (IAWC RBOE at 29, citing City of Chicago v. Illinois Commerce Commission, 133 Ill. App. 3d 435, 442-443 (1st Dist. 1985)) Since Bolingbrook never presented evidence on its new issue, the Company argues, Bolingbrook failed to meet its burden of proof. (IAWC RBOE at 29)

Having reviewed the record, the **Commission concludes** that the adjustment to "labor and labor-related savings" proposed for the first time in Bolingbrook's brief should not be adopted. Staff reviewed the Company's calculation of acquisition savings/sharing and proposed adjustments where deemed appropriate. Neither Staff witnesses nor any other witnesses proposed the adjustment advanced in Bolingbrook's brief.

The Commission also agrees with the Company's contention that according to the order in Docket 00-0476, the correct starting point for measuring changes in labor costs is calendar year 1998, rather than 2001.

As noted above, Bolingbrook acknowledges that "the Company has made a prima facie case, with respect to the existence of labor and labor-related savings relative to the CUCI asset acquisition." The Commission does not agree with Bolingbrook's argument that the Company has somehow rebutted its own prima facie showing. In conclusion, the Commission finds that the adjustment proposed by Bolingbrook is not supported by evidence of record, and it should not be approved.

H. Lincoln District Merger Savings

In their brief, the Cities of **Lincoln and Streator** address the subject of Lincoln District merger savings. This matter was not addressed in the testimony of those Cities or any other Intervenor. Lincoln/Streator state that the instant proceeding is the first rate case for IAWC since the Lincoln District was acquired through IAWC's merger with United Water Illinois Inc. ("UWI") approved by order of the Commission on May 10, 2000, in Docket 99-0457. That Order stated, in part, on page 16, that "(i) at such time as Illinois-American proposes a change in rates for the area presently served by UWI, all merger savings included in data for the rate case test year should be reflected in rates and, thereby, allocated to ratepayers; and (ii) no amount of merger costs will be reflected in rates, and the entire balance of merger costs will be allocated to the shareholder..." On page 24, it was ordered that the merger not be reflected in rates.

On page 8 of their brief, Lincoln/Streator complain that "[no] adjustment was made by IAWC or the Staff to the Lincoln proposed rates to reflect merger savings."

They add, "Now, in addition to the merger savings that were never passed th[r]ough to the customers in the Lincoln District, the Company is seeking a 17.4% increase from those customers without any off-set for the previously estimated merger savings or any proof that the merger costs and merger premium have not been included in rates." (LincolnIStreator brief at 9)

LincolnIStreator argue that the Commission "should find that the Company has failed to comply with the Order in Docket 99-0457 regarding the ratemaking treatment of merger savings, merger costs and the merger premium, and require that appropriate adjustments be made to the rates for the Lincoln District." (LincolnIStreator brief at 9; LincolnIStreator BOE at 4) In the alternative, they argue, "the Commission should find that the Company has failed to meet its burden of proof with respect to its requested rate increase for the Lincoln District by failing to identify an account for the merger savings, the merger costs and the merger premium." (Id.)

In response, **IAWC** contends that the assertion made in the LincolnIStreator brief is not correct. (IAWC reply brief at 41; IAWC RBOE at 31) IAWC says all merger savings are reflected in the costs of service for the Lincoln District. In other words, IAWC states, the rates proposed by the Company, and by Staff, reflect the actual costs of service for that District, and reflect all merger savings. In the Company's view, no separate calculation of merger savings is appropriate, because it would serve no purpose.

In its reply brief, **Staff** asserts that Lincoln/Streator's argument regarding merger savings is misguided and must be ignored. (Staff reply brief at 25; Staff RBOE at 9-11) In Staff's view, no adjustment was made because no adjustment is necessary in order to reflect these savings. To the extent savings were achieved, Staff states, 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.

Staff says the situation with Lincoln is different than the "Savings Sharing" related to the acquisition of the CUCI system. According to Staff, with the "Savings Sharing" feature, an adjustment is made in order to prevent ratepayers from receiving all of the savings, and that adjustment effectively increases the lower costs that would otherwise be reflected in the Company's revenue requirement. Staff says this allows the Company to recover an imputed higher level of costs than those it actually incurred, thereby allowing the Company to retain a portion of the savings in the form of higher costs. (Staff reply brief at 26)

Having reviewed the record, the **Commission concludes** that the recommendations first appearing in the LincolnIStreator brief should not be adopted. As Staff explains, the treatment of savings from the Lincoln merger is different than the treatment of savings from the acquisition of the CUCI system discussed above. When the acquisition of the CUCI system was approved, a "Savings Sharing" mechanism was ordered whereby 50% of quantified savings are added to revenue requirement, thereby

allowing shareholders to share in the savings on a 50150 basis. In connection with the Lincoln merger, however, no such mechanism allowing shareholders to share in the merger savings was ordered.

Consequently, for Lincoln, no adjustment was made because no adjustment is necessary in order to reflect or allocate these savings. As Staff further explains, 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 such savings would already be reflected as lower costs in the revenue requirement initially filed by the Company. In conclusion, the Commission finds that the recommendations proposed in the LincolnlStreator brief are not supported by evidence of record, and they should not be adopted.

The Commission is mindful of the unique set of circumstances between the treatment of savings with regard to LincolnlStreator and the savings associated with the acquisition of the CUCI system discussed above. We note that our treatment of LincolnlStreator savings is consistent with long-standing Commission policy as it pertains to merger-related savings for rate-of-return regulated companies. Notably, the CUCI system 50150 savings sharing deviates from that policy precedent. The Commission is of the opinion that certain distinguishing factors are present in this case that warrant approval of the 50150 savings sharing mechanism. The Commission is keenly aware that, to the extent savings are achieved as a result of merger synergies, applying past Commission precedent in a rate case for a rate-of-return company, those savings would be reflected as lower costs in the revenue requirement and would not result in ratepayers effectively facing a higher revenue requirement. However, given the prior decisions of this Commission in Dockets 00-0476 and 01-0556, the IAWC acquisition and methodology cases respectively, we accept the 50150 savings sharing treatment described herein and reiterate that this should not be construed as binding the Commission to this type of treatment for any future acquisition-related savings for rate-of-return regulated utilities.

I. Other Issues

IAWC proposed a **chemical expense** for the test year of $3,830,983. Staff, LWC, and CUB witnesses recommended adjustments to the Company's filing, based in part on more current pricing information from contracts in 2003. (Staff brief at 29) The current version of this adjustment is calculated on Staff Exhibit 13.0, Schedule 3.6. In rebuttal testimony, the Company accepted the Staff's adjustment, thereby reducing total Company chemical expense by $371,737 to reflect the updated estimate. (IAWC Ex. R-4.0 at 1-2)

Having reviewed the record, the Commission finds that Staff's proposed adjustment to chemical expense is reasonable and should be adopted.

In its testimony, CUB proposed an adjustment to disallow payments for losses associated with periods preceding the test year. (CUB Rev. Ex. 1.0 at 12) Bolingbrook did not offer testimony on this issue, but says it supports the adjustment in its brief.

IAWC contends that such **insurance premium payments** are current payments made in the test year, and that the insurance program in question is the least cost alternative due to lower administrative loads than other types of policies. (IAWC brief at 57-58)

Having reviewed the record, the Commission agrees with the Company's assertion that the premium payments in question are current payments made in the test year, and that the insurance program in question is the lower cost alternative. Accordingly, the amount proposed by IAWC should be allowed.

J. Security Related Issues

1. Test Year Level of Security Related Expenses

a. Staffs Position

For the 2003 test year, IAWC originally included in its operating expenses a level of security related expenses that was subsequently modified to $6,774,971. (Staff brief, Appendix A, Schedule 5-SPSP at 2) Staff engaged a security consultant, Mr. Jaehne, who performed on-site inspections and met with Company security management in order to determine the reasonableness and prudency of Company security plans and costs for each of three distinct periods: Pre-9/11/01, Post-9111/01, and the 2003 Test Year. (Staff brief at 37) Mr. Jaehne's testimony is contained in Staff Exhibits 10.0 and 20.0.

It is Staff's position that IAWC security costs for the pre-9/11/01 and post-9111/01 periods were prudent and reasonable.

For the 2003 test year period, Staff asserts that Company security measures were prudent but that the reasonableness of the costs was overstated. Staff recommends that the IAWC's total test year operating expenses for security costs be reduced by $1,461,441 to $5,313,530. (Staff brief at 37-38 and Appendix A, Schedule 5-SPSP at 2) For purposes of this proceeding, IAWC and CUB witnesses do not object to this recommendation by Staff, although IAWC objects to Staff's method for allocating such costs.

As more fully explained in its testimony and briefs, Staff states that the Company's security program involves several types of security measures including the deployment of Security Guards, the costs of which were overstated for the test year, in Staff's view. (Staff brief at 38)

According to Staff, the primary threats against IAWC's water facilities post-9/11/01 and in the test year include both terrorist and criminal activity. Staff states that terrorism presents a new and unique set of security challenges involving well-planned, intentional use of deadly force, the use of a weapon of mass destruction, and harm to a large civilian/non-combatant population. Staff says that since 9/11/01, both State and Federal Homeland Security Advisory Systems have advised that the risk of terrorist attack were either "significant" or "high." It is Staff's position that a clear potential terrorist threat is to conduct such an attack by contaminating a water system. (Staff brief at 38)

Staff states that the Company's security enhancements post-9111/01, when combined and synchronized, substantially increased the value of security guards. Staff's testimony and briefs more fully explain Staff's position. (Staff brief at 38)

It is Staff's position that the events of 9/11/01 demanded immediate and unprecedented security enhancements across the entire range of critical facilities in local communities, throughout Illinois and across the United States. Staff asserts that one such enhancement was to place security guards at water facilities. Staff believes that immediate implementation of enhanced security was required and it was not known how long such enhancements would be required. Staff claims that this unprecedented requirement to enhance security continued for more than a year as county and state threat and security assessments were conducted as part of a federal assessment process. Staff states that when these processes were completed and post-9/11/01 security posture parameters established, IAWC converted the security guard program to contract guards. It is Staff witness Jaehne's expert opinion that this process was prudent and the associated security guard costs, as stated by Staff, were reasonable. (Staff brief at 39)

In Staff's view, security guards are a beneficial element in the overall security system against terrorism. (Staff brief at 39)

Staff argues that the test year security plan, and associated costs, represents prudent Company operations conducted under "significant" and "high" risk of terrorist attack. After analyzing the Company's test year security guard costs, Staff witness Jaehne concluded that the number of security positions and their allocation by district are prudent. (Staff brief at 39)

It is Staff's position that the wage rates for security personnel in each district are appropriate when compared to the statewide contract security coverage in all but two districts. In these two districts a contract wage scale would be significantly less costly than the post-9111/01 wage rates. Staff recommends that the Commission find that test year security guard costs as adjusted by Staff are reasonable. This reflects local rates for two districts, and contract rates for all other guard positions. (Staff brief at 40; reply brief at 27)

It is Staff's position that increased staffing costs for certain testing and monitoring activities were appropriate post-9111/01 as a prudent and necessary response. Staff states, however, that test year costs were based on the overtime staffing costs incurred during the post-9111/01 period and do not reflect a reduction of these overtime costs resulting from the installation of certain technology described in Staff's testimony and briefs. Staff says reasonable test year operating expenses should reflect a reduction in overtime for such costs, from the Company's recommendations. (Staff brief at 40)

Staff states that in reducing Company staffing costs through installation of technology there is an increase in the costs to maintain these systems. Staff believes that these additional charges are prudent and reasonable. (Staff brief at 41)

Staff does not agree with Lincoln/Streator that the "reasonable rate of police officers is un-rebutted." (Staff reply brief at 27, citing Lincoln/Streator brief at 17) Staff disagrees; asserting that Lincoln/Streator recognize only the direct wage costs of security guards. Staff argues that security guard costs also include indirect costs. (Staff reply brief at 27, citing Tr. at 588-589)

According to Staff, Lincoln/Streator's assertion regarding the pay rates for trained police officers in Lincoln and Streator is only relevant to the Company for security guard direct wage rates. Staff states that these rates are comparable with the direct wage rates under the security contracts with the Company. Staff asserts that Lincoln/Streator ignore other costs such as equipment, operations, maintenance, selection, training and management incurred by security contractors in executing the contract and calculated as part of the overall hourly contract rate. Staff says these other costs are presumably also a part of the budget of the Lincoln and Streator police departments. (Staff reply brief at 27-28)

It is Staff's position that the composite security contractor hourly contract rate is reasonable unless the Cities of Lincoln and Streator are able and willing to provide police officers to the Company for guard positions at the direct wage rate, as is the case in two rate districts. Staff states that the Cities of Lincoln and Streator have not demonstrated a similar offer on the record. (Staff reply brief at 28)

Staff notes that Lincoln/Streator question the cost-effectiveness of IAWC's use of security guards. (Staff reply brief at 28-29, citing Lincoln/Streator brief at 16) Staff indicates that its witness, Mr. Jaehne, explained in detail the role and benefits of security guards as an element in the overall security system against terrorism. (Staff reply brief at 29, citing Staff Ex. 20.0 at 3)

In response to O'Fallon's assertion that IAWC did not take advantage of federal and state grant opportunities to obtain contributions toward the costs of increased security expenses, Staff claims such grants were not available to the Company. Staff also states that O'Fallon's contention that Company security costs are "gold-plated" is unfounded and unsubstantiated. According to Staff, since events of September 11, 2001, federal and state terrorist security alert systems have characterized the terrorist

threat as either "Elevated" or "High". (Staff reply brief at 29, citing Staff Ex. 20.0 at 7) Given this alert status, Staff believes the Company created and continues to conduct security activities that provide a prudent, synergistic security system. (Staff reply brief at 29, citing Staff Ex. 10.0 at 9-11)

In response to the LWC's "double counting" argument, discussed below, Staff contends that the annual security costs recommended by Staff specifically exclude costs of IAWC current employees for monitoring and sampling. Staff says it found no double counting in its analysis. (Staff RBOE at 11-12)

b. The LWC's Position

According to the LWC, the Company revised its test year ongoing security expenses and provided the updated expenses to the parties via data responses. The LWC state that Staff witness Jaehne then proposed an adjustment to the Company's filing to reflect the IAWC updated and lower security expense estimate. (LWC brief at 11, citing Staff Ex. 10.0 at 15-16 and schedule 10.1)

The LWC assert that the Company's updated security expense was still overstated due to double counting. (LWC BOE at 8) The LWC claim that part of the higher security costs was related to IAWC employee salaries and American Water Works' affiliate fees. The LWC contend that IAWC failed to demonstrate that these costs were not already reflected elsewhere in the Company's cost of service via IAWC labor expense and affiliate transaction fees. Therefore, LWC recommended a further reduction to the security expense adjustment proposed by Staff as detailed in Mr. Gorman's rebuttal testimony. (LWC brief at 11, citing LWC Ex. MPG-2 at 14-16; LWC BOE at 8-10 and Att. A at 8-9)

The LWC claim that the primary difference between the LWC and Staff recommended security expense is that the LWC argue that IAWC has not supported its claim that its updated security expenses should include costs for certain non-guard related sampling and monitoring staffing activities. The LWC assert that Company personnel, using Company equipment, perform the activities in question. In the LWC's view, IAWC was not able to satisfactorily demonstrate that the IAWC's security related personnel costs and affiliate charges are not already included in IAWC's labor expense and affiliate transaction costs for these security functions. (LWC brief at 11, citing LWC Ex. MPG-2 at 14-15)

It is the LWC's position that absent a clear demonstration that these security costs are not already included in IAWC's labor expense and affiliate management fees, the Commission should accept the LWC's recommendation to reject this amount of IAWC's estimated ongoing security costs for the above referenced activities. (LWC brief at 11-12)

c. Lincoln/Streator's Position

In their brief, LincolnIStreator argue that the costs incurred for security guards is excessive in light of the benefits provided. (LincolnIStreator brief at 15-16, citing Staff Ex. 10.0, Schedule 10.1)

LincolnIStreator take issue with assertions of the Staff witness regarding the role of security guards as an element in the overall security system against terrorism, and the cost associated therewith. In their brief LincolnIStreator make various arguments about alleged limitations of utilizing security guards. (LincolnIStreator brief at 16)

LincolnIStreator assert that even if some level of security guard coverage would be deemed cost beneficial, the amounts being requested by the Company are not just and reasonable. LincolnIStreator state that the Company only looked at three security guard providers and did not go out for bids before entering into the contract, and that the Company did not even select the low bidder. LincolnIStreator contend that the Company did not quantify what it would cost in the long term to hire guards as company employees, rather than going with the contract service. According to LincolnIStreator, Staff witness Jaehne opined that the amount of the contract was reasonable, but on cross-examination admitted that he has never hired security guards, that he did not do any independent search to see if the market for guards was lower than the contract entered into by the company and that he just looked at the 3 bids that the Company provided to him. (LincolnIStreator brief at 16-17, citing Tr. 422-424)

LincolnIStreator state that IAWC incorrectly claims it was justified in hiring off duty policemen, and paying them overtime. In Lincoln/Streator's view, a person who works for the City full time and has a part time job does not expect or require overtime. LincolnIStreator contend that the local rate should govern the cost of security officers and not some statewide rate that pushes up the overage costs using labor prices in more affluent neighborhoods. LincolnIStreator argue that IAWC paid more than the reasonable rate for security guards. In its brief, LincolnIStreator suggest that IAWC's security costs are significantly overstated by an amount stated therein. LincolnIStreator recommend that the Commission eliminate or significantly reduce security costs. (LincolnIStreator brief at 17-18; LincolnIStreator BOE at 5-7)

d. O'Fallon's Position

In the event that the Commission does not approve the competitive agreement between IAWC and O'Fallon, O'Fallon recommends that the Commission not allow IAWC to recover certain costs. In O'Fallon's view, IAWC is "gold-plating" its security arrangements and passing waste along to the Company's customers. (O'Fallon BOE at 4) If the Commission does approve the competitive agreement, O'Fallon says its positions on such issues become moot. (O'Fallon brief at 10)

e. IAWC's Position

In its reply brief, IAWC says the LWC speculate that certain security related personnel costs and affiliate charges were double counted by inclusion in labor expense and affiliate transaction costs. IAWC claims LWC's position has been repudiated by two witnesses, and is unfounded. (IAWC reply brief at 29, citing IAWC Ex. R-4.0 at 20-21; SR-4.0 at 7; Staff Ex. 10.0 and 20.0; IAWC RBOE at 19-20) IAWC argues that LWC has the burden of proof to establish its assertion, and it failed to do so. (IAWC reply brief at 29)

IAWC states that O'Fallon relies on testimony presented by O'Fallon witness Brooks. IAWC says that Staff expert security witness Jaehne disagreed with all of Mr. Brooks' assertions. (IAWC reply brief at 32, citing Staff Ex. 20.0) IAWC also says that Company witness Mitchem also rejected Mr. Brooks' assertions. (Id., citing IAWC Ex. R-2.0 at 1-5; Ex. SR-2.0 at 1-3) It is IAWC's position that Mr. Brook's assertions are unproven and should be disregarded.

According to IAWC, Lincoln/Streator's assertion regarding the benefits of using security guards is untrue. IAWC quotes Staff's expert witness, Mr. Jaehne in support of its position that security guards are beneficial. (IAWC reply brief at 42-43, citing Staff Ex. 20.0 at 2-4 and Tr. 570, 573)

In response to Lincoln/Streator's complaint that the Company did not hire guards as employees, IAWC states that it does not want the guards to be employees of the Company to avoid legal liability for guards' conduct. (IAWC reply brief at 44, citing Tr. 422) IAWC states that it received proposals from three guard services and selected the second lowest bidder because the lowest bidder would not assume legal liability. (Id., citing Tr. 425; 590; IAWC RBOE at 32-33))

In response to Lincoln/Streator's assertion that the Company is paying more than a reasonable amount for police officers as guards, IAWC states that except for one service area, ongoing security costs do not include costs of off-duty police. (IAWC reply brief at 44)

f. Commission's Analysis and Conclusions

As indicated above, in the 2003 test year filing, IAWC included in operating expenses an annual level of security related expenses that was subsequently modified to $6,774,971. Based on the analysis of its security consultant, Mr. Jaehne, Staff recommends that such expenses be reduced by $1,461,441 to $5,313,530. For purposes of this proceeding, IAWC and CUB do not object to this recommendation by Staff. However, the Company does not agree with Staff's allocation of such costs, or with Staff's position on deferred security costs as indicated in the discussion of those issues below.

The LWC contend that IAWC may have double counted certain security related costs by including them in both security expenses on the one hand and in labor expense or affiliate transaction costs on the other. IAWC claims that no such double counting has taken place.

The Commission has reviewed the record and finds no evidence to support the LWC's assertion of double counting. In the Commission's view, while it would be possible for a utility such as IAWC to attempt to include the same costs in the revenue requirement through both direct utility costs and payments to affiliates, there is no evidence that this has occurred in the instant proceeding. Furthermore, while the LWC complain of the lack of a clear demonstration that security costs were not included in both IAWC's labor expense and affiliate management fees, the LWC failed to explain what additional information should have been provided to do so.

As discussed above, Lincoln/Streator complain about the Company's use of security guards and the costs associated with this security measure. However, the record of the proceeding, including the testimony of Staff's security expert, demonstrates that the Company has developed a security program which consists of a number of appropriate security measures, including the use of security guards. The evidence of record does simply not support Lincoln/Streator's argument that IAWC has overstated the benefits of deploying security guards.

In addition, the Commission finds that the test year level of expense related to security guards recommended by Staff witness Jaehne to be reasonable. Lincoln/Streator's claim that the test year costs are overstated is not supported by the record. Among other things, Lincoln/Streator considered only direct costs, rather than both direct and indirect costs. In summary, the Commission approves the test year level of security costs of $5,313,530 as proposed by Staff.

In the wake of September 11th the Commission is keenly aware of the increased security costs incurred by regulated entities. Many of these costs are mandated by Homeland Security mandates in conjunction with security needs as determined by state and local governmental entities as well a company's own management initiatives. As in this matter the Company has sought recovery of these costs that the Commission has determined are proper and should be included in its base rates. On a going forward basis, the Commission in its oversight capacity will continue to monitor the reasonableness and prudency of these types of costs. We believe that this scrutiny will insure that increased security costs do not result in expenditures that are imprudent or unreasonable but continue to be recovered simply because the security costs are included in a company's base rates. The Commission's continual monitoring of the security costs for all utilities should alleviate legitimate concerns with regard to these ongoing costs.

2. Allocation of Test Year Security Costs

a. Staffs Position

According to Staff, in each rate area the Company has implemented its security plan, yet has adopted it to fit the specific needs of the area. In Staffs view, it is more equitable to have ratepayers pay for the security expenses generated to protect their own system than it is to charge ratepayers for security costs that have been allocated based on some method that does not reflect cost-causation. (Staff brief at 41, citing Staff Ex. 4.0 at 4) Hence, Staff assigned security costs to the district in which they were incurred. Staffs position is explained in its testimony, briefs, and its RBOE in which it responds to arguments made by IAWC and Lincoln/Streator. (Staff RBOE at 12-14)

Staff asserts that the Company initially accepted Staffs proposed adjustment then later recanted and contested the allocation portion of Mr. Sant's adjustment but not the overall amount of the adjustment. (Staff brief at 41, citing IAWC Ex. R-4.0, at 1 and SR-4.0 at 4)

According to Staff, the Company contends that it will under-recover security expenses in the Lincoln and Sterling rate areas because of Staffs proposal to limit rates in those areas to what has been requested by the Company. To neutralize any such under-recovery, Staff says the Company proposed that the agreed upon amount of security costs be allocated to the rate areas based on water rate base. Staff states that as an alternative, the Company proposed to take the under-recovered amounts from Lincoln and Sterling and reallocate just that portion to other rate areas on a "ratable" basis. (Staff brief at 41-42, citing IAWC Ex. SR-4.0 at 4)

Staff asserts that the Company's proposal is flawed because it singles out security expense as the only expense item that will be under-recovered in Lincoln and Sterling. Staff says the Company neither recognized that other expenses would jointly be under-recovered nor proposed similar solutions for other expenses as those it proposed for security expense. Staff says its proposed revenue requirements reflect the total Staff-adjusted amount for all expenses, including security, yet the Company's argument inappropriately concludes that one expense can be segregated rather than comparing revenues to the aggregate amount of expenses. (Staff brief at 42)

Staff believes that the Company's argument is also flawed because it fails to explain why its proposed water rate base allocation factor achieves a more equitable allocation of costs than Staff's proposed direct assignment of costs. In Staffs view, the Company's proposal is wholly results-oriented; it does not seek to set rates that are reflective of a consumer's fair cost. (Staff brief at 42)

Staff contends that the company's alternative proposal is also flawed. Staff says the record does not contain any evidence about how the supposed under-recovery would be calculated nor does the record identify what the "ratable" allocation basis might be. Furthermore, in Staffs view the record also does not indicate any reasons

why the "phantom ratable" basis would be any more appropriate than other methods proposed by the Company or Staff. (Staff brief at 42-43)

In its reply brief, Staff asserts that there is a difference between facilities and rate base. According to Staff, IAWC 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. Staff states that the Chicago Metro Water district has approximately $72.6 million in rate base, which is roughly 16.5% of the total company rate base proposed by Staff. (Staff reply brief at 30, citing Staff brief, Appendix A) Staff claims, however, that ongoing security costs in Chicago are approximately only 3.3% of the Company total. Staff asserts that this is because the nature of the facilities in Chicago Metro Water district lends themselves to needing different security measures than are needed in other rate areas. It is Staff's position that the Company's proposal to allocate security costs based on rate base does not follow. (Staff reply brief at 30)

Staff also disputes IAWC's suggestion that Staff witness Sant agrees with allocation based on rate base. Staff states that Mr. Sant did mention during cross-examination that he allocated some of the tank painting costs using a different methodology, but he then corrected himself because those allocated tank painting costs were allocated based on capacity, which was the cost-causation factor. (Staff reply brief at 30-31, citing Tr. 512) In addition, Staff says Mr. Sant acknowledged that all the costs would not be allocated to the rate area in which the corporate headquarters are located. (Staff reply brief at 31, citing Tr. 513) In Staff's view, this underscores its position that cost-causation is a key factor in allocating costs. Staff says to it'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.

In response to Lincoln/Streator, Staff says the main argument by those cities is that Staff's position 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. Staff believes that this argument made by Lincoln/Streator is unpersuasive and should be given no weight by the Commission. (Staff RBOE at 12) Staff asserts that the ratepayers have little control over many management decisions, yet are still expected to pay their cost of service.

b. IAWC's Position

According to the Company, it assigned security costs based on rate base in accordance with its strategy of protecting all its water assets from threats of terrorism on a consistent basis. IAWC states that Staff assigned security costs to the district in which they were incurred. IAWC asserts that Staff's approach would cause a substantial underrecovery of security costs in the Sterling and Lincoln Districts due to Staff's proposal to limit the amount of a rate increase in a particular district to the original requested level. IAWC claims this adverse impact would result, even though

Staff security expert witness Jaehne found the full amount of the security costs to be prudent. (IAWC brief at 37; reply brief at 21; IAWC BOE at 54-55)

IAWC suggests that on cross-examination, Staff witness Sant appears to agree with allocation based on rate base. (IAWC brief at 37, citing Tr. at 511-512) IAWC recommends that the Commission approve allocation of security costs based on water rate base, consistent with the Company's original filing. In the alternative, the Company recommends that the Commission reallocate any shortfall in security cost recovery in Sterling and Lincoln on a ratable basis to other rate areas. (IAWC brief at 37; reply brief at 21-22)

In its reply brief, IAWC argues that Staff's method of allocating security costs is both unfair and inconsistent with Staff's treatment of other costs such as for steel structure painting and corporate headquarters. IAWC argues that if Staff believes that fairness requires all costs to be allocated solely by district, presumably it would have done so. (IAWC reply brief at 21)

IAWC asserts that Staff's allocation by District is not logical. The Company says it allocated security costs by rate base in recognition that the Company is employing a statewide strategy to secure its facilities. (IAWC reply brief at 21)

c. Bolingbrook's and Lincoln/Streator's Reply Brief Positions

According to Bolingbrook, IAWC and some intervenors have argued that security-related labor costs should be allocated to the Districts in proportion to that District's rate base. (Bolingbrook reply brief at 7, citing IAWC brief at 37) Bolingbrook says that as a result of IAWC's proposed allocation methodology, Districts that do not incur security-related labor costs would nonetheless have to pay for them.

Bolingbrook argues that the Chicago Metro Water District does not incur security-related labor costs and its ratepayers should not be required to pay for expenses wholly unrelated to their cost of service. Bolingbrook urges the Commission to adopt Staff's rationale for allocating security-related labor expenses to the District in which these costs were incurred. (Bolingbrook brief at 20; reply brief at 7; Bolingbrook RBOE at 4)

In their reply brief, **LincolnIStreator** take the position that test year security costs should not be allocated directly to the districts where the security measures were taken. LincolnIStreator say these costs should be recovered, if at all, proportionately across all districts. (Lincoln/Streator reply brief at 9)

LincolnIStreator assert that cost causation is not a reasonable and appropriate justification for assigning costs when the consumer has no control over those costs. (LincolnIStreator reply brief at 9-10)

LincolnIStreator claim that Staff fails to consider that the districts that just happen to have the facilities that require the most security measures might have the smallest customer bases over which to spread the costs if those costs are assigned directly to them. (LincolnIStreator reply brief at 10)

LincolnIStreator contend that the events that spawned the concerns that caused the Company to incur the security expense were not regional events, but were national or international events. It is Lincoln/Streator's position that it is not just and reasonable to allocate the security costs on any basis other than on a company-wide basis. (LincolnIStreator reply brief at 10)

d. Commission's Analysis and Conclusions

It is IAWC's position that test year security costs should be allocated based on rate base in accordance with its strategy of protecting all its water assets from threats of terrorism on a consistent basis. In the alternative, IAWC recommends that the Commission reallocate any shortfall in security cost recovery in Sterling and Lincoln on a ratable basis to other rate areas.

Staff assigned security costs to the district in which they were incurred. Staff argues that its proposal results in customers paying the costs that they cause to be incurred. Bolingbrook endorses Staff's rationale and proposed allocation methodology while LincolnIStreator support the Company's proposal.

Having reviewed the record, the Commission finds that Staff's proposal to directly assign security costs to the rate area in which they are incurred should be adopted. Given the nature of the activities giving rise to these expenses, the direct assignment method recommended by Staff is more reflective of cost-causation than is the allocation method advanced by the Company and supported in Lincoln/Streator's reply brief. As Staff suggests, the Company's proposal appears to be more result-driven than cost based.

For similar reasons, the Commission finds that the Company's alternative proposal should not be adopted.

3. Deferred Security Costs

a. IAWC's Position

IAWC says that in immediate response to September 11, 2001, the Company implemented enhanced security measures. IAWC states that the security measures described more fully in its brief and Staff's testimony were necessary and prudent. (IAWC brief at 4-5, citing Staff Ex. 10.0 at 9-12; Schedule 10.2) IAWC says that the costs of these enhanced security measures, for the period 9111/01 until the rate order is entered in this case, are referred to as the deferred security costs. IAWC's position in support of its proposed recovery of such deferred costs in the instant proceeding is set

forth in its testimony, briefs, and brief on exceptions. (IAWC BOE at 5-33 and App. D at 1-3)

According to IAWC, Staff does not dispute that the deferred security costs are prudent and reasonable. (IAWC brief at 5; reply brief at 3; IAWC BOE, App. D at 1-2) IAWC says that Staff's sole reason for proposing denial of recovery of Deferred Security Costs is that recovery would violate the concept of a test year. (Id.) IAWC asserts that because Staff reviewed the prudency of deferred security costs, and concluded that they are prudent, demonstrates that Staff intends that these costs are recoverable. (IAWC brief at 17-18)

In its reply brief, IAWC argues that the "test year principle" is not a legal rule. IAWC claims it is embodied in the portion of the Commission's Standard Filing Requirements that provides that a utility select a test year for the supporting schedules filed in a rate case. IAWC argues it does not dictate what is or is not recoverable in rates. IAWC claims that is a matter for Commission adjudication. (IAWC reply brief at 3)

IAWC states that in 1995, the Illinois Supreme Court allowed recovery of deferred environmental compliance costs. (IAWC brief at 6, citing *Citizens Utilities Board v. ICC,* 166 Ill. 2d 111 (1995)) IAWC says that case concerned clean up of former manufactured gas sites contaminated by coal tar.

IAWC indicates that the Commission proceeding in *Citizens Utilities Board* was a generic rulemaking case, which followed three company-specific cases in which the Commission allowed deferred cost recovery of coal-tar clean-up costs. IAWC states that the Supreme Court held that utilities are entitled to recover deferred coal tar clean up costs over a five-year amortization period, with carrying charges on the unamortized balance. According to IAWC, the Court stated that the Commission "must allow the utility to recover costs prudently and reasonably incurred." (IAWC brief at 6-7, citing *Citizens Utilities Board* at 121) IAWC says the Court also stated, "coal-tar cleanup expenses benefit a utility's ratepayers because payment of this legally mandated cost allows a utility to remain in business and to continue to provide service to its customers." (Id., citing *Citizens Utilities Board* at 123)

It is IAWC's position that the Commission must allow recovery in rates of prudently incurred costs of service. (IAWC brief at 17, citing *Citizens Utilities Board)* IAWC claims that if recovery of deferred security costs is not allowed, the Company will be denied recovery of a prudently incurred cost of service that benefited customers and would be confiscatory. (IAWC brief at 17; reply brief at 7-8, 29, 32)

IAWC asserts that deferred security costs are deferred environmental compliance costs similar to those allowed to be recovered in the *Citizens Utilities Board* case. (IAWC BOE at 7-13 and App. D at I) In support of this assertion, IAWC cites Sections 8-101 and 8-401 of the Act as well as 83 Ill. Adm. Code 600 and the federal Safe Drinking Water Act and the Illinois Environmental Protection Act. (IAWC brief at 8-

9; reply brief at 5-6) In addition, IAWC cites various documents, including the San Francisco Chronicle, in support of actions it undertook as a result of the events of September 11, 2001. (IAWC brief at 9-12)

In its reply brief, IAWC asserts that Staff does not, and cannot, distinguish the *Citizens Utilities Board* decision from the situation of deferred security costs in this proceeding. IAWC contends that *Citizens Utilities Board* does not purport to overrule *BPI II*. IAWC argues that deferred costs, which are prudently incurred to comply with environmental requirements, are recoverable. IAWC asserts that holding is fully consistent with *BPI II*, which dealt with routine operating expenses which were not mandated environmental costs. (IAWC reply brief at 6)

IAWC says the Court in *Citizens Utilities Board* rejected the argument that coal tar clean up costs were not recoverable because they were historical costs unrelated to providing current service. IAWC asserts that the Court stated that lack of a direct connection to current service does not bar a utility from recovering a mandatory, prudently incurred operating expense from ratepayers. (IAWC reply brief at 6-7, 28)

According to IAWC, in *United Cities Gas Co. v. ICC* the Court held that a utility was entitled to recover as a deferred cost a consulting and non-compete agreement, amortized over the ten-year life of the agreement. (IAWC brief at 13, citing 225 Ill. App. 3d 771 (4th Dist. 1992); reply brief at 10) IAWC says the Court held that because the cost of the agreement was a legitimately incurred cost of service, the utility was entitled to recover it in rates. (Id., citing *United Cities Gas* at 778)

It is IAWC's position that if Staff's position that recovery of deferred security cost is precluded by test-year principles were correct, no deferred costs ever would be recoverable because, by definition all deferred costs are incurred outside of a test year. IAWC asserts that Staff's position is contradicted by its own recommendation in this proceeding that the Company recover steel structure painting expense as a deferred cost and rate case expense as a deferred cost. IAWC also claims that Staff's position is contradicted by its acknowledgment that a recoverable deferred debit is anything in Account 186, including operating expense, which the Commission has accepted as recoverable. IAWC also asserts that Account 186 includes "extraordinary expenses". (IAWC brief at 13 citing Tr. 523-524; reply brief at 28)

In support of its proposal to recover deferred security costs, IAWC sites previous Commission decisions. IAWC asserts that, among other things, the Commission has allowed utilities to recover deferred maintenance, deferred franchise cost, deferred extraordinary property loss, deferred nitrate study costs, deferred legal cost, deferred management audit costs, deferred repair cost of gas line washed out by flood, deferred flood damage repair cost, deferred workforce resizing expenses and, deferred information systems consulting costs. (IAWC brief at 14-15) IAWC claims that most of the Commission decisions it cited which allowed recovery of deferred costs are post-BPI *II*. (IAWC reply brief at 28)

In response to Staff's attempts to distinguish some Commission decisions where the deferred cost recovery involved allegedly was not contested, IAWC claims that is no cogent basis to explain away this precedent. IAWC asserts that the Commission's authority does not depend upon whether an issue is contested. (IAWC reply brief at 8)

IAWC criticizes Staff's attempt to explain a Commission decision to allow amortization of the undepreciated balance of the damaged plant, plus depreciation expense and ratebase treatment of the rebuilding costs. IAWC responds that the amortization of the damaged plant was tantamount to depreciation, and depreciation is an operating expense. (IAWC reply brief at 8)

In IAWC's view, Staff misses the point about all the Commission cases cited by the Company. The Company contends those cases demonstrate that, after BPI *II*, the Commission has continued to approve recovery in rates of deferred operating expenses. (IAWC reply brief at 8, 28)

IAWC asserts that Staff mischaracterized the Commission order involving a one-time lump sum franchise payment, to be paid at the beginning of the franchise, in addition to the annual franchise fee. IAWC claims the Commission allowed recovery of the lump sum payment on a deferred cost basis, amortized over the 15-year life of the franchise. According to IAWC, that result had nothing to do with whether the payment was made in the test year, and in subsequent rate orders, that payment became a prior year cost still recoverable in rates. (IAWC reply brief at 8-9)

IAWC asserts that Staff relies on the Commission decision in Docket 98-0895 even though that case did not involve recovery of a deferred cost. IAWC contends that case implies that a deferred cost that is "sufficiently large, or sufficiently unique" is recoverable. IAWC says Staff also cites the order in Docket 93-0408, in which the Commission held that there was no need for a general rule on deferred costs. (IAWC reply brief at 9)

In IAWC's view, a review of Court decisions and Commission orders that allow recover of deferred costs shows that allowable deferred costs have the following characteristics in common:

- The deferred costs at issue have not been included in revenue requirements used by the Commission to determine current rates;
- The deferred costs are prudent costs incurred in providing service to customers; and
- The deferred costs are incurred to comply with a legal, environmental or regulatory requirement or to address an unanticipated event.

(IAWC brief at 15)

IAWC asserts that its deferred security costs have all of these characteristics. IAWC asserts that recovery of the deferred security costs is even more compelling than recovery of many of the other types of deferred costs allowed to be recovered by the

Commission, such as deferred maintenance, deferred litigation cost, deferred management costs, and deferred consulting costs. According to IAWC, the deferred security costs were necessary to assure the provision of safe drinking water, and the adequate supply for fire fighting and business use. (IAWC brief at 15-16)

IAWC says that prior to September 11, 2001, it was impossible to know that such an extraordinary event would occur and would impose terrorism risks on water utilities. IAWC asserts that the burden of these risks and the costs of enhanced security measures after 9/11/01 was not immediately known and could not be immediately known. (IAWC brief at 16-17)

The Company says it explored with Staff and others possible cost recovery approaches; however, IAWC says it determined that the only available alternative was to file a general rate case. IAWC claims that it takes a great deal of time and effort to prepare a rate filing and that this proceeding was initiated at the earliest practicable opportunity. (IAWC brief at 17; reply brief at 11)

It is IAWC's position that Staff's proposed disallowance of recovery of deferred security costs runs contrary to this public policy. IAWC claims that Staff's proposal would discourage public utilities from responding immediately and appropriately to the emergency conditions brought by the risks of terrorist intrusion. IAWC asserts that in the high risk environment beginning 9/11/01, the overriding public interest in having enhanced security measures protecting the public water supply clearly outbalances narrow accounting interpretations which are applicable more appropriately to ordinary operating expenses and which arose in the pre-9/11/01 era. (IAWC brief at 18; reply brief at 7; IAWC BOE, App. D at 1-2)

According to IAWC, Staff erroneously asserts that, if the Company were allowed to recover deferred security costs, it would recover the same costs twice. (IAWC brief at 19, citing Staff Ex. 4.0 at 5-6 and Tr. 523; reply brief at 13) IAWC asserts that the deferred security costs are the costs incurred from 9/11/01 through August 2003 while the current costs included in the test year are costs incurred beginning September 1, 2003, which is the approximate date on which the new rates will become effective. IAWC argues that it is the nature of deferred costs that amortization can overlap current costs. (IAWC brief at 19)

It is IAWC's position that O'Fallon's testimony regarding security guard services and enhanced security water monitoring should be disregarded because the Company and O'Fallon have resolved their issues in a proposed water supply agreement as described in their letter of intent. IAWC also claims it has demonstrated that O'Fallon's assertions are unfounded. (IAWC brief at 21)

In response to the criticisms of Lincoln/Streator, IAWC argues that 9/11/01 created an immediate need to provide enhanced security for the Company's facilities, including those serving Lincoln and Streator. It is IAWC's position that, for the reasons stated in its brief, the most expeditious and prudent course of action was undertaken to

obtain security services. IAWC claims it incurred significant costs to do so but the Company has subsequently been able to move to lower cost options. (IAWC brief at 21)

IAWC argues that Staff's proposed adjustment raises a serious public policy issue. IAWC says it is concerned that such an adjustment would create a strong disincentive for utilities to promptly respond to unanticipated or unique situations such as terrorism that threaten reliable and safe utility service. In IAWC's view, that would be the wrong regulatory signal to send. (IAWC brief at 23)

IAWC asks the Commission to consider the implications of the following scenario:

> Suppose the Company had not implemented enhanced security measures at one of its water facilities after 9/11. Suppose further that a terrorist destroyed the facility with a bomb. IAWC claims that the costs to the Company to replace the facility would be included in rate base. IAWC also asserts that the original cost of the destroyed facility, net of accumulated depreciation, also would be recoverable in rates as a deferred cost amortized over a period of years.

(IAWC brief at 24)

IAWC states that under Staff's proposal, the Company would not be allowed to recover the deferred costs of enhanced security costs to prevent destruction of the facility by a terrorist with a bomb. In IAWC's view, Staff's proposal makes no sense. (IAWC brief at 24; reply brief at 7-8, 11)

In its reply brief, IAWC argues that to determine whether a well-defined and dominant public policy can be identified, a court will look at the constitution, statutes and relevant judicial opinions. (IWAC reply brief at 4-5, citing Chicago Fire Fighters Union Local No. 2 v. City of Chicago, 315 Ill. App. 3d 1183 (1st Dist. 2000), County of De*Witt* v. American Federation of State, County, and Mun. Employees, 298 Ill. App. 3d 634 (4th Dist. 1998), Illinois Nurses Association v. Board of Trustees of the University of Illinois, 318 Ill. App. 3d 519 (1st Dist. 2000), Doane v. Chicago City Ry. Co., 160 Ill. 22 (1895), American Country Insurance Co. v. Wilcoxon, 159 Ill. App. 3d 884 (1st Dist. 1987), Rozier v. St. *Mary's* Hospital, 88 Ill. App. 3d 994 (5th Dist. 1980), and Kelsay v. Motorola, Inc., 74 Ill. 2d 172 (1979))

IAWC says Staff asserts that $10,651,250 of deferred security costs is not large and unique, and claims that among other things Staff witness Sant did not dispute that they are large. (IAWC reply brief at 9, citing Tr. at 516, 518) The Commission notes that a review of the transcript does not support IAWC's characterization of Mr. Sant's testimony.

According to IAWC, Staff does not dispute the extraordinary nature of the 9/11/01 attacks but disputes the Company's claim that enhanced security costs are incurred upon an extraordinary event. (IAWC reply brief at 9) It is IAWC's position that deferred security costs are recoverable as a matter of fairness and common sense. (IAWC brief at 10)

IAWC cites a NARUC resolution in support of its request to recover deferred security costs. (IAWC brief at 16, reply brief at 11-12) IAWC states that while a NARUC resolution is not binding on the Commission, it is a strong recommendation by a national organization of state commissioners and a strong statement of public policy enunciated by those commissioners. IAWC says NARUC's resolution should be given serious weight. (IAWC reply brief at 12)

IAWC asserts that an accounting variance is not necessary. (IAWC brief at 20; reply brief at 12) IAWC argues that in the Commission's Uniform System of Accounts for Water Utilities, Account 186, the phrase "deferred by authorization of the Commission" relates only to "losses on disposition of property net of income taxes." IAWC claims that the separate category of "unusual or extraordinary expenses" is not qualified by the authorization phrase. (IAWC brief at 20)

According to IAWC, in Docket 95-0220, the Commission approved both the deferral and recovery of deferred pilot study and other costs without prior accounting authorization and without a prior pattern of approval for those cost items. IAWC contends that the Commission can approve deferral and recovery of deferred security costs in its rate order in this proceeding. (IAWC reply brief at 13)

IAWC states that other state commissions have allowed recovery of deferred security costs. (IAWC brief at 20)

In its reply brief IAWC states that it does not seek to justify recovery of deferred security costs by relying upon the September 11, 2001 terrorist attacks in New York and Washington, D.C. Instead, IAWC says it implemented enhanced security measures upon 9/11/01 for all the reasons stated in Mr. Ruckman's testimony and the Company's brief. (IAWC reply brief at 33)

IAWC states that security prior to 9/11/01 was modest and concerned only vandalism, not terrorism. IAWC says there was no requirement for security against terrorism prior to 9/11/01. It is IAWC's position that prior rate order revenue requirements may have included a modest level of security cost for the limited type of security implemented prior to 9/11/01. (IAWC reply brief at 34)

According to IAWC, there is no potential for over-recovery because the amortization period for deferred security cost is five years and the Company has a history of filing rate cases every two to three years. (IAWC reply brief at 34)

IAWC states that the ongoing security costs in the test year do not overlap any recovery of deferred security costs in the test year because the new rates to be set in this case will not be effective until approximately September 1, 2003 and at that point, deferral of security costs will cease. (IAWC reply brief at 34)

b. Staffs Position

Staff recommends that all of the Company's proposed deferred security costs be disallowed. In Staff's view, the Company's proposal violates the test year concept. According to Staff, the Company has deferred enhanced security expenses since shortly after September 11, 2001 and has combined the deferred amount with the estimated amount to be incurred through August 2003 to arrive at an estimated total deferred security amount. Staff says the Company has proposed to include this amount in rate base while amortizing it over a five-year period. (Staff brief at 7)

It is Staff's position that the general ratemaking principle of a test year provides that only expenses incurred during the test year may be used to offset revenue accrued during that year. Staff says the Company's proposal includes not only the ongoing security expense amount but also the amortized deferred security expense amount to be included in the operating statement supporting the revenue requirement. Staff states that the Company's proposal will result in more than $7 million in total security expense "run through" the operating expenses while the test year amount is only $5.35 million. (Staff brief at 7, citing Tr. 66)

Staff asserts that the Company's test year, without the deferral, already reflects a normal ongoing level of increased post-9/11/01 security costs. Staff argues that because the deferred security costs and the ongoing security expenses are incurred for the same purpose, and are nearly identical in scope, allowing more than a test year amount into the revenue requirement is a form of double-counting expenses and violates the regulatory test year principle. (Staff brief at 7-8)

In Staff's view, the Commission has previously stated its disapproval of deferring operating expenses. Staff asserts that previous Commission orders make it clear that operating expenses subject to test year rules should not be generated outside of the test year, deferred and subsequently offset against test year revenue to determine rates. (Staff brief at 8-10)

Staff states that in Docket 98-0895, the Commission considered the deferral of Y2K expenses. Staff says that although not a rate case, that type of proceeding could be a precursor to the acceptance of deferred costs in the revenue requirement of a subsequent rate case. Staff asserts that while the Commission did not prohibit the utility from attempting to recover the Y2K costs in a subsequent ratemaking proceeding, the Commission stated the requirement of recognizing expenses in the year they are incurred and the inappropriateness of matching expenses outside a test year with the revenues of a test year. (Staff brief at 8-9)

Staff argues that this is exactly the scenario IAWC has proposed in this case, by requesting that deferred security operating expenses, as well as test year security expenses, be matched against 2003 test year revenues. In Staff's view, the Commission has already analyzed this issue and found such regulatory treatment inappropriate. (Staff brief at 10)

According to Staff, IAWC has not made a case that the deferred security cost constitutes a large enough expense to justify special accounting treatment. Staff states that estimated deferred security expenses are approximately 4.4% of the total estimated utility operating expenses for 2002 and 2003 combined. Staff says the Company claims that it did not meet its authorized rate of return on rate base for 2001 and 2002, but does not provide any support in the record that deferred security expenses were solely to blame for its financial failures or that meeting its authorized rate of return was a guaranteed right. (Staff brief at 11, citing Staff Ex. 14.0 at 6 and 21)

Staff also argues that the deferred security expenses cannot be termed "unique" when they are analogous to the test year security expenses expected to indefinitely continue. Staff asserts that the deferred security expenses are less unique than the Y2K expenses at issue in Docket No. 98-0895. (Staff brief at 11)

Staff also cites the Commission decision in Docket 93-0408 as well as Business and Professional People for the Public Interest vs. ICC, 146 Ill. 2d 175 (1991) ("BPI II") in support of its position regarding deferred security costs. (Staff brief at 9-10) In Staff's view, IAWC's assertion that BPI II is not controlling as to recovery of deferred security costs is misguided. Staff contends that a simple review of the case law indicates that BPI II has not been overruled or modified in any way to support the Company's claims that deferred security expenses are recoverable. (Staff brief at 12) Staff argues that the decision in Citizens Utility Board dealt only with the recovery of coal-tar cleanup costs. (Id., citing Citizens Utility Board vs. ICC, 166 Ill. 2d 111 (1995))

According to Staff, the Company sees similarities between environmental compliance costs and deferred security expenses in that both are costs incurred to prevent the interruption and contamination of the water and sewer supply, both are reasonable and necessary, and both are compliance costs incurred to satisfy the requirements of the law. (Staff brief at 12, citing IAWC Ex. R-1.0 at 4) Staff does not find IAWC's arguments compelling because such arguments can be made about any operating expense. Staff contends that if an expense is not reasonable or necessary, or does not directly or indirectly help a utility meet its obligation to provide a safe and adequate water supply, then the expense would not be allowed in the utility's revenue requirement.

It is Staff's position that the issue is not the reasonableness of security measures taken immediately after 9/11/01 but rather the appropriate ratemaking treatment of the resulting costs. Staff is not disputing the extraordinary and provoking nature of the 9/11/01 attacks; however, Staff is disputing the Company's claims that the resulting enhanced security costs are extraordinary or are "incurred upon an extraordinary

event." Staff contends that the deferred security costs, as well as the costs included in the test year revenue requirement, are not incurred upon the extraordinary event of 9/11/01, but rather are operating expenses that the Company expects to incur into the foreseeable future. (Staff brief at 13)

Staff argues that from an accounting standpoint, to be considered extraordinary, a cost must be both unusual and infrequent. Staff claims that the deferred security costs are almost identical to the costs included as a test year operating expense. In Staff's view, the Company's proposal to include the test year security costs in the revenue requirement as ongoing and recurring costs is inconsistent with its contention that similar costs are unusual or infrequent. (Staff brief at 13; reply brief at 8-10) According to Staff, "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." (Staff RBOE at 22-23) From Staff's standpoint, "Either the security expenses (deferred and future) are extraordinary or they are not." (Staff RBOE at 23)

Staff asserts that an important difference between the coal tar cases referenced by the Company and the instant proceeding is that in the former, the utilities sought approval from the Commission's Director of Accounting before deferring coal tar remediation costs. Staff says that IAWC did not do so with it's past security costs in violation of both Accounting Instruction 5 and Account 186 of the Uniform System of Accounts ("USOA). (Staff brief at 14)

Staff argues that the coal tar cases indicate the practice of utilities' receiving permission from the Commission to defer costs before incurring the costs. Staff asserts that utilities that recovered deferred coal tar costs through riders deferred those costs after seeking approval for the deferral. In Staff's view, the coal tar cases may be distinguished from this case where IAWC deferred its past security costs without prior approval to do so. (Staff brief at 15)

Staff attempts to further differentiate the ratemaking treatment of coal tar remediation costs and security costs. Staff asserts that coal tar remediation costs fluctuate greatly from one year to the next rendering the ability to estimate an annual expenditure level extremely difficult. Staff claims this is one of the main reasons the Commission found the rider mechanism to be the preferred method for recovering coal tar expenses. Staff alleges that the rider recovery method and base rates recovery method are not equivalent. In Staff's view, it is not appropriate to compare the allowance of deferred costs for two different types of recovery mechanisms. (Staff brief at 15-16)

Staff also asserts that there is a difference between deferred rate case and steel structure painting and deferred security expenses. Staff says that rate case and steel structure painting expenses have been specifically approved for deferral in prior dockets, but there is no such pattern of specific approval for deferred security expenses. (Staff brief at 15) Staff also argues that in neither of those cases does it propose to defer costs and simultaneously approve a test year amount so that double-counting

expenses becomes an issue. Staff says it opposed the Company's original proposal concerning steel structure maintenance, which Staff believes constituted double counting. (Staff brief at 17; reply brief at 11)

Staff also attempts to differentiate between this proceeding and a Commission proceeding in which the deferral of a watershed study, an ion exchange pilot plant study and groundwater investigation costs were approved. Staff asserts that in the latter case, study and investigation costs were recorded in Account 183, consistent with the USOA. Staff says it was not until after receiving Commission authorization to have the costs in question deferred in Account 186 that the Company did so. Staff concludes that such costs were not deferred prior to receiving Commission approval. (Staff brief at 15)

Staff does not believe that the United Cities Gas decision supports IAWC's proposal to recover deferred security costs. Staff says the deferred security costs are not comparable to the costs at issue in United Cities Gas because security costs are not an integral part of an acquisition agreement. (Staff brief at 15)

In response to IAWC's assertion that taken to the extreme, Staff's proposal would be that no deferred costs ever would be recoverable because all such costs are incurred outside of a test year, Staff argues that the Company's position could be taken to the opposite extreme, such as all deferred costs would have to be accepted because they are out-of-test year expenses, and test year principles do not apply. In Staff's view, such extreme arguments do not advance the decision-making process and they highlight the necessity of discussing each deferral on its own merits. Staff asserts that the Company does not do this; rather, it merely lists several cases in which the Commission approved recovery of a deferred expense without explaining how the case supports its present proposal to recover deferred security costs. (Staff brief at 17-18)

Staff states that in several of the Commission cases cited by IAWC, deferred expense issues were uncontested and, therefore, do not support the Company's deferred security expenses proposal. In addition, Staff asserts that several Commission cases cited by IAWC involve extraordinary property losses that Staff says are considered to be non-recurring events. Staff argues that there is nothing about these extraordinary property loss cases that support IAWC's proposal to recover deferred security expenses. (Staff brief at 18-19)

Staff says another case cited by IAWC, Docket 89-0176, involved an expenditure made during the test year that Staff says the Commission found to provide benefits to ratepayers out into the future. Staff says deferred security costs are different because they were incurred prior to test year and do not provide ongoing benefits. (Staff brief at 20-21)

Staff asserts that two cases cited by IAWC involve expenses incurred pursuant to Section 8-102 of the Act. Staff claims deferred security costs do not fall under Section 8-102 of the Act and are therefore different. (Staff brief at 21) It is Staff's position that

any decision the Commission has made regarding an alternative regulation plan provides no support for the Company's position in this proceeding because IAWC operates as a fully regulated water company.

According to Staff, 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. In Staff's view, these arguments do not outweigh the fact that the Company proposal violates the test year rule by matching operating expenses outside of a test year with revenues of the test year. Staff also complains that 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. (Staff reply brief at 7-8)

Staff also asserts that some of the security measures taken by the Company are plant items that have been included in rate base by the Company. Staff says it has not opposed these additions' inclusion in rate base. Staff states that the deferred security costs at issue in this proceeding are operating expenses similar to the ongoing security expenses. (Staff reply brief at 10-11) According to Staff, "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." (Staff RBOE at 16) In Staff's view, what the Company is seeking is synonymous with capitalizing plant items, which are included in rate base net of accumulative depreciation. (Staff RBOE at 17)

Staff says IAWC, in it brief, developed a three prong test for recovery of deferred costs: 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. (Staff reply brief at 12, citing IAWC brief at 15). In Staff's view, the Company has prepared a list that describes most deferred costs rather preparing a list that is exclusive to deferred costs deemed recoverable by the Commission.

Staff asserts that contrary to IAWC's assertion, it is not explicitly, or implicitly, suggesting that the Company should recover deferred security expenses. (Staff reply brief at 12-13, citing IAWC brief at 18) Staff disagrees with IAWC's suggestion that prudence is the only factor in deciding recoverability. Staff argues that other rules and precepts of ratemaking also play a part in deciding the recoverability of a cost. Staff believes that in this proceeding, the test year rule is an example of another relevant factor.

In response to IAWC's assertion that Staff's proposal would 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", Staff argues that the Commission should not reward the Company for its attempt to skirt the rules that shape ratemaking by appealing to the emotions concerning the 9/11/01 tragedy. (Staff reply brief at 13, citing IAWC brief at 1, 18, 22) Staff says the Company responded to 9/11/01 by enhancing its security before being assured of rate recovery and there is no reason to believe other utilities have not also responded and would also respond to future threats and emergencies. Staff adds that it is proposing to allow the Company to recover its ongoing security expenses which Staff believes will help the Company respond to any future risk of terrorist intrusion or destruction.

In response to IAWC's suggestion that the Commission consider that the Florida Commission has allowed incremental power plant security costs through a fuel clause, Staff suggests the Commission should consider the California Public Utilities Commission's ("CPUC") decision concerning an affiliate of IAWC, the California-American Water Company ("CAWC"). (Staff reply brief at 14, citing IAWC brief at 20) Staff claims the CPUC denied a petition by CAWC to establish a special and temporary Security Cost Memorandum Account. (Id., citing Public Utilities Reports, 220PUR4th No. 3, December 15,2002, p. 556)

According to Staff, 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 9/11/01 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. Staff asserts that other states' public utility commissions' thoughts concerning recoverability of enhanced security measures cannot be deemed unanimous. In Staff's view, the Commission should make its decision regarding IAWC's deferred, prior-period security expenses based upon the evidence in the record in this proceeding. (Staff reply brief at 14-15)

According to Staff, 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. (Staff reply brief at 15, citing IAWC brief at 24) Staff responds that 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. Staff claims that while this has been the result in prior cases cited by the Company, for this hypothetical it is pure supposition. Staff also contends that the hypothetical given by the Company concerns plant items rather than continuing operating expenses, which are at issue in this proceeding. In Staff's view, the Company has failed to provide precedence that is analogous to the instant proceeding. (Staff reply brief at 15-16)

c. LWC's Position

As explained in its briefs and on pages 1-10 of its reply brief on exceptions, it is the LWC's position that the Company's proposal for recovery of deferred security costs should be rejected because these are annual recurring expenditures and not appropriate for deferred cost recovery as proposed by the Company.

The LWC also assert that the Company has not adequately demonstrated that the rates in effect during the periods these charges were deferred would not have compensated the Company for these expenses. (LWC brief at 6) The LWC assert that other costs included in IAWC's last rate case have decreased after that rate filing, which provided savings that, in the LWC's view, likely allowed IAWC to recover the security expenses through the rates in the year the expenses were incurred. (LWC brief at 6, citing LWC Ex. MPG-1 at 7-8)

The LWC state that the Company's embedded cost of debt has decreased from IAWC's last rate case. The LWC assert that the annual cost savings to IAWC for this debt interest cost reduction could have offset these deferred expense items. It is the LWC's position that IAWC has the obligation to file for a rate increase if and when it believes its rates are not fully adequate to provide recovery of its operating costs. The LWC contend that IAWC chose to forego a rate case and therefore should assume all responsibility for all costs realized prior to the test year. (LWC brief at 6-7, citing LWC Ex. MPG-1 at 7-9 and LWC Ex. MPG-2 at 21-23)

The LWC also agree with Staff's position that the Company's proposal for deferred costs between September 11, 2001 and December 31, 2002 were not incurred during the test year, and should therefore be disallowed. The LWC argue that the recovery of deferred operating expenses, such as deferred security costs in this case, has been deemed a violation of test year rules by the Illinois Supreme Court. (LWC brief at 7, citing Business and Professional People for the Public Interest v. Commerce Commission, 146 Ill. 2d 175, 239 - 241, 585 N. E. 2d 1032, 1061 - 1060 (1991); LWC RBOE at 3)

The LWC say that in *BPI II*, the Court held that depreciation expense and nuclear decommissioning expense were operating expenses which could not be recovered as deferred charges because recovery violated test year rules. The LWC assert that the Court noted that the purpose of a test year rule is to prevent a utility from overstating its revenue requirement by mismatching low revenue data from one year with high expense data from another. According to the LWC, in *BPI II*, the Commission and the utility argued the deferred charges in that case were unrecovered capital costs rather than operating expenses; therefore, they reasoned that test year principals would not apply to deferred charges. (LWC brief at 7-8)

According to the LWC, the Supreme Court stated that resolution of the disputed issue in that case would depend on whether test year principals applied to deferred charges. The LWC say that the Court concluded the test year principals did apply to deferred operating expenses and, therefore, it denied recovery of deferred depreciation and deferred nuclear decommissioning costs which had considered to be operating expenses. The LWC claim the deferred security costs in this case are operating expenses and the Company did not seek permission to defer and record these expenses. The LWC say the Company now seeks to recover current security expenses

as part of a traditional rate case, therefore, under the holding in *BPI II* they are not recoverable. (LWC brief at 8; reply brief at 1-2)

The LWC argue that the cases cited by IAWC involved Commission Orders which were issued prior to the *BPI II* decision in December of 1991 or were themselves decided before the *BPI II* decision or shortly thereafter. The LWC contend that this suggests that *BPI II* was not considered by the reviewing court in reaching its decision. (LWC brief at 8)

The LWC assert that the Illinois Supreme Court cases sited by IAWC, such as *Citizens Utility Board,* which were decided after the *BPI II* decision, did not turn upon the utility's right to recover deferred costs. The LWC claim that in the *Citizens Utility Board* case, the Supreme Court agreed with the Commission's determination that coal tar clean-up costs were recoverable even though they had no direct connection to the current service offered by the utility. The LWC say that in that case the court reviewed a Commission Order holding that utilities could recover the costs of statutorily mandated cold tar clean-up expenses from customers.

The LWC state that the Commission's decision was challenged on appeal because the costs were not associated with the provision of current service but rather with the clean up of manufactured gas plant sites, which had not been in service for many, many years. According to the LWC, the Supreme Court ruled that the costs were recoverable even though they were not associated with current service. The LWC say the current case deals with operating expenses from a prior period that were deferred and recorded in hope of recovery in the subsequent rate case proceeding. In the LWC's view, recovery of deferred security costs in this case would violate the test year rule which is intended to prevent a utility from overstating revenue requirement by mismatching low revenue data from one year with high expense data from a different year, a situation which is prohibited under the holding in *BPI II*. (LWC brief at 9)

The LWC state that the *Citizens Utility Board* case was a generic rulemaking case, not a traditional rate case. The LWC claim that *BPI II* involved a traditional rate case like the case now pending before the Commission in this proceeding. (LWC reply brief at 3)

The LWC state that the *Citizens Utility Board* Court, in responding to the argument that recovery of coal tar clean-up costs through an automatic recovery rider constituted single issue ratemaking, reasoned that the principles set forth in *BPI II* apply only in the context of a general rate case. The LWC say this case is a general rate case; therefore, the principles in *BPI II* apply. (LWC reply brief at 3)

The LWC disagree with IAWC that the *Citizens Utility Board* case is controlling because the costs in question are deferred "environmental compliance costs" similar to those which the Commission and the *Citizens Utility Board* Court permitted utilities to recover. The LWC believe the costs in question are operating costs and do not represent the cost of compliance with any environmental standard or requirement.

The LWC argue that security costs have been included in the Company's rates as operating expenses in prior cases, and in its test year filing in this case, the Company has included a request for recovery of security expenses it will incur in the normal course of business on an ongoing basis. The LWC say coal tar clean-up costs were temporary non-recurring costs incurred to restore certain utility property to an environmentally safe condition. In the LWC's view, they were closer to one-time capital expenditures than to ongoing operating expenses. (LWC reply brief, citing Tr. 68 and 64-65)

The LWC also dispute the Company's assertion that its earnings prior to the test year were inadequate and thus, deferring security costs should be permitted. The LWC assert that the Company incurred significant acquisition-related expenses in the years prior to the test year. The LWC state that IAWC acquired the Citizens Utility Company of Illinois ("CUCI") in 2002 and incurred acquisition-related costs for this district in 2002. The LWC state that the Company has not requested recovery of acquisition-related costs in its rates, therefore, to the extent these non-operating expenses drove the Company's earnings down in years prior to the test year, earnings prior to the test year have no bearing on whether the rates in effect during those years were adequate to permit recovery of security costs and all other operating expenses. (LWC brief at 9-10)

The LWC also contend that IAWC's proposal for recovery of deferred security costs may provide it with the opportunity to recover those expenses twice; first, when the expenses were actually incurred through rates then in effect and second, in the context of the deferred security costs it proposes to include in rates and to amortize over a fixed period. (LWC reply brief at **4)**

It is the LWC's position that the *United Cities Gas* case does not support the Company's position. The LWC state that in *United Cities Gas,* the Commission Order appealed from was entered in November of 1990. The LWC aver that this was more than one year prior to the decision of the Illinois Supreme Court in *BPI II* (December 1991). The LWC say the *United Cities Gas* Court did not mention or discuss the holding in *BPI II*. According to the LWC, application of test year rules and principles were not the subject of the appeal in the *United Cities Gas* case. The LWC say that instead the issue was whether the Commission's decision, to deny the right to recover the cost of an agreement not to compete, was against the manifest weight of the evidence. The LWC state that the issue here is whether allowing the Company to recover deferred operating expenses from a period prior to the test year is a violation of test year rules. (LWC reply brief at 5)

The LWC do not agree with IAWC that security costs are unique. (LWC reply brief at 5, citing IAWC brief at 16) The LWC say that security costs have been incurred at some level prior to September 11, 2001 and will continue to be incurred hereafter. The LWC state that under traditional accounting rules these are not extraordinary expenses, nor are they non-recurring expenses. (LWC reply brief at 5, citing Tr. 68 and 64-65) According to LWC, in arguing that deferred security expenses were

"extraordinary" expenses and, therefore, recoverable, the Company ignores the basic facts in evidence in this proceeding that security expenses have been reflected in the Company's rates on a historic basis as an operating expense and will be reflected in the Company's future rates as a test year operating expense. Therefore, LWC argues, they are not "extraordinary." (LWC RBOE at 4-5)

It is the LWC's position that security costs are not like tank painting/steel structure painting costs. The LWC say that tank-painting expenses are essentially capital costs in that steel structure painting has an anticipated life of 15 years. The LWC contend that tank-painting expense does not represent an annual operating expense. (LWC reply brief at 6)

LWC The do not agree with the Company's suggestion that rate case expenses are akin to deferred security costs. (LWC reply brief at 6, citing IAWC brief at 19) The LWC assert that rate case expenses are incurred at the time of each rate case and such expenses are not annual operating expenses. The LWC argue that security costs are and will be an annual operating expense. The LWC conclude that recovery of a deferred rate case expense is not analogous to the recovery of deferred security costs. (Id.)

The LWC argue that if the Company wanted to defer and record an annual operating expense such as deferred security costs, it should have sought such a variance as Commonwealth Edison did in the context of the *BPI II* case. The LWC also contend that the Company should have attempted to show, as it says ComEd did in *BPI II*, that its current rates were set at a level that would not allow it to recover those annual operating expenses. The LWC assert that IAWC did not do so. (LWC reply brief at 6)

d. CUB's Position

CUB states that IAWC proposes to amortize its September 11, 2001 through August 2003 security costs over a five-year period and include the unamortized balance in rate base. CUB recommends disallowance of these costs because they represent a prior period and are outside the test year. (CUB brief at 2; reply brief at 1-2)

It is CUB's position that IAWC has not offered a compelling reason for abandoning the test year concept. In CUB's view, IAWC's reliance upon the possibility of post-September 11, 2001 terrorist threats without further justification is simply intended to scare regulators into meeting the Company's requests. CUB contends that water companies were required to provide security measures prior to the terrorist attacks and will no doubt be required to continue to do so. CUB argues that this alone does not justify a significant departure from traditional regulatory reliance upon the test year concept. (CUB brief at 3)

According to CUB, IAWC's proposed treatment of security costs also creates the potential for over-recovery. CUB says that the Company is requesting recovery of on-

going security costs as well as an annual amortization of deferred security costs. (CUB brief at 3, citing Tr. 66)

CUB states that under IAWC's proposal, deferred security costs will continue to be paid by ratepayers even though the actual costs may be fully satisfied. CUB claims that there will be no reconciliation between the amounts collected and the actual cost incurred. CUB asserts that no failsafe exists to ensure that the Company does not over collect and without such protection in place it is imprudent to allow a probable over-recovery. (CUB brief at 3-4)

According to CUB, under generally accepted accounting principles, "extraordinary expenses" are those that are deemed to be both unusual and infrequent and IAWC's proposed cost recovery fails to satisfy both prongs of the test. CUB argues, in part, that security costs are not unusual because IAWC maintained security prior to September 11, 2001. In addition, CUB contends that it is not the purpose of the recovery that governs their categorization as "extraordinary," but their nature. CUB argues that the fact IAWC responded to the events of 9/11/01 by increasing security measures does not negate the fact that security costs were generally recovered in rate base in prior years and are thus considered usual and frequent thereby disallowing their recovery as an extraordinary expense. (CUB brief at 4-5)

According to CUB, the instances of recoverable deferred costs cited by the Company are either inapposite to IAWC's current case or distinguishable therefrom. In CUB's view, the Commission should disallow the proposed deferral. (CUB brief at 5-6)

In its reply brief, CUB argues that Business and Professional People v. ICC, 146 Ill. 2d 175, 585 N.E. 2d 1032(1991) controls the permissibility of deferred costs such as the security expenses and reverse osmosis costs that IAWC seeks to recover. CUB claims that in BPI *II*, the Illinois Supreme Court held that operating expenses cannot be recovered as deferred costs in a ratemaking proceeding. According to CUB, both IAWC's security expenses and reverse osmosis costs are operating expenses, thus their deferral is prohibited. (CUB reply brief at 2)

CUB also argues that pursuant to 83 Ill. Adm. Code 285.150, a water utility may select any current, future or historical 12 month period as a test year upon which to base its costs in a ratemaking proceeding. CUB says that IAWC selected 2003 as its test year in this proceeding but the proposed costs were incurred from 2001-2002 and thus fall outside of the test year chosen by the company. (CUB reply brief at 2)

e. O'Fallon's Position

In the event the Commission does not approve the alterative rate agreement between O'Fallon and IAWC, O'Fallon say it objects to the recovery of deferred security costs. O'Fallon asserts that the award of deferred costs of the increased security costs incurred is not within the authority of the Commission. (O'Fallon brief at 12)

O'Fallon also asserts that IAWC entered into a number of costly and dubiously effective security arrangements for which it now seeks additional compensation. O'Fallon argues that IAWC's customers should not be made to shoulder the burden for such arrangements. O'Fallon also claims that IAWC did not take advantage of federal and state grant opportunities to obtain contributions toward the costs of increased security expenses for its customers following September 11th. According to O'Fallon, the Commission should not allow the costs for "gold-plated" security arrangements and waste to be passed along to the Company's customers. (O'Fallon brief at 13)

f. Lincoln/Streator's Position

It is Lincoln/Streator's position that the Company cannot recover deferred security costs incurred in the years 2001 and 2002 because, (a) granting the request would violate the Commission's test year rules, (b) granting the request would provide double recovery of security cost expense in the forecasted test year of 2003, and (c) the amount of the security costs was unreasonable. (Lincoln/Streator brief at 13; Lincoln/Streator RBOE at 2-5)

In support of its position, Lincoln/Streator cite *Citizens Utilities Co.,* 124 Ill.2d at 201, 124 Ill. Dec. 529, 529 N.E. 2d 510; *Business and Professional People v. ICC* (1991), 146 Ill.2d 175, 166 Ill.Dec. 10, 585 N.E.2d 1032; and *Business and Professional People 1,* 136 Ill.2d at 219, 144. (Lincoln/Streator brief at 14)

According to Lincoln/Streator, the Company would have the Commission believe that IAWC had no other choice than to defer the security expenses incurred in 2001 and 2002. Lincoln/Streator claim this is not accurate because when the Company filed its rate case in 2002 it could have selected a historical (2001), a current (2002) or a future (2003) test year. Lincoln/Streator say the Company voluntarily chose the future test year of 2003. Lincoln/Streator contend that IAWC could have chosen a 2002 test year and eliminated the problem they are now faced with. (Lincoln Streator brief at 15) Lincoln/Streator also claim that the Company could have attempted to get expedited approval from the Commission of a rider mechanism, like the one in the *Citizens Utility Board* case. (Lincoln/Streator reply brief at 8)

In its reply brief, Lincoln/Streator assert that, contrary to the arguments of the Company, the Illinois Supreme Court in *Citizens Utilities Board* did not create an exception to the Commission's test year rules to allow recovery of environmental compliance costs, and it did not overturn or supercede the Court's prior decision in *BPI II*. According to Lincoln/Streator, while the Court did recognize that coal tar clean up costs were legally mandated environmental remediation and that they were an operating expense, and while it did uphold the Commission's decision to allow recovery of said costs, the Company's interpretation of the case could not be more wrong. (Lincoln/Streator reply brief at 5)

Lincoln/Streator argue that as it relates to the issue of whether the recovery of the coal tar clean up costs violated the Commission's test year rules or the rule against

single issue ratemaking, the Court held that the test year rules and the rule against single issue ratemaking do not apply to the Commission's approval of a rider mechanism to recover the costs. LincolnIStreator aver that the Court held that the test year rules and the rule against single-issue ratemaking only apply to general rate cases or base rate increases. (LincolnIStreator reply brief at 5)

LincolnIStreator assert that while the test year rules were found not to be applicable in the Citizens Utility Board case, they were applicable in BPI *II* and they are applicable to the pending case. LincolnIStreator say that the purpose of the test year rule is to prevent a utility from overstating its revenue requirement by mismatching low revenue data from one year with high expense data from a different year. (LincolnIStreator reply brief at 6)

According to LincolnIStreator, the Court in BPI *II* used the question of whether a cost item was an "operating expense" as its test for determining if the item is subject to test year principles. LincolnIStreator say the Court held that depreciation and decommissioning expense were operating expenses and that therefore recovery of deferred depreciation and deferred decommissioning expense violates the test year principles. LincolnIStreator state that the Court reversed the Commission in BPI *II* for failing to follow its own rules by attempting to allow recovery of deferred depreciation. (LincolnIStreator reply brief at 6)

LincolnIStreator argue that granting the Company's request to also recover the deferred security costs would violate the test year rules and would result in double recovery of security costs in the test year. LincolnIStreator say the Company claims that this is not a double recovery because the rates from this proceeding will not take effect until September 1, 2003.

According to LincolnIStreator, the Company is complaining about regulatory lag. LincolnIStreator assert that the Court in BPI *II* specifically rejected the arguments about regulatory lag that were proffered by the parties therein. (LincolnIStreator reply brief at 7, citing BPI 11, 146 Ill.2d at 239-242) LincolnIStreator say the Court went so far as to say that the Commission could amend its rules to address the concern over regulatory lag. LincolnIStreator contend that the Commission has not changed the rule, and even the draft revised rate case rules do not change the test year requirements and the test year rule is still the law. (LincolnIStreator reply brief at 7-8)

In its reply brief, Lincoln/Streator's takes the position that any attempt by the Commission to make up for past under-earnings by the Company, such as approval of the deferred security costs, would violate the rule against retroactive ratemaking. (LincolnIStreator reply brief at 8, citing BPI 11, 146 Ill.2d at 243, 585 N.E.2d at 1061)

g. Bolingbrook's Position

In its reply brief, Bolingbrook takes issue with the Company's reliance on the decision in Citizens Utility Board as support for recovery of deferred security costs.

According to Bolingbrook, the holding in *Citizens Utility Board* hinged on whether the expenses were mandated by law. Bolingbrook contends that despite IAWC's argument to the contrary the deferred security costs in issue here have never been mandated by law. It is Bolingbrook's position that *Citizens Utility Board* does not support IAWC's argument that these deferred costs should be included in current rates. (Bolingbrook reply brief at 8-9; Bolingbrook RBOE at 1-4)

It is Bolingbrook's position that the controlling precedent with respect to the deferred security cost issue is *Business and Professional People v. Illinois Commerce Commission,* 146 Ill.2d 175, 585 N.E.2d 1032, 166 Ill.Dec. 10 (1991). In Bolingbrook's view, inclusion of IAWC's deferred security costs would violate test year principles and should, therefore, be denied pursuant to the Supreme Court ruling in *BPI II*. (Bolingbrook reply brief at 9-10)

h. Commission's Analysis and Conclusions

As noted above, the Company's test year filing includes an annual amount in operating expenses for ongoing enhanced security expenses. The Company also proposes to recover a ratable or one-fifth portion of "deferred" enhanced security expenses. This deferred amount is arrived at by combining the amount of enhanced security expenses deferred by IAWC since September 11, 2001 ("9/11") with the estimated amount to be incurred through August 2003. The Company proposes to include this deferred amount in rate base while amortizing it over a five-year period through the income statement.

As indicated above, Staff and some Intervenors agree that the Company should be allowed to include an annual amount in the 2003 test year operating expenses for ongoing enhanced security expenses. However, Staff, LWC, CUB and several other Intervenors contend that the Company's proposal to recover deferred security expenses violates test year principles, and should be rejected.

The parties' arguments on the deferred security cost issue, including cases cited by them, are set forth in some detail above, and will not be repeated here. Having reviewed the record, the Commission finds that the Company should not be allowed to recover deferred security expenses in the rates set in this proceeding.

In analyzing this issue, 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. However, as explained by Staff, the ratemaking treatment sought by the Company for deferred security expenses, as described above, is essentially the same as when plant items are capitalized and included in rate base net of accumulated depreciation.

Under the Commission's "test year" procedures in effect at the time of the Company's filing, 83 Ill. Adm. Code 285, a utility seeking rate relief may select a historic,

current or future test year. In its filing, IAWC selected a "future" test year consisting of the 12 months ended December 31, 2003, rather than a current or historic test year. Therefore, the operating statement provided by IAWC was for the 12-month period ending December 31,2003.

Generally speaking, under the test year concept, an operating statement for a future test year will include a reasonable level of ongoing operating expenses expected to occur during that period, while operating expenses that occurred in years prior to the test year will not be included in the test year operating statement.

Consequently, the inclusion of "deferred" operating expenses in a test year rate filing is problematic. As several parties have noted, this issue was addressed by the Supreme Court of Illinois in its BPI *II* decision in 1991, cited above. The Court focused on whether the costs in question were in the nature of "expenses". The Court found that two of the costs in question, depreciation and decommissioning, were in the nature of "expenses" subject to the test year rule, and thus to allow recovery of amounts of such expenses that had been deferred prior to the 12-month test year violated test-year principles. The Court noted that in a rate case, "the purpose of the test year rule is to prevent a utility from overstating its revenue requirement by mismatching low revenue data from one year with high expense data from a different year." (146 Ill. 2d 175 at 238, citing Business & Professional People *I*, 136 Ill. 2d at 219)

In its briefs, the Company claims that the "test year principle'' is not a legal rule, BPI *II* notwithstanding. IAWC relies heavily on a 1995 decision by the Supreme Court of Illinois, Citizens Utility Board, cited above, involving the Commission's generic coal tar proceeding and order in consolidated Dockets 91-0080 through 91-0095. The Commission order in that docket addressed the ratemaking treatment of expenses incurred in investigating and remediating former manufactured gas plant ("MGP") sites. A review of that decision, however, simply does not support either the Company's interpretation of the Court's holdings in that matter or the Company's conclusions in the instant proceeding.

For one thing, the coal tar proceeding was simply not a traditional rate case. In BPI *II*, on the other hand, the issues were considered "within the context of a traditional rate case" as noted by the Court in its decision in Citizens Utility Board. (166 Ill. 2d 111 at 138) This distinction is significant, as test year rules only apply to a traditional rate case.

In the Citizens Utility Board decision, the first question actually examined by the Court was "whether, and to what extent, coal-tar remediation expenses are recoverable from ratepayers." The issue here went to the nature of the expense. Some parties had argued that expenses incurred in remediating MGP sites that had not been operated in decades, even if the expenses themselves were incurred currently, should not be charged to current ratepayers because they provided no benefit to current ratepayers. The Court rejected this argument, observing that expenses commonly incurred to

comply with the mandate of Federal and State law have historically been recoverable from ratepayers.

This portion of the Court's analysis, including its discussion of the "sharing" issue, dealt with the nature, and underlying recoverability, of the type of expense at issue. The Court found that "the coal tar cleanup expenses are being incurred in the course of utility operations and are current costs." (166 Ill. 2d 111 at 128) In 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.

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.)

On the other hand, the instant case, Docket 02-0690, is a general rate proceeding, and test year rules clearly apply. The test year selected by IAWC is the 12-month period ending December 31,2003.

As explained above, as a general rule, under the test year concept applicable in a base rate proceeding such as this one, a reasonable level of ongoing operating expenses expected to occur during a future test year will be included in the operating statement for that period, provided such amounts are normal. Operating expenses that occurred in years prior to the test year, however, generally will not. In the instant case, the "deferred" security costs in question are operating expenses incurred, for the most part, prior to the test year selected by the Company.

The parties have cited a number of cases where the issue of recovery of deferred costs has been addressed. The parties' arguments regarding these cases are summarized above, and will not be reiterated here.

For example, the Company asserts that deferred tank painting and deferred rate case expense are routinely approved, including in the instant case. Staff states that unlike security costs, tank painting and rate case expense have been specifically approved for deferral in prior dockets.

The Commission believes these situations are distinguishable from the treatment of security costs proposed by the Company in other respects. For one reason or another, such as wide fluctuations in tank painting costs from one year to next or the fact that rate case expense is simply not incurred every year, the amounts in the test year for such expenses may not be representative of a normal year. Therefore, deferred amounts may be used to help arrive at a more normal or representative test year allowance as an alternative to unrepresentative test year projections, but they are not used to provide a supplement or addition to a normal level of annual expenses. IAWC's proposal, on the other hand, seeks to recover both a test year allowance for normal, ongoing security expenses and a ratable portion of prior expenses it has deferred.

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 93-0184 where extraordinary property losses were suffered due to flooding.

The Commission also agrees with Staff and LWC that allowing the deferred security costs to be recoverable by considering them to be "extraordinary", while simultaneously treating ongoing security expenses of the same type as "ordinary" and thus recoveable as a test year operating expense, is illogical and inconsistent.

Staff also states that in some of the cases cited, the utility sought prior authorization to defer the costs in question. As indicated above, in a general ratemaking proceeding, recovery of pre-test year deferred operating expenses is not the norm. For that matter, deferring operating expenses is not the norm. According to Staff, if a utility wants to defer operating expenses so as to be able to seek recovery of such costs in a subsequent rate proceeding, it should seek prior approval to do so. Without prior approval, Staff asserts, such deferral would be inconsistent with the Uniform System of Accounts. With regard to deferred security expenses, no such prior approval was sought by IAWC.

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.

In conclusion, the Commission finds that the Company should not be permitted to recover, over the objections of numerous other parties, its deferred enhanced security

expenses for the reasons set forth above. The result sought by IAWC creates a mismatch of 2003 test year revenue with prior-period expenses, and is inconsistent with the test year rule. The record does not support the Company's proposal.

K. Deferred Reverse Osmosis Costs

The Company described deferred reverse osmosis costs as "the costs of the Company's full scale pilot study of reverse osmosis technology for removal of nitrate contamination in the source water at the Streator District." (IAWC brief at 25) The Company says the study was performed in 2001, at a cost of $497,604. The Company has treated this item as a deferred cost "to be amortized in rates over a 5 year period." (Id.) In this proceeding, the Company maintains that a ratable portion of these costs should be included in test year operating expenses and recovered through rates. (IAWC brief at 24-30; IAWC reply brief at 14-17; IAWC BOE at 33-42 and App. E at 1-3) Staff witness Everson proposed an adjustment, supported by certain Intervenors, to disallow amortization of deferred reverse osmosis costs.

IAWC witness Johnson provided a history of the nitrate problem in Streator. (IAWC brief at 25-27, citing IAWC Ex. R-3.0 at 5-7) He said the source of water supply for the Streator Water Treatment Facility is the Vermilion River ("River"), which has a long history of high nitrate levels related to agricultural fertilizer run-off. He stated that the United States Environmental Protection Agency ("USEPA") has imposed a Maximum Contaminant Level (MCL) of 10 mg/l for finished water nitrate, and that all water utilities must comply with this water quality standard.

Mr. Johnson testified that Northern Illinois Water Corporation ("NIWC"), the predecessor of Illinois-American in Streator, had been complying with the nitrate standard by storing low nitrate River water in a side-channel reservoir and blending that water with River water during high nitrate periods, but when nitrate levels in the River began to increase, NIWC was compelled to enter into a Letter of Commitment with the Illinois Environmental Protection Agency ("IEPA) to assure compliance with the nitrate standard by April, 1995.

NIWC initiated an analysis of possible nitrate control alternatives, including ion exchange treatment, reverse osmosis treatment, electrodialysis treatment, alternative groundwater supply-Ticona aquifer, side-channel reservoir expansion, and watershed management-nitrate control at the source.

Mr. Johnson said the cost estimates for these alternatives ranged from $262,000 to $9.8 million, and that NIWC determined the most cost-effective step was to try to solve the problem at the source through a watershed management program which was successful until 2001, when nitrate levels in the River once again soared and low-nitrate water in the side-channel reservoir was depleted and not available for blending. He said the Company concluded that nitrate removal treatment was necessary as it became clear that voluntary efforts to control nitrate at the source could not be assured.

According to Mr. Johnson, the selection of an appropriate water treatment technology is complex and frequently centers around the waste produced in the treatment process. He said pilot testing of new treatment processes is critical to determine the viability of the process and the quantity and type of waste produced, and that the IEPA requires pilot testing of new treatment processes to ensure viability. The witness stated that in 1993, NIWC pilot tested only ion exchange treatment as it appeared to be the most economical at the time.

Mr. Johnson testified that the Company rented and installed temporary reverse osmosis treatment equipment in 2001 as a further pilot study of nitrate removal technology. He said the Company wanted to make sure that all viable treatment techniques were examined in the field prior to installation of permanent facilities. Mr. Johnson believes the data gathered from both pilot studies was invaluable in determining treatment viability, waste characteristics and cost, and that the cost of the study was an investigative cost properly recorded as a deferred cost. Ultimately, the Company selected ion exchange treatment, which was installed in 2002, as the most cost-effective removal technology in the Company's view. (IAWC brief at 26-27)

For the reasons discussed in its brief regarding Deferred Security Costs, IAWC argues that "Deferred Reverse Osmosis Pilot Study Costs also are recoverable." (IAWC brief at 27) In particular, the Company asserts, Ms. Everson's reliance upon the order in Docket No. 98-0895 is misplaced because that case did not involve a question of rate recovery of a deferred cost. IAWC claims it's "Deferred Reverse Osmosis Pilot Study Cost" falls squarely within Citizens Utilities *Board* v. ICC, 166 Ill 2d 111 (1995), which allowed recovery of deferred environmental compliance costs. IAWC says the Court stated that utilities are entitled to recover deferred coal-tar clean up costs over a five year amortization period, with carrying charges on the unamortized balance.

According to IAWC, the Court stated that the Commission "must allow the utility to recover costs prudently and reasonably incurred", and that "coal-tar cleanup expenses benefit a utility's ratepayers because payment of this legally mandated cost allows a utility to remain in business and to continue to provide service to its customers." (Id., citing Citizens Utilities *Board* v. ICC, 166 Ill 2d at 121, 123)

IAWC says the "Deferred Reverse Osmosis Pilot Study Costs" are costs incurred to enable the Company to continue to assure that its customers will not be exposed to harmful levels of nitrate and to maintain compliance with USEPA's limit for nitrate, 10 mg/l, by choosing the most cost-effective nitrate removal technology. (IAWC brief at 28; IAWC BOE, App. E at 1)

IAWC also argues that "Deferred Reverse Osmosis Pilot Study Costs" are recoverable under prior identical precedent. IAWC asserts that in Docket 95-0220 involving NIWC, the Commission ordered that the costs of NIWC's Ion Exchange Pilot Plant Study, as well as its Vermilion River Watershed Study and Groundwater Investigation, be deferred and recovered in rates over a 5-year amortization period. In IAWC's view, "Since the Reverse Osmosis Pilot Study is in the same category, and for

the same purpose, as the Ion Exchange Pilot Study, it should be treated in the same manner." (IAWC brief at 28-29; IAWC BOE, App. E at 2)

IAWC also argues that contrary to Staff witness Everson's assertion, the Company will not recover the same costs twice. IAWC says that in her rebuttal testimony, Ms. Everson in fact changed her position, stating the "Company would not be recovering the same costs twice." (IAWC brief at 29, citing Staff Ex. 12.0 at 7) According to IAWC, the deferred reverse osmosis costs were incurred in 2001 to test that particular nitrate removal technology, whereas, the ongoing costs included in the test year are costs incurred for the different and permanent Ion Exchange removal technology ultimately installed. (IAWC BOE, App. E at 2) IAWC also argues that recovery of both deferred and ongoing costs at the same time is consistent with the Illinois Supreme Court's decision in the *Citizens Utilities Board* case and the Commission 's order in a NIWC docket, 93-0184. (IAWC BOE, App. E at 2)

Staff's position is set forth in its testimony, its briefs and on pages 27-31 of its RBOE. As explained in its briefs, **Staff** witness Ms. Everson proposed an adjustment to disallow amortization of deferred reverse osmosis expense. (Staff brief 46-50; Staff reply brief at 16-22) First, Staff claims the Company's proposal violates the concept of a test year, noting that the test year selected by the Company is 2003, while the costs for nitrate removal using reverse osmosis equipment occurred in 2001. In Staffs view, to include expenses incurred in 2001 in a 2003 test year improperly creates a mismatch of 2001 expenses with 2003 test year revenues. (Staff brief at 46, citing Staff Ex. 12.0 at 4)

Staff says the expenses incurred in 2001 were not of an investigative nature, but instead were operating expenses, such as rental of equipment, site preparation and installation, electricity, fuel, and materials and labor to operate the equipment, and should be classified as operating expenses in the year they were incurred.

Regarding the Company's characterization of these activities as a pilot study, Staff says the Company 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. (Staff brief at 47, citing Tr. 290; Staff RBOE at 27) Staff also says the Company acknowledged 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, and that the Company had tested ion exchange equipment which is what was permanently installed at the Streator Water Treatment Facility.

Staff also contends that IAWC improperly recorded reverse osmosis expense in 2001 as a deferred charge in Account 183, Preliminary Survey and Investigative Charges. In support of her position, Staff witness Ms. Everson cited the following instruction for Account 183:

> 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.

According to Staff, 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 wished to use alternative recording to that specified in the instruction, Staff asserts, the Company should have petitioned for approval to defer the reverse osmosis expenses in 2001, when the operating expenses were incurred according to the instruction for Account 183. (Staff brief at 48, citing Staff Ex. 12.0 at 5-7)

Staff also argues that the Company's proposed treatment of deferral and amortization of nitrate removal expense using reverse osmosis equipment, if allowed, would result in a double recovery of nitrate removal expense. IAWC proposed including nitrate removal expense incurred in 2001 and also including ongoing amounts for nitrate removal in the 2003 test year, which, in Staff's view, would result in IAWC recovering expenses for nitrate removal twice. (Staff brief at 49, citing Staff Ex. 12.0 at 7) By its very nature, Staff argues, recovery of a deferred cost, which also continues as an ongoing cost, means that, in the test year, a company will recover more than the "normal annual amount" for that cost.

Regarding the cases cited by IAWC, Staff argues that each instance of a request to defer an expense should be individually judged. Staff also argues that as discussed in the section of its Initial Brief titled, "Deferred Security Expense", IAWC's analysis of the court cases it cites is flawed. (Staff brief at 49-50)

In its testimony and briefs, **CUB** also contends that IAWC's reverse osmosis costs should be disallowed. (CUB brief at 6-8; CUB reply brief at 3-4) In CUB's view, the record clearly illustrates that implementation of the reverse osmosis treatment was not study-related. CUB says all pilot studies, particularly those undertaken with the consent or knowledge of the IEPA, require that a report be forwarded to the agency. (CUB brief at 7, citing Tr. 276)

In the instant case, CUB states, IAWC neither developed nor provided the IEPA with such a report. Instead, CUB asserts, the Company requested "immediate" delivery "as quickly" as the vendor could arrange to provide the necessary equipment "including over the weekend." (CUB brief at 7, citing Staff Cross Ex. 1.0 at 2) According to CUB, IAWC's arguments that it rented temporary equipment, filed for an IEPA permit to install the equipment and decided to conduct a study, all on June 26, 2001, is implausible. (CUB brief at 7, citing Tr. 290)

Because IAWC cannot prove that the costs associated with the temporary use of the reverse osmosis treatment were actually pilot study costs, CUB argues, the Commission should disallow recovery of these costs.

In its brief, the **City of Streator** says it supports Staffs recommendation to deny the recovery of deferred reverse osmosis costs. Citing Business and Professional People v ICC, ("BPI *"I*"), (1989), 136 Ill.2d 192, 219, 144 Ill.Dec. 334, 346, 555 N.E.2d 693, 705; and Business and Professional People v ICC, ("BPI *II*"), (1991), 146 Ill.2d 175, 237-38, 166 Ill.Dec. 10, 36-37, 585 N.E.2d 1032, 1058-59, the City of Streator argues that the Company's position is inconsistent with test year rules. (Lincoln/Streator brief at 12-13; Lincoln/Streator RBOE at 5-8)

Having reviewed the record, the **Commission concludes** that the Company should not be allowed to recover deferred osmosis costs through rates set in this docket. Many of the arguments on this issue are the same as those made with regard to deferred security expenses. For the most part, the reasons for disallowing recovery of deferred security costs also apply to deferred osmosis costs.

The type of cost in question is in the nature of an operating expense that occurred in 2001, well prior to the 2003 test year selected by the Company. For the reasons explained by Staff and CUB, the Commission agrees with those parties that the activities in question did not constitute a pilot study. Further, as noted by Staff, the Company did not seek approval to defer the expense.

In conclusion, the Commission finds that the Company's request for recovery of deferred osmosis expense is inconsistent with the 2003 test year selected by the Company, and it should not be granted.

L Approved Operating Income Statement

Upon reflecting the effects of the determinations made above, the operating statements for IAWC's respective districts are approved as shown in the Appendix attached hereto. It is noted that in the Lincoln and Sterling districts, calculated revenue requirement would produce a revenue increase in excess of that requested in the Company's filing. For those districts, the rates approved shall be designed to produce only the amount of the requested increase, not the higher amount that would produce the calculated revenue requirement.

VI. CAPITAL STRUCTURE AND COST OF CAPITAL

Five witnesses submitted testimony regarding IAWC's **cost of capital.** On behalf of IAWC, Paul R. Moul presented testimony regarding the Company's cost of common equity (IAWC Exhibits 7.0, 8.0, R-7.0, and SR-7.0); Frederick L. Ruckman submitted testimony on capital structure, cost of debt and overall weighted average cost of capital ("WACC"). (IAWC Exhibits 1.O, 13.0, R-1.O, SR-1.O) On behalf of O'Fallon, Charles W. King presented testimony on the cost of equity. (O'Fallon Exhibits 1.0 and

R-1.0) On behalf of LWC, Michael Gorman presented testimony on the cost of equity. (LWC Exhibits MPG-1 and MPG-2) Sheena Kight presented Staff's analysis of IAWC's capital structure, cost of debt, cost of equity, and WACC. (Staff Exhibits 6.0 and 16.0)

IAWC and Staff did not agree on the costs and balances of long-term debt. However, for the purposes of this proceeding, IAWC, LWC and CUB have accepted Staff's cost of equity recommendation. In the event the Commission "fails to approve the competitive alternative rate agreement proposed by O'Fallon and Illinois-American", then O'Fallon stands on the analysis of Mr. King. Ms. Kight's recommendations on capital structure and cost of capital, resulting in an overall cost of capital recommendation of 7.36%, may be summarized as follows:

Component	Amount	Ratio	Cost Rate	Weighted Cost
Short-Term Debt	$9,707,764	1.81%	1.60%	0.03%
Long-Term Debt	$284,559,791	52.95%	5.06%	2.68%
Common Equity	$243,109,450	45.24%	10.27%	4.65%
Total	$537,377,005	100.00%		7.36%

A. Capital Structure and Cost of Debt

IAWC witness Ruckman presented the Company's proposed capital structure in IAWC Exhibit 13.0, Schedule D-1. It consisted of $296,005,645 in long-term debt (54.85%) and $243,632,832 in common equity (45.15%).

Staff witness Kight adjusted the Company proposal by adding short-term debt, making several adjustments to the long-term debt schedules to reconcile it with Company responses to Staff data requests and to reflect other corrections, and adjusting the Company's common equity balance to reflect Staff's proposed rates. (Staff Ex. 6.0 at 4-5) Staff's final capital structure proposal consisted of $9,707,764 in short-term debt (1.81%), $284,559,791 in long-term debt (52.95%) at a cost rate of 5.06%, and $243,109,450 in common equity (45.24%). (Staff brief at 54, 56; Staff Ex. 16.0, Schedule 16.01)

The Company accepted Staff's adjustment to the common equity balance to reflect Commission-approved rates. (IAWC Ex. R-1.0 at 16-17) The Company did not rebut Staff's inclusion of short-term debt in the Company's capital structure or it's proposed cost rate for short-term debt. For purposes of this proceeding, the Company is in agreement with Staff on most capital structure and cost of debt issues; however, the Company disputes (1) Staff witness Kight's method of calculating the test year balance and interest costs related to its two Bolingbrook debt issues; and (2) the proposed cost rates Ms. Kight assigned to its two variable rate debt issues. (IAWC brief at 30)

Regarding the Bolingbrook debt issues, Company witness Mr. Ruckman testified that the correct test year balance for the Bolingbrook-Fixed issue is $5,227,466 and the correct interest cost is $507,799. For the Bolingbrook-Variable issue, he asserted that the correct test year balance is $1,027,323 and the correct interest cost is $99,876. According to Mr. Ruckman, the correct cost rates for both issues is the "cost rate of 9.87%...used in the determination of the acquisition adjustment of $7,207,852 stated at finding 9 of the Order [in Docket 01-0001]." (IAWC brief at 31; IAWC Ex. R-1.0 at 18)

The Company used the 9.87% rate because it was the authorized rate of return approved by the Commission at the time of the Bolingbrook Asset Exchange. It is the rate the Company believes most accurately reflects an appropriate rate of return on investment available to the Company. (IAWC RBOE at 8-10)

Mr. Ruckman stated that the Commission has approved use of the authorized rate of return on investment as the appropriate financing rate in a number of Illinois-American proceedings. He said that in Docket No. 99-0068, the Commission approved use of the authorized rate of return for variances from Part 600.370 to finance customer surcharge payments in lieu of lump sum payment of customer contributions, and that in certificate proceedings identified as Docket Nos. 96-0353, 97-0209, and 97-0276, the Commission approved tariffs that recognized used of the then authorized rate of return on investment as the financing rate for customer surcharge payments.

According to the Company, there have been numerous Illinois-American certificate proceedings in the past 10 years where an investment was required and the Commission reviewed the appropriate level of Company contribution, when compared with the appropriate level of contribution required by proposed new customers, the overall authorized rate of return was used to measure the reasonableness of the Company's proposed investment. (IAWC brief at 31-31; IAWC Ex. R-1.0 at 18-19)

IAWC indicated that it is willing to agree with use of Staffs methodology discussed below, provided that the correct cost rate is used and the starting point for calculating present value is July 25, 2002, which is the date the Asset Exchange was completed and the first payment was made to the Village of Bolingbrook. The Company presented IAWC Exhibit R–1.8, which it says is a corrected version of Staff witness Ms. Kight's calculations. (IAWC Ex. R-1.0 at 17)

Staff witness Ms. Kight adjusted the face amount outstanding, maturity date and the interest rate of the Bolingbrook-Fixed issue to reflect the payment schedule in the Bolingbrook Asset Purchase and Exchange Agreement ("contract") and the interest rate of equivalent debt when the contract was signed in 1996. She also changed the maturity date, face amount outstanding and the interest rate of the Bolingbrook-Variable issue so it would reflect the minimum payment and the interest rate of Utility debt when the contract was signed in 1996. (Staff brief at 57, citing Staff Ex. 6.0 at 10-11)

Ms. Kight said the Bolingbrook-Variable issue has a minimum payment of $275,000 per year for six years, and that the amount paid under the Agreement could increase depending on the number of customers that take service from IAWC. Consequently, she stated, those contingent payments are more akin to a purchase obligation than debt. Moreover, she says that portion of the obligation is not known and measurable. Therefore, Ms. Kight excluded it from the face amount outstanding of the Bolingbrook-Variable issue. That adjustment reduces the face amount outstanding from the Company's original estimated $1,444,609 to $1,185,374 and changes the maturity date from 12/31/07 to 12/31/08. (Staff Ex. 6.0 at 11-12)

Ms. Kight disagreed with the Company's use of a rate of 9.87% because it includes the higher cost of common equity in what Staff characterizes as a debt obligation. (Staff brief at 58) As explained on pages 57-58 of Staff's brief, Ms. Kight used imputed rates on debt of 6.55% and 6.21% for the two issues, rather than the rate of 9.87%. Staff's position on this issue is set forth in Ms. Kight's testimony, and in Staff's briefs and its brief on exceptions. (Staff BOE at 4-7)

With regard to the cases cited by the Company in which the Commission used the authorized rate of return as the appropriate financing rate to charge on an investment, Staff asserts that in those cases, the investments were assets, whose specific sources of funding cannot be identified. (Staff reply brief at 35-36) An asset, Staff submits, is assumed to earn the overall rate of return granted to a company in its most recent rate case. In contrast, Staff argues, the Bolingbrook debt issues are liabilities, not assets. Liabilities are either debt or equity. In this case, Staff asserts, 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.

With regard to Docket 01-0001, Staff contends that the Order in that docket approves neither an acquisition adjustment nor a cost rate of 9.87% for the Bolingbrook debt issue. (Staff brief at 35; Staff BOE at 4-7)

In response to that argument, the Company argues that the Commission approved application of 9.87% to both payment obligations in Docket No. 01-0001. According to IAWC, the Commission approved an acquisition adjustment and journal entries in Docket 01-0001 that could only be arrived at through use of a 9.87% interest rate for the Bolingbrook debt issues. (IAWC reply brief at 17-18; IAWC Ex. SR-1.0 at 8-9)

In its brief on exceptions, Staff states that if the Commission finds the correct rate to be 9.87%, then the amount of Cost of Capital Savings Sharing for non-Citizens service territories should be increased to $496,368. (Staff BOE at 7-9) Staff submits that use of the 9.87% rate for the Bolingbrook issues increases the cost of debt excluding assumed debt to 5.47% from 5.39% and the cost of debt including assumed debt from 5.06% to 5.12%. These calculations are shown in schedules attached to Staff's BOE, and the Commission finds them to be correct.

For the Bolingbrook debt issues, the Commission finds that the 9.87% cost rate contained in the Company's calculations should be used. Although Staff has made a strong argument that use of imputed rates on debt rather than overall cost of capital is more consistent with the nature of the obligation for the reasons clearly articulated by Ms. Kight, the fact remains that many aspects of the accounting treatment for the underlying transaction were the subject of a prior Commission order in Docket 01-0001.

In this regard, the Company asserts, and the Commission agrees, that the accounting entries by accounts and amounts approved by the Commission in that order, and the final journal entries filed pursuant to that order, could only be reached through use of the 9.87% cost rate. Accordingly, in the Commission's view, approval of a different cost rate methodology in the instant docket would be inconsistent with the findings made in, and actions taken pursuant to, the prior order. The effects of using the 9.87% rate for the Bolingbrook issues are correctly shown on Schedules 1 through 7 of Staff's brief on exceptions. The effects on revenue requirement are incorporated in Appendix A attached to this order.

For IAWC's variable rate debt issues, the Company proposes that "the Commission use the 5 year forecast of 3.47%." (IAWC brief at 33; IAWC reply brief at 19; IAWC BOE at 42-46 and App. F) Staff witness Kight proposed to use spot interest rates of 1.25% and 1.20% for the Citizens Series debt and the Tax-Exempt debt, respectively. (Staff reply brief at 36; Staff RBOE at 31-35)

IAWC witness Ruckman objects to the "low rates" used by Staff. In his opinion, Staff's use of spot rates is inappropriate for a projection for the period the new rates will be in effect. He said this spot rate, given both historic averages as well as future projections, is unrealistically low. As a consequence, he argues, the Company will be prejudiced in the future by the risks of the likely increases in interest rates. In the absence of adopting a rate at or approaching the 5-year projection, Mr. Ruckman claims the Company's only real defensive option is to lock in a fixed rate, which will be even higher than the 5-year rate. (IAWC brief at 32-33, citing IAWC Ex. R-1.0 at 21)

Mr. Ruckman testified that the historical 5-year average for variable rate tax-exempt debt issues, adjusted for issuance fees, is 3.10%. (IAWC Ex. R-1.0 at 20) In terms of what the future variable rates may be, he said the Bond Market Association survey of member firms concludes that interest rates are expected to increase, especially in the second half of 2003. (IAWC Exhibit R-1.16) He also stated that Bank One estimates that the 5-year future average will be 3.47%.

Mr. Ruckman further stated that if the Company were to convert its variable rate debt issues to fixed rate debt issues at this time, the 5-year fixed rate would be in the range 3.74% to 3.94% as shown on IAWC Exhibit R-1.17. (IAWC Ex. R-1.0 at 21)

In support of her recommendation, Staff witness Kight disagreed with the Company's assertion that an interest rate IAWC is currently paying on its variable rate debt may ever be properly characterized as "unrealistic." In her opinion, current rates

are the best predictor of future rates. Although interest rates may currently be low on a historical basis, she believes room exists for further interest rate declines. She said that while no one can predict with certainty which way interest rates will move in the future, the consensus among analysts surveyed is that the Federal Reserve Board will leave rates unchanged or cut them in the near term. (Staff brief at 59-60; Staff Ex. 16.0 at 5)

Ms. Kight asserts that the use of a 5-year forecast period is an inappropriate interest rate for IAWC's variable rate debt. She stated that the longer the forecast period, the less accurate the forecast. She also said that use of a 5-year is inappropriate in this case because it exceeds the projected life of the rates. (Staff brief at 60; Staff Ex. 16.0 at 6)

In its brief, IAWC argues that if spot interest rates are used at all, which the Company opposes, then more current rates should be substituted for the rates used by Staff. Staff objects to this recommendation on the basis that the updated rates are not in the record. A review of the record indicates that the Company asked Ms. Kight about the more current rates, "subject to check." As stated by Staff, however, the witness did not accept the newer rates subject to check. (Staff RBOE at 35) Hence, they are not in the record.

Having reviewed the record, the **Commission finds** that Ms. Kight's recommendation should be adopted. The Commission agrees with Staff that the spot interest rate provides a more accurate means of forecasting the cost of variable rate debt during the estimated life of the rates than does the five-year forecast period used by the Company. The Commission also agrees with Staff that the spot interest rates actually used in Staff's analysis are the most recent spot rates in the evidentiary record. The Commission also notes that use of a spot rate to estimate the cost of short-term debt has been approved by the Commission in recent dockets, such as Docket 01-0465101-0530/01-0637 (cons.).

B. Cost of Common Equity

As explained in Staff briefs, Staff witness Kight estimated the cost of common equity for IAWC using the discounted cash flow ("DCF") and risk premium models. (Staff brief at 62-66; Staff reply brief at 36-38) Since DCF and risk premium models cannot be applied directly to IAWC because its common stock is not market-traded, Ms. Kight applied those models to two samples. The first sample was comprised of eight market-traded water utilities within the Standard & Poor's Utility Compustat database that were not in the process of being acquired by another company, and for which either Institutional Brokers Estimate System ("IBES") or Zacks Investment Research ("Zacks") growth forecasts were available ("water sample").

The second sample consists of seven public utilities selected from the Standard & Poor's Utility Compustat database that have matched IAWC's implied credit rating of 'A' and business profile score of 3, were not in the process of being acquired by another

company, and for which either IBES or Zacks growth forecasts were available ("utility sample"). (Staff Ex. 6.0 at 14-16)

Ms. Kight said a **DCF** analysis assumes that the market value of common stock equals the present value of the expected stream of future dividend payments. Since a DCF model incorporates time-sensitive valuation factors, it must correctly reflect the timing of the dividend payments that stock prices embody. The companies in both of Ms. Kight's proxy samples pay dividends quarterly. Therefore, Ms. Kight applied a constant-growth quarterly DCF model. (Staff Ex. 6.0 at 16-17)

Ms. Kight stated that the DCF methodology requires a growth rate that reflects the expectations of investors. She measured the market-consensus expected growth rates with projections published by IBES and Zacks. The growth rate estimates were combined with the closing stock prices and dividend data as of December 4, 2002. Based on this growth, stock price, and dividend data, Ms. Kight's DCF estimate of the cost of common equity is 9.39% for the water sample and 10.64% for the utility sample. (Staff Ex. 6.0 at 18-20)

As noted above, Ms. Kight also performed a risk premium analysis. She said that according to financial theory, the required rate of return for a given security equals the risk-free rate of return plus a risk premium associated with that security, consistent with the theory that investors are risk-averse. That is, investors require higher returns to accept greater exposure to risk. In equilibrium, she stated, two securities with equal quantities of risk have equal required rates of return. Ms. Kight used a one-factor risk premium model, the Capital Asset Pricing Model ("CAPM"), to estimate the cost of common equity. In the CAPM, the risk factor is market risk, which cannot be eliminated through portfolio diversification. (Staff brief at 63-64; Staff Ex. 6.0 at 21-22)

Ms. Kight said the CAPM requires the estimation of three parameters: beta, the risk-free rate, and the required rate of return on the market. First, using Value Line beta estimates and regression analysis, Ms. Kight estimated forward-looking betas of 0.52 for the water sample and 0.58 for the utility sample. (Staff Ex. 6.0 at 30-31) Second, Ms. Kight considered two current estimates of the risk-free rate of return: the 1.23% yield on U.S. Treasury bills and the 5.24% yield on U.S. T-bonds. Both estimates were measured as of December 4, 2002. She asserted that forecasts of long-term inflation and the real risk-free rate suggest that the U.S. T-bond yield is currently the superior proxy for the long-term risk-free rate. (Staff Ex. 6.0 at 22-26)

Finally, to measure the expected rate of return on the market, Ms. Kight conducted a DCF analysis on the firms composing the Standard & Poor's 500 Index. That analysis estimated that the expected rate of return on the market equals 14.8%. (Staff Ex. 16.0 at 2) Inputting those three parameters into her risk premium model, Ms. Kight estimated that the cost of common equity equals 10.16% for the water sample and 10.79% for the utility sample. (Staff Ex. 16.0, Schedule 16.03)

Along with DCF and risk premium analyses, Ms. Kight considered the observable 6.84% rate of return the market currently requires on A-rated utility long-term debt. (Staff Ex. 6.0 at 31-32) Based on her analysis, Ms. Kight concludes that the investor-required rate of return on common equity for IAWC is 10.25%. Ms. Kight estimated the investor-required rate of return on common equity by: 1) averaging the DCF-derived estimates of the required rate of return on common equity, or 10.02%, 2) averaging the risk premium-derived estimates of the required rate of return on common equity, or 10.47%, and 3) taking the midpoint of the DCF and risk premium derived estimates, or 10.25%. (Staff Ex. 6.0 at 32 and 16.0, Schedule 16.03)

Ms. Kight said the return on common equity should be adjusted for **issuance costs.** The Company's filings with the Commission pursuant to 83 Ill Adm. Code 240 verify that the Company incurred a total of $112,500 in common equity issuance costs in 2002. Ms. Kight stated that the common equity issuance cost adjustment can be calculated in two different ways. The "perpetual" method calculates an adjustment to be added to the cost of common equity that provides a return on, but no recovery of common equity issuance costs since common equity has an indefinite life span and thus, no standard, finite recovery period. The perpetual adjustment is calculated by multiplying the investor-required return on common equity by the unrecovered issuance cost then dividing the result by the common equity balance.

The second or "amortization" method calculates an adjustment that allows the Company to recover its flotation cost over a defined period of time. The amortization adjustment is calculated by dividing the unrecovered issuance cost by the time period allowed for recovery and then dividing that quotient by the common equity balance. (Staff Ex. 6.0 at 33)

Using IAWC's adjusted average 2003 balance of common equity of $243,109,450 and an investor-required rate of return on common equity of 10.25%, the common equity issuance cost adjustment equals 0.0047% for the perpetual method and .0155% for the amortization method assuming a three year amortization period. Upon inclusion of an adjustment for issuance costs as discussed above, Staff estimates the Company's cost of common equity to be 10.27%. (Staff Ex. 6.0 at 33-34 and Ex. 16.0, Schedule 16.01)

As an "argument in the alternative", the City of **O'Fallon** states that if the Commission "fails to approve the competitive alternative rate agreement proposed by O'Fallon and Illinois-American", then O'Fallon stands on the analysis and professional opinion of its expert, Charlie King, that the overall return should be 7.14% including a cost of equity of 9.1%. (O'Fallon brief at 9, citing O'Fallon Ex. 1.0 at 3) O'Fallon says Mr. King's cost of equity was derived directly from the DCF analysis of comparable water companies performed by IAWC's witness, Mr. Moul.

O'Fallon also argues that there is no justification for assuming IAWC's equity cost is higher now than the 10.20% rate allowed in its last rate case, Docket 00-0340 decided on February 15, 2000. (O'Fallon brief at 9-10, citing O'Fallon Ex. 1.0 at 3-4) In

support of this argument, O'Fallon states that since February 2000, interest rates have declined. In February, 2003, O'Fallon states, the yield on 10-year Treasury bonds was only 3.90%, 262 basis points lower than the 6.52% yield on the same bonds when the Commission last set the Company's equity return on February 15, 2000. O'Fallon says yields on high-grade corporate bonds have also slipped, from 6.98% in February, 2000, to 5.95% in February of 2003, and that Baa corporate bonds were yielding 8.29% in February, 2000, but only 7.06% in February of 2003. (O'Fallon brief at 9-10)

In its brief on exceptions, O'Fallon argues that approval of "the Letter of Intent with IAWC agreeing to a competitive alternative rate" would render moot the issue relating to IAWC's recommendations on cost of equity. (O'Fallon BOE at 5-7) O'Fallon also argues that "the record was an insufficient one on which to make...specific and affirmative findings" in the Proposed Order rejecting O'Fallon's position on the cost of equity. (O'Fallon BOE at 5-7)

In its RBOE, the Company argues that O'Fallon's exception should be rejected. (IAWC RBOE at 39)

In response to O'Fallon's analysis regarding the cost of common equity, Staff contends that Mr. King's exclusion of gas distribution companies from his analysis was unfounded. Staff asserts that 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. (Staff reply brief at 36-37) Staff also argues that Mr. King provided no evidence in support of his claim, based on current interest rates, that that there is no justification for assuming IAWC's equity cost is higher now than it was two years ago. (Staff reply brief at 37) Staff also asserts that Mr. King provided no evidence to support his claim that the DCF procedure is more reliable than the CAPM.

Having reviewed the record, the **Commission finds** that the analysis used by Ms. Kight for purposes of estimating the cost of common equity in this proceeding should be adopted. As explained in detail in Ms. Kight's testimony and as summarized above, she estimated the cost of common equity for IAWC using the discounted cash flow ("DCF") and risk premium models. Since DCF and risk premium models cannot be applied directly to IAWC because its common stock is not market-traded, Ms. Kight applied those models to two samples that she developed.

The Commission believes Staff has demonstrated that the screens used and judgment employed in formulating each of the two samples were reasonable; that the use of both DCF and CAPM models was appropriate; that the inputs and parameters used in its DCF and CAPM models were properly measured; and that these models were properly applied to the proxy groups. In the Commission's view, Ms. Kight's analysis provides a more comprehensive and accurate means of estimating the Company's cost of common equity that does Mr. King's.

C. Approved Capital Structure and Cost of Capital

Upon giving effect to the conclusions contained above, IAWC's capital structure and cost of capital, resulting in an overall cost of capital of 7.39%, may be summarized as follows:

Component	Amount	Ratio	Cost Rate	Weighted Cost
Short-Term Debt	$9,707,764	1.81%	1.60%	0.03%
Long-Term Debt	$283,638,908	52.87%	5.12%	2.71%
Common Equity	$243,109,450	45.32%	10.27%	4.65%
Total	$536,456,122	100.00%		7.39%

VII. COST OF SERVICE AND RATE DESIGN

As a result of various mergers and acquisitions over the years, the Company has numerous service areas. In terms of single tariff pricing or "STP", the Southern, Peoria, Streator and Pontiac districts are currently combined for revenue requirement purposes, and to some extent have uniform rates, in the "SPSP" district. The same is also true for the Chicago Metro district, which has separate usage charges depending on the source of water.

In the present case, IAWC does not propose to include any additional Districts in single-tariff pricing.

A. Staffs Position

Staff's recommendations on cost of service and rate design issues are set forth in its testimony, briefs and pages 35-40 of its reply brief on exceptions. According to Staff, a cost of service ("COS") study is performed to determine each customer class' respective cost responsibility for the costs imposed on the utility by that specific customer class. Staff states that rates can then be designed with the knowledge of the cost to serve each customer class. Staff asserts that in the water industry, COS studies are utilized as the main guide to designing rates and that the Commission has consistently followed COS study principles when approving water rates. (Staff brief at 66)

Staff states that IAWC proposed setting rates on an across the board basis to all rate areas in accordance with revenue requirements applicable to each rate area. According to Staff, IAWC's current rates for most rate areas are based on COS studies performed three years ago. (Staff brief at 67)

Staff says it performed a COS study for all rate areas. Staff believes that COS studies should be performed with the most recent data, if available, so that rates reflect current conditions. Staff asserts that the Company's methodology of an across the board increase would be acceptable if current data was not available, or unforeseen

circumstances arose which did not allow a COS study to be performed, or if the data was somehow unreliable. In Staff's view, the data received from IAWC is reliable and current enough, therefore Staff incorporated Company provided data into its COS studies. Staffs COS studies use the Base-Extra Capacity method of cost allocation to distribute costs to customer classes. Staff says the Base-Extra Capacity method is the same methodology employed and accepted by the Commission in IAWC's last rate case, Docket 00-0340. (Staff brief at 67)

According to Staff, the objectives of a COSS are to functionalize a utility's revenue requirement into basic categories and allocate those costs across rate classes to determine each class' cost of service. Staff says rates can then be designed to recover the cost to serve each customer class. Staff says that in the water industry, embedded cost studies are utilized as the main guide to designing rates that are unique to each utility. Staff asserts that the development of water rates, in general, involves the following procedures:

- Determination of the total annual revenue requirements for the period for which the rates are to be effective;
- Allocation of the total annual revenue requirements to the basic functional cost components;
- Distribution of the component costs to the various customer classes in accordance with their requirements for service; and
- Design of water rates that will, recover from each class of customer, within practical limits, the cost to serve that class of customer.

(Staff Ex. 8.0, Appendix A)

Staff's COS study uses the Base-Extra Capacity method which Staff asserts is a generally accepted and often used method of determining the cost to serve water customers and thus provides the basis of designing rates for a water utility. Staff says the basic breakdown of cost is the functionalization into operational components. For a water utility the three basic types of costs are: 1) operation and maintenance ("O&M") expense, 2) depreciation expense, and 3) return on capital investment. This information is normally readily available from the utility's accounting records. (Id.)

Staff states that after the costs are functionalized, they are allocated to four main components: 1) base costs, 2) extra capacity costs 3) customer costs, and 4) direct fire protection costs. Staff says that base costs are those costs that tend to vary with the total quantity of water used. These costs also include O&M expenses and capital costs associated with serving customers under average load conditions. Staff says that extra capacity costs, and their associated O&M and capital costs, are costs correlated with meeting usage in excess of average usage. These costs can be further subdivided into costs associated with maximum-day extra usage and maximum-hour extra usage. According to Staff, customer costs encompass those expenditures related to serving a customer regardless of that customer's water usage or rate of usage. These contain costs associated with meters, services and other customer related costs. Finally, Staff says that direct fire protection costs are directly applicable to the fire protection function.

After costs are properly allocated between cost components, the cost of service for each meter size is determined.

Staff says the fixed customer cost of service per meter has three basic components: 1) equivalent meter costs include those customer costs associated with meters, 2) equivalent service costs include those customer costs associated with services, and 3) other customer costs are those costs attributed directly to customers, divided by the number of bills to obtain a customer charge per bill. Other customer costs are non-meter size sensitive with each meter size being allocated the same per unit charge, regardless of class (i.e. residential, commercial, industrial etc.). (Id.)

Staff states that equivalent meters and services is a method of assigning costs based on the size of the meter. Distribution of customer costs by equivalent meter and service ratios recognizes that meter and service costs vary, depending on considerations such as size of service pipe, materials used, locations of meters, and other local characteristics for various sized meters as compared to ⅝" meters and services.

Staff states that the number of equivalent meters and services (i.e. which is based on meter ratios) assists in allocating costs assigned for recovery in the customer charges. According to Staff, this is necessary to adjust the units of service for each customer class as indexed against the smallest meter size. Therefore, customers are allocated a charge that reflects the costs associated with their particular meter size. Staff states that actual cost differentials are taken from the AWWA Water Meters-Selection, Installation, Testing, and Maintenance Manual (M6), 1972 pages 32-33. (Id.)

It is Staff's position that if the difference between the Commission's approved revenue requirement and Staff's proposed revenue requirement is five percent or less, usage rates for each rate area should be determined by multiplying Staff proposed usage rates by a uniform percentage to recover the Commission's revenue requirement. If the difference between the Commission's revenue requirement and Staff's proposed revenue requirement is more than five percent, Staff says a revised version of Staff's COS study should be used to determine rates. (Staff brief at 91)

1. Test Year Usage

Staff indicates that the Company proposed using year ending December 2003 as the test year for all rate areas. Staff says it examined the Company's workpapers, data request responses, and testimony related to test year billing units and concurred with the results for all rate areas except the Chicago Metro Sewer rate area. According to Staff, IAWC's Chicago Metro Sewer rate area's current tariffs list a minimum bill for commercial and industrial customers of $13.42 for collection service and $33.50 for collection and treatment service. Staff asserts that IAWC's corresponding Schedule did not show billing units for minimum bills or revenues associated with them. Staff says that instead, billing units were added to the water usage levels to calculate revenues for the minimum bills. Staff states that the Company provided revised billing units that

separated out minimum billing units. (Staff brief at 67-68, citing Staff Ex. 7.0 at 6)

According to Staff, the Chicago Metro Sewer rate area's Rollins service area is currently charged a collection and treatment charge, but this service area should only be charged a collection charge and then have a purchased sewage treatment surcharge applied to its customers. Staff states that the purchased sewage treatment surcharge is authorized by 83 Ill. Adm. Code 655 and the Commission on December 5, 2001 in Docket 01-0282 granted such authority. Staff says it incorporated the billing units into its rate proposal and proposed that the Company treat the Rollins service area in accordance with the Company's tariffed purchased sewage treatment surcharge rider, Ill. C.C. No. 5, First Revised Sheet No. 60-68. Staff also proposed that the Company revise the tariff sheet to show that the Rollins service area is collection only. (Staff brief at 68, citing Staff Exhibit 7.0 at 6-7)

Staff asserts that no party disagreed with the Company's proposed test year billing units or Staff's proposed adjustments to the Chicago Metro Sewer rate area. (Id. at 69) The test year billing units for the Chicago Metro Sewer rate area is addressed further in this Order below.

2. Southern Division, Peoria District, and Streator District (STP Group)

In the Company's filing, the Southern, Peoria, Streator and Pontiac districts are currently combined for revenue requirement purposes, and to some extent have uniform rates, in the "SPSP" district. Staff states that currently, rates in the Streator District are different from rates for the Southern Division and Peoria District. Staff completed a COS study for the Streator District that it says indicated moving Streator into a STP schedule with the Southern Division and Peoria District resulted in usage and fire protection rates that are lower than on a stand-alone basis. Staff asserts that adding Streator to the STP group is consistent with the Commission's guideline for moving Streator into the STP group. (Staff brief at 81)

Staff states that the Peoria District 3rd and 4th usage block rates are less than the 3rd and 4th usage block rates for the Southern Division and Streator District, but Staff's proposed rate design narrows the difference in current rates between Peoria and Southern, which now includes Streator. Staff says that inclusion of Streator in the STP group is complete for the purposes of rate design, with Streator paying the same customer charge and usage rates as comparable Southern Division customers, which includes the fourth usage block. (Staff brief at 81)

Initially, Staff included Streator in STP for customer charges and usage rates, but left the development of Streator fire protection charges as a stand-alone district. Staff's initial proposal more than doubled the current charges and resulted in an overall increase in the billing for the typical Streator water customer of more than 40 percent. (Staff brief at 81)

IAWC suggested moving the Streator fire protection rates into STP. (Staff brief at 82, citing IAWC Exhibit R-6.0 at 4) In response, Staff included Streator with the Southern Division and Peoria District fire protection costs. Staff states that including Streator fire protection costs in STP resulted in a decrease in current Streator public and private fire protection rates. According to Staff, fully including Streator in STP reduced Staff's overall increase to the typical Streator residential customer by nearly half, from 40.5 percent on a stand-alone basis for fire protection to 20.4 percent under complete STP. In Staff's view, this dampening effect should assuage some of the rate impact complaints expressed by the City of Streator. (Id. citing City of Streator Exhibit 2 at 6-8)

In response to the AG's complaints about the magnitude of Staff's proposed rate increase for Streator, Staff asserts that its 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. (Staff reply brief at 53-54)

Also in response to the AG, Staff claims that "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." (Staff reply brief at 54-55)

According to Staff, demand factors are used in its COS study to allocate the elements of base cost and extra capacity costs resulting from maximum day demand and maximum hour demands to various customer classes. Staff says it applied demand factors used in the Company's previous rate case, Docket 00-0340. Staff states that the demand factors in Docket 00-0340 originated from the prior rate case, Docket 97-0102. (Staff brief at 82)

Staff says the Company did not offer a revised or new demand study in this proceeding and other parties have not demonstrated that the demand factors in Staff's COS study are materially inaccurate in presenting current demand relationships among the customer classes. (Staff brief at 82-83; Staff RBOE at 36) Staff suggests, nevertheless, that it is desirable for the Company to update its customer class demand factors prior to its next rate increase request, particularly with the addition of Streator into the STP group. (Staff brief at 82-83)

According to Staff, the Company's current Competitive Services tariffs has prices for with industrial customers and municipal customers set by contract at levels lower than comparable full tariff rates paid by other customers. Staff states that since Competitive Services tariff customers pay less than cost of service, the rates of other customers are increased to recover the difference between cost of service for Competitive Service tariff customers and revenues recovered from Competitive Service customers. Staff claims that its COS study and rate design include the allocation

factors affected by, and the revenues recovered from, Competitive Service tariff customers.

Staff asserts that if the usage billing units and revenues from Competitive Service tariff customers had not been included in its COS study, the customer class allocation factors and rates to recover revenues from other customer classes would have been higher because the Company's cost of service would not have been reduced by an amount equaling or surpassing the revenues recovered under Competitive Service tariffs. (Staff brief at 83; reply brief at 41)

Staff claims that its proposed rates for the STP group consider cost of service, rate impact to customer groups, the effect of competitive service tariffs on similar full tariff customers, and the potential effect of losing large customers to competitive alternatives. Staff says that under its proposal, residential customers are required to pay approximately 105.4 percent of cost of service with a rate increase of approximately 10 percent. Staff proposes that industrial customers pay only approximately 86.5 percent of cost of service but have a rate increase of nearly 20 percent. Staff asserts that if the Competitive Service tariff industrial customers paid the full tariff fourth usage block on all usage, the industrial customer class would pay approximately 96 percent of cost of service. It is Staff's position that, overall, full tariff industrial customers are not substantially below cost of service. (Staff brief at 83-84)

Staff states that during the hearings, the Company and **O'Fallon** reached a general **agreement** on a contractual rate that is less than full tariff rates for the Other Water Utilities rate class. According to Staff, O'Fallon stated that three alternative water supply studies have been done and that O'Fallon will leave the IAWC water system and pursue an alternative supply if the Commission does not approve the contract negotiated rate between O'Fallon and IAWC. (Staff brief at 84-85, citing Tr. 722, 725)

Staff states that at $1.69 per thousand gallons, the general agreement between the Company and O'Fallon translates into $1.2641 per 100 cubic feet ("CCF"). According to Staff, $1.2641 per CCF is more than other Competitive Service tariffs, but less than the fourth usage block rate proposed by Staff. Staff says the rate agreed-upon between the Company and O'Fallon is also somewhat higher than $1.215 per CCF O'Fallon would have paid under the Large User rate proposed by Staff, assuming the same demand factor of 1.2 that affects the rate, which is the same as the customer currently on the Large User rate. (Staff brief at 84)

Staff states that under its proposed Metered General Service rates, O'Fallon would pay approximately $1.4472 per CCF or $216,028 per month. Staff says it will be necessary for other customers to pay the revenues lost through the difference per CCF in order for the Company to recover its revenue requirement. According to Staff, the rates for other customers will be higher if the Commission approves the rate in the general agreement. However, Staff also says that if the rate in the general agreement is not approved by the Commission and O'Fallon discontinues service with IAWC, leaving its contribution to revenue recoveries to other customers, rates for other

customers in future rate dockets will likely be higher than the rates otherwise would have been. (Staff brief at 85) According to Staff, 1,791,325 CCF in O'Fallon test year usage multiplied by the $1.2641 agreed-upon rate totals $2,264,414 in revenue, or 2.65 percent of Staffs proposed revenues from the STP group.

Staff says that with little opportunity to review the support for the rate generally agreed-upon between the Company and O'Fallon, and little or no opportunity to comment on the rate through testimony, Staff has no position on the rate. (Id.) Staff did, however, attach to its brief a set of schedules that purportedly contain cost of service studies, rates and bill comparisons that reflect the affect of the O'Fallon IAWC agreed upon rate.

O'Fallon witness Mr. King proposed a new "Large Wholesale Water Service" rate ("Wholesale Rate"), which is 21.9 percent less than the fourth usage block rate to be determined in this docket. (O'Fallon Exhibit 1.0 at 41, Exhibit R-1.0 at 24) Staff says the Wholesale Rate was developed primarily through the re-allocation of costs from O'Fallon to other customer classes and is separate from the contract rate between O'Fallon and IAWC. (Staff brief at 85-86) IAWC witness Stafford suggests that O'Fallon's Wholesale Rate proposal is beyond the scope of this rate case and is sufficiently vague that it cannot be properly evaluated. Mr. Stafford suggested that O'Fallon might be able to negotiate and enter into a long-term contract with IAWC under a Competitive Alternative Tariff. (IAWC Ex. R-4.0 at 48-50) As discussed in this order, O'Fallon and IAWC agreed to a letter of intent that anticipates O'Fallon will purchase water from IAWC at a negotiated rate.

It is Staff's position that given the difficulties with O'Fallon's support for its proposed wholesale rate and with its apparent failure to qualify for the proposed wholesale rate, the Commission should reject O'Fallon's proposed wholesale rate regardless of whether or not the Commission approves the contractual rate agreed upon between IAWC and O'Fallon. (Staff brief at 87) In its brief on exceptions, O'Fallon argues that "with...approval of the Letter of Intent regarding entry into the competitive alternative rate agreement, O'Fallon chooses not to pursue the wholesale rate at this time." (O'Fallon BOE at 7-8) Under those circumstances, O'Fallon believes it is more appropriate to eliminate any mention of the wholesale rate in the order.

Having reviewed the record, the Commission finds that O'Fallon's proposed Wholesale Rate proposal is not clearly defined and is not supported by the evidence. Furthermore, it appears this proposal is moot. In any event, the Commission declines to adopt O'Fallon's Wholesale Rate proposal at this time.

In its reply brief, Staff complains that the **LWC** did not provide an alternative COS study and rates. Staff says 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. Staff states, "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." (Staff reply brief at 49-50)

Staff says that while the LWC are technically correct 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, on a practical basis, the effect of Streator on the demand factors is immaterial. Staff claims that Streator added only 4.6% more industrial billing units so an adjustment of demand factors would properly weight Southern and Peoria industrial demand factors at 95.4% and Streator 4.6%. (Staff reply brief at 50-51; Staff RBOE at 36-37) Staff characterizes LWC's complaint as "hypercritical." (Staff reply brief at 52)

According to Staff, 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." (Staff reply brief at 52) Staff suggests that the LWC engage in a self-interested attempt to secure lower rates at the expense of other customer classes. (Id.; Staff RBOE at 37)

In response to Lincoln/Streator's complaints about the magnitude of proposed increase, Staff asserts that 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. (Staff reply brief at 55-56)

3. Pontiac District

Staff asserts that its proposed rates in this docket continue to move Pontiac rates more fully into the STP group, with customer charges that are the same as those for the Southern Division, Peoria District, and Streator District. Under Staff's proposal, Pontiac usage rates are different from STP usage rates, so the Pontiac District would not be fully included in the STP group through rates determined in this docket. Staff proposed no change in current Pontiac Fire Protection rates. Staff claims that if the Pontiac Fire Protection costs were added to STP group fire protection costs, Pontiac Fire Protection rates would be lower but other STP group Fire Protection rates would have increased. (Staff brief at 87-88)

Staff states that in order to reduce the amount that Pontiac residential and commercial customers pay above cost-of-service, Staff's proposed rates for the Pontiac District do not fully recover the revenue requirement from the Pontiac District on a stand-alone basis, with the shortfall to be recovered from the STP group. Staff asserts that with the current usage block billing structure at Pontiac, it is difficult to adjust usage rates to further reduce the amounts that Pontiac residential and commercial customers pay above cost of service without a flattened usage block rate structure.

Staff suggests that given the considerably smaller differences in usage block rates at Pontiac compared to the STP group, and in order to maintain a declining usage block structure, the next IAWC rate proceeding involving the Pontiac District will likely require further, if not complete, integration of Pontiac into the STP group. Staff recommends that in the next rate proceeding involving the Pontiac District, the Company provide billing information for the Pontiac District usage based upon both the current Pontiac usage block structure and the STP usage block structure. (Staff brief at 88-89)

4. Pekin Rate Area; Chicago Metro Water Rate Areas

Staff says that while it prepared COS studies for the Pekin and Chicago Metro Water rate areas, since the Chicago Metro Water rate area has residential customers and commercial customers that are distinguished by well water usage, lake water usage, and Moreland water usage, Staff was only able to use the COS study to determine customer charges and fire protection charges. Staff asserts that the COS study it used does not allow for the type of allocations that are necessary to separate out the distinct differences prevalent between well water, lake water, and Moreland lake water customers. (Staff brief at 72)

In response to the AG's concern about what it characterized as large changes in expenses since the last case in various categories, Staff argues that general changes occurring in this case are directly related to additions to plant in service and operation and maintenance costs. Staff also asserts that the Pekin, Lincoln, and Chicago Metro Water rate areas have been introduced to a new uniform system of accounts, which affects allocations between costs and classes. Staff believes its COS studies are all consistent in that all districts use the same uniform system of accounts and allocation factors, all of which were used in the Company's last rate case. (Staff brief at 69-70; Staff RBOE at 39)

In response to the AG's complaints about the costs allocated to fire protection, Staff claims that its fire protection charges are based on the same methodology used and approved in the last case, except for the Chicago Metro Water rate area which did not use Staff's COS study in its last case. Staff notes that Section 9-223 of the Act states that any fire protection charge imposed shall reflect the costs associated with providing fire service. (Staff brief at 70; reply brief at 44)

In its reply brief, Staff asserts that fire protection costs include not just direct costs such as hydrant costs, but also base, max day, max hour, and billing costs. (Staff reply brief at 44, citing Staff brief Appendix B, Schedule 1.0-P at 12, Schedule 1.0-C at 12, and Schedule 1.0-S/P/St. at 12) Staff argues that actual hydrant costs may not have increased but fire protection must take into account that mains and storage must be in place to not only meet regular system demands, but also the added demands of fighting a fire. Staff contends that any addition to either mains, storage, or any other max hour, max day, base, and billing expense will add to fire protection costs. Staff complains that AG witness Rubin provides criticism but has not provided a COS study

to determine fire protection charges nor has he defended his position by proposing an alternative. (Staff reply brief at 44)

Staff says that the AG objects to Staff's small main adjustment because it does not have a theoretical foundation yet, states that the AG does not have enough information to either agree or disagree with the theory as it applies to IAWC. (Staff brief at 71, citing AG Ex. 2.0 at 12 and 15) Staff states that the Commission in a previous IAWC rate case, Docket 90-0100, approved Staff's small main adjustment. Staff says it has used the small main adjustment in its COS study, for pertinent areas, since its inception in Docket 90-0100. In Staff's view, the "theoretical foundation" is grounded in prior Commission approval. (Staff brief at 71; reply brief at 45-46; Staff RBOE at 40)

According to Staff, the AG states 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. (Staff reply brief at 46, citing AG brief at 22) Staff believes the AG has made innuendos and incorrect claims without bothering to take the time to examine the issue thoroughly. (Id.) Staff adds, "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." (Id.) Staff argues that if 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. Staff contends that in that case, such large customers are paying the same rates as smaller customers. Staff states that if the majority of usage is in the first two blocks, no matter what class the customer is in, they will pay for the largest customers on the system who do not make use of the small mains. (Staff reply brief at 46)

While Staff performed COS studies for the Pekin and Chicago Metro Water Areas, the Company proposed setting rates on an across the board basis to all rate areas in accordance with revenue requirements applicable to each rate area. According to Staff, IAWC had no disagreement with Staff's proposed total fire protection COS for the Pekin and Chicago Metro Water rate areas, but thought that Staff's proposed increase in public fire protection charges should be gradual. Staff says the Company suggested there be gradual movement toward increasing public fire protection rates and decreasing private fire protection rates with full movement spread over this rate case and the next two rate cases. (Staff brief at 69 and 74, citing IAWC Exhibit R-6.0 at 5-6)

Staff claims that its proposal for the Chicago Metro Water rate area was to set customer charges and fire protection rates at COS and then allocate the remainder of the revenue requirement on an equal percentage basis to all usage rate charges. Staff argues that while its method does not constitute a full cost of service determination, it does allow for COS determination for customer charges and allows for the setting of fire protection rates at COS. Staff believes its proposed method minimizes the portion of a customer's bill that is not cost based, compared to a complete equal percentage basis as proposed by the Company. (Staff brief at 75)

In response to IAWC, Staff agreed with the proposal for a gradual movement of the fire protection rates. Staff did not commit to spreading the increase over two future rate cases, as IAWC recommended, because, in Staff's view, there is a possibility that many events may occur over an extended time period that may affect fire protection rates. Staff also adjusted the Pekin public fire protection section of the COS study to compensate for an input error in the number of fire hydrants, which corrected the imbalance between public and private fire protection. (Staff brief at 76)

According to Staff, the AG proposed a move towards complete STP for all IAWC rate areas but did not perform a COS study. Staff says the AG questions the consistency of Staff's COS studies. In response, Staff claims its COS studies all use the same allocation factors, uniform system of accounts, and overall methodologies. Staff also says its COS studies use demand factors that were approved in prior cases before the Commission. (Staff brief at 69)

Staff says that the AG is proposing a move towards complete STP for all IAWC rate areas. According to Staff, complete STP means all rate areas would, sometime in the future, have the same customer charges (based on meter size) and consumption charges. Staff says the AG's goal is to standardize the meter ratios across all IAWC rate areas, move toward a single set of customer charges, establish a uniform set of rate blocks for all rate areas, move toward a single set of block ratios for all rate areas, and begin the process of moving toward a single set of consumption charges for all rate areas. Staff says the AG also believes that under STP there would no longer be distinctions by the physical location of the customer. Staff says it is the AG's position that Staff did not follow principles of gradualism, rate continuity, and fairness. Staff says the AG further claimed that Staff made no significant movement toward making IAWC’s rates more understandable or standardizing the consumption blocks, and that Staff's rates vary significantly from cost. (Staff brief at 74)

In its reply brief Staff argues that if the AG's current proposal to shift costs from non-STP rate areas to STP rate areas is accepted, then the move toward complete STP has begun. Staff claims that those rate areas that are not in a STP rate area will have STP costs included in their revenue requirement and 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. In Staff’s view, the Commission should reject the AG's proposal since it transcends past Commission decisions and is at a minimum "murky" with respect to how it would affect future proceedings. (Staff reply brief at 47)

Staff asserts that its proposed rates for the Pekin area are based on its COS study and take into consideration gradualism, fairness, rate moderation, rate continuity, 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. (Staff brief at 75)

According to Staff, well systems are not included in the STP group because of differences between well and surface water source of supply and treatment costs. Staff argues that the minimal treatment facilities needed for well water 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. Staff also asserts that 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. In Staff's view, the surface water treatment plants alone would contain substantial costs that well systems would not have. (Staff brief at 77; reply brief at 39)

Staff states that the Chicago Metro rate area has STP customer charges and separate STP consumption charges for lake water, well water, and the Moreland service area. Staff says the Commission approved STP for the Chicago Metro area in Docket Nos. 95-0181195-0182 (Consol.). According to Staff, the Commission has been moving gradually and cautiously towards STP in some of the rate areas; Staff believes it should continue that way. Staff recommends that the Commission reject the AG's STP proposal. (Staff brief at 77, reply brief at 39-40)

According to Staff, 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. (Staff reply brief at 41-42, citing AG brief at 12) In response, Staff states that 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." (Staff reply brief at 42)

Staff says it is one thing to assume that since some expenses are centrally incurred that charges should be similar, and another thing to see if that theory holds up to reality. Staff suggests that if 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. Staff claims 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." Staff argues, however, that there are differences from a source of supply and treatment perspective that will always exist and create differences in usage charges. Staff claims there are other differences as well. (Staff reply brief at 42)

Staff asserts that the reason why large volume users may pay different rates depending on where they are located within the IAWC system is because each district has different sources of supply that affect costs. Staff claims that each rate area has various projects, such as main replacement, that vary depending on how serious the replacement needs are. Staff also contends that certain rate areas may have competitive rates that call for certain levels of charges depending on such factors as the ability to bypass or an agreement for a fifth rate block. (Staff reply brief at 42-43)

Staff asserts that under the AG's proposal, the Pekin rate area customers would not be treated fairly with Staff's proposed revenue requirement. (Staff reply brief at 43, citing Tr. at 313-314)

In response to the AG's complaints about Staff's COS studies as having inconsistent charges in the 5/8 inch meter costs, Staff says its COS studies all use the same meter ratios, found on the equivalent meter ratio schedule attached to each COS, to determine customer charges. Staff asserts that 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 previous cases. Staff also claims the meter ratios are taken from the AWWA Water Meters-Selection, Installation, Testing, and Maintenance Manual (M6), 1972 pages 32-33. (Staff reply brief at 44-45, citing Staff Ex. 7.0 at 13)

5. Champaign Rate Area

While Staff's proposed rates for the Champaign rate area are based on Staff's COS study, the Company proposed setting rates on an across the board basis to all rate areas in accordance with revenue requirements applicable to each rate area. Under Staff's proposal, the customer charge remained at the present rate as cost of service had already been met for this rate area. Staff proposed to increase the usage charges to recover the revenue requirement. (Staff brief at 79)

Staff says the Company is proposing to increase the standby charges 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 rate area based on the Commission's Order in the last rate case for this utility since no further experience has been obtained in the Champaign rate area. (Staff brief at 78-79) This issue is further addressed below in the discussion of the Sterling rate area.

Staff says it developed a raw water rate based on Exhibit B to Schedule F attached to the Order by the Commission in Docket 97-0254. (Staff brief at 79)

In its reply brief, Staff asserts that perfect cost responsibility by individual or class is difficult. Staff says that rate design should weigh many factors during the decision process and then implement those that best fit the utility and situation. Staff states that the AG's 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, is for four consumption blocks. Staff claims that the University of Illinois has an agreement with IAWC that calls for a fifth consumption block and Staff is unsure of the implications for the agreement if the fifth block is eliminated. (Staff reply brief at 40-41)

6. Lincoln Rate Area

While Staff's proposed rates for the Lincoln rate area are based on Staff's COS study, the Company proposed setting rates on an across the board basis to all rate areas in accordance with revenue requirements applicable to each rate area. Staff says it used the Company's requested revenue requirement to design rates instead of Staff's revenue requirement because, in Staff's view, the rate increase for the Lincoln rate area should be limited by the revenues proposed by the Company. Under Staff's proposal, both the customer and the usage charges were increased to recover the revenue requirement for this rate area. (Staff brief at 79)

Staff says the City of Lincoln suggests that Staff's proposed rates would increase 40.5%, with all charges and surcharges, for a typical residential usage customer. Staff claims, however, that a typical residential customer's bill would increase 17.4% in the Lincoln rate area. (Staff brief at 79)

Staff says it 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 claims its 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. (Staff reply brief at 48)

Staff says 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. (Staff reply brief at 45, citing AG brief at 21) Staff states that the Lincoln rate area was acquired by IAWC on May 10, 2000 and has not filed a rate case since Docket No. 94-0183. Staff asserts that 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. Staff contends that there should be cost differences, however, Staff also expects that customer charges for each rate area should start to parallel each other as time goes on. (Staff brief at 71; reply brief at 45)

7. Sterling Rate Area

Staff says that while its proposed rates for the Sterling rate area are based on Staff's COS study, the Company proposed setting rates on an across the board basis to all rate areas in accordance with revenue requirements applicable to each rate area. Staff says, as with the Lincoln rate area, it used the Company's requested revenue requirement to design rates instead of Staff's revenue requirement and both the customer and the usage charges were increased to recover the revenue requirement. (Staff brief at 80)

According to Staff, 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. (Staff reply brief at 47, citing IAWC brief at 58) Staff says 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. Staff says there are currently no customers on standby rates for the Champaign or Sterling rate areas and Staff still stands by its original recommendation of no increase for Standby rates in the Champaign and Sterling rate areas. (Staff brief at 80; reply brief at 47-48)

8. Chicago Metro Sewer Rate Area

Staff did not perform a COS study for the Chicago Metro Sewer rate area since Staff does not currently have a sewer COS study. Staff says it agrees with the Company's concept of basing rates upon an across the board revision to all rates in accordance with the Commission approved revenue requirement. However, Staff recommends several adjustments to the Company's proposed billing units, rates, and revenues that ultimately allowed the Company to receive the proposed rates they requested for the Chicago Metro Sewer rate area.

As previously discussed, Staff asserts that the Company input incorrect charges for residential multi-unit rates, provided incorrect billing units for minimum bill customers in the commercial and industrial class, and the Rollins service area was being charged a collection and treatment charge instead of a collection charge. (Staff brief at 77-78)

According to Staff, the Company recommends that Staff design rates to recover the total revenue requirement determined in this case. (Staff reply brief at 56, citing IAWC brief at 59) Staff states that when IAWC filed its rate case, specific rates were proposed in order to collect the revenue requirement requested. Staff says it 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 says it found some inconsistencies that included adjustments to billing units and the Company inadvertently used different rates for the residential multi-unit customers, than those filed, when calculating total revenues. (Staff reply brief at 56-57)

It is Staff's position that when the Company filed its proposed rates with the Commission, it set into motion a request for specific rates. Staff says that 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. Staff claims this issue was addressed in the Order for Docket Nos. 00-0513/00-0514 (Consol.). Staff asserts that 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. (Staff reply brief at 57, citing Docket 00-0513/00-0514 (Consol.),

Order at 12) In its BOE, Bolingbrook says it supports Staff's position. (Bolingbrook BOE at 9)

B. The AG'S Position

The AG presented the testimony of Mr. Scott Rubin, who analyzed the Company's filing in terms of fairness, single tariff pricing; rate moderation and continuity; and cost of service. Mr. Rubin recommended that the Commission standardize IAWC's rate structure, so that the rates are simplified and made consistent. The AG says this will enable the Commission and the parties to review IAWC's rates in the future to determine whether and to what extent single tariff pricing for the region should be adopted.

According to the AG, **Staff's** COS studies contained "unexplained anomalies" and "questionable assumptions" that cast doubt on their accuracy and reliability, and these problems were not corrected on the record. The AG states that in order to use cost as a guiding principle in setting rates, a reliable cost of service study must be presented. (AG brief at 20)

The AG asserts that Staff's COS studies showed an "enormous" change in the costs associated with fire service as compared with the costs for fire service shown in Staff's COS studies in IAWC's last rate case. The AG claims that although the direct costs of fire service either decreased or showed modest increases, the allocated costs, which represent the portion of total company costs attributed to fire service, skyrocketed. (AG brief at 20; reply brief at 7, 9)

The AG says that the fire cost changes also affect the costs associated with other categories of service. The AG states that the types of cost showing the most change are common costs that are allocated to fire and to other customer classes. The AG suggests that if the calculation of the common costs is in error, or the allocation is improper, the costs for all other classes of service are affected, calling into question the reliability of the studies. The AG also complains that Staff's COS studies also showed major yet inconsistent changes in the 5/8 inch meter cost. The AG asserts that designing rates based on erratically changed costs, which its says Staff did for fire service, results in dramatic price shifts that contradict the principles of gradualism and rate continuity. (AG brief at 21-22)

The AG objects to Staff's small mains adjustment. The AG says the small mains adjustment was designed to remove the cost of mains that are 12 inches and smaller from large volume customers and assign these costs to other customer groups. The AG asserts that although in theory large volume users may not take service from smaller mains, a significant portion of IAWC's large customers take service from meters that are one inch or smaller. The AG believes it would be "surprising" if customers with such small meters took service directly from mains larger than 12 inches. (AG brief at 22-23)

The AG complains that Staff did not present any evidence to demonstrate that large volume users take service from mains larger than 12 inches. The AG contends that this is an erroneous assumption. (AG brief at 23, citing AG Ex. 2.0, Sch. SJR-R5)

According to the AG, Staff's implementation of the small mains adjustment was erroneous. The AG says Staff removed the costs of mains 12 inches and smaller from large volume customers, and, despite "great variation" in the consumption block structure throughout IAWC, Staff reassigned those costs to classes with consumption in the first and second consumption block. The AG argues that the lack of standardization in IAWC's rates distorts the application of the small mains adjustment. (AG brief at 23)

It is the AG's position that the small mains adjustment improperly shifts costs from the industrial, sales for resale and other public authority classes to the residential and commercial classes of customers. The AG contends that the effect on the consumption costs allocated to the various classes is pervasive, and undermines the reliability of Staff's cost of service studies. (AG brief at 23; reply brief at 14-15)

The AG contends that, contrary to Staff's assertion, the Commission did not resolve any disputes about the small mains adjustment in Docket 90-0100. According to the AG, no issue was presented to the Commission for decision, and the Commission acceptance of an agreement of the parties, when no party objected, cannot be considered an established Commission policy. (AG reply brief at 13-14)

The AG asserts that in the four IAWC rate cases since 1990, the Commission has not addressed the issue of a small mains adjustment. In the AG's view, Staff's suggestion that the issue need not again be addressed because in 1990 neither Staff nor the large water users objected to the Company's small mains adjustment is "irresponsible and unjustifiable." (AG reply brief at 14)

It is the AG's position that given the problems in the Staff cost of service studies, and IAWC's growth through consolidation, the centralization resulting from the single customer service center, the growth in administrative and general expenses, and its acquisition by a new parent, the Company should be required to present a new cost of service study as part of its direct case in its next rate case. The AG believes this will enable the Staff and interested parties to review the changes resulting from the recent changes at IAWC and to incorporate these changes into cost based rates. (AG brief at 24) In their BOE, pages 11-12, Lincoln/Streator say they support this recommendation.

The AG requests that the Commission direct IAWC to produce a cost of service study, based on the Base-Extra Capacity Method described by the American Water Works Association, when it files its next rate case. The AG says the Commission should direct the Company to file a proposal for adopting STP in all of its districts together with a comprehensive analysis of the appropriateness of this or other alternatives. The AG states that without the development of a class of customers who specifically and exclusively take service from mains greater than 12 inches, no small mains adjustment should be made. (AG brief at 24)

According to the AG, the Commission has approved single tariff pricing, referred to as "STP", for IAWC in previous dockets. (AG brief at 4-8, citing Docket 92-0116, Order at 90; Docket 85-0202, Order at 38, 45; Docket 95-0076, Order at 71-74; Docket 97-010210081, Order at 12; Docket 00-0340, Order at 26-31) It is the AG's position that there is great disparity among the increases requested, and recommends that the Commission move toward standardized rates or "single tariff pricing," while moderating the overall increase so that no area or customer class receives an increase that is 50% more or less than the system average increase. (AG brief at 4)

The AG asserts that since 1985 the Commission has embraced the concept of unifying the rates of IAWC and recognized that such consolidation can benefit consumers, some in the short run and some in the long run. In the AG's view, this policy should be continued in this docket. (AG brief at 9; reply brief at 1,3)

The AG contends that IAWC's rates contain different rate structures and "vastly different" rates for the same class and character of service. The AG claims that consumption or usage rates also vary significantly from district to district and that the structure of the usage or consumptions blocks themselves is inconsistent. (AG brief at 10)

According to the AG, the differences in usage charges are complicated by the differences in the declining rate structure. The AG complains that the second usage block varies significantly and large use customers may pay significantly different rates depending on where they are located within the IAWC system. (AG brief at 11)

The AG also complains that, using the cost of service study as presented in the last rate case, IAWC's current rates do not always recover the cost of service. While it did not produce a cost-of-service study in this docket, the AG asserts that a review of the last and the current cost of service studies and proposed rates shows that problems with below-cost rates would persist under the Company's proposals and under Staff's proposals. (AG brief at 11)

It is the AG's position that there is a need to a) simplify and unify IAWC's rates by moving toward single tariff pricing; b) moderate the rate increases received by customers, which includes concepts of gradualism, fairness and rate continuity; and c) to move specific rates elements closer to cost. (AG brief at 12)

In the AG's view, as the Company expands, the impact of company improvements on any individual district or class can be diluted because there are more customers over which to spread additional expenses and investments. The AG also asserts that consistent rates promote simplicity, fairness and customer understanding because rates are based on consistent rate design and cost of service principles. (AG brief at 12-13)

According to the AG, the first step in moving to simplified rates is to standardize rates, or put all districts on a common rate design. The AG contends that this involves establishing a common rate structure. The AG suggests applying the price relationship between the meter charges for different sized meters (e.g. 518 inch, ¾ inch, 1 inch etc.) that exists in the Southern District to the other districts, so that customers using a I-inch meter (and any other size meter) pay the same increase over the 518 inch meter in all districts. (AG brief at 14, citing AG Ex. 1.0 at 17)

The AG also recommends that the usage or consumption blocks be standardized, again using the Southern-Peoria structure as a model, because more customers are served under this rate structure than any other rate on IAWC's system. According to the AG, the usage or consumption blocks for Southern, Peoria and Pekin are currently the same, although there are four other block structures in the IAWC service area. The AG claims that its proposed rate design standardizes the declining block structure, although it does not standardize the actual price per block. The AG says it does not proposed to standardize charges due to the wide discrepancies among the districts and the large rate impact this would have on some customer classes. (AG brief at 13-14)

It is the AG's position that while it is impossible to achieve a uniform set of rates in this docket due to concerns about rate continuity and gradualism, meter or customer and consumption charges should begin to move toward uniformity. The AG argues that, in contrast, the Company's approach would result in different customer charges in each district except Streator, Peoria and Southern. The AG claims that Staff's recommendation also moves IAWC toward more standard customer charges, including the same customer charge ($11.52) for Southern, Peoria, Streator and Pontiac. The AG states that under Staff's proposal, the Sterling, Pekin and Chicago Metro Water customer charges would be similar to each other ($10.75, $10.50 and $10.72 respectively), leaving Champaign and Lincoln at $7.60 and $8.00 respectively. (AG brief at 14-15)

The AG also recommends moving to consolidate the consumption charges. The AG proposes to start with the current consumption charges in the Southern District, and move the consumption charges in other districts toward the Southern District level, with the provision that no increase should be more than 25%, which approximates the average increase requested by IAWC. The AG asserts that the current consumption charges are also widely disparate, that it is not possible to equalize the rates within these constraints. The AG proposes no increase to the consumption rates in Pekin, because when the ratios among consumption blocks are set, the full increase for that district was reached. In addition, the AG says in Champaign an adjustment to standardization to limit the size of the increase is necessary to properly reflect the declining block ratios calculated from the cost of service studies. (AG brief at 15)

According to the AG, a major concern in making the transition to STP is the impact a consolidated rate will have on customers in areas where the rates are currently lower than a unified rate. In order to move toward single tariff pricing fairly, and to

provide the benefits of single tariff pricing to the customers of IAWC during the transition, the AG says the Commission should avoid wide swings in rate changes. In other words, the AG recommends that the Commission try to avoid giving some customers huge rate increases while others receive relatively small increases or even rate reductions. The AG suggested implementing this concept by keeping all rate changes within 50% of the overall, system average increase. The AG says that both IAWC and the Staff have recommended huge rate swings for particular areas and for particular customer classes. (AG brief at 16)

The AG contends that one of the primary purposes of single tariff pricing is to spread extraordinary increases over a larger number of customers so that no particular customer group or location is burdened with a huge increase. It is the AG's position that this case demonstrates how moving toward single tariff pricing can protect customers from these large swings. The AG says that while some customers may see a larger increase due to single tariff pricing, they will be assured that when the costs in their area increase by more than the system average, they will also be protected from huge rate increases to cover those higher costs. (AG brief at 16-17)

According to the AG, the last IAWC rate increase case provides an example of this effect where the Alton area treatment plant was added to rate base at a cost of $38 million. The AG says that Alton treatment plant is a good example of how STP can temper large rate swings by spreading costs over a large customer base. The AG believes the same principles should apply across the IAWC service area. (AG brief at 17)

The AG argues that while the Company and Staff have recommended that the Southern, Peoria, Streator and Pontiac areas be consolidated into a single tariff area, neither party has explained why these areas should be consolidated now, while other areas are wholly unaffected by consolidation. The AG also complains that neither Staff nor the Company recommend that the rate structure of these districts be made wholly consistent. The AG says they recommend that the consumption block structure and that the consumption rates in the Pontiac area remain different from the rest of the group, while recommending that Streator's customer charges and consumption blocks be revised to match Southern's rates despite increases of more than 35% for that area.

The AG also complains that they would have lower charges in the third and fourth consumption blocks in Peoria than in Southern. According to the AG, while the concept of consolidation is correct, the implementation recommended by these parties is not an effective or a fair method of moving toward uniform rates. (AG brief at 17-18)

It is the AG's position that if the Commission allows the Company's requested increase, in order to allocate the rate increase requested by the Company in as fair a manner as possible, the customer classes and areas that received lower increases when rates are standardized would be allocated an additional portion of the increase. The AG says that the principle guiding this step is that no customer group should receive an increase that is greater or lesser than 50% of the system average. The AG

contends that while that is a broad range, in practice, the AG's proposal produces a fairly tight range of increases. (AG brief at 19)

The AG says that under its proposal, all customer groups and areas are moved toward standardization so that the consumption blocks and meter ratios become consistent. The AG claims that this will allow the Commission to review future movement toward a standardized rate without the distractions of inconsistent rate structures. The AG says that if the Commission chooses to make some elements different for different areas, like different consumption rates depending on source and cost of water, the Commission can make those modifications easily and plainly. The AG asserts that under the current rates and rate structures, it is difficult to compare rates among districts. (AG brief at 19)

It is the AG's position that Staff's proposed rate design fails to incorporate the information contained in its cost of service studies, resulting in industrial rates that are less than the cost of service and residential rates that are greater than the cost of service. The AG states that Staff recommends industrial rates that are below cost as calculated by Staff in five of the seven districts that have an industrial class of customers. The AG claims that the Staff rate design recommendation for the Southern/Peoria district does not accurately or fairly reflect the cost of serving Southern/Peoria customers. (AG brief at 24-25; reply brief at 8-9)

In the AG's view, its proposed rate design fairly reflects the different costs of water among the districts and enables the Commission to appropriately adjust rates in future cases. The AG says its proposal does not result in uniform rates -- only a standardized rate structure, and its proposed consumption rates reflect the cost of water in the various IAWC districts. (AG brief at 26, citing AG Ex. 2.0 Sch. SJR-R8 and R9)

The AG argues that the effect of water supply costs can be reflected in consumption rates once a common rate structure is in place for each district. In the AG's view, that the districts may have different water sources does not undermine the fact that a significant portion of the Company's and each district's total costs is unrelated to water supply source. The AG asserts that the costs associated with water source for five out of eight districts fall within a fairly tight range of 25% and 32%, and the overall average portion of costs associated with water source is 24.2%. (AG reply brief at 2-3, citing AG Ex. 2.0 at 23 & Sch. SJR-R8)

In its reply brief, the AG argues that the Company's and Staff's limited application of single tariff pricing and their willingness to impose extraordinarily high increases on some customer groups should be viewed as "radical" and a "dramatic departure" from past Commission practice. (AG reply brief at 1) The AG also asserts that in Docket 95-0076, the Company argued in favor of single tariff pricing for Pekin as well as for its other districts and suggested that an appropriate water credit be developed for Pekin to account for the lower water production cost, because costs other than water production costs are all common or essentially the same and can, therefore, be more accurately

accounted for on a Company-wide basis and recovered through use of a uniform tariff. (AG reply brief at 2)

In its reply brief, the AG complains that the rate design proposed by Staff does not further the principle of gradualism despite the fact that it purports to expand STP to include Streator and Pontiac. The AG asserts that Staff's rate design for Streator residential customers includes a 28% increase to the 5/8 inch meter charge and a 33% increase to the ¾ inch meter charge, while the first and second block consumption charges continued to rise from direct, to rebuttal to Staffs Initial Brief.

It is the AG's position that Staff's recommendation will impose a disparate and burdensome increase on a small community that makes up only tiny fraction of IAWC's total revenues. The AG asserts that single tariff pricing could alleviate this effect by spreading the $1 million Streator increase over more customers so that no single customer group or district is so disproportionately affected. The AG contends that if Staff had "fairly" and "correctly" applied the principles underlying single tariff pricing, it would have more fairly spread the increase to Streator among all customers in the single tariff area. (AG reply brief at 3-5)

The AG also criticizes Staff's treatment of the Pontiac district for failing to further the principles underlying single tariff pricing. Rather than Staff's proposal, the AG claims the more reasonable approach is to change the Pontiac usage block structure so that it is consistent with the other districts. The AG criticizes Staffs proposal to leave Pontiac's structure, which is currently the same as Streator's, untouched. The AG asserts that the reasons Staff gives for not modifying the block structure are circular and can be accommodated by simply setting the rate for each block to address Staff's concerns about cost and gradualism. (AG reply brief at 5-6)

The AG complains that neither Staff nor the Company address the underlying purposes of single tariff pricing in their briefs, nor do they explain why they support a proposal with disparate effects on consumers, and change some rate structures but not others. The AG asserts that their proposal will result in rate shock in the Streator area by misapplying single tariff pricing principles, while leaving Pontiac's rate structure inconsistent with the other STP districts. (AG reply brief at 6)

In response to the LWC's assertion that the AG's witness, Mr. Rubins, did not create a bill frequency analysis to support his proposals, the AG says that Mr. Rubin's direct testimony included two bill frequency analyses: AG Ex. I.O, Schedule SRJ-5 and SRJ-7. The AG says that Schedule SRJ-5 shows how many IAWC bills will increase in 10% increments using Mr. Rubin's rate design and the Company's revenue requirement request, and Schedule SRJ-7 shows the same information using a hypothetical $15 million increase. (AG reply brief at 7, citing LWC brief at 20, AG Ex. 2.0 at 15-17, 25-31)

In its reply brief, the AG argues that Staff did not recognize that the Company changed its method of accounting and, as a result, Staff should have revisited its

allocation methodology. The AG contends that Staff failed to realize that different accounting systems and different "numbers" may affect the validity of its method and require some modification of the method. It is the AG's position that Staff's "rigid adherence" to a methodology, even when the Company has changed its calculation of costs, has resulted in cost swings that would have been unlikely had a consistent method and a consistent accounting system been used. (AG reply brief at 9-10)

According to the AG, the **LWC** argues that the cost of service studies prepared by Staff for the Southern/Peoria and Pontiac districts are flawed and should not be used to design rates in this docket. (AG reply brief at 11, citing LWC brief at 16) The AG asserts that the LWC identified essentially one problem with the studies -- use of stale data. In the AG's view, the fact remains that Staff was the only party to prepare such studies, and the studies it prepared used the same model, although different inputs, as Staff used in IAWC's previous rate cases. It is the AG's position that the lack of a reliable cost of service study should not prevent the Commission from moving to standardize IAWC's rate structure. (AG reply brief at 11-12)

The AG contends that the LWC's support of an across the board rate design is inconsistent with its professed concern about cost-based rates. The AG suggests that if Staff's cost of service studies are outdated and unreliable, the same should hold true for IAWC's current rates, which were based on cost of service studies from 2000 and 1997. The AG argues that if the LWC believe that existing rates fairly reflect cost so that modifying them with an "across the board" increase is acceptable, it should not object to the use of cost of service studies which are closely related to the cost of service studies upon which those rates were based. (AG reply brief at 12-13)

According to the AG, neither the LWC nor IAWC have presented an analysis showing what costs would be saved if large consumers left the system. The AG claims it is unfair to small users to assume that all costs would continue to be incurred if large customers left the system. The AG suggests that the Commission should also not assume that remaining customers should provide all the revenues lost when a large customer transfers its business to another provider. (AG reply brief at 17)

The AG wonders why, if there is less expensive water "on the other side of the river" in St. Louis, that IAWC cannot reduce its cost of service. The AG recommends that the Commission adopt a policy that promotes efficiency within IAWC. The AG suggests that allowing the Company to transfer its higher costs to customers with no competitive choices encourages waste and unreasonable practices that drive up prices. The AG encourages the Commission to require IAWC to respond to competitive choice by lowering its costs for service, or lose revenue. The AG believes this would be the effect of a competitive market, and the Commission should mimic that effect here. (AG reply brief at 17-18)

According to the AG, the LWC argue that the Chicago Metro District should be excluded from the single tariff pricing group because its cost structure is "vastly different" from the rest of the IAWC territory and because the Commission Order

approving IAWC's acquisition of that district included the Company's guarantee that IAWC customers not be negatively affected by the acquisition. (AG reply brief at 18, citing LWC brief at 21) The AG says LWC's arguments should be rejected because the AG's recommendation to standardize the IAWC rate structure accommodates differences in costs among districts, especially the differences in water costs.

In addition, the AG asserts that assuming the revenue requirement for the Chicago Metro District has been fairly and accurately determined, if that district were excluded from the AG's single tariff pricing proposal, only $3.6 million would be reallocated away from the single tariff pricing group. (AG reply brief at 19, citing Tr. 363) The AG claims that while this would result in a burdensome and disproportionate increase to customers in the Chicago Metro District, it would not significantly interfere with the movement to a uniform rate in the other districts.

In its brief on exceptions, the AG argues, in Exception 1, that the Proposed Order fails to recognize the Commission's long history of promoting single tariff pricing in IAWC's service area. (AG BOE at 2-5)

In Exception 2, the AG argues that the Commission should recognize the problems with the Staff cost of service studies and should require IAWC "to prepare a cost of service study using updated information in its next rate case to insure consistency and give all parties an opportunity to address cost of service and rate design issues." (AG BOE at 6-8; AG RBOE at 3) The AG also asserts that the Proposed Order's conclusions regarding the small main adjustment "omit that the theory behind the adjustment was never supported by facts, and that the inconsistent implementation of the adjustment undermines its reliability." (AG BOE at 9-13)

In its third exception, the AG maintains "the Proposed Order should be revised to conclude that the People's rate design should be adopted to moderate the effect of the Staff and Company proposals on small districts, and to move toward standardizing the rate structures in IAWC districts." (AG BOE at 13-18) Although the AG says it "do[es] not object to the Commission's use of the Staff's cost of service studies, it maintains that the rate design recommended by the People is more appropriate because it moderates the effect of the increase on all districts and classes and provides movement toward single tariff pricing for IAWC as a whole." (AG BOE at 13) The AG also disagrees with language characterizing the AG's proposal as "somewhat of an all or nothing approach."

C. **LWC's** Position

The Large Water Consumers argue that under the circumstances, IAWC's original proposal for an across-the-board increase is appropriate and should be adopted for the Southern District. (LWC brief at 21-22; LWC BOE at 10 and Att. A at 12)

In its testimony, LWC took issue with AG witness Rubin's proposal, but did not address Staff's proposed COS study and rate design. In its brief, LWC asserts that

Staffs proposed COS study and rate design for the Southern/Peoria and Pontiac Districts is flawed and therefore its proposed rates should not be adopted in this proceeding. The LWC complain that Staff relied on demand ratios that were developed more than five years ago in Docket 97-0102 and improperly applied those demand ratios to districts for which they were not originally designed. The LWC assert that demand ratios can differ by district and therefore, Staffs use of demand ratios that are stale and were never based on the districts to which Staff applied them resulted in a severe flaw in its cost of service study. (LWC brief at 16-17; LWC BOE at 10)

The LWC assert that Staff has not evaluated whether there have been changes to the customer usage profiles of IAWC customer loads. The LWC claim it is not possible to properly assess the demand characteristics and load characteristics of these customers without some analysis. The LWC complain that Staff applied demand factors developed for the Southern and Peoria Districts to the Southern, Peoria, and Streator Districts combined. (LWC brief at 17, citing Tr. 669)

According to the LWC, the City of St. Louis is considered to be a competitor of the Company in the Southern District, and can cross the Mississippi River at seven locations to serve load in southwestern Illinois. The LWC say that a substantial portion of the industrial development in the Southern District is located near the City of St. Louis and as industrial water rates go up, competitive options become more economically attractive. The LWC assert that if these customers left the system, the associated reduction in the Company's cost of service would not prevent rates for remaining customers from going up and the remaining customers' rates would go up. (LWC brief at 18, citing Tr. 664-666; IAWC Ex. DR-3 at 16) In the LWC's view, IAWC is facing severe competitive pressure to retain large customers.

The LWC also complain that the COS study contained in Staffs direct testimony was based on the Southern and Peoria single tariff pricing group, and Streator and Pontiac individually, while, in rebuttal Staff combined Streator with Southern and Peoria to create a second cost of service grouping district. The LWC state that Staff did not change the demand factors for Southern and Peoria to reflect the inclusion of the Streator district. According to the LWC, this is important because Staffs own rate schedules show that the demand factors for Streator were not comparable to those for the Pontiac and Southern districts. (LWC brief at 18-19, citing Staff Ex. 18.0, Schedule 18.1 at 3, and Staff Ex. 8.0-Streator at 3) The LWC argue that because of this flaw, Staffs COS study does not accurately assign costs between base and extra capacity and therefore, its proposed blocking rates are flawed.

The LWC encourage the Commission to also reject the **AG's** rate design recommendations. According to the LWC, the AG's reliance on a COS analysis that was developed by Staff in IAWC's last rate case two years ago in Docket No. 00-0340 is flawed because it is based on demand ratios (i.e., max day and max hour ratios) developed in Staffs cost study used more than six years ago. The LWC state that the AG did not perform an analysis to show that these demand ratios were appropriate for any IAWC operating district today, much less all the districts combined. The LWC claim

that that there is no way for the Commission to verify that the AG's proposed rates would produce the revenue requirement that the Commission finds appropriate and reasonable for IAWC in this proceeding. (LWC brief at 19-20; reply brief at 17-18)

The LWC assert that the Commission has long objected to including districts that receive raw water from well water sources in a single tariff pricing group consisting of districts that receive raw water from surface water sources. The LWC claim that over the last two rate proceedings, the Commission and Staff identified single tariff pricing group largely by the makeup of cost of service in those districts. The LWC argue that the AG's analysis should be rejected because it is a dramatic departure from the Commission's past STP practices. (LWC brief at 20)

According to the LWC, the AG does not recognize or acquiesce in the Commission's precedent for excluding districts from a single tariff pricing group based on material difference in cost of service. (LWC RBOE at 17-19) The LWC contend that the AG failed to recognize the significant difference in cost of service between the Chicago Metro District, Pekin District, and other Districts in the State because of the source of water supply. The LWC assert that the Chicago Metro District has a significant difference in cost because it obtains purchased water from Lake Michigan and the Pekin District has an underground water supply. The LWC say the balance of raw water supply in other districts is from surface water sources, not purchased water or ground water sources. (LWC reply brief at 15-16; LWC RBOE at 17-19)

The LWC assert that the AG's failure to distinguish between the sources of water supply is contrary to prior orders of the Commission and also fails to recognize and apply the Commission's approach in implementing single tariff pricing. The LWC claim that this approach involved determination of the appropriateness of the cost structure within a given district prior to including that district within a single tariff grouping. The LWC state that the Chicago Metro District has not had its cost based rates established and, therefore, is not eligible for inclusion of a single tariff pricing district at this time. (LWC reply brief at 16)

The LWC assert that the Chicago Metro district's cost structure is vastly different than those of other IAWC districts. (LWC RBOE at 17-19) The LWC state that the Chicago Metro district purchases treated water, rather than invest in its own water treatment plant and transportation mains. The LWC say that the Commission will not set the rate of return, depreciation expense, and reasonable operating costs of Chicago Metro's production and transmission assets. The LWC recommend that the Chicago Metro district not be included in the single tariff pricing group with IAWC's other operating districts. (LWC brief at 21)

According to the LWC, the Commission's order approving IAWC's acquisition of CUCI adopted the Company's recommendation to guarantee that IAWC's customers do not receive negative rate impacts as a result of IAWC's acquisition of CUCI. The LWC assert that the AG's proposed rate design will increase IAWC's rates outside the Chicago Metro district (formerly CUCI) in order to cover some of the Chicago Metro

district's cost of service. The LWC argue that this is in direct contradiction of the Commission's commitment of no negative rate impact due to IAWC's acquisition of CUCI. (LWC brief at 21; reply brief at 17-18, citing LWC Ex. MPG-2 at 1-7)

The LWC contend that many of the AG's criticisms of Staffs COS study would apply to the AG's recommendations as well since its recommendations are based on the Staffs study

In the LWC's view, the AG's simplified cost structure would create havoc among IAWC's customers. (LWC reply brief at 18)

According to the LWC, Staffs small main adjustment is intended to assign the costs of the "small mains" assets to the customers who use them. The LWC assert that it is neither fair nor reasonable to expect customers that do not use these assets in the course of receiving water service from IAWC, to pay for their cost. (LWC reply brief at 18)

The LWC contend that the larger customers and especially wholesale water districts, do not cause the Company to incur all of the maintenance costs that go with serving all of the small mains and meters used in serving individual residential customers. The LWC assert that larger customers and wholesale customers absorb all of that expense themselves since they redistribute purchased water within their area or plant. It is the LWC's position that Staff's small main adjustment continues to be appropriate because it gives some recognition to the cost difference in serving larger customers. (LWC reply brief at 18-19)

According to the LWC, the AG's argument that large customers with multiple service sizes use small mains for the small meter size services is based on questionable and unsupported assumptions. The LWC assert that just because a large customer has small services, in addition to large services, does not prove they use small mains. The LWC contend that it is reasonable and prudent for IAWC to construct a distribution system where the mains serving a large customer are sized to serve the largest service or meter size at that location. The LWC say that constructing large mains to serve large meters would allow IAWC the ability to also serve smaller meter services from those same large mains at the same or nearby location. (LWC reply brief at 19)

The LWC argue that even if the AG were correct that only small mains serve small meter services, Staffs proposed cost allocation of small mains and rate design will ensure that large customers with small services pay for small mains even if they are not used. The LWC say the volume of water sales through a small service meter predominantly falls in the first and second consumption rate blocks. The LWC state that if a large user has a small meter service, its water volume would fall in the first two volume rate blocks and it would pick up its allocated share of Staffs reallocated small mains costs. The LWC claim greater volume usage would flow through larger meter services. The LWC assert that large services would pick up a share of small main costs

in the first two consumption blocks even on their large meter service size accounts. The LWC state that the small main adjustments proposed by Staff is reasonable and should be approved by the Commission. (LWC reply brief at 19-20; LWC RBOE at 19-21)

The LWC assert that **IAWC's** initial cost allocation was intended to improve communications with customers, minimize rate impacts, and minimize the probability that IAWC will lose large customers. The LWC recommend that Staff's proposed rate design be rejected, and the Company's original recommendation for an across-the-board increase be adopted for the Southern District. (LWC brief at 21-22; LWC BOE at 10)

D. Lincoln/Streator's Position

Lincoln/Streator's position is set forth in its briefs, its BOE on pages 7-12, its RBOE at pages 8-9, and in the testimony of Ms. Elizabeth Davis, Mayor of Lincoln, and Mr. Ray Schmitt, Mayor of Streator.

LincolnIStreator assert that Section 9-201 of the Act places the duty on the Commission to set just and reasonable rates. LincolnIStreator state that Section 8-401 of the Act provides that every public utility shall provide services and facilities which are in all respects adequate, efficient, reliable and environmentally safe and which, consistent with these obligations, constitute the least-cost means of meeting the utility's service obligations. LincolnIStreator also assert that that the Commission must consider the impact of rate design on consumers. (LincolnIStreator brief at 5; reply brief at 3, citing Citizens Utility *Bd.* v. ICC, (1st Dist. 1995), 213 Ill.Dec. 173, 276 Ill.App.3d 730, 658 N.E.2d 1194)

LincolnIStreator argue that large rate increases for a necessary and essential utility service, such as water, requires a greater showing than that which was presented by the Company and Staff in this proceeding. LincolnIStreator assert that neither the Company nor the Staff provided an explanation of what caused the Company's expenses to increase so dramatically in the less than 2 years between the Commission's order in the Company's last rate case in Docket 00-0340 and the date of the tariff filing that initiated the pending proceeding. In addition, LincolnIStreator complain that neither the Company nor the Staff presented evidence about the ability of water customers to absorb such a significant increase in their monthly bills, especially residential customers who will be required to bear a larger percentage increase than other classes of service. LincolnIStreator believe the Commission should consider the rate shock that will result from the proposed rate increases. (Lincoln/Streator brief at 4-5)

According to LincolnIStreator, the record in this proceeding does not show why the Company's expenses increased so drastically in less than two years. LincolnIStreator state that the proposed increase in revenue requirement for Streator is 51.66%. LincolnIStreator assert that citizens of LincolnIStreator cannot afford the "largess" of the Company or the economic cost and rate design theories of the Staff. It

is the position of LincolnIStreator that the Commission should consider the impact of the proposed rate increases on the citizens of Lincoln and Streator. (LincolnIStreator brief at 6)

It is Lincoln/Streator's position that if most or all of the Staff proposed revenue requirement increase for the Company is to be approved, then the Staff's revised recommendation regarding the Streator fire protection surcharge and single tariff pricing should also be approved. LincolnIStreator say that in its rebuttal testimony, Staff recommended that Streator's rates, including the charge for public fire protection, be brought into the Single Tariff Pricing group with Southern and Peoria. (LincolnIStreator brief at 7)

In its reply brief, LincolnIStreator say that if the Commission agrees with the LWC that the Staffs cost of service studies are flawed, Streator should not be brought fully into the STP group at this time because it would result in a substantial increase for the typical residential customer in Streator. LincolnIStreator suggest that if the LWC's position is accepted, the Streator District, the Southern Division, the Peoria District and the Pontiac District should all receive across the board increases no higher than the 13.38% increase proposed by Staff for the combined revenue requirement for the SPSP districts. It is Lincoln/Streator's position that if the proposal of the LWC is not accepted, Streator should be brought fully into the STP group in order to mitigate the increase that would result from Staff's rate design. (LincolnIStreator reply brief at 1-2)

According to LincolnIStreator, IAWC's original rate design recommendation would have increased the facilities charge for the smallest size delivery facilities in Streator by 57% from $9.00 per month to the same increased monthly rate as the Southern Division and the Peoria District, $14.12. LincolnIStreator assert that the Company's original rate design recommendation would also have raised the first block usage charge for Streator 40% from $1.9130 to the increased Southern/Peoria rate of $2.6809. LincolnIStreator state that for the typical residential ratepayers in Streator these combined elements would have resulted in a 39.24% rate increase, while at the same time the same rate elements for the Southern Division, the Peoria District and the Pontiac District would have increased by 23% each resulting in a 22.60%, 22.58% and 22.60% rate increase respectively for the typical residential ratepayers in those areas. (LincolnIStreator reply brief at 3-4)

E. Bolingbrook's Position

Bolingbrook did not present testimony on the issue of COS and rate design. In its brief, Bolingbrook's takes the position that the Commission should adopt the AG's rate design for IAWC's water rate tariffs. (Bolingbrook brief at 23-24; Bolingbrook BOE at 23) If the Commission decides not to utilize the AG's proposed rate design, Bolingbrook recommends that the Commission adopt Staff's proposed rate design since it more equitably allocates district-specific costs than does IAWC's proposed rate structure. (Bolingbrook brief at 23-24)

Bolingbrook argues that one of the important consequences of receiving service from a large utility, such as IAWC, should be that the percentage increase in rates is proportional over all similar rate blocks in each District. Bolingbrook asserts that all ratepayers should share in meeting the utility's overall proposed revenue requirement when a rate increase is requested. Bolingbrook claims that wide disparities in the percentage rate increase by district only serve to erode ratepayer confidence in the fairness of the rate structure approved by the Commission. (Bolingbrook brief at 23)

According to Bolingbrook, the LWC's tariff pricing proposal would exclude the Pekin District and the Chicago Metro District from the benefits of single tariff pricing. Bolingbrook characterizes the LWC proposal as "selective" single tariff pricing that would only benefit certain districts. It is Bolingbrook's position that if the Commission determines that single tariff pricing is appropriate for IAWC, there is no reasonable justification for excluding the Pekin District and the Chicago Metro District from the benefits of single tariff pricing simply on the basis of source of water. (Bolingbrook brief at 22)

F. City of O'Fallon's Position

O'Fallon states that it and the Company have entered into a letter of intent to establish a competitive alternative rate agreement, which has been admitted into the record as Exhibit IAWC FLR-1. O'Fallon alleges that both IAWC and O'Fallon seek the approval of this Agreement by the Commission as part of this proceeding. O'Fallon asserts that the competitive alternative rate agreement provides benefits not only to O'Fallon and IAWC, but also to the customers each serves as well, and, consequently, it should be approved. (O'Fallon brief at 3)

O'Fallon suggests that it has competitive options to taking service from IAWC, particularly if the proposed rate increase is approved. (O'Fallon brief at 3-5) O'Fallon claims it could also compete with IAWC free of any regulation or restriction from the Commission. O'Fallon asserts that the competitive alternative rate agreement prevents such competitive pressures from driving up the costs that must be shouldered by other customers who have no alternative, even in the absence of any municipal condemnation. (O'Fallon brief at 6, citing Staff Exhibit 18 revised at 9)

O'Fallon asserts that if it were merely to remove itself from the IAWC system, without attracting away other customers, the affect on other customers would be dramatic as compared to the "negligible" affect that the competitive rate agreement will have. O'Fallon claims that under Staff's revised cost of service study, the Company calculates that the annual differential in cost between the general rate and the competitive rate agreement, if spread over the other customers of the single tariff pricing group would be only one and one-half cents per thousand gallons, or nine cents per month. O'Fallon contends that if it were to leave the system by going with a pipeline to St. Louis, the impact on the other customers of the single tariff pricing group would be a minimum of 74 cents per thousand gallons of water per month, or 12 cents per

thousand gallons for the typical residential customer using 6,000 gallons per month. (O'Fallon brief at 6-7, citing Tr. 241-242)

O'Fallon states that the proposed competitive rate is at the high-end of the possible range of cost to bring water from St. Louis. O'Fallon says that although it could cost as little as $1.40 per thousand gallons, it could run as high as $1.85 per thousand gallons. (O'Fallon brief at 7-8, citing Tr. 246) O'Fallon claims the $1.69 rate provided in the agreement is well above not only the low end, but also the midpoint of the range.

According to O'Fallon, the competitive rate is not fixed at $1.69 for the forty-year life of the agreement. O'Fallon says that as long as there is an increase in the designated cost of living index, the rate under the agreement will increase year after year. O'Fallon claims it is possible that over time, depending on how Company rates compare to inflation, that O'Fallon's rates could increase to levels approximating general service rates. (O'Fallon brief at 8, citing IAWC Ex. FLR-1 and Tr. 241)

O'Fallon states that this is not the first rate agreement between the Company and the City of O'Fallon. O'Fallon claims that previously, there was a water requirements rate agreement that also had a forty-year term, that ended in 1982. (O'Fallon brief at 8, citing Tr. 240) O'Fallon asserts that the proposed forty-year agreement merely reinstitutes such a contractual basis for the relationship. In O'Fallon's view, the proposed agreement is unexceptionable, reasonable, and should be approved. (O'Fallon brief at 8-9)

G. IAWC's Position

IAWC did not present a cost of service study. Rather, it initially proposed an across the board rate increase. The Company said it allocated revenue requirements in accordance with the cost of service allocations established in the Company's most recent prior rate case. In its brief, the Company indicates that it now generally accepts Staff's cost of service study and related rate design, with limited exceptions. (IAWC brief at 58)

According to IAWC, Staff has proposed no change to the Standby Service rates for the Champaign and Sterling Districts. The Company states that Staff proposed no change because there were no billing units. The Company claims that if these Standby Service rates are not increased in this proceeding, they will become seriously outdated. The Company recommends that these Standby Service rates be increased at the same overall level of increase approved for these respective Districts. (IAWC brief at 58-59)

IAWC states that generally, Staff's overall rate design demonstrates that its district-specific rates are designed to produce Staff's calculation of district revenue requirements, except for Chicago Metro Sewer. IAWC asserts that Staff's calculation of revenue requirements for Chicago Metro Sewer increased substantially from Staff's direct case to its rebuttal case. IAWC claims this increase resulted primarily from Staff's reallocation of certain operating expenses between Chicago Metro Water and Chicago

Metro Sewer. According to IAWC, in its rebuttal testimony, Staff did not increase its rates for Chicago Metro Sewer. IAWC contends that Staff should design rates for Chicago Metro Sewer that recover the total revenue requirement determined in this case, as Staff has done for all other districts. (IAWC brief at 59)

It is IAWC's position that the **AG** proposed a radical rate design. IAWC says the AG proposed to move all base water rates, except for fire protection rates, for all districts to single-tariff pricing. IAWC says that the AG would begin by having a common rate structure for all districts. (IAWC brief at 59)

In IAWC's view, the AG's proposal appears to have been developed in the abstract, without regard to the Company's operations and customers and Commission precedent and policy. IAWC says that the AG would eliminate any distinction between the source of water, contrary to prior orders of the Commission. (IAWC brief at 59-60; IAWC RBOE at 34-35, 37)

It is IAWC's position that where single tariff pricing is determined to be appropriate, there should be gradual movement to single-tariff pricing and only when the cost of service studies demonstrate that such movement is cost-based. IAWC asserts that gradualism is necessary to achieve sensitivity to any impacts in moving to single-tariff pricing. (IAWC brief at 60)

IAWC states that in its prior rate order, the Commission adopted Staff's cost of service study. IAWC says the present rates are the resulting rate design recommended by Staff and the AG's assertion, that the current rate structure is unfair to customers, is a collateral attack on prior Commission orders. (IAWC brief at 61)

IAWC asserts that the AG has not assessed the risks to the Company from potential loss of customers when proposing increases in rates above those proposed by the Company. IAWC contends that the AG proposes to combine disparate districts and to shift costs unique to Chicago Metro to other districts. In IAWC's view, the AG's proposal is unfair and would adversely impact customers. In addition, IAWC claims the AG's proposal would cause a violation of the Company's agreement with the University of Illinois. (IAWC brief at 61, citing IAWC Ex. SR-6.0 at 4 and 9)

In its reply brief, IAWC states that the AG's position does not benefit either the People of the State of Illinois or IAWC's customers. (IAWC reply brief at 35) IAWC complains that AG witness Rubin did not prepare a cost of service study; did not visit any of the Company's districts; has no idea as to the Company's facilities in each District; and appears to be unfamiliar with the prior Commission orders cited in the AG's brief establishing IAWC's rate design. (IAWC reply brief at 36)

IAWC also asserts that the AG presented no evidence that the existing rate design was not understandable by customers of the respective districts. IAWC says the AG's assumption that the Company's present rate design needs simplification and standardization to be understandable is incorrect. IAWC also asserts that the AG

incorrectly assumes that varying rate increases to the different rate districts show that the rate increases are not cost based. IAWC claims the rate increases vary by district because they are based on cost of service. (IAWC reply brief at 36)

According to IAWC, the AG asserts that that the rates of Commonwealth Edison, Ameren CIPS, UE, CILCO and Illinois Power are uniform within each company's service area. IAWC claims that comparison is flawed because each of those utilities has a service area that is generally contiguous and limited to a small, defined portion of the state; in contrast, IAWC essentially serves the entire state. IAWC asserts that Ameren, which owns CIPS, CILCO and UE, does not have uniform rates in those company service areas. (IAWC reply brief at 37)

According to IAWC, the AG's assertion that industrial rates may be below the cost of service is exaggerated. IAWC asserts that the AG disregarded that in many of the districts, industrial rates have been set at less than cost of service in order to retain industrial load. IAWC claims that if industrial customers left the system, residential customers would bear even more cost. (IAWC reply brief at 38, citing IAWC Ex. R-6.0, at 1-2; IAWC Ex. R-6.1; IAWC RBOE at 35-36)

IAWC complains that in its brief the AG proposes for the first time that the Company be directed to present a cost of service study in its next rate case, using a base-extra capacity model. IAWC asserts that while preparation of such a study would impose a substantial cost, no benefit would result. The Company says it is not required to submit a cost of service study under the applicable Standard Filing Requirements, Part 285. IAWC claims that the Commission's rules anticipate that Staff will prepare a cost of service study when a utility provides the necessary information. (IAWC reply brief at 39; IAWC RBOE at 36)

IAWC says Staff uses the base-extra capacity method, and the Commission has approved Staff's model. IAWC asserts that had the Company prepared a cost of service study for this proceeding, it would have been substantially the same as Staff's. (IAWC reply brief at 39)

IAWC states that O'Fallon has its own water distribution system, but obtains its water supply from IAWC. IAWC says the City of St. Louis is willing to sell water to O'Fallon and O'Fallon has caused studies to be performed, which have determined that it is feasible to construct a pipeline from St. Louis to O'Fallon. IAWC asserts that the estimated ultimate cost of water to O'Fallon, including transmission, is approximately $1.40-1.85, per 1,000 gallons. IAWC says O'Fallon has stated that it will obtain water from St. Louis if it cannot obtain accommodation from IAWC. IAWC also says O'Fallon has discussed providing water from its proposed pipeline to other customers of the Company. (IAWC brief at 37-38)

IAWC indicates that under the letter of intent, the parties anticipate a 40-year agreement, under which IAWC will provide all of O'Fallon's water supply requirements at an initial rate of $1.69 per 1000 gallons, with annual inflation adjustments. IAWC

claims the letter of intent is a competitive alternative arrangement based upon the Company's review of the direct testimony of O'Fallon witness Dean Rich, the responses of O'Fallon to the Company's data requests and various meetings between representatives of the Company and O'Fallon. The Company concluded that O'Fallon has a viable competitive alternative to obtain its water supply from St. Louis instead of from the Company, and that O'Fallon has done extensive planning and study of this competitive alternative. (IAWC brief at 38, citing Tr. 238-239)

IAWC asserts that the arrangement's benefits to customers far exceed costs. (IAWC brief at 38-39) IAWC states that O'Fallon is the Company's largest and fastest growing customer. IAWC claims that if the reduction in revenue from O'Fallon is spread over the balance of the single tariff pricing group, this amount would add 1 1/2 cents per 1,000 gallons or 9 cents per month for a typical residential customer. According to IAWC, if O'Fallon were to leave the Company's system, the loss of revenue would cause a rate increase to the balance of the single tariff pricing group of 12 1/2 cents per 1,000 gallons, and would increase a typical residential customer bill by 74 cents. (IAWC brief at 39, citing Tr. 240-242)

IAWC requests that the O'Fallon arrangement be "recognized" in the cost of service study and rate design approved by the Commission in this case. Specifically, IAWC asserts that the revenue requirements assigned to O'Fallon, but not fully recovered under the $1.69 rate, should be assigned to the Southern Division, Peoria, Pontiac and Streator rates. The Company claims the Commission has recognized similar long-term water supply arrangements that the Company has with other wholesale customers. (IAWC brief at 40)

In its reply brief, IAWC states that no intervenor presented testimony objecting to the proposed competitive alternative rate. (IAWC reply brief at 22) On this point, the Commission notes that the letter of intent was apparently not signed, and was definitely not distributed to other parties, until the day of the hearing.

In response to **Bolingbrook**, IAWC asserts that because of source of supply and other differentials, there is no rationale that would justify including Chicago Metro in a hypothetical statewide single tariff pricing group as proposed the AG. (IAWC reply brief at 27)

According to IAWC, **Lincoln/Streator** appear to criticize the amount of rate increase proposed by Staff for each district. IAWC states that the rates to be determined by the Commission in this proceeding will reflect the revenue requirements found by the Commission and the rate design approved by the Commission, for each rate district. IAWC contends that anything less will result in cross-subsidization by other customers. IAWC says that Lincoln/Streator appears to propose such cross-subsidization. In IAWC's view, Lincoln/Streator presented no cogent evidence that any operating expense or any other component of cost of service or rate design is unreasonable. (IAWC reply brief at 40)

In the tariffs filed in this proceeding, the Company proposed certain changes it refers to as "**miscellaneous rate matters.**" The Company proposed that its NSF charge and Reconnection charge for the Lincoln and Chicago Metro Districts, and the Late Payment charge for the Lincoln District, be revised to be the same as applicable to the Company's other Districts. The Company also proposes a revision in its charge for recovery of municipal franchise fees. The Company also proposes a change to its Sewerage Treatment Plant Connection Fee, based upon the Construction Cost Index at June 2002. No party presented evidence objecting to any of these proposed changes. The Commission finds that they are reasonable and should be approved.

H. Commission's Analysis and Conclusions

1. Recap of Parties' Positions

The positions of the parties are described above, and will be briefly summarized here. As a result of various mergers and acquisitions over the years, the Company has numerous service areas. In terms of single tariff pricing or "STP", the Southern, Peoria, Streator and Pontiac districts are currently combined for revenue requirement purposes, and to some extent have uniform rates, in the "SPSP" district. The same is also true for the Chicago Metro district, which has separate usage charges depending on the source of water.

Staff performed a COS study for each rate area using data received from IAWC. In its analysis, Staff utilized the Base-Extra Capacity method for allocating costs to customer classes. In Staff's view, the data received from IAWC is sufficiently current and reliable to be used for this purpose.

Staff proposed to move Streator more fully into the SPSP district STP rate schedule with the Southern and Peoria District. Staff's proposed rates for the Peoria District 3rd and 4th usage block rates are less than for the Southern Division and Streator District. For the STP Group, excluding those industrial customers that have a competitive rate, Staff claims that under its proposal, industrial customers would pay 96% of cost of service.

In the event the adopted revenue requirement for water service for any given rate area differs from that proposed by Staff by 5% or less, Staff recommended that this differential be reflected by making a uniform adjustment in the usage rates applicable to that rate area, excluding competitive rates. This proposal was further explained at the hearing by Staff witness Luth. Chicago Metro sewer rates would be adjusted by a uniform percentage.

Staff objects to what it describes as the AG's proposal to move towards complete STP for all IAWC rate areas. It is Staff's position that the AG proposal would shift costs from non-STP rate areas to STP rate areas. Staff also objects to the LWC's proposal for an across the board increase, asserting it is a self-serving proposal intended to

secure lower rates at the expense of other customer classes. Staff took no position on the negotiated rate between IAWC and O'Fallon.

IAWC did not perform COS studies for this proceeding. The Company instead relied upon the COS studies that were performed by Staff and adopted by the Commission in previous IAWC rate proceedings. Using these COS studies, IAWC initially recommended an across the board increase in rates. Subsequently, IAWC generally agreed to the COS studies and related rate design proposals that were presented by Staff in the current docket. However, IAWC recommends that the rates proposed by Staff for the Chicago Metro Sewer district be modified to recover the total revenue requirement for the district. In addition, unlike Staff, IAWC recommended increases in the Standby Service rates for the Champaign and Sterling Districts.

IAWC objects to the AG's proposal in this proceeding. Among other things, IAWC suggests that the AG's proposal is inconsistent with prior Commission orders because it would ignore the differences in cost of service related to the source of water supply. IAWC also complains that the AG did not base its proposal upon a cost of service study and overstates the extent to which industrial rates may be below the cost of service.

IAWC argues that the terms and effects of its Letter of Intent with O'Fallon, which would provide a competitive rate for O'Fallon, should be "recognized" in the cost of service study and rate design approved by the Commission. In its brief, O'Fallon seeks Commission approval of the Letter of Intent between O'Fallon and IAWC. It is O'Fallon's position that the agreement benefits O'Fallon, IAWC and IAWC's customers.

In its testimony, LWC did not address Staffs COS studies. In its brief, LWC characterize Staff's COS studies as flawed. (LWC brief at 16-17) Among other things, the LWC complain that the COS studies prepared by Staff relied on demand ratios developed more than five years ago. The LWC recommend that the COS studies presented by Staff in this proceeding be rejected and that rates be increased on an across the board basis. In addition, the LWC assert that in the Southern Division, large customers have competitive alternatives that should be taken into consideration when setting rates.

Finally, the LWC object to the AG's proposal to move towards complete STP for all IAWC rate areas. The LWC complain that the AG relies on demand ratios developed more than six years ago. The LWC also assert that the AG ignores the Commission practice of excluding districts from a single tariff pricing group based on material differences in cost of service.

It is the AG's position that there is great disparity among the increases requested, and recommends that the Commission move toward standardized rates while moderating the overall increase so that no area or customer class receives an increase that is 50% more or less than the system average increase. It is the AG's position that while it is impossible to achieve a uniform set of rates in this docket due to

concerns about rate continuity and gradualism, meter or customer and consumption charges should begin to move toward uniformity. The AG argues that the effect of water supply costs can be reflected in consumption rates once a common rate structure is in place for each district.

Among other things, the AG asserts that Staff's proposed rate design fails to incorporate the information contained in its cost of service studies, resulting in industrial rates that are less than the cost of service and residential rates that are greater than the cost of service.

The AG also objects to the LWC proposal for an across the board rate increase. The AG argues that if the LWC believe that existing rates fairly reflect cost so that modifying them with an "across the board" increase is acceptable, it should not object to the use of cost of service studies which are closely related to the cost of service studies upon which those rates were based. The AG also contends that neither the LWC nor IAWC have presented an analysis showing what costs would be saved if large consumers left the system.

LincolnlStreator assert that the record in this proceeding does not show why the Company's expenses increased so drastically in less than two years. LincolnlStreator complain about the magnitude of possible rate increases and recommend that the Commission consider the rate shock that will result from the proposed rate increases.

It is Lincoln/Streator's position that if Staff's cost of service studies are rejected, Streator should not be brought fully into the STP group at this time because it would result in a substantial increase for the typical residential customer in Streator; rather, the Streator District, the Southern Division, the Peoria District and the Pontiac District should all receive across the board increases no higher than the 13.38% increase proposed by Staff for the combined revenue requirement for the SPSP districts. LincolnlStreator recommend that if Staff's cost of service proposal is not rejected, Streator should be brought fully into the STP group in order to mitigate the increase that would result from Staff's rate design.

In their RBOE, page 8, LincolnlStreator argue that if Lincoln must have a rate increase at all, then the increase shown in the attachment to IAWC's BOE should be approved.

Bolingbrook did not present evidence on cost of service issues. In its brief, Bolingbrook says the Commission should adopt the AG's rate design for IAWC's water rate tariffs. If the Commission decides not to utilize the AG's proposed rate design, then Bolingbrook recommends that the Commission adopt Staff's proposed rate design since it more equitably allocates district-specific costs than does IAWC's proposed rate structure.

2. Commission Analysis and Conclusions

Before proceeding with its conclusions on COS and rate design issues, the Commission has two brief observations to make. First, as noted above, IAWC consists of a large number of service areas located in several areas in Illinois. Currently, in terms of single tariff pricing or "STP", the Southern, Peoria, Streator and Pontiac districts are combined for revenue requirement purposes, and to some extent have uniform rates, in the "SPSP" district. The same is also true for the Chicago Metro district, which has separate usage charges depending on the source of water.

Second, there are several COS and rate design proposals that have been advanced in this docket. Generally speaking, the AG's proposal would produce a lower rate impact on small users than would Staff's recommendations. The LWC's "across the board" increase recommendation, on the other hand, would result in a lower rate impact on industrials and other large users than would Staff's proposal. The Company initially recommended an across the board increase, but subsequently accepted the Staff approach, subject to certain exceptions.

In arriving at its conclusions in these issues, the Commission will first address the cost of service analyses presented or otherwise relied upon by parties. The two most comprehensive alternatives were those sponsored by the Staff and AG cost of service/rate design witnesses. The Commission notes that the AG's proposal is well presented in its testimony and briefs, and expresses a number of concerns and objectives that are relevant to the consideration of the COS and rate design. The Commission finds, however, that of the alternatives presented, the analyses presented by the Staff witnesses are, on the whole, the most appropriate for purposes of allocating costs, determining class revenue responsibility and recovery, and designing rates in this proceeding.

Except as noted above, Staff performed a COS study for each rate area using a method of cost allocation, Base-Extra Capacity, that has been found appropriate by the Commission in prior cases. While many parties have taken exception to Staffs analysis, and have offered various positions on these issues, Staff is the only one that actually prepared and presented comprehensive cost of service studies.

One criticism of Staff's analysis is that the demand ratios used are based on outdated data. On this point, while the Commission appreciates the concerns of other parties such as the AG and LWC, the Commission observes that no other party presented a COS analysis based on more current data. The alternatives to utilizing Staff's cost of service studies as the basis for setting rates in this proceeding appear to involve the use of cost of service studies prepared several years ago. This alternative does nothing to mitigate any purported problems associated with the demand factors, and may in fact exacerbate them by relying upon additional old data. For the reasons given by Staff, the Commission agrees with Staff that the demand data it utilized is sufficiently reliable for use in allocating costs in this proceeding.

With regard to this issue, as stated above, Staff has recommended that IAWC be required to present updated customer demand factors in the Company's next rate filing. The Commission believes such information will help address the concerns cited by other parties. Accordingly, IAWC is directed to provide updated demand factors for each rate area for which a rate increase is proposed.

In the Company's next rate case that involves the Pontiac district, IAWC is also directed to provide billing information for Pontiac district usage based upon the then current Pontiac usage block structure as well as the STP usage block structure, as urged by Staff.

Another objection to Staff's analysis was to its “small mains adjustment" that is intended to assign the costs of small main assets to the customers who use them. According to the AG, a significant portion of IAWC’s large customers take service from meters that are one inch or smaller. The AG says there is no evidence to show that large volume users take service from mains larger than 12 inches, thus the adjustment unfairly shifts costs from large users to small users.

As explained by Staff, the cost assignment through the small mains adjustment is accomplished through the declining block usage charges. The Commission agrees with Staff that "large" customers who take service from small meters are unlikely to receive meaningful benefits from the small mains adjustment because their usage will be concentrated in the same usage blocks as the smaller customers. Furthermore, the Commission notes that the small mains adjustment has been routinely applied since approximately 1990.

As discussed above, the AG also raised concerns with respect to the magnitude of increases in fire protection costs in some rate areas. In the Commission's view, Staff has adequately explained the relatively large increase in fire protection costs. As explained by Staff, in addition to direct costs, fire protection costs include base, max day, max hour, and billing costs.

For the reasons stated above, and except as otherwise noted, the Commission believes the cost allocations, class revenue recovery ratios, and rates designed in Staff's COS are reasonable for purposes of this docket. The Commission finds that the record supports the use of Staff's cost of service studies as the basis for setting rates in this proceeding. As indicated above, the AG has criticized the percentage increases for smaller customers, and the class revenue to cost of service ratios recommended by Staff which the AG believes are unduly favorable to larger customers. As pointed out by Staff, under the Staff proposal, the percentage increases for the industrial class, for most districts, is significantly higher than the percentage increases for the residential class.

In the event the adopted revenue requirement for any given rate area differs from that proposed by Staff by 5% or less, Staff recommended a method for reflecting this

differential, as indicated above. The Commission finds that this recommendation is reasonable and should be used for purposes of setting rates in this proceeding.

The Commission rejects the LWC proposal to rely upon the cost of service studies from the Company's last rate case and to increase rates across the board. In an effort to reduce similar problems in IAWC's next rate case, however, IAWC is directed, as indicated above, to provide updated demand factors for each rate area for which a rate increase is proposed. With the addition of Streator into the STP group, the Commission believes updated demand factors will be particularly helpful.

The Commission turns next to the AG's proposal for movement toward standardizing rates across all IAWC rate areas. The Commission has previously found that, in certain circumstances, standardization of rates and the implementation of the single tariff pricing or "STP" group is appropriate. Currently, the Southern, Peoria, Streator and Pontiac districts are combined for revenue requirement purposes, and to some extent have uniform rates, in the SPSP district.

With regard to the particular STP proposal advanced by the AG, the Commission first observes that this proposal is an integral part of the AG's overall cost allocation and rate structure approach, and is linked to and dependent on the other elements of that approach. As such, the AG's proposal is somewhat of an "all or nothing approach". As noted above, the AG's analysis is well explained in its testimony and briefs; however, the Commission believes, as explained above, that of the alternatives in the record, Staff's cost of service methodology is the one that is most appropriate for allocating costs and designing rates in this proceeding. Thus, use of the AG's rate standardization proposal on its own would be problematic.

One factor the Commission believes must be considered before implementing standardized rates or incorporating a rate area into a single pricing group is whether the resulting rates bear a reasonable relationship to cost of service. For example, as Staff has stated, different types of sources of supply can result in significantly different costs. In this docket, the Commission finds that there is inadequate information to evaluate the relationship between the AG's proposed rates both with respect to cost of service by rate area or allocated cost responsibility by customer class.

Another important concern in moving toward STP is consideration and mitigation of rate impacts, and it has been the Commission's practice to move gradually toward single tariff pricing where appropriate. Despite the potential benefits, imposing STP can result in very large increases for some types of customers in some districts. This problem is exacerbated when large numbers of rate districts are coupled with large rate increase requests, such as in the instant case. Under such circumstances, any significant progress in the movement toward STP is difficult.

For the reasons stated by the AG, however, the Commission does believe that further movement toward STP in the future should be considered. In furtherance of this practice, the Commission has directed IAWC to provide billing information for Pontiac

district usage based upon the then current Pontiac usage block structure as well as the STP usage block structure. This type of information will assist the Commission in evaluating the propriety of moving the Pontiac district more fully into the STP group.

As noted above, the AG requested in its brief that IAWC be directed to produce a cost of service study, based on the base extra capacity method, for its next rate case. While IAWC is free to produce one or more cost of service studies for its next rate case, the Commission finds imposing such a requirement is unnecessary at this time. Given that Staff routinely provides cost of service studies for water rate cases, and that any other party to a proceeding is also free to do so, the Commission will not require the Company to provide a cost of service study over its objections at this time. As indicated above, the Company has been directed to provide updated demand data in its next filing, which the Commission believes will be of benefit to others in preparing or reviewing COS analyses.

As previously noted, IAWC proposes to increase standby rates for the Sterling and Champaign rate areas consistent with an across the board increase based on the revenue requirements applicable to each rate area. The Company suggests such increases are necessary to avoid the standby rates becoming outdated. Staff on the other hand, recommends no change to these standby rates. Staff says there is currently no customer on these standby rates and that there has not been any actual experience supporting the Company's proposed increases.

Having reviewed the record, the Commission finds no support for the Company's assertion that the standby rates for Sterling and Champaign will become "outdated" in the absence of its proposed increases. The Company has cited no cost basis for increasing these rates and the Commission has previously rejected proposed across the board rate increases in this proceeding.

With respect to the Chicago Metro sewer rate area, IAWC's filing appears to have contained certain errors and inconsistencies that were detected by Staff. Once these errors are corrected, the rates originally filed do not produce either the revenue requirement requested by the Company or that calculated by Staff. The Company believes Staff should update the rates so that the approved revenue requirement will be achieved. Staff objects to this proposal for the reasons discussed above.

In reviewing the record, it appears that if rates are set to achieve the approved revenue requirement for the Chicago Metro sewer rate area, such rates would not produce revenues that exceed the Company's original revenue requirement proposal (IAWC Exhibit No. 12.0, Schedule C-1 at 9, Line 1, Column "Proposed Rates"), and would not produce a revenue increase in excess of that requested in the Company's original filing. In the Commission's opinion, while the burden should not be on Staff to update its rate proposal, the Company should be allowed to file rates that achieve the approved revenue requirement for the Chicago Metro sewer rate area.

As discussed above, Lincoln/Streator recommend, in the event that most or all of the Staff proposed revenue requirement increase is approved, that Staff's revised recommendation regarding the Streator fire protection surcharge and single tariff pricing be adopted. That is, Streator's charge for public fire protection should be brought into the single tariff pricing group. Consistent with previous findings in this Order, the Commission accepts Staff's cost of service studies and its recommendation that Streator's fire protection charge be brought into the single tariff pricing group.

The Commission will next address the **Letter** of **Intent** provided by IAWC and **O'Fallon.** As explained above, O'Fallon and IAWC have signed a letter that "states [their] ... intent ... to negotiate and enter into a definitive written agreement ... under which IAWC will sell and deliver to the City, and the City will purchase and receive, as the City's sole source of supply, all of the City's water supply requirements for its entire water system." (IAWC Ex. FLR-1) The letter of intent also identifies the initial competitive rate to be charged and the method for modifying it annually, and it states that the agreement will specify the same rate identified in the Letter of Intent. The Letter of Intent was first provided to other parties, and entered into the record, at the hearing.

IAWC requests that the O'Fallon arrangement be "recognized" in the cost of service study and rate design approved by the Commission in this case. Specifically, IAWC asserts that the revenue requirements assigned to O'Fallon, but not fully recovered under the $1.69 rate, should be assigned to other customers in the Southern Division, Peoria, Pontiac and Streator rates.

The Company also recommends that the following sentence be removed from the Proposed Order: "The Commission takes no position on whether such shortfalls should continue to be assigned to other customers in future rate dockets." (IAWC BOE at 58-59) The Company believes the sentence is unnecessary and could raise questions about the competitive rate. O'Fallon agrees with the Company's recommendation, while the AG does not. (O'Fallon RBOE at 3; AG RBOE at 4-5) On this point, the Commission observes that Paragraph 8 of the Letter of Intent refers only to "the revenue effects of the agreement in the rates to be established in IAWC's pending rate case, Docket 02-0690."

O'Fallon argues that the Commission "should approve the competitive alternative rate agreement entered into between the Company and the City of O'Fallon."

Staff indicates that it has no position on the rate identified in the Letter of Intent, noting that there was little or no opportunity to review the support for the rate or to comment on it through testimony. (Staff brief at 85) Staff does note that while the competitive unit rate is lower than the otherwise applicable fourth usage block rate proposed by Staff, it is higher than the competitive rates in other Competitive Service tariffs, and is also higher than the Large User rate assuming the same demand factor that affects that rate. As noted above, Staff also calculated the revenues from O'Fallon using the Letter of Intent rate versus the otherwise applicable rate shown in Staff's testimony. (Staff brief at 85)

While not directly taking a position on the O'Fallon competitive alterative rate agreement, the AG recommends that the rates of other customers should not be increased to offset any reduction O'Fallon may receive.

The alleged benefits of the competitive rate arrangement were described by the Company and O'Fallon and are summarized above. Based on the information provided, it appears to the Commission that the competitive rate specified in the Letter of Intent is reasonable. In the Commission's view, the record shows that O'Fallon does in fact have a competitive alternative by which sufficient supplies of wholesale water could be obtained at a price more economic than that available under the Company's regular rates, and that there is a strong possibility O'Fallon will leave the system if a competitive rate is not available from the Company. Furthermore, the rate to be paid by O'Fallon in the Letter of Intent is toward the high end of the estimated range of costs for obtaining water under the alternative supply option, and is higher than the competitive rates in other Competitive Service Tariffs.

The Company has requested that the revenue shortfall arising from the discounted rate in the Letter of Agreement be allocated to other customers in this docket. The AG takes issue with this request. In the Commission's opinion, retaining O'Fallon as a customer on the IAWC system will still provide significant net benefits to other customers, even if the revenue shortfall is allocated to them, because the amount of revenues lost if O'Fallon left the system is approximately seven times the amount of the revenue shortfall being allocated.

Accordingly, for purposes of this proceeding, the Commission finds that the Company should file tariffs specifying the initial competitive rates identified in the Letter of Intent as well as the method for making subsequent modifications to the initial rates. Further, rates for other customers should be adjusted to cover the revenue shortfall resulting therefrom, using the methodology set forth by Staff. In the instant order, the Commission does not reach the issue of how such shortfalls, if any, should be treated from a revenue allocation/recovery standpoint in future rate dockets.

With regard to the **effective date** of the new tariffs, the Company argues that the order should provide that the tariff sheets authorized therein should reflect an effective date not less than two working days after the date of filing. (IAWC BOE a 58) The Commission agrees with Staff that a longer review period might be more appropriate, given the large number of rate districts and tariffs; however, a two working day period will be ordered due to the proximity to the end of the resuspension period. (Staff RBOE at 38)

VIII. FINDINGS AND ORDERING PARAGRAPHS

The Commission, having reviewed the entire record herein, is of the opinion and finds that:

(1) Illinois-American Water Company is in the business of furnishing water service to the public in various areas in the State of Illinois and is a public utility as defined in the Public Utilities Act;

(2) the Commission has jurisdiction of the parties and of the subject matter herein;

(3) the findings and conclusions stated in the prefatory portion of this Order are supported by the evidence of record and are hereby adopted as findings of fact; Appendix A attached hereto provides supporting calculations for various conclusions in this Order;

(4) the test year in this proceeding is a future test year consisting of the 12 months ending December 31, 2003; such test year is appropriate for purposes of this proceeding;

(5) for purposes of this proceeding, Illinois-American's net original cost rate base is set forth in Appendix A;

(6) a just and reasonable rate of return which Illinois-American should be allowed an opportunity to earn on its net original cost rate base is 7.39%; this rate of return incorporates a rate of return on common equity of 10.27%;

(7) the rates of return set forth in Finding (6) hereinabove result in operating revenues and net annual operating income as shown in Appendix A based on the test year herein approved;

(8) Illinois-American's rates which are presently in effect for water service and sewer service are insufficient to generate the operating income necessary to permit Illinois-American the opportunity to earn a fair and reasonable return on net original cost rate base; these rates should be permanently canceled and annulled;

(9) the rates proposed by Illinois-American will produce a rate of return in excess of a return that is fair and reasonable; Illinois-American's Proposed Tariffs should be permanently canceled and annulled;

(10) Illinois-American should be authorized to place into effect tariff sheets designed to produce annual operating revenues as contained in Appendix A, such tariff sheets to be applicable to service furnished on and after their

effective date; the terms and conditions in these tariff sheets shall be consistent with Finding (11) below;

(11) the cost of service, interclass revenue allocation, rate design, and tariff terms and conditions found appropriate in the prefatory portion of this Order are just and reasonable for purposes of this proceeding and should be adopted;

(12) the new tariff sheets authorized to be filed by this Order shall reflect an effective date not less than two working days after the date of filing, with the tariff sheets to be corrected within that time period if necessary.

IT IS THEREFORE ORDERED that the Proposed Tariffs proposing a general increase in rates, filed by Illinois-American Water Company on September 20, 2002, are permanently cancelled and annulled.

IT IS FURTHER ORDERED that Illinois-American Water Company is authorized and directed to file new tariff sheets with supporting workpapers in accordance with Findings (10), (11) and (12) of, and other determinations in, this Order, applicable to service furnished on and after the effective date of said tariff sheets.

IT IS FURTHER ORDERED that upon the effective date of the new tariff sheets to be filed pursuant to this Order, the tariff sheets presently in effect for water service rendered by Illinois-American Water Company which are replaced thereby are hereby permanently canceled and annulled.

IT IS FURTHER ORDERED that Illinois-American is hereby directed to file tariffs implementing the initial competitive rates identified in the Letter of Intent with O'Fallon, and specifying the method provided in the Letter of Intent for making subsequent modifications to the initial rates; these tariff sheets shall reflect an effective date not less than two working days after the date of filing, with the tariff sheets to be corrected within that time period if necessary.

IT IS FURTHER ORDERED that within six months of the date of this Order, IAWC shall make the filing described under "Management Fees" in Section V of this order above.

IT IS FURTHER ORDERED that if IAWC elects to request a positive amount for cash working capital in rate base in its next general rate filing, it shall include a lead-lag study in that filing.

IT IS FURTHER ORDERED that IAWC is hereby directed to perform a depreciation study prior to its next rate case.

IT IS FURTHER ORDERED that all objections or motions in this proceeding that have not been ruled upon are hereby deemed disposed of in a manner consistent with the ultimate conclusions herein contained.

IT IS FURTHER ORDERED that subject to the provisions of Section 10-113 of the Public Utilities Act and 83 Ill. Adm. Code Section 200.880, this Order is final; it is not subject to the Administrative Review Law.

By order of the Commission this 12th day of August, 2003.

(SIGNED) EDWARD C. HURLEY

Chairman

Commissioner Squires dissented; a written opinion will be filed.